TAXING PUNITIVE DAMAGES

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There is a curious anomaly in the law of punitive damages. Jurors assess punitive damages in the amount that they believe will best "punish" the defendant. But, in fact, defendants are not always punished to the degree that the jury intends. Under the Internal Revenue Code, punitive damages paid by business defendants are tax deductible and, as a result, these defendants often pay (in real dollars) far less than the jury believes they deserve to pay.

To solve this problem of under-punishment, many scholars and policymakers, including President Obama, have proposed making punitive damages nondeductible in all cases. In our view, however, such a blanket nondeductibility rule would, notwithstanding its theoretical elegance, be ineffective in solving the under-punishment problem. In particular, defendants could easily circumvent the nondeductibility rule by disguising punitive damages as compensatory damages in pre-trial settlements.

Instead, the under-punishment problem is best addressed at the state level by making juries "tax-aware." Tax-aware juries would adjust the amount of punitive damages to impose the desired after-tax cost on the defendant. As we explain, the effect of tax awareness cannot be circum-

vented by defendants through pre-trial settlements. For this and a number of other reasons, tax awareness would best solve the under-punishment problem even though it does come at the cost of enlarging plaintiff windfalls. However, given the defendant-focused features of current punitive damages doctrine, this cost is not particularly troubling.

INTRODUCTION

AS the name implies, punitive damages are principally awarded to *punish* defendants for torts committed with a malicious or reckless state of mind.[1] In crafting an appropriate financial punishment for such misconduct, jurors are typically instructed to consider, among a number of other factors, the defendant's financial condition.[2] However, jurors are *not* currently informed of the fact that business-related punitive damages are, like other business-related expenses, deductible for federal income tax purposes. When punitive damages are deductible, the true cost of a punitive damages award is often substantially less than the nominal amount of the award. As a result, business defendants in punitive damages cases are typically under-punished relative to the jury's intentions.[3]

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[1] Our claims in this paper are limited to the American legal context. On the punishment rationale of punitive damages, see *Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2621 (2008) ("Regardless of the alternative rationales over the years, the consensus today is that punitives are aimed not at compensation but principally at retribution and deterring harmful conduct."); *Philip Morris USA v. Williams*, 549 U.S. 346, 352 (2007) (reaffirming the Court's long-held view that it is "clear that '[p]unitive damages may properly be imposed to *further a State's legitimate interests in punishing unlawful conduct* and deterring its repetition'") (quoting BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 568 (1996)) (alteration in original) (emphasis added); *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) (describing punitive damages as "private fines" designed to punish and deter "reprehensible conduct").

[2] See generally TXO Prod. Corp. v. Alliance Res. Corp., 509 U.S. 443, 462 n.28 (1993) (describing as "well-settled law" the notion that evidence related to the financial condition of a defendant is admissible in the context of determining punitive damages awards). For specific citations to each state's practices regarding the admission of evidence related to the wealth or financial position of the defendant, see 1 Linda L. Schlueter, Punitive Damages § 5.3(F), at 297–307 (5th ed. 2005); Michael L. Rustad, The Closing of Punitive Damages' Iron Cage, 38 Loy. L.A. L. Rev. 1297, 1316 n.108 (2005).

[3] A small number of studies and academic articles have noted the "under-punishment problem" and, in some cases, have addressed either or both of the plaintiff- or defendant-related tax issues associated with punitive damages. However, for

This Article considers this problem and its potential solutions.[4]

The under-punishment problem stems from the fact that the typical jury's understanding of federal tax law is inconsistent with how the tax law actually operates. This inconsistency could be resolved in two independent ways. One option would be to change federal tax law to match juror expectations by making punitive damages nondeductible in all cases. A number of scholars and policymakers, including President Barack Obama in February 2010 as

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reasons enumerated later in the Article, their analyses fall short in various respects. First, they all overlook a critical threshold issue regarding the possibility of tax awareness and gross ups. Second, they fail to adequately address the benefits and costs of alternative tax regimes or some of the transition costs associated with them. See, e.g., Kimberly A. Pace, The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct?, 47 Ala. L. Rev. 825, 881 (1996) (arguing that punitive damages ought to be made nondeductible); Brock D. Phillips, The Tax Consequences of a Punitive Damage Award, 31 Hastings L.J. 909, 928 (1980) (arguing that punitive damages ought to remain deductible); Robert W. Wood, Further Thoughts on Tax Treatment of Punitive Damages, 93 Tax Notes 1502 (Dec. 10, 2001) [hereinafter Wood, Further Thoughts] (same); K. Todd Curry, Comment, The Deductibility of Punitive Damages as an Ordinary and Necessary Business Expense: Reviving the Public Policy Doctrine, 26 San Diego L. Rev. 357, 369 (1989); Catherine M. Del Castillo, Note, Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine, 68 Tex. L. Rev. 819, 833–34 (1990); Note, An Economic Analysis of the Plaintiff's Windfall from Punitive Damage Litigation, 105 Harv. L. Rev. 1900, 1917 (1992) [hereinafter Note, An Economic Analysis]; see also Schlueter, supra note 2, at § 18 (briefly discussing certain tax issues); New York State Bar Association Tax Section, The Deductibility of Punitive Damages, 93 Tax Notes 1209, 1213–15 (Nov. 26, 2001) [hereinafter NYSBA Report]; Paul Feinberg, Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions, 42 Case W. Res. L. Rev. 339, 340–41 (1992) (arguing that plaintiffs should not be able to exclude punitive damages from income).

[4] The under-punishment problem is implicated only in cases where the defendant's liability for punitive damages arises in connection with the defendant's trade or business. Only in these cases are punitive damages deductible. See I.R.C. § 262 (disallowing deductions for expenses that are not attributable to business or investment activity); cf. Rev. Rul. 80-211, 1980-2 C.B. 57, 58 (characterizing punitive damages incurred in connection with a trade or business as deductible business expenses under I.R.C. § 162). When punitive damages are nondeductible, there is no under-punishment problem because the defendant bears the full burden of the nominal penalty. Thus, unless otherwise explicitly stated, all of the examples in this Article assume that the plaintiff's claim arose out of the defendant's business. In addition, it should be noted that, depending on the specific manner in which punitive damages are calculated, under-punishment might not result. For example, if punitive damages are based exclusively on the pre-tax profit from the defendant's tortious activity, then current practices might not result in under-punishment. However, if punitive damages are based on the defendant's wealth or the after-tax profit from the defendant's tortious activity, then current practices would result in under-punishment.

part of his fiscal year 2011 budget, have proposed this solution.[5] Invoking the same rationale as these academic arguments, the Obama administration has argued that the under-punishment effect of current tax law "undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities."[6]

Unfortunately, the full implications of such a policy shift have yet to be explored.[7] Indeed, while we agree with President Obama that the under-punishment effect is problematic, we disagree with his proposed solution. Instead, we think an alternative approach, which has been largely ignored until now, ought to be adopted. This alternative approach would focus on changing juror expectations to match current federal tax law, in particular by educating jurors about the effect of the deductibility of punitive damages paid by business defendants. These "tax-aware" jurors would take this effect into account when crafting the punitive damages award by adjusting or grossing up the punitive damages to offset deductibility, thus ensuring that the intended financial sanction is in fact borne by the defendant.

Our principal goal in this Article is to explain which of the two approaches to solving the under-punishment problem—blanket nondeductibility or juror tax awareness—is better, given the stated purposes of punitive damages law in most states.[8] As we demon-

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[5] See, e.g., NYSBA Report, supra note 3, at 1209, 1210 (detailing Clinton administration proposals in 1999 and 2000); 149 Cong. Rec. 13065–66 (May 22, 2003) (noting that the Conference Committee rejected a Senate amendment to the tax code that would deny deductions for punitive damages paid); Dep't of Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals 95 (2010), available at http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf [hereinafter General Explanations]; see also sources cited supra note 3.

[6] General Explanations, supra note 5, at 95.

[7] See supra note 3 (noting the failures of extant scholarship and analysis to explore the issue in sufficient detail).

[8] Two caveats are in order. First, in what follows, we assume that most state tort law policies embrace the point that punitive damages are designed at least in part to punish. As we observe, infra note 9, a small number of states view punitive damages as additional measures of compensation (and thus would be justified in not admitting evidence of defendants' wealth); in those cases, our analysis will not apply. Second, while the text discusses two mutually exclusive *solutions* to the under-punishment problem, they are not mutually exclusive *options*. Thus, punitive damages could be made nondeductible and jurors could simultaneously be made tax aware. But as we

strate, the choice between these two approaches depends largely on how easily defendants could circumvent a rule of nondeductibility through settlements that disguise punitive damages as compensatory damages, which would remain deductible under either approach. It is likely that this type of circumvention would be easy in the vast majority of punitive damages cases. To the extent that a rule of nondeductibility is circumvented, the defendant would be able to participate in the tax gains from circumvention in the form of lower after-tax settlement costs; this would result in precisely the same under-punishment effect that nondeductibility is intended to correct. Accordingly, if circumvention is in fact relatively easy, the tax-awareness approach (which, as we explain, is not subject to circumvention) is the preferred solution to the under-punishment problem.

Federalism and regulatory diversity concerns also support choosing the tax-awareness approach. Tax awareness is a state tort law solution to under-punishment, while nondeductibility would require a change to federal tax law. The goal of correcting the under-punishment problem is to advance the state's interest in adequately punishing blameworthy conduct that is committed within its borders. States are therefore more capable of determining whether the benefit of correcting under-punishment is worth its associated costs, such as the administrative burdens of implementation. Additionally, by avoiding a blanket federal solution, the tax-awareness approach preserves greater regulatory diversity at the state level. Thus, states whose extracompensatory damages regimes are not designed to punish could easily opt out of tax awareness.[9] The federal solution of blanket nondeductibility is not nearly as flexible.

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discuss, since jurors implicitly assume nondeductibility, making jurors tax aware would have no effect if punitive damages were nondeductible.

[9] Michigan, New Hampshire, and Connecticut have in the past ascribed a "private" and compensatory function to punitive damages awards in their states. See, e.g., Doroszka v. Lavine, 150 A. 692, 692–93 (Conn. 1930); Wise v. Daniel, 190 N.W. 746, 747–48 (Mich. 1922); Fay v. Parker, 53 N.H. 342, 397 (1872). Additionally, approximately four states (Louisiana, Massachusetts, Nebraska, and Washington) only allow punitive damages where expressly authorized by statute. See Schlueter, supra note 2, § 2.2, at 29 (2005) (providing sources). By contrast, the vast majority uses punitive damages as a jury-determined measure to achieve state interests in retribution and deterrence. See id. § 1.4(A)–(B), at 15–16; see also Exxon Shipping Co. v. Baker, 128 S. Ct. 2605, 2621 (2008).

Unfortunately, while a rule of tax awareness would best solve the under-punishment problem, it does so at the cost of increasing what many believe to be "windfall" gains to plaintiffs.[10] While this tradeoff might be lamented, it is also unavoidable under current punitive damages doctrine. However, because punitive damages doctrine is focused on the *defendant's* culpable wrongdoing, this result is not especially troubling.

The Article unfolds in three Parts. In Part I, we provide some background and then examine a critical threshold issue that has been ignored by litigants, courts, and scholars: whether plaintiffs are, under current state tort law, permitted to make punitive damages jurors tax aware. If so, plaintiffs would be able to argue to jurors that they should augment punitive damages awards to account for tax deductibility by defendants. Furthermore, once tax evidence is introduced, it could also be considered by reviewing courts in assessing the constitutionality of punitive damages under the Due Process Clause.

Oddly, as a matter of current practice, plaintiffs (through their counsel) have not been seeking to introduce tax evidence against defendants when seeking punitive damages. In fact, to our knowledge, this precise issue has never been raised in any reported deci-

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[10] A number of problems have been identified with extending windfalls to plaintiffs, such as decreased incentives for plaintiffs to take adequate precautions and increased incentives to bring frivolous suits. See A. Mitchell Polinsky & Yeon-Koo Che, Decoupling Liability: Optimal Incentives for Care and Litigation, 22 RAND J. Econ. 562, 563 (1991); Note, An Economic Analysis, supra note 3, at 1909. Additionally, windfalls provide a kind of lottery gain that, ex ante, citizens would prefer to avoid if it could alternatively be shared through lower taxes or more services. Eric Kades, Windfalls, 108 Yale L.J. 1489, 1564 (1999).

To be sure, there is a venerable school of thought that views punitive damages awards to plaintiffs not as a windfall, but rather as a remedy that vindicates the injury to a plaintiff's dignity interests in a manner separate from the non-economic compensatory damages a plaintiff might receive. See, e.g., Thomas B. Colby, Clearing the Smoke from *Philip Morris v. Williams*: The Past, Present, and Future of Punitive Damages, 118 Yale L.J. 392, 434 (2008); Marc Galanter & David Luban, Poetic Justice: Punitive Damages and Legal Pluralism, 42 Am. U. L. Rev. 1393, 1432–33 (1993); Mark A. Geistfeld, Punitive Damages, Retribution, and Due Process, 81 S. Cal. L. Rev. 263, 269–74 (2008); John C. P. Goldberg, Tort Law for Federalists (and the Rest of Us): Private Law in Disguise, 28 Harv. J.L. & Pub. Pol'y 3, 7 (2004); Anthony J. Sebok, Punitive Damages: From Myth to Theory, 92 Iowa L. Rev. 957, 960–62, 1023–29 (2007) (arguing that punitive damages should be regarded as "a form of state-sanctioned revenge"); Benjamin C. Zipursky, A Theory of Punitive Damages, 84 Tex. L. Rev. 105, 107, 110, 151–53 (2005).

sion by any American court. Part I therefore also considers the arguments both in support of and against making jurors tax aware when they are deciding the amount of punitive damages. Ultimately, Part I concludes that, under current tort law, jurors should be made tax aware. Accordingly, the problem of under-punishment could be corrected without the necessity of any legislative action. This discussion should thus be of substantial interest to tort litigants and courts; indeed, we think that plaintiffs' lawyers will be especially interested to learn that they are able to introduce tax evidence that would increase their clients' punitive damages recoveries.

Part II then analyzes which of the two solutions to the under-punishment problem—tax awareness or nondeductibility—is better, given the goals and constraints of current punitive damages law as practiced in most states. While tax awareness would solve the under-punishment problem, a universal rule of nondeductibility could as well, at least in theory. After all, in each case the intent is for the defendant to bear the same after-tax cost. However, as mentioned earlier, there is good reason to think that a rule of nondeductibility would be easily circumvented through settlement. For this reason, tax awareness is more likely to achieve settled tort law goals than the alternative solution of blanket nondeductibility. Part II therefore should be of significant interest to Congress when it considers whether to implement the nondeductibility approach that has been regularly touted, most recently by President Obama. Part III raises and addresses some possible objections to our proposal.

I. THE UNDERAPPRECIATED ISSUE OF JURY TAX AWARENESS

In this Part, we explore how jury (or judicial) tax awareness can operate as a way to solve the under-punishment problem identified by torts and tax scholars and, more recently, President Obama. As mentioned at the outset, a principal purpose of current punitive damages law in almost all states is to punish a defendant for reprehensible conduct. Punitive damages that are incurred in connection with the defendant's business are tax deductible.[11] Over the last few

[11] I.R.C. § 162(a) (2006) (allowing deductions for ordinary and necessary business expenses incurred in carrying on a trade or business); Rev. Rul. 80-211, 1980-2 C.B. 58 ("Amounts paid as punitive damages incurred by the taxpayer in the ordinary con-

decades, a number of articles have argued that Congress should change this tax rule to avoid a "reduction in the sting" of the jury's intended punishment.[12] The Obama administration's recent proposal, like prior similar legislative proposals, is premised on this same notion of under-punishment.[13] In cases where punitive damages are deductible, the argument is that defendants are under-punished relative to the jury's intentions.[14] This is because the after-tax cost of the jury's award is less than its nominal dollar amount.

For example, assume that a defendant in a 40% marginal tax bracket makes a deductible punitive damages payment of $100,000.[15] Had the defendant not been forced to make the punitive damages payment, the defendant would have been left with only $60,000 of the $100,000 cash paid to the plaintiff. This is because the government would have received the remaining $40,000 (that is, 40% of the extra $100,000 of taxable income that had been sheltered by the punitive damages deduction). Accordingly, the after-tax cost to the defendant is only $60,000.[16] More generally, in cases where punitive damages are deductible, the after-tax cost to the defendant is equal to the product of (a) the nominal dollar amount of the punitive damages and (b) 1 minus t, where t is the defendant's marginal tax rate.

This under-punishment argument, however, makes the critical implicit assumption that jurors currently are and will always be "tax blind" regarding the fact and effect of deductibility in busi-

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duct of its business operations are deductible as an ordinary and necessary business expense under section 162 of the Code.").

[12] See sources cited supra note 3.

[13] See General Explanations, supra note 5.

[14] See supra note 4.

[15] This is roughly the top effective marginal federal, state, and local income tax rate that could currently apply to a given defendant. Tax scholarship typically uses this figure in examples. See, e.g., Michael S. Knoll, *Compaq* Redux: Implicit Taxes and the Question of Pre-Tax Profit, 26 Va. Tax Rev. 821, 833 (2007).

[16] This is similar to the "matching contribution" effect resulting from the charitable contribution deduction. See Gregg D. Polsky, A Tax Lawyer's Perspective on Section 527 Organizations, 28 Cardozo L. Rev. 1773, 1776–77 (2007) (showing that a $1000 deductible contribution costs a 35% marginal tax bracket donor only $650, with the remaining $350 effectively paid by the government).

ness-related cases.[17] If jurors were in fact made tax aware, they would be able to adjust or "gross up" a punitive damages award to reflect the fact of deductibility. Indeed, once properly grossed up, a punitive damages award would inflict the jury's desired punishment, and the under-punishment argument in favor of making punitive damages nondeductible dissolves.

To illustrate, assume that a jury determines that a defendant's net worth is $1,000,000 and decides that, to impose an appropriate punishment, the defendant should pay 10% of its net worth. If the jury is not aware of the fact that the defendant is able to deduct the punitive damages award, it would render an award of $100,000. However, if the defendant's marginal tax rate is 40%, then the after-tax cost of a deductible punitive damages award levied is only $60,000, which is $40,000 less than what the jury had intended. Under these facts, the under-punishment argument is forceful because the jury's intended punishment is blunted by the unforeseen tax deduction.

But if the jury were properly informed as to the tax consequences of the award, the sting reduction argument loses all of its force. A tax-aware jury would, in this situation, issue a $167,000 punitive damages award to impose an after-tax penalty on the defendant in the amount of $100,000.[18] This grossed-up award of

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[17] This "tax blindness" will be true when jurors, in determining the amount of an award, either (a) do not think about the tax consequences of paying punitive damages at all or (b) do think about the tax consequences of paying punitive damages but incorrectly assume that punitive damages are nondeductible in all instances.

Jurors who do think about taxes may assume nondeductibility for a number of reasons. They may simply assume that punitive payments would be nondeductible. Alternatively, jurors may be aware that statutory fines and penalties are nondeductible, I.R.C. § 162(f) (2006), and may assume that, by analogy, punitive damages are as well. Finally, some jurors may infer nondeductibility from the fact that they, under current practices, are not given information about the defendant's marginal tax rate, a fact which would be necessary to know to calculate a proper gross up. We recognize that hypothetically someone could be utterly ignorant of the prevailing tax effects of punitive damages and yet guess that such damages would be deductible. But for reasons we explain later on, we think most people are not likely to know that punitive damages can be paid with pre-tax dollars by some defendants but not others. See infra notes 22–31 and accompanying text.

[18] A total of $167,000 in pre-tax dollars is necessary to create $100,000 post-tax dollars on the assumption of the application of a 40% marginal tax rate. Except in a few examples later on where greater specificity is required, we have rounded to the closest thousand dollars.

$167,000 would result in an after-tax cost of $100,000 ($167,000 * 60%), which is 10% of the defendant's net worth, consistent with the jury's intentions. More generally, the amount of a given intended penalty would be grossed up by dividing the intended penalty amount by $(1 - t)$, where t is the defendant's marginal tax rate.[19]

Thus, the threshold doctrinal question that must be considered is whether plaintiffs, under current state tort law, may inform juries about the tax consequences of the punitive damages awards that they render.[20] If so, it would be unnecessary to change the federal tax rules to avoid "undermin[ing] the role of [punitive] damages in discouraging and penalizing certain undesirable actions."[21] Unfortunately, we could not find any reported cases discussing the tax-awareness issue in the punitive damages context,[22] and treatises and articles have largely ignored the issue.[23] Our discussions with plain-

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[19] It might appear that this math could be difficult for a lay jury to perform correctly. We are relatively indifferent regarding whether the jury or the judge is the fact-finder vis-à-vis the marginal tax rate and the calculation of the gross up. For the sake of simplicity, we will generally refer to jury tax awareness, but the discussion below applies equally to judges if they are the relevant fact-finder. For further discussion of the procedural aspects of tax awareness, see infra Section III.B.

[20] To be clear, we are advocating universal tax awareness by juries. Thus, for example, if juries, in crafting an award, are permitted or required to take into account the amount of profits generated by an activity or during a specific period, these profits should be expressed in after-tax terms.

[21] General Explanations, supra note 5, at 95. However, as we point out later, there may be other considerations involved in a decision to change the tax rules even if jurors are made tax aware. See infra Part II (discussing whether making punitive damages nondeductible or making jurors tax aware would be the better rule).

[22] The New York State Bar Association Tax Section, in its 2001 report on the taxation of punitive damages, found that "[s]tate laws dealing with punitive damages do not address the issue" of whether juries are instructed as to deductibility. NYSBA Report, supra note 3, at 1214.

[23] We have found scant treatment of the issues. One treatise, Schlueter, supra note 2, at 96–99, adverts to the issues briefly but without any substantial argument or citation to authorities. That treatise limits its principal discussion of the defendant's taxation consequences to the following:

> Because most punitive damage awards are deductible, the defendant's counsel should be familiar with the local rule regarding the admissibility of tax consequences. A jury may well be swayed by the plaintiff's argument that the punitive damages award will only cost the defendant one-half the amount of its award in after-tax dollars. The United States Supreme Court held that in trials involving the Federal Employer's Liability Act, instructions as to tax effects should have been given. However, most states do not allow such evidence in state claim actions.

tiffs' lawyers indicate that they too have not focused on the issue of tax awareness.[24] Accordingly, as a matter of practice, it appears that punitive damages jurors are not currently tax aware.

This neglect of the tax-awareness issue is quite surprising in light of the potentially large dollar amounts that are at stake and the basic logic that supports the argument that punitive damages juries should be made tax aware. It seems highly likely that jurors, unless they are informed of the tax consequences of paying punitive damage awards, either will simply not consider tax consequences at all

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Id. § 18.2, at 99 (citations omitted).

Another treatise likewise mentions the issue in passing:

> Lastly, the jury should be informed that under federal law, any punitive damages imposed on a defendant are deductible by the defendant from taxable income. Since the defendant can deduct the expense from its taxes, it thereby reduces the deterrent effect of the amount of punitive damages awarded by whatever its tax rate is. As such, the amount of punitive damages that must be imposed in order to have a sufficient deterrent effect must be increased to account for the deduction and the jury should be made aware of that fact.

Mark P. Robinson Jr. & Sharon J. Arkin, Punitive Damages, *in* 3 American Association for Justice, Litigating Tort Cases § 28:36, at 90 (2009) (citation omitted).

A few studies have also referred to the issue briefly. The New York State Bar Association Report on the Deductibility of Punitive Damages noted that state laws have not addressed the issue of admissibility of the defendant's tax consequences to rebut the notion that allowing deductibility would unduly reduce the sting of a punitive damages award. NYSBA Report, supra note 3, at 1213–15. Likewise, Robert Wood has made the claim that if Congress made punitive damages awards nondeductible, the jury should be instructed on that fact. Wood appears to assume that juries currently gross up deductible awards; otherwise, there would be no reason to instruct them of the fact of nondeductibility. Wood, Further Thoughts, supra note 3, at 1502. However, there is no evidence to support this inference because it appears there are no cases where evidence is admitted regarding defendants' marginal tax rates. Likewise, another commentator implicitly assumes that jurors currently take into account tax deductibility of a punitive damages award in determining the size of the award to support his argument that to reduce the size of the plaintiff's windfall, awards should be nondeductible for defendants. Note, An Economic Analysis, supra note 3, at 1918. As we discuss below, making punitive damages nondeductible would reduce the size of the awards *only if a jury is aware of the tax treatment of punitive damages*. If juries are unaware, the size of the awards would be the same whether or not awards are deductible.

[24] One nationally prominent plaintiffs' class action lawyer surmised that the failure to press the tax argument was predicated on case law precluding admission of tax treatment evidence—along the lines of the case law excluding admission of insurance coverage. We have seen no case law to that effect but we address the underlying analogy to insurance coverage infra at Subsection I.B.5. Several other prominent plaintiffs' lawyers thought we were spot-on in identifying the oversight of the plaintiffs' bar. In any event, we do not suggest that we have exhaustively surveyed the world of practice and would welcome more empirical information one way or the other.

or instead will incorrectly assume that these damages are always nondeductible.[25] In either case, introducing into evidence the fact of deductibility and informing the jury of the effect of deductibility would often increase the punitive damage award substantially. For example, if the defendant's marginal tax rate is 40%, making jurors tax aware would augment a punitive damages award by 67%.[26]

Making jurors tax aware in such a case would increase the standard 33% contingent fee by 22% (one-third of 67%) of the original, pre-grossed-up amount of the punitive damages award.[27] Furthermore, since settlements are reached in the shadow of what a jury would be expected to award, the prospect of gross ups would similarly increase settlement values. Plaintiffs' lawyers would therefore appear to have strong financial incentives to argue for jury tax awareness, though, as mentioned earlier, they are apparently not doing so.

We discuss below, in Sections A and B respectively, the doctrinal arguments both for and against tax awareness under current state tort law. Ultimately, we conclude that the argument in favor of tax awareness is more persuasive.

A. Arguments for Tax Awareness

The arguments in favor of making juries tax aware are straightforward. First, the tax evidence is relevant information, like the de-

[25] This is a factual premise of the proposals to make punitive damages nondeductible because if jurors were grossing up damages then there would be no underpunishment problem. The premise seems reasonable to us given that most law students (and law professors) we spoke with were surprised to learn that punitive damages incurred in connection with a business are deductible. Cf. Inland Revenue Comm'rs v. Alexander von Glehn & Co., (1920) 2 K.B. 553, 570–71 (stating that the answer to the question of whether a defendant can deduct fines from his business income is an "obvious" no). Even if some jurors were aware of the fact and effect of deductibility despite the fact that they are not presented with evidence such as the marginal tax rate of the defendant, informing them about tax consequences and marginal tax rates would simply make these "inherently" tax-aware jurors more tax aware. For example, without explicit tax awareness, inherently tax-aware jurors might incorrectly estimate the defendant's marginal tax rate, which would result in erroneous gross-up amounts.

[26] Recall the example above where tax awareness increased a $100,000 award by $67,000 in the case of a 40% marginal tax bracket defendant.

[27] Thus, if a jury intended a penalty of $100,000 on a 40% marginal tax bracket defendant, the gross up would equal $67,000. One-third of the gross up is $22,000, which equals 22% of the original, pre-gross-up amount of the punitive damages.

fendant's financial condition, that a jury should consider in designing an appropriate financial punishment. Second, tax awareness facilitates the reduction of unwarranted disparities among similarly situated defendants.

As discussed earlier, a principal purpose of punitive damages law in virtually all states is to impose a financial setback on the defendant to punish its reprehensible conduct. The problem with the current practice of tax blindness is that a jury cannot decide the amount of a proper punitive damages award without also knowing how much of the award the defendant will actually have to pay. To determine the real cost of punitive damages awards, jurors must be informed about the defendant's tax consequences of paying punitive damages.[28] Thus, like net worth evidence and other similar evidence relating to the defendant's financial condition, evidence regarding the fact and effect of deductibility is relevant in calculating the size of an appropriate punitive damages award.[29]

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[28] Cf. John Y. Taggart, Fines, Penalties, Bribes, and Damage Payments and Recoveries, 25 Tax L. Rev. 611, 615 n.5 (1970) (arguing that to determine whether deductibility of a fine dilutes an intended penalty, one needs to know whether the imposer of the fine believed that the fine was deductible); Eric M. Zolt, Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions, 37 UCLA L. Rev. 343, 352 (1989) ("Whether a policy of disallowing deductions increases a penalty or prevents dilution of the intended penalty depends on the government's intent when setting the primary fine. If the government intended the fine to be deductible, then a policy of nondeductibility increases the sanction; similarly, if the government intended the fine to be nondeductible, then a policy of deductibility reduces the sting."); see also Wood, Further Thoughts, supra note 3, at 1502 (contending that if punitive damages were made nondeductible, "there must be a fundamental change in the information provided to juries so they take into account the after-tax effects of the punitives").

[29] For purposes of this Article, we accept without argument the conventional assumption that business defendants are permissibly punished in a way similar to individuals and that wealth-adjusted penalties are reasonably imposed on business entities. A normative justification for this claim with respect to intermediate civil sanctions is offered in Dan Markel, Punishing Entities (Civilly) (unpublished manuscript, on file with author). A range of justifications and authorities have been offered for punitive sanctions against firms. See, e.g., Brent Fisse & John Braithwaite, Corporations, Crime and Accountability 15 (1993) ("[T]he law should hold an axe over the head of a corporation that has committed the *actus reus* of a criminal offence. . . . The private justice system of the firm is then put to work under the shadow of that axe."); Peter French, Collective and Corporate Responsibility (1984); Amy J. Sepinwall, Shared Responsibility for Corporate Crime (2009) (unpublished manuscript, on file with author) (explaining how corporate criminal liability can be justified in terms of retributive theory); see also N.Y. Cent. & Hudson River R.R. v. United States, 212 U.S. 481, 492–93 (1909); Regina v. St. Lawrence Corp., [1969] 2 O.R. 305, 5 D.L.R. 3d

Second, tax blindness results in unwarranted disparate treatment of otherwise similarly situated defendants. For example, assume that Defendant A, a self-employed courier, drives recklessly to deliver a package on time, while Defendant B drives similarly to get to a movie on time. Assume also that each defendant injures and causes the same harm to a victim, and each defendant is in the same financial position. In both cases, a tax-blind jury awards $100,000 of punitive damages, believing that both defendants' after-tax cost will equal the same amount. Yet, because Defendant A's driving was in the course of her courier business, she gets to deduct the $100,000, reducing her after-tax cost to $60,000.

By contrast, because his driving was not business-related, Defendant B receives no reduction in his after-tax cost. Thus, while the degree of reprehensibility is the same and each defendant's financial position is the same, Defendant B is punished more harshly than Defendant A. This inequity would be resolved, however, if the punitive damages judgment against Defendant A were properly grossed up by a tax-aware jury to $167,000.

Of course, it might be argued that Defendant A and Defendant B are *not* similarly situated because Defendant A was pursuing a taxable benefit (earning his courier fee) while Defendant B was pursuing a tax-free benefit (seeing the beginning of a movie). While this distinction is accurate, it is hard to see why it is one that is relevant in determining the amount of the financial punishment that each defendant should bear.

Besides creating inequity between business and non-business taxpayers, current tax blindness creates inequities among business defendants that are subject to different marginal tax rates. If two defendants with the same net worth injure a victim similarly in the

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263, 273–74 (Can.); Melissa Ku & Lee Pepper, Corporate Criminal Liability, 45 Am. Crim. L. Rev. 275, 277 (2008). To be sure, some law and economics scholars reject the notion that businesses (or, at least, public corporations) can sensibly be punished even though they think the businesses can be deterred. See, e.g., A. Mitchell Polinsky & Steven Shavell, Punitive Damages: An Economic Analysis, 111 Harv. L. Rev. 869, 948–54 (1998). Thus, it is possible that such scholars will view "under-punishment" as appropriate if the amount of punitive damages is nevertheless sufficient to achieve optimal deterrence. However, at least one economist has argued that wealth-based punitive damages are appropriate for business entities in certain instances. See Keith N. Hylton, A Theory of Wealth and Punitive Damages, 17 Widener L. Rev. 927, 946 (2008).

course of their business and one defendant has a higher current-year marginal tax rate than the other, then that defendant's after-tax punishment would be less than the other defendant's sanction.[30] This inequity would likewise be solved by making jurors tax aware.[31]

B. Assessing the Arguments Against Tax Awareness

In response to these arguments in favor of tax awareness, a number of interrelated counterarguments may be offered. These arguments, however, are ultimately not fully persuasive.

1. Symmetry Between Plaintiffs and Defendants

Defendants could first note that information regarding the tax consequences of awards to *plaintiffs* is sometimes not allowed into evidence,[32] and then argue that consistency and fairness require that the same rule of tax blindness be followed in the punitive damages context vis-à-vis *defendants*. Defendants are generally not allowed, in an effort to reduce the amount of damages awarded against them, to introduce the fact that Section 104(a)(2) of the Internal Revenue Code allows physically injured plaintiffs to exclude

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[30] See Pace, supra note 3, at 849–50. Because marginal tax rates depend on the amount of the taxpayer's current year income (not on the amount of the taxpayer's accumulated wealth), it is possible for two similarly wealthy taxpayers to be subject to different marginal tax rates in the current year.

[31] There is another type of horizontal inequity that could arise. One could argue that, under a tax-awareness scheme, plaintiffs who are similarly situated (for example, a plaintiff who is run over by Defendant A and experiences the same injury as a plaintiff run over by Defendant B) will enjoy different recoveries under our proposed rule. However, given the defendant-centered goals of punitive damages (to punish and deter), this is not a significant concern. Under current punitive damages law, if Defendant A were wealthier than Defendant B, their respective victims would frequently receive disparate amounts of punitive damages. See infra Subsection I.B.3.

[32] The Second Restatement of Torts includes this general rule in § 914A, and the commentary notes that this is the rule in the majority of jurisdictions. Restatement (Second) of Torts § 914A, at 494 (1979). But see Norfolk & W. Ry. v. Liepelt, 444 U.S. 490, 496–98 (1980) (holding that the tax-free status of an award under the applicable statute was admissible); Burlington N., Inc. v. Boxberger, 529 F.2d 284, 295–98 (9th Cir. 1975) (holding that if a defendant requests an instruction regarding tax exclusion, the court must give it); Blake v. Del. & Hudson Ry. Co., 484 F.2d 204, 208 (2d Cir. 1973) (same); Domeracki v. Humble Oil & Ref. Co., 443 F.2d 1245, 1248–51 (3d Cir. 1971) (same).

compensatory damages from gross income.[33] To illustrate why defendants would want to introduce this evidence, consider a case where a plaintiff suffers lost wages of $100,000. Assuming that the Section 104(a)(2) exclusion applies, damages representing lost wages would not be taxed. The defendant therefore would want to introduce the fact that, had the lost wages been earned in due course, the plaintiff's after-tax income from the wages would equal $60,000 (assuming a 40% marginal tax rate). Thus, the defendant would argue to the jury, the plaintiff should be awarded only $60,000 of lost wages damages instead of $100,000.

Courts have generally, though not universally, precluded defendants from making this type of argument to juries.[34] Courts faced with the argument must decide whether the benefit of the Section 104(a)(2) exclusion should go to the plaintiff or to the defendant. If the Section 104(a)(2) exclusion is *not* admitted into evidence, then the *plaintiff* will capture the benefit because the plaintiff will receive $100,000 of after-tax damages for lost wages, even though the plaintiff has in fact lost only $60,000 of after-tax wages. If the Section 104(a)(2) exclusion *is* admitted into evidence, the *defendant* will capture the benefit because it will pay only $60,000 of lost wages even though it caused the plaintiff to lose $100,000 of such wages.

This choice creates a dilemma. Compensatory tort damages are conventionally thought to fulfill two goals: to compensate the plaintiff for his or her injury and to promote optimal deterrence by forcing the defendant to internalize the tortious costs of its activities.[35] The Section 104(a)(2) exclusion makes it impossible to achieve these two goals simultaneously. The exclusion thus forces courts to choose between (i) over-compensating plaintiffs through tax blindness by making jurors tax blind as to the effects of Section 104(a)(2), or (ii) under-deterring—from a cost-internalization per-

[33] I.R.C. § 104(a)(2) (2006) (specifically excluding compensatory damages received on account of personal physical injury from gross income).

[34] See, e.g., John E. Theuman, Annotation, Propriety of Taking Income Tax into Consideration in Fixing Damages in Personal Injury or Death Action, 16 A.L.R. 4th 589, § 3, at 594–99 (1982) (providing citations to many jurisdictions that do not allow defendants to introduce tax effects on awards to plaintiffs).

[35] Catherine M. Sharkey, Punitive Damages as Societal Damages, 113 Yale L.J. 347, 390 (2003) [hereinafter Sharkey, Punitive Damages] (discussing "the predominant dual functions of tort law—compensation and deterrence").

spective—defendants by making jurors tax aware as to the effects of Section 104(a)(2).[36] Faced with this dilemma, courts have generally (though not universally) chosen over-compensation rather than under-deterrence, a reasonable choice though not an indisputable one.

In the punitive damages context, there is no such difficult dilemma. Tax awareness will further the punishment objective of punitive damages without adversely affecting any other purpose of punitive damages.[37] Thus, while the issue of Section 104(a)(2) awareness is a difficult one that requires a balancing of conflicting objectives, tax awareness in the punitive damages context is a far easier choice.

In addition, it should be noted that while courts generally have followed a rule of tax blindness in the Section 104(a)(2) context, this rule is by no means universal. For example, the United States Supreme Court has determined that the effect of Section 104(a)(2) ought to be considered by courts in determining an award under the Federal Employers' Liability Act ("FELA").[38] Under the FELA statute, an estate is entitled to a recovery of "the damages . . . [that] flow from the deprivation of the pecuniary benefits which the [decedent's] beneficiaries might have reasonably received . . . ."[39] The Court held that such language mandates the use of after-tax earnings in assessing the proper amount of damages because "[i]t is . . . after-tax income, rather than . . . gross income before taxes, that provides the only realistic measure of [the decedent's] ability to support his family."[40] Accordingly, the Court determined, "[i]t follows inexorably that the wage earner's income tax is a relevant factor in calculating the monetary loss suffered by

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[36] See Joseph M. Dodge, Taxes and Torts, 77 Cornell L. Rev. 143, 146 (1992) [hereinafter Dodge, Taxes and Torts] (noting that § 104(a)(2) "forces states to choose between overcompensating plaintiffs and potentially underburdening defendants").

[37] The assumption here, which we think is uncontroversial, is that most jurisdictions permitting punitive damages are thus pursuing retribution and complete deterrence of the underlying misconduct, not optimal deterrence. Even the leading proponents of optimal deterrence agree that current punitive damages law in most states is not designed or structured in such a way as to achieve optimal deterrence. See Polinsky & Shavell, supra note 29, at 896–97.

[38] Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490, 493, 498 (1980).

[39] Id. at 493 (quoting Mich. Cent. R.R. Co. v. Vreeland, 227 U.S. 59, 70 (1913)).

[40] Id.

his dependents when he dies."[41] Lower federal courts have followed this tax-awareness rule in other cases involving federal causes of action for lost earnings.[42]

Furthermore, a growing number of courts have implemented a rule of tax awareness regarding the plaintiff's tax consequences in employment discrimination cases. In these cases, plaintiffs have sought an augmented award to counteract the effect of certain adverse tax consequences that they would suffer as a result of receiving a lump sum payment of lost wages in lieu of the periodic wages that they would have received absent the discrimination. State and federal courts have generally allowed such augmentations in cases applying a range of anti-discrimination laws.[43]

2. Complexity and Speculation

In opposition to a plaintiff's attempt to introduce tax evidence, a defendant might also argue that this evidence would cause undue complexity and result in too much speculation by the jury. In a related context, a similar argument has met with some success. In some personal injury cases, for example, defendants have sought to introduce evidence that plaintiffs are allowed to exclude compensatory damages, including lost wages, from gross income for tax

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[41] Id. at 493–94.

[42] See, e.g., Kirchgessner v. United States, 958 F.2d 158, 161 (6th Cir. 1992) (holding that a plaintiff's tax consequences may be introduced under the Federal Tort Claims Act); Davis v. Little, 851 F.2d 605, 611 (2d Cir. 1988) (holding that a plaintiff's tax consequences may be introduced in claims arising under 42 U.S.C. § 1983); Fanetti v. Hellenic Lines Ltd., 678 F.2d 424, 431 (2d Cir. 1982) (stating that the tax-awareness rule in *Liepelt* applies at least to all federal law claims for future lost wages).

[43] See Gregg D. Polsky & Stephen F. Befort, Employment Discrimination Remedies and Tax Gross Ups, 90 Iowa L. Rev. 67, 91–99 (2004). The Third Circuit recently affirmed such an award under the Americans with Disabilities Act, noting that in crafting an appropriate remedy to restore the plaintiff to its ex ante economic position, these adverse tax consequences should be considered. Eshelman v. Agere Sys., Inc., 554 F.3d 426, 440–43 (3d Cir. 2009). An earlier Tenth Circuit decision reached the same conclusion in a Title VII case, Sears v. Atchison, Topeka & Santa Fe Ry. Co., 749 F.2d 1451, 1456–57 (10th Cir. 1984), as have a number of other federal and state courts in applying various anti-discrimination laws. See, e.g., O'Neill v. Sears, Roebuck & Co., 108 F. Supp. 2d 443, 447 (E.D. Pa. 2000); Arneson v. Sullivan, 958 F. Supp. 443, 446 (E.D. Mo. 1996); see also Blaney v. Int'l Ass'n of Machinists & Aerospace Workers, Dist. No. 160, 87 P.3d 757, 761–64 (Wash. 2004) (applying Washington discrimination law); Ferrante v. Sciaretta, 839 A.2d 993, 994–96 (N.J. Super. Ct. Law Div. 2003) (applying New Jersey discrimination law).

purposes. To determine the value to the plaintiff of this tax exclusion, a jury must determine how lost future wages would have been taxed had they been earned in due course.[44] As the Restatement (Second) of Torts explains in support of its rule that defendants may not introduce evidence of the exclusion to the jury:

> [T]he calculation of the potential income tax for future earnings is a very complicated one, fraught with many imponderables, such as the potential number of exemptions or exclusions, the tax bracket that the injured party would be in because of income from other sources and the uncertainty as to the tax rate in the future.[45]

These concerns about undue complexity and speculation, however, are not nearly as significant in the punitive damages context. Ordinarily, calculating punitive damages gross ups would be relatively simple. The jury would need only to determine the defendant's expected marginal tax rate for the defendant's *current* taxable year, as punitive damages are payable in a lump sum rather than over a period of years.[46] Once the marginal tax rate is known, the jury's intended penalty is grossed up by dividing that intended after-tax penalty amount by $(1 - t)$, where t is the defendant's marginal tax rate.[47] Thus, while the benefit of the Section 104(a)(2) exclusion might depend on marginal tax rates that will apply in *multiple* and *distant* years in the future, a punitive damages gross up

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[44] For example, if a jury decides that the plaintiff suffered lost future wages in the amount of $100,000 per year for the next thirty years, a tax-aware jury would have to speculate as to the plaintiff's marginal tax rate during that time period in order to determine the amount of lost after-tax wages.

[45] Restatement (Second) of Torts § 914A, at 495 (1979).

[46] While appeals could delay the defendant's payment and resulting deduction until later tax years, and marginal tax rates might change before the deduction is taken, defendants can take steps to protect themselves from any harm caused by a reduction in their marginal tax rate. Tax law allows defendants to deduct immediately contingent liabilities (such as an adverse judgment pending appeal) by paying the amount of the contested liability into an escrow account. See I.R.C. § 461(f) (2010). This would effectively "lock in" the defendant's marginal tax rate at the rate to which the defendant is subject during the year of the jury verdict. Accordingly, the possible delay from appeals and its effect on the marginal tax rate applied to a payment of punitive damages can safely be ignored in grossing up these awards.

[47] If a punitive damages payment causes a defendant to "drop" tax brackets, a blended rate must be used to properly gross up the intended penalty. This would make the math somewhat more complex but not inordinately so.

would depend only on the single marginal tax rate for the *current* year.

That said, gross-up calculations could involve some degree of complexity in certain cases. The defendant's marginal tax rate for the current taxable year is known with precision only after the end of that year. Thus, for example, a jury determining the amount of punitive damages early in the defendant's taxable year would have to speculate as to what the defendant's taxable income will be for the rest of that year. This would be a significant concern only with regard to defendants whose short-term profitability is highly volatile.

Nevertheless, even in these cases, the complexity concerns necessitated by gross ups are significantly less profound than those associated with determining the amount of damages generally.[48] After all, in determining the amount of compensatory damages, juries are often required to speculate as to "future employment . . . , future health, future personal expenditures, future interest rates, and future inflation . . . ."[49] All of these issues involve significant conjecture about future events, yet juries deal with them to the best of their abilities, usually with expert assistance.[50] We think that juries should be allowed to do the same in estimating the marginal tax rate for the defendant's current taxable year.[51] If juries are not allowed to do so, the marginal tax rate of all defendants is effectively assumed to be zero, which would be substantially erroneous in many cases.

3. Augmenting Windfalls

In addition to the symmetry and complexity arguments previously discussed, defendants might also argue that tax awareness

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[48] Cf. Mark Geistfeld, Due Process and the Determination of Pain and Suffering Tort Damages, 55 DePaul L. Rev. 331, 331–33 (2006) (arguing that due process concerns also arise in the compensatory damages category).

[49] Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490, 494 (1980).

[50] Id.

[51] Thus, for example, to determine future medical costs, the jury must speculate both as to the plaintiff's future medical needs and as to the plaintiff's life expectancy. A jury would never be able to predict each of these with precision, yet this does not prevent juries from awarding, with expert assistance, their best estimate of future medical costs.

will unduly augment the size of the plaintiff's windfall.[52] Some scholars have argued, however, that punitive damages awards to plaintiffs are not always properly construed as windfalls in all cases; rather, these awards can sometimes be justified as compensation of an injury to a particular dignity interest held by the plaintiff that is not currently accounted for by compensatory damages.[53] If these scholars are correct, then the concern about extra windfalls is mitigated or possibly eliminated in some cases.[54]

Even assuming that the windfall characterization were appropriate—a reasonable assumption if the plaintiff is already compensated adequately by compensatory damages[55]—the augmentation argument does not persuasively refute the need for tax awareness. While the size of the plaintiff's recovery would in fact be increased through tax awareness, when evidence regarding deductibility is excluded from the jury's consideration, the jury's intended sanction is blunted.[56] The question then is which of the two evils—augmented windfalls for plaintiffs or blunted penalties for defendants—is worse. It is clear that current punitive damages law in most states is focused on defendants, their conduct, and their financial circumstances. In endeavoring to get the defendant's

[52] Augmented windfalls are problematic for reasons we discuss below and adverted to earlier. See supra note 10. Of course, plaintiffs and their counsel must be sufficiently compensated to assure litigation of worthy punitive damages claims. Making punitive damages nondeductible would marginally reduce this compensation vis-à-vis a deductible regime. The question is whether such a reduction would cause plaintiffs and attorneys to forgo litigation of worthy claims.

[53] See generally sources cited supra note 10.

[54] Even if these scholars were not correct, the now-prevalent use of *Philip Morris* instructions, which require the jury to forbear from punishing the defendant in an amount of punitive damages that includes the harms to non-parties, may also reduce the larger concern regarding the prospect of unduly large windfalls to plaintiffs. See Philip Morris USA v. Williams, 549 U.S. 346, 353–55 (2007).

[55] Congressional legislative history suggests that this is Congress's view. H.R. Rep. No. 104-586, at 143 (1996) ("Punitive damages are intended to punish the wrongdoer and are not intended to compensate the claimant (e.g., for lost wages or pain and suffering). Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income.").

[56] In addition, as described above, if the jury fails to take into account tax deductibility in crafting punitive damages awards, it will result in disparate treatment of similarly situated defendants. See discussion supra Subsection I.B.1.

treatment right, punitive damages law in most states appears unconcerned with the size of the plaintiff's windfall.[57]

Thus, for example, a victim injured by a wealthy malicious tortfeasor will, all else being equal, receive a larger windfall than that received by a victim of a poor malicious tortfeasor. Yet this possibility has not prevented the fact of the tortfeasor's wealth from being introduced to the jury. Likewise, the prospect of augmented plaintiffs' windfalls should not prevent the fact of deductibility from being admitted into evidence so as to give the jury the requisite tools to impose a financial penalty on the defendant that it deems appropriate.[58]

4. Award Sizes

Defendants could also argue that punitive damages awards are larger than they normatively ought to be; therefore, the blunting effect achieved by tax blindness is beneficial. Fortunately for defendants, the Supreme Court over the last two decades has installed a series of constitutional checks on both the amount of punitive damages that can be awarded and the procedures through which those awards may be made.[59] This has been coupled with ag-

[57] Some states have experimented with or adopted split-recovery schemes, in part to address windfalls. See Sharkey, Punitive Damages, supra note 35, at 372–89.

[58] Awards of punitive damages, even when augmented, would still be subject to judicial review for compliance with constitutional legal norms.

[59] The Court's due process requirements in regards to punitive damages can be summed up in six rules. First, when courts review the constitutionality of punitive damages awards, the most important factor that they must consider is the degree of reprehensibility of the defendant's misconduct. See State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 419 (2003) (restating the rule that punitive damages will only be awarded where a defendant's conduct is so reprehensible that it justifies an award in addition to compensatory damages). The Court has further specified a number of factors that contribute to a determination of reprehensibility. See BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 575–77 (1996) (listing recidivism, vulnerability of victims, deceit, and violence as factors indicating a greater degree of reprehensibility). Second, reviewing courts must also consider whether "the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award" is constitutionally excessive. *State Farm*, 538 U.S. at 418. More controversially, in *State Farm*, the Court established a presumption that "in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process." Id. at 425. Third, reviewing courts should consider "the disparity between the punitive damages award and the 'civil penalties authorized or imposed in comparable cases.'" Id. at 428 (quoting *Gore*, 517 U.S. at 575). Fourth, reviewing courts, under the Supreme Court's new *Philip Morris* decision, must ensure that the

gressive efforts at the state level to achieve tort reform through the imposition of caps, multipliers, and other limits on the amount of punitive damages awarded.[60] These efforts might make blunting through tax blindness unnecessary. Furthermore, recent empirical evidence suggests that the current sizes of punitive damages awards predictably track the sizes of compensatory damages awards.[61] If true, this evidence arguably undermines the claims made by those who contend that punitive awards are systematically too high.

Nevertheless, even assuming *arguendo* that punitive damages awards are "too large," fixing this problem through tax blindness would not be the optimal approach. Under a rule of tax blindness, there would be no blunting effect whatsoever in cases where the plaintiff's claim did not arise out of the defendant's business. Because defendants in those cases do not get any deduction for payments of punitive damages, they would be required to bear the full cost of excessive awards. Furthermore, even in cases arising out of the defendant's business, the degree of blunting would be dependent on the defendant's marginal tax rate, with the greatest blunting occurring in cases where the defendant's marginal tax rate is highest. If punitive damages awards are systematically too high, then blunting should instead occur systematically and evenhandedly.

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jury does not impose on defendants an amount that includes the harms to non-parties to the litigation. See *Philip Morris*, 549 U.S. at 353. One might see this rule as related to the Court's stated interest in ensuring that states refrain from punishing defendants for conduct lawfully performed in other states. *State Farm*, 538 U.S. at 421. Fifth, judicial review of a jury's award of punitive damages must be available. See Honda Motor Co., Ltd. v. Oberg, 512 U.S. 415, 432 (1994) (holding that Oregon's denial of judicial review for punitive damages awards violated the Fourteenth Amendment's Due Process Clause). Finally, appellate review of punitive damages must apply a de novo standard of review of the jury's award, at least in a federal case. See Cooper Indus., Inc. v. Leatherman Tool Group, Inc., 532 U.S. 424, 435–36 (2001).

[60] See generally Rustad, supra note 2.

[61] See generally Theodore Eisenberg, Michael Heise, Nicole Waters, & Martin T. Wells, The Decision to Award Punitive Damages: An Empirical Study, 2 J. Legal Analysis (forthcoming 2010) (manuscript at 22–24, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1412864) (reporting findings that challenge the claim that punitive damages are unduly high or erratic); Sebok, supra note 10, at 962–89 (challenging the empirical and normative claims made by defendants and their supporters).

5. The Analogy to Insurance Evidence

Defendants might argue that, because evidence of insurance coverage is generally inadmissible, tax evidence should likewise be inadmissible.[62] Insurance evidence is somewhat analogous because insurance blindness, like tax blindness, could result in lower than intended penalties inflicted on punitive damages defendants.

As an initial matter, it should be noted that in some states insurance coverage for punitive damages has been determined to be contrary to public policy because of under-punishment concerns.[63] In those states, the analogy is not helpful to those advocating for maintaining tax blindness because insurance for punitive damages would never exist; as a result, jurors could never be insurance blind.

In states where insurance is available to cover punitive damages, it is not altogether clear that plaintiffs may not introduce evidence of such insurance in the punitive damages phase of the trial. Insurance coverage has generally been admissible to rebut the defendant's claim that it lacked the financial resources to pay a punitive damages award.[64] There appear to be no cases addressing the issue

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[62] Cf. supra note 24.

[63] See, e.g., N.W. Nat'l Casualty Co. v. McNulty, 307 F.2d 432, 440 (5th Cir. 1962) (finding that disallowing punitive damages coverage ensures that the wrongdoer suffers the intended sanction). For a useful overview of the punitive damages coverage issue, see Catherine M. Sharkey, Revisiting the Noninsurable Costs of Accidents, 64 Md. L. Rev. 409 (2005) [hereinafter Sharkey, Revisiting the Noninsurable Costs]. Courts that have allowed punitive damages insurance coverage have focused on the fact that, under the specific language in the insurance contract, insured parties would expect that punitive damages are covered and that a public policy prohibition would upset those expectations. See, e.g., Lazenby v. Universal Underwriters Ins. Co., 383 S.W. 2d 1, 5 (Tenn. 1964) (noting that "the average policy holder reading [the insurance policy's] language" would expect punitive damages coverage). Thus, courts allowing punitive damages coverage have determined that the contractual expectations of the insured trump the under-punishment concern. See Sharkey, Revisiting the Noninsurable Costs, supra, at 436 (describing how "courts have increasingly weighed the absence of any punitive damages exclusion as a strong factor in favor of concluding that punitive damages fall within the policy's coverage"). Accordingly, the availability of punitive damages insurance coverage in some states should not be viewed as an expression that those states are unconcerned about under-punishment.

[64] See, e.g., Schaefer v. Ready, 3 P.3d 56, 59 (Idaho Ct. App. 2000); Wilder v. Cody Country Chambers of Commerce, 933 P.2d 1098, 1108 (Wyo. 1997); Wheeler v. Murphy, 452 S.E. 2d 416, 426 (W.Va. 1994); see also Edward M. Swartz & Elly D. Swartz, 3 Handbook of Pers. Inj. Forms & Litig. Materials § 6:46.140 (2d ed. 2010) (providing

of whether insurance evidence may be admitted if it is not solicited in rebuttal to a lack of resources claim.

Assuming that a state allows punitive damages coverage and that evidence of such coverage is inadmissible, is there a good argument that jurors in that state should be tax aware even while they are insurance blind? We think there is, because insurance awareness would implicate significant collateral public policy issues that would not be affected by tax awareness. If punitive damages juries were insurance aware, juries might routinely add the insurance limits to their intended punishment amount. Thus, if the insurance policy's limit is $100,000 and the jury intends to inflict a $100,000 punishment on the defendant, an insurance-aware jury might award $200,000 because it knows that the first $100,000 will be covered by insurance. The effect is that the market for punitive damages would be distorted. This is because the defendant effectively pays exemplary damages twice: once ex ante in the form of the additional premiums for punitive damages coverage and then again ex post in the form of the increased jury award.[65] As a result, one might be concerned that on the one hand, if jurors were made insurance aware, the market for insurance for punitive damages would disappear in those states where courts have determined that

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an example of a motion in limine arguing that the plaintiff should be able to introduce punitive damages insurance coverage in the punitive damages phase of the trial).

[65] See Gerald Reading Powell & Cynthia A. Leiferman, Results Most Embarrassing: Discovery and Admissibility of Net Worth of the Defendant, 40 Baylor L. Rev. 527, 533–34 (1988) (noting that admitting insurance coverage for punitive damages would cause the defendant to "lose[] the benefit of its foresight in obtaining liability coverage, for the jury will discount the coverage before assessing punitive damages," and therefore concluding that "the defendant might benefit more without any liability coverage"). Alternatively, jurors might decide to award no punitive damages against a covered defendant, on the theory that the insurance company would bear the burden of the punitive damages award up to the policy limits. Cf. Fleegel v. Estate of Boyles, 61 P.3d 1267, 1272–73 (Ala. 2002) (noting that the *defendant* solicited punitive damages insurance evidence during the trial, after which the jury awarded zero punitive damages despite finding that the conduct warranted them). This effect would, like the augmentation effect described in the text, be problematic. It would change the amount of liability attributable to a tort depending on whether or not the defendant was insured. A self-insured defendant would pay the full punitive damages award, while an insurance company insuring the defendant would pay a discounted award. This would distort the punitive damages insurance market by creating an artificial incentive for defendants to acquire such insurance in lieu of self-insuring.

such insurance does not violate public policy.[66] On the other hand, there is no risk that tax awareness would have any similar perverse collateral consequences.[67]

6. If There is a Problem, Federal Tax Law Should Fix It

Defendants may argue that, because Congress could easily make punitive damages nondeductible, state courts should not take it upon themselves to solve the under-punishment problem. There are two significant problems with this argument. First, as we argue below in Part II, it is likely that the nondeductibility solution would, in practice, be far inferior to the tax-awareness approach in addressing under-punishment. Second, a variety of federalism and regulatory diversity concerns, also detailed in Part II, push strongly in favor of a state, rather than federal, solution to the under-punishment problem.

7. Summary

In sum, plaintiffs should be allowed to introduce evidence regarding tax deductibility of punitive damages awards. The ambiguity surrounding the issue appears to stem principally from the fact that plaintiffs' lawyers have not yet pressed the issue, despite the potentially large stakes involved and the good arguments in favor

[66] See Powell & Lieferman, supra note 65, at 533–34 (concluding that insurance awareness would make defendants who purchased punitive damages insurance coverage worse off than those who did not). If, however, the effect of introducing punitive damages insurance evidence is to lower punitive damages awards, the punitive damages insurance market would be distorted in the other direction as described in supra note 65.

[67] In addition to the perversity of this result (that is, the destruction of an insurance market that has been determined not to be contrary to public policy), it can be argued that punitive damages insurance is normatively desirable on a number of grounds, including mitigating the effects of false positive errors in adjudication. See Dan Markel, How Should Punitive Damages Work?, 157 U. Pa. L. Rev. 1383, 1393–98 (2009) (explaining why insurance for recklessness-based punitive damages should be allowed on retributivist grounds, and why insurance for punitive damages should be allowed when those damages are facilitating either optimal deterrence or victim vindication for dignity losses otherwise uncompensated by standard compensatory damages); see also David G. Owen, Products Liability Law § 18.5, at 1237 (2d ed. 2008) ("When the law is poorly defined and poorly administered . . . , the risk of undeserved punitive damage awards is substantial, making insurance contracts for such events more reasonable.").

of admissibility. While defendants can make some facially plausible arguments in opposition, upon closer inspection these arguments are not persuasive. We therefore believe that under current tort law in most states plaintiffs should be able to make jurors (or judges) aware of the tax consequences of payments of punitive damages.[68]

C. Constitutional Implications

The preceding analysis presents significant implications for the constitutional review of punitive damages. Consider the case of *State Farm v. Campbell*, where the Supreme Court set aside a jury's $145 million punitive damages award because the amount of the award violated the Due Process Clause of the Fourteenth Amendment.[69] In so doing, the Court announced that "few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."[70] Importantly, nothing in the opinion reveals that the Court (or any lower court) was aware of the fact that the defendant, a large insurance company, would have been able to deduct the punitive damages at issue. We have thus far argued that Campbell's lawyers should have enlightened the trial court as to the fact and effect of such a deduction, but this would have likely been fruitless in this particular case because the Court found even the non-grossed-up amount excessive.

Nevertheless, the *State Farm* case seems to leave open the question of whether, in assessing the constitutionality of punitive damages awards, courts should focus on the pre-tax amount of the award or its after-tax cost. For example, in applying the single-digit multiplier presumption,[71] should courts compare the compensatory damages to the nominal (pre-tax) amount of the award or to the

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[68] Of course, if punitive damages were made nondeductible, then *defendants* should be able to introduce this fact to the jury so the jury is not tempted to adjust upward on the basis of conjecture. Also, to the extent that profitability of an activity or a certain period is relevant to the determination of a punitive damages award, these facts should be expressed to the jury in after-tax terms. In short, we propose universal tax awareness in calculating punitive damages under current state tort law.

[69] State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 417–29 (2003).

[70] Id. at 425.

[71] See id.

actual (after-tax) cost of the award? Business defendants would clearly prefer to use the nominal amount of the award to keep the presumptive ceiling where it is. To accomplish this, defendants might point to the language of *State Farm*, which focuses on the nominal amount of the award.[72]

This argument, however, is not persuasive because the Court never addressed the defendant's tax consequences. Indeed, it likely never realized that the after-tax cost of the award might have differed substantially from the nominal award. Even if the Court were generally aware of the fact of deductibility, no evidence of the deduction's value to the defendant was presented during the course of litigation. Furthermore, because the majority in *State Farm* found its rejection of the 145:1 ratio of nominal punitive damages to compensatory damages "neither close nor difficult,"[73] even if the Court were inherently aware of tax consequences, a tax adjustment likely would have made no difference to the disposition of that particular case. Thus, any suggestion that *State Farm* itself addressed the constitutional tax-awareness issue places far too much weight on mere dicta.

The Court has interpreted the Due Process Clause to prohibit "grossly excessive" punitive damages awards,[74] and the application of the single-digit ratio presumption is intended to help courts assess when punitive damages awards become unconstitutionally arbitrary deprivations of property. Because the due process analysis focuses on the *amount* of property deprivation, courts should focus on the after-tax actual cost of the award because that is the amount that represents the real financial setback imposed upon the defendant. To focus on nominal or pre-tax amounts, which in some cases will equal or closely approximate after-tax costs and in other cases will not, would introduce unnecessary arbitrariness into the process. To more accurately assess the punitive force of damages on the defendant, courts applying the due process analysis should focus on the after-tax costs to the defendant in cases where the relevant tax evidence has been introduced.

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[72] Id. at 429.
[73] Id. at 418, 425–26.
[74] Id. at 416.

Needless to say, this reasoning provides another significant incentive for plaintiffs' lawyers to introduce tax evidence in punitive damages trials against business defendants. Not only will tax-aware juries, all else being equal, render higher punitive damage verdicts, but, in our view, tax-aware judges would raise the ceiling on constitutionally permissible awards.[75]

II. IMPROVING THE TAXATION OF PUNITIVE DAMAGES

In this Part, we consider the appropriate taxation of punitive damages, leaving current state tort law constant. The principal issue is whether business-related punitive damages should remain deductible. Over the years, a series of proposals have argued that these damages ought to be made nondeductible to prevent federal tax law from "undermin[ing]" the role of punitive damages in "discouraging and penalizing certain undesirable actions or activities."[76] The premise of the proposals is that, under current tax law, the after-tax cost of punitive damages awards is lower than that intended by juries. Such a premise assumes, however, that juries are and will continue to be tax blind. As we discussed in Part I above, the assumption that tax blindness will invariably persist is not warranted because the issue of tax blindness has not yet been addressed by state courts.

As we have already argued, the stated goal of President Obama's reform proposal—ensuring that the jury's intended punishment is imposed to buttress the state law goals of punitive damages law—could be achieved simply by making jurors tax aware. The question then becomes which of the two solutions to the under-punishment problem—either states making jurors tax aware or the federal government making punitive damages nondeductible—

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[75] *State Farm* also reiterates that reviewing courts should compare the amount of the punitive damages award to the amount of "civil penalties authorized or imposed in comparable cases." Id. at 428 (quoting BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 575 (1996)). In order to make an appropriate apples-to-apples comparison, courts should compare the after-tax costs of such penalties. As we discuss below, civil penalties are nondeductible, so these nominal amounts should be compared to the tax-adjusted amount of deductible punitive damages. See infra Section III.D (describing the tax treatment of civil fines and comparing such treatment to the taxation of punitive damages).

[76] See, e.g., General Explanations, supra note 5, at 95; see also supra notes 6–8 and accompanying text (quoting the Obama proposal).

is preferable. As we show below, the answer depends principally on the degree to which a rule of nondeductibility might be circumvented through settlements disguising punitive damages as compensatory damages, as the latter would remain deductible under either proposal.[77]

A. Assuming Perfect Enforcement

We will initially assume that the Internal Revenue Service ("IRS") would be able to perfectly enforce a rule of nondeductibility. This would mean that the IRS would readily be able to determine the value of the punitive damages portions of settlements. The IRS could then deny deductions for that portion of the defendant's settlement payments. As we explain below, we believe that in fact it would be exceedingly difficult for the IRS to determine the punitive damages portions of settlements, and accordingly, that a rule of nondeductibility would be practically unenforceable. Nevertheless, to illustrate the stakes involved, we begin our analysis by assuming that the IRS would be able to perfectly enforce a rule of nondeductibility.

Under this perfect-enforcement assumption, the defendant would be indifferent regarding the choice between the two approaches—making jurors tax aware or making punitive damages nondeductible—to the under-punishment problem. The after-tax cost to the defendant would be the same in each case because a tax-aware jury would adjust a deductible award to inflict the desired after-tax penalty. Thus, if the jury intended an after-tax penalty of $100,000, it would render a $167,000 award if the award were deductible and a $100,000 award if it were not. Under either approach, the defendant's after-tax cost would be $100,000. The

[77] We do not believe that Congress would seriously entertain a rule of nondeductibility for compensatory damages. Such a rule would result in significant over-deterrence because ex ante precautionary measures would be deductible while compensatory damages would not. While current punitive damages law is not concerned with the risk of over-deterrence, non-punitive damages tort law is concerned with this risk. In any event, none of the prior proposals for nondeductibility have proposed making compensatory damages nondeductible. Accordingly, we assume throughout that the taxation of compensatory damages would remain unchanged. But cf. Alfred F. Conard, Who Pays in the End for Injury Compensation? Reflections on Wealth Transfers from the Innocent, 30 San Diego L. Rev. 283, 292, 299–300 (1993) (exploring the argument that even compensatory damages should be nondeductible).

defendant therefore would be indifferent as to which of the two solutions is chosen.

But the choice of solutions would, under a perfect enforcement assumption, have an impact on the plaintiff and the federal government. This can be inferred from the fact that both solutions to the under-punishment problem increase the defendant's after-tax cost by $40,000, from $60,000 to $100,000. This $40,000 must go to some party and the only other actors at the scene are the plaintiff and the government.

To show that only the plaintiff and the government care about the issue if enforcement were perfect, consider again an example where a tax-aware jury would award $167,000 under a deductible regime and $100,000 under a nondeductible regime. Assume also that (i) the defendant earns $167,000 of gross income before taking into account any deduction that it might receive for paying punitive damages, (ii) the defendant has no deductions other than any deduction that it might receive from paying punitive damages, and (iii) the plaintiff, like the defendant, is subject to a 40% marginal tax rate. The net after-tax consequences to the plaintiff, the defendant, and the government under these facts are shown in the following chart.

	Plaintiff's After-Tax Result from Punitive Damage Award	**Defendant's After-Tax Result from Earning 167K Gross Income and Paying Punitive Damages Award**	**Tax Due from Plaintiff**	**Tax Due from Defendant**	**Total Tax Collected by Gov't**
Tax Awareness Solution: 167K deductible award	167K PD award – 67K taxes (i.e., 167K * 40%) = **100K**	167K – 167K PD award – 0 taxes = **0**[78]	167K * 40% = **67K**	0 income (167K gross income – 167K PD award deduction) * 40% = **0**	67K from plaintiff + 0 from defendant = **67K**
Nondeductibility Solution: 100K nondeductible award	100K PD award – 40K taxes (i.e., 100K * 40%) = **60K**	167K – 67K taxes (i.e., 40% * 167K) – 100K PD award = **0**	100K * 40% = **40K**	167K income (167K gross income – 0 deductions) * 40% = **67K**	40K from plaintiff + 67K from defendant = **107K**
Difference Between the Two Solutions	**-40K**	**No change**	**-27K**	**+67K**	**+40K**

[78] As noted earlier, amounts have been rounded. The defendant's taxable income is $0 because the $167,000 deduction for the punitive damages award shelters all $167,000 of her gross income.

There are several significant conclusions to draw from this chart. First, the defendant's after-tax financial status is unaffected by the choice of solutions; this is expected as it is the explicit purpose of gross ups. If jurors were made tax aware, the jury's award would be $167,000. There would be no tax liability for the defendant because the deduction for paying the award would shelter all of the defendant's gross income. Nevertheless, the defendant ends up with $0 because all of the defendant's gross income goes towards paying the punitive damages award. If, however, punitive damages were made nondeductible, the jury's award would be $100,000. In that case, the defendant would have $167,000 of taxable income ($167,000 of gross income less zero deductions[79]), resulting in $67,000 of taxes due.[80] The $67,000 of taxes due and the $100,000 nondeductible jury award would consume all $167,000 of the defendant's gross income. Again, the defendant is left with $0.

But the plaintiff *is* affected by the choice of solutions. If tax awareness is chosen, the plaintiff's after-tax result is $40,000 *higher* than if nondeductibility were chosen. This is because a tax-aware jury would gross up the plaintiff's award by $67,000 before tax to offset the defendant's economic benefit of its deduction for paying punitive damages. After the plaintiff pays 40% tax on the $67,000 augmentation, the plaintiff is left with an extra $40,000.

Meanwhile, if the nondeductibility solution is chosen, then the government's tax revenues increase by this $40,000 amount (going from $67,000 to $107,000). With tax awareness, the entire $167,000 award is taxed only once—to the plaintiff. With nondeductibility, the $100,000 award is taxed twice—as part of the defendant's income and then again when awarded to the plaintiff; the remaining $67,000 of the defendant's gross income is taxed only once—to the defendant.

Thus, under conditions of perfect enforcement, the choice of solutions affects only the plaintiff and the government—either the plaintiff ends up with the extra $40,000 (applying a rule of tax awareness) or the government does (using a nondeductibility

[79] The defendant has no deductions because the assumed facts indicate that it will have no deductible expenses other than any deduction that is available for paying the punitive damages award.

[80] The tax on $167,000 of taxable income is 40% of $167,000 or $67,000.

rule)—but not the defendant. Accordingly, the important normative question in deciding between the solutions to under-punishment would be whether the plaintiff or the government should end up with this extra $40,000.

Who should get this gain? Under current punitive damages law in most states, and as Congress seemingly understands these damages, the plaintiff's recovery of such awards is generally viewed as a windfall.[81] If true, there is no compelling reason to enlarge the windfall by choosing the tax-awareness solution.[82] As long as sufficient incentives exist under the current tax-blindness rule for plaintiffs to pursue worthy punitive damages cases, the federal government could, by making punitive damages nondeductible, simultaneously correct under-punishment while also generating additional tax revenues without any resulting deadweight loss to society.[83] Furthermore, windfalls are undesirable because people are risk-averse; as a result, they prefer guaranteed lower taxes or greater services as opposed to the unlikely prospect of a large windfall, even where these two options have the same risk-adjusted value.[84]

To be sure, others argue that compensatory damages are insufficient to compensate the plaintiff fully for her injuries,[85] especially after litigation costs are considered.[86] Accordingly, awards of punitive damages may not be properly characterized as complete windfalls under those arguments. Under the nondeductibility solution, plaintiffs would receive the same amount of after-tax punitive damages as they do under the current situation of tax blindness combined with deductibility. Unless one believes that plaintiffs are

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[81] See Kades, supra note 10, at 1562–64 (summarizing views of punitive damages as windfalls); Note, An Economic Analysis, supra note 3, at 1903; see also H.R. Rep. No. 104-586, at 143 (1996) (revealing Congresspersons' views that punitive damages are windfalls to taxpayers).

[82] See generally Note, An Economic Analysis, supra note 3, at 1917.

[83] Kades, supra note 10, at 1564.

[84] See id.

[85] See Sebok, supra note 10, at 1007 and other sources cited supra note 10. The point here is that the victim vindication theorists believe that there exists a private wrong requiring redress for an insult to dignity that was not otherwise addressed in the non-economic damages associated with the plaintiff's receipt of compensatory damages.

[86] See, e.g., Dodge, Taxes and Torts, supra note 36, at 167 (arguing that legal fees impose significant and unaccounted-for costs to litigants and proposing possible solutions).

currently under-compensated even where they win an award of punitive damages, our proposal of gross ups from tax awareness would constitute increased windfalls.

Even if one believes that plaintiffs are systematically under-compensated under current tort law, this problem is best resolved directly and comprehensively, not through punitive damages gross ups. First, punitive damages are relatively uncommon and therefore the increased awards would apply only to a small number of cases.[87] Second, gross ups would only mitigate the under-compensation problem in punitive damages cases arising out of the defendant's business; in all other punitive damages cases, the plaintiff's recovery would be unaffected. Third, since the amount of gross ups depends on the defendant's marginal tax rate, the amount of under-compensation relief would vary from plaintiff to plaintiff even in cases arising out of the defendant's business.

In any event, it is not necessary for policymakers to decide who should get the gains created by solving the under-punishment problem. Once we relax the perfect enforcement assumption, it becomes clear that a rule of nondeductibility would be quite easy for litigants to circumvent in the vast majority of punitive damages cases. As we explain below, the likely result is that the government would be unable to capture any significant part of the gains created by under-punishment correction.

B. Relaxing the Assumption of Perfect Enforcement

1. Circumventing the Nondeductibility Rule

In practice, it will be quite difficult for the IRS to enforce a rule of nondeductibility in cases that settle before a jury verdict is reached. Settlements usually resolve all of the plaintiff's claims, whether compensatory or punitive, at once. To enforce effectively a rule of nondeductibility for punitive damages, the amount paid by a defendant to settle a case must be allocated between the compensatory portion, which would be deductible, and the punitive portion, which would not be. Such allocations will be difficult for the IRS to make for a variety of reasons.

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[87] See generally Eisenberg, supra note 61 (collecting and summarizing data showing punitive damages are uncommon).

First, there appears to be no intrinsically correct way to make these allocations. To illustrate this problem, assume that a personal injury plaintiff suffers a $1,000,000 injury and that the plaintiff has a 50% chance of proving that the defendant is liable for the injury. Assume further that, if the defendant is liable, there is a 50% chance that the defendant will be required to pay $1,000,000 in punitives and a 50% chance that the defendant will not be required to pay any punitives.[88] Under these facts, risk-neutral parties would value the claim at $750,000.[89] If the case settles for that amount, how much of the $750,000 should be allocated to the plaintiff's punitive claim?

On the one hand, the plaintiff has received less than the amount of the harm ($1,000,000) that she has incurred. This is because the value of the plaintiff's claims is discounted to reflect the chance of a defense verdict. Because the plaintiff is not "made whole," it might appear that the entire $750,000 should be allocated to compensatory damages.[90] In addition, the plaintiff had only a one-in-four chance of receiving a punitive damages award;[91] this low probability could also be viewed as supporting the view that the entire settlement amount ought to be allocated to the compensatory claim.

On the other hand, if the plaintiff's punitive claim did not exist, the value of her cause of action would be only $500,000 (instead of

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[88] In other words, there is only a 50% chance that the jury will find the defendant's conduct sufficiently malicious to justify a punitive damages award.

[89] There is a 50% chance that the plaintiff will recover nothing because that is the chance of a defense verdict on the underlying claim. There is a 25% chance that the plaintiff will recover $1,000,000 because that is the chance that the plaintiff will win the compensatory claim but lose the punitive damages claim; this chance has a value of $250,000. There is a 25% chance that the plaintiff will recover $2,000,000 because that is the chance that the plaintiff will win both the compensatory and punitive claims; this chance has a value of $500,000. The combined value of these chances is $750,000.

[90] Cf. Rev. Rul. 75-230, 1975-1 C.B. 93 (ruling that settlement proceeds will first be allocated to previously deducted medical expenses because they represent a sum certain, while amounts paid for pain and suffering are speculative).

[91] The plaintiff's chance of receiving a punitive damages award is only 25% because (i) the plaintiff's chance of a compensatory award was 50% and a compensatory award is a condition to receiving a punitive damages award, and (ii) even after the plaintiff wins the compensatory award, there is a 50% chance that the jury would choose not to award punitive damages.

$750,000).[92] This is because the punitive damages claim had an expected value of $250,000 (or a one-in-four chance at $1,000,000).[93] This suggests that $250,000 of the settlement amount ought to be allocated to punitive damages.[94]

The hypothetical above was highly stylized and unrealistically simple. The specific amounts of the different types of damages, as well as the specific probabilities of the plaintiff's success, were known precisely by both parties. Plaintiffs will generally be more risk-averse in pursuing such litigation than defendants or their insurance companies, in part because only the latter typically have a diversified "portfolio" of litigation; this factor would affect and likely reduce settlement values. But, a defendant might also be risk-averse because of the potential for significant adverse collateral effects of a punitive damages judgment (publicity, insurance coverage problems, etc.); this factor would likely increase settlement values. Introduction of these real-world complexities makes allocations incredibly difficult, even as a theoretical matter.

In addition to these conceptual difficulties, there would be significant practical obstacles to making settlement allocations. Allocations depend on the relative values of the plaintiff's compensatory and punitive claims. Several factors make this valuation exercise onerous. First, there is currently no market for selling or

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[92] Absent the punitive claim, the plaintiff would have a 50% chance of winning $1,000,000; the value of that chance is $500,000.

[93] That is, there exists a 25% chance of a $1,000,000 punitive award. The plaintiff's chances of receiving the punitive damages award was only 25% because (i) the plaintiff's chance of a compensatory award was 50% and a compensatory award is a condition to receiving a punitive damages award, and (ii) even after the plaintiff wins the compensatory award, there is a 50% chance that the jury would choose not to award punitive damages.

[94] The Eighth Circuit used this sort of reasoning to uphold an allocation of $500,000 to punitive damages in a case where the settlement amount equaled the amount of compensatory damages awarded by the jury. Bagley v. Comm'r of Internal Revenue, 121 F.3d 393, 393–94, 397 (8th Cir. 1997). In that case, the jury awarded $1,500,000 of compensatory damages and $7,250,000 of punitive damages. Id. at 394. While an appeal was pending the case was settled for $1,500,000. Id. The settlement agreement allocated none of the amount to punitive damages, and the taxpayer's tax return reflected that position. Id. The court concluded otherwise, noting that the taxpayer's "argument that none of the settlement is taxable requires us to believe that this potential liability did not affect the size of the settlement at all, and thus, that [the defendant] paid nothing to [the taxpayer] to secure a release from this sizable exposure." Id. at 395.

buying pre-trial tort claims, and the vast majority of claims settle quietly. Second, the value of the plaintiff's claims usually depends on the individual attributes of the plaintiff and the defendant, and on the specific acts that form the basis of the lawsuit.[95] For these reasons, it would often be very difficult to find any "comparable sales" that are useful in valuing the plaintiff's respective claims.

As a result, the valuation exercise will typically require speculation as to what a jury would have awarded had the case gone to trial. This usually would allow defendants to make a plausible contention that none of the settlement payment should properly be allocated to punitive damages. Punitive damages require a specific jury finding that the defendant acted in a morally reprehensible manner, a fact that is inevitably hotly disputed by the litigants. Furthermore, compensatory damage components such as pain and suffering damages, lost future wages, and future medical expenses are often subject to an extremely wide valuation range, thus making it easy for defendants to attempt to allocate large amounts of a settlement to these components of compensatory damages. Accordingly, defendants would be able to take extremely aggressive positions on allocations without much risk of penalties if these allocations were successfully contested by the IRS.

As a result of this low risk of penalties, a nondeductibility rule would rarely be self-enforcing. Instead, the IRS would have to find good settlements to challenge. While jury verdicts involving punitive damages may be reported in newspapers or legal periodicals, pre-trial settlements rarely are. The IRS would, as a result, be required to review court pleadings and other public documents to try to uncover, out of the entire universe of pre-trial settlements, those settlements that involve the compromise of viable punitive damages claims. Because (as we discuss below) both litigants would be able to participate in the benefits of circumventing a rule of nondeductibility, litigants would have strong incentives to minimize the

[95] But see Nora Freeman Engstrom, Run of the Mill Justice, 22 Geo. J. Legal Ethics 1485, 1490 (2009) (discussing certain litigation contexts where tort valuations occur in a relatively predictable manner); Alexandra D. Lahav, Rough Justice and the Problem of Value in Tort Law (Working Paper, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1562677 (same).

apparent value of the plaintiff's punitive damages claim in the public record.[96]

Making matters even worse, courts tend to put an undue amount of weight on self-serving allocations made by litigants in written settlement agreements.[97] There is no benefit (tax or otherwise) to be gained by either party in making explicit allocations to punitive damages; however, there are often tax, insurance, or public relations benefits to be gained by avoiding explicit allocations to punitive damages.[98] As a result, settlement agreements routinely and expressly allocate the entire amount to compensatory damages.[99] Given the mutually self-serving nature of these allocations, they should not be assumed to reflect the true nature of the plaintiff's claims. But courts have given these self-serving, agreed-upon allocations some degree of weight.[100] These courts seem not to consider

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[96] Cf. Kevin A. Palmer, Recent Developments in the Taxation of Punitive Damage Awards, 73 Taxes 596, 600 (1995) (arguing that, because punitive damages in personal physical injury cases are taxable while the related compensatory damages are not, plaintiffs should avoid making punitive damages claims in their initial complaint to strengthen the evidence in support of the plaintiff's later tax claim that the entire settlement should be allocated to compensatory damages).

[97] See, e.g., McKay v. Comm'r, 102 T.C. 465, 482 (1994), vacated on other grounds, No. 94-41189, 1996 WL 248936, at *1 (5th Cir. Apr. 10, 1996) (noting that an express allocation in a settlement agreement is "the most important factor" in allocating pretrial settlements); Byrne v. Comm'r, 90 T.C. 1000, 1007 (1988) (same).

[98] See Robert W. Wood, 522-3d Tax Mgmt. (BNA), Tax Aspects of Settlements and Judgments, at A-33 (2006) (noting that, even leaving aside tax considerations, "it would be highly atypical for a settlement agreement to acknowledge that any portion of the settlement was being paid on account of punitive damages" and that "[v]irtually no defendant would agree to such a characterization"); Bagley v. Comm'r, 121 F.3d 393, 396 (8th Cir. 1997) ("It will almost never be to a defendant's advantage to allocate part of a lump-sum settlement to punitive damages, and it will often be disadvantageous. Often, insurance policies will not cover such awards, and punitive-damage awards result in worse publicity than compensatory awards. Most plaintiffs will not want specific allocations to punitive damages in their settlement agreements, because punitive damages are taxable.").

[99] See Tom Baker, Transforming Punishment into Compensation: In the Shadow of Punitive Damages, 1998 Wis. L. Rev. 211, 218 (1998) (noting that not one of thirty prominent personal injury lawyers interviewed "reported ever settling a case for an amount that included a portion identified as 'punitive damages'"); Wood, supra note 98, at A-33 (stating that an allocation to punitive damages would be "highly atypical"); see also *Bagley*, 121 F.3d at 396 n.7 (noting that the defendant's attorney, "an experienced Iowa litigator, told the Tax Court that he could recall no settlement with which he had been involved that specifically allocated a certain amount to punitive damages in the settlement agreement").

[100] See sources cited supra note 97.

the fact that, no matter how adversarial the parties are throughout most of the litigation, at the point of settlement the parties' interests in reducing the tax burdens of the settlement are perfectly aligned.[101] Nevertheless, in light of the respect that many courts give to these self-serving allocations, the burden of proof effectively shifts from the taxpayer (on whom this burden is nominally placed) to the IRS to show why a reallocation is appropriate.[102] As a result, to challenge a defendant's self-serving allocation, the IRS would be forced to relitigate the plaintiff's underlying claims long after the case was settled and without the benefit of a financially interested plaintiff. Accordingly, even if the IRS were somehow able to find good settlements to challenge, these proof problems would make it very difficult for the IRS to be successful in winning these challenges.

For these reasons, we expect that a rule of nondeductibility would be readily circumvented in cases that settle prior to a jury verdict. An extremely large percentage of tort cases already settle under current law,[103] and as we explain below, a rule of nondeductibility should serve only to increase the settlement rate.[104] Accordingly, we expect that, under a rule of nondeductibility, circumvention through disguised settlements would be the norm, not the exception.[105]

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[101] Not all courts fall victim to this problem. See, e.g., *Bagley*, 121 F.3d at 396 (noting that "when the time comes to settle a case, no matter how adversarial the proceedings have been to that point, the parties will almost always be in agreement that no part of a settlement agreement should be explicitly allocated to punitive damages").

[102] See Brent B. Nicholson & Douglas K. Chapman, Enforceability of Settlement Agreement Allocations Under Section 104(a)(2) of the Internal Revenue Code, 47 Baylor L. Rev. 97, 113 (1995) (arguing that making express allocations in settlement agreements "shift[s] the debate to the issue of enforceability, which . . . [should be] an easier argument [for the taxpayer] to win").

[103] See John C.P. Goldberg et al., Tort Law: Responsibilities and Redress 40 (2d ed. 2008) (observing that only 3% of all torts suits reach a jury verdict and that settlements or dismissal resolves the rest of claims).

[104] See infra Subsection II.C.2.

[105] That said, in some cases, circumvention of the nondeductibility rule might not be possible. For example, if the "settlement gap" (that is, the gap between what the plaintiff thinks the case is worth and what the defendant thinks the case is worth) is large enough, the gains from circumvention would not be large enough to induce litigants to settle. Likewise, if the plaintiff has a strong enough desire to "have her day in court," the gains from circumvention might not be large enough to sway the plaintiff. In addition, if the maximum amount of compensatory damages can be easily ascertained, putting at least a minimum value on the punitive damages portion of a settle-

The alternative solution to the under-punishment problem—making jurors tax aware—is not easily circumvented through settlement. Gross ups, in addition to increasing jury verdicts, would increase settlement values because litigants determine these values in the shadow of what a jury would be expected to award. Thus, defendants could not avoid any part of the under-punishment correction resulting from gross ups simply by settling before trial.

2. Effect of Easy Circumvention

If we are correct that a rule of nondeductibility would typically be circumvented, what would be the effect of such a rule? First, the defendant's after-tax cost of settlement would be lower than the penalty that a jury would intend to impose, though it would be higher than the after-tax cost borne by the defendant under current law. Thus, in terms of correcting under-punishment, a rule of nondeductibility would be better than current law but not as good as the alternative option of making jurors tax aware. Second, the plaintiff's windfall would be higher than it is under current law, but lower than it would be under the alternative solution of making jurors tax aware.

To illustrate these effects, consider again the case where a jury would, if the case went to trial, render a punitive damages award with an after-tax cost of $100,000. Assume that if the case were settled before a jury verdict, the defendant would be able to deduct the entire settlement amount because the punitive damages could be disguised as additional compensatory damages. But if the case

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ment would be easy. Thus, for example, if a plaintiff is defrauded out of $10,000, and the case settles for $100,000, it would be easy for the IRS to assert that at least $90,000 of the settlement is attributable to punitive damages (assuming that there is no possibility that the plaintiff would have recovered attorney's fees and ignoring the possibility of prejudgment interest). In personal injury cases, however, the amount of compensatory damages is usually not easy to ascertain, primarily because pain and suffering awards are very difficult to predict but also because the amounts of lost wages and future medical costs are often the subject of much dispute. In addition, conflicts of interest could impede mutually beneficial settlements in certain cases. Cf. Elizabeth Chamblee Burch, Litigating Groups, 61 Ala. L. Rev. 1, 13–14 (2009) (explaining that conflicts of interest between attorney and client and among multiple clients can affect settlement decisions in the nonclass aggregation context). One source of potential conflicts relates to tax: contingent fee arrangements are typically based on the *pre-tax* amount of the plaintiff's recovery; however, the plaintiff is interested in maximizing the *after-tax* recovery.

proceeds to a jury verdict, none of the award would be deductible because at that point it would be clear that the $100,000 payment by the defendant constitutes a payment of punitive damages.

Under these facts, the defendant would prefer settling for any amount up to $166,667 to paying a jury verdict of $100,000 because the after-tax cost of the former would be less than the after-tax cost of the latter. Meanwhile the plaintiff would prefer settling for any amount over $100,000 to receiving a jury verdict of $100,000. Thus, there is a settlement "sweet spot" between $100,001 and $166,666 where both parties would be better off by settling than going to trial. The only question is how the settlement surplus is distributed. A settlement of $100,001 would distribute the surplus almost entirely to the defendant, while a settlement of $166,666 would distribute it almost entirely to the plaintiff.

Both parties must agree to settle to obtain the surplus. If either party holds out, the case will proceed to trial, the jury will award a $100,000 nondeductible award, and the surplus will be lost. Because obtaining the surplus requires mutual cooperation, the distribution outcome will be a function of the parties' bargaining. Assume for now that, as a result of this bargaining, the surplus is divided equally.[106] A settlement of $133,333 would accomplish this, as shown below:

[106] For nearly 30 years, scholars in experimental economics have deployed variations on the "Ultimatum Game" to understand the reasons and extent to which people cooperate when there are gains to divide and opportunities to punish those who do not play "fairly." For a description of the Ultimatum Game, see Manuel A. Ustet, Reciprocal Fairness, Strategic Behavior, and Venture Survival: A Theory of Venture Capital-Financed Firms, 2002 Wis. L. Rev. 45, 124–27 (2002); see also Hessel Oosterbeek et al., Cultural Differences in Ultimatum Game Experiments: Evidence from a Meta-Analysis, 7 Experimental Econ. 171 (2004) (providing a meta-analysis of studies involving the Ultimatum Game).

	Plaintiff After-tax Benefit	**Defendant After-tax Cost**
Go to trial; $100,000 (nondeductible by Defendant) jury award	$100,000 – (40% of $100,000) = **$60,000**	$100,000 – 0 = **$100,000**
Settle for $133,333 (deductible by Defendant)	$133,333 – (40% of $133,333) = **$80,000**	$133,333 – (40% of $133,333) = **$80,000**
Intended after-tax penalty	N/A	**$100,000**

By settling, the plaintiff and the defendant are each $20,000 richer than they would be had they gone to trial. This means that (i) the defendant's after-tax cost is $20,000 less than the correct penalty—the one that a jury would have imposed had the case proceeded to trial, and (ii) the plaintiff's windfall is $20,000 greater than if the case had proceeded to trial.

Nevertheless, relative to current law, this brings the punishment closer to that which the jury would have intended. Under current law, the defendant would always pay $100,000 regardless of whether a settlement was reached or the case went to trial, because there would be no tax benefit to be gained by settling. The chart below compares that result with the $133,333 settlement reached under a nondeductible regime:

	Plaintiff After-tax Benefit	**Defendant After-tax Cost**
Scenario #1 Current law: $100,000 settlement/verdict (deductible by Defendant)	$100,000 – (40% of $100,000) = **$60,000**	$100,000 – (40% of $100,000)= **$60,000**
Scenario #2 Nondeductibility rule: $133,333 settlement (deductible by Defendant)	$133,333 – (40% of $133,333) = **$80,000**	$133,333 – (40% of $133,333) = **$80,000**
Intended after-tax penalty	N/A	**$100,000**

Thus, a rule of nondeductibility is better than current law in terms of reducing under-punishment, though it is not perfect in this regard. The after-tax cost to the defendant under a nondeductibility rule falls $20,000 short of the intended punishment of $100,000, and the after-tax cost would fall $40,000 short under current law. In addition, a rule of nondeductibility comes at the cost of increasing the plaintiff's windfall by $20,000 relative to current law.

Consider now the results under the alternative solution of making jurors tax aware. Under this scenario, the jury would award $166,667 if the case went to trial; this would impose the intended after-tax punishment of $100,000. Because compensatory damages and punitive damages are taxed the same (that is, they are both deductible by the defendant), there is no tax surplus to be gained by settling. The defendant would therefore pay $166,667 regardless of whether the case settled or went to trial. The after-tax consequences of this result are shown in the chart below under scenario #3:

	Plaintiff After-tax Benefit	**Defendant After-tax Cost**
Scenario #1 Current law: $100,000 settlement /verdict (deductible by Defendant)	$100,000 – (40% of $100,000) = **$60,000**	$100,000 – (40% of $100,00) = **$60,000**
Scenario #2 Nondeductibility rule: $133,333 settlement (deductible by Defendant)	$133,333 – (40% of $133,333) = **$80,000**	$133,333 – (40% of $133,333)= **$80,000**
Scenario #3 Tax awareness plus current tax rule: $166,667 settlement /verdict (deductible by Defendant)	$166,667 – (40% of $166,667) = **$100,000**	$166,667 – (40% of $166,667) = **$100,000**
Intended after-tax penalty	N/A	**$100,000**

In scenario #3, the intended after-tax cost of $100,000 is borne by the defendant. In terms of correcting under-punishment, therefore, this scenario is the best. This is because settlements are generally reached in the shadow of the anticipated jury award.[107] Thus, while a nondeductibility rule is largely avoidable through settlement, the effect of tax awareness is not.

Nevertheless, while tax awareness best solves the under-punishment problem, it does come at the cost of enlarging the plaintiff's windfall. Unfortunately, to the extent that a rule of non-deductibility is circumvented, there is simply no way to correct under-punishment without at the same time augmenting the plaintiff's windfall.

[107] See Marc Galanter, The Civil Jury as Regulator of the Litigation Process, 1990 U. Chi. Legal F. 201, 241 (1990); Robert H. Mnookin & Lewis Kornhauser, Bargaining in the Shadow of the Law, 88 Yale L.J. 950, 968 (1979).

Assuming circumvention is relatively easy (as we have argued), the critical issue is whether reducing a given dollar amount of under-punishment is worth giving the same dollar amount of added windfall. If so, we conclude that (i) a rule of nondeductibility is an improvement over current law, but (ii) a rule of tax awareness with gross ups is even better. If not, we conclude that current law should be left unchanged because the costs of either solution to the under-punishment problem (augmented plaintiff windfalls) would exceed the benefits (reduced under-punishments). Accordingly, a rule of nondeductibility, such as that proposed by President Obama and various legal scholars, is never the optimal rule.

3. The Effect of Unequal Surplus Sharing

As mentioned above, where a rule of nondeductibility is circumvented through settlement, a tax surplus is created for the litigants to share. The litigants must cooperate to obtain the surplus because if either party holds out and forces the case to go to the jury, the surplus will be lost. Thus far, we have assumed that, as a result of negotiation, the surplus is shared equally. However, it would be impossible to predict in any particular case how the surplus would be shared.[108] Moreover, it is difficult to make generalizations about whether plaintiffs or defendants would tend to capture disproportionate shares of the surplus. Ultimately, though, it is not important to predict how the surplus would be shared. This is because, regardless of whether the plaintiff or the defendant captures the surplus, our conclusions above are unaffected.

Consider the effects, for example, if the settlement surplus in a case were captured disproportionately by a defendant. Thus, in our hypothetical, the parties might settle for $101,000. This would make both parties better off, compared to a jury verdict of

[108] In fact, it is possible that a bargaining breakdown would prevent the parties from obtaining the surplus. For example, a failure to agree on how the surplus would be divided could cause the parties to go to trial, at which point the surplus would be lost because the IRS would be able to make allocations to punitive damages. This would be relatively rare because of the fact that almost all litigation currently settles before trial; thus, we can infer that there are strong, non-surplus-related factors pushing in favor of settlement. A bargaining breakdown over a surplus would have to trump the factors that preexist the surplus opportunity.

$100,000, with the defendant much better off than the plaintiff.[109] Notice that this result is nearly identical to that obtained under the current situation (of deductibility combined with tax blindness), where the defendant would pay $100,000, whether by settlement or pursuant to a judgment. The only difference is that, under the rule of nondeductibility, where the surplus is captured mostly by the defendant, a small portion of the defendant's $40,000 underpunishment is shared with the plaintiff in order to induce the plaintiff to cooperate in circumventing the rule. Thus, *to the extent that the tax surplus from circumvention is captured mostly by a defendant, a rule of nondeductibility will have nearly the same impact on the litigants as current law.*

Now assume instead that a plaintiff captures most of the surplus from a settlement that circumvents a rule of nondeductibility. Thus, the parties might settle for $165,667. Again, both parties are better off, but the plaintiff this time is much better off than the defendant.[110] This result is nearly the same as that obtained from the alternative solution of making juries tax aware, where the defendant would pay $166,667 regardless of whether the case settled or proceeded to trial. The only difference is that, under a rule of nondeductibility, where the surplus is captured mostly by the plaintiff, a small portion of the surplus created by circumvention is shared by the plaintiff with the defendant to induce the defendant to cooperate. With tax awareness, however, the full benefit of the gross up inures to the plaintiff. Thus, *to the extent that the tax surplus from circumvention is captured mostly by a plaintiff, a rule of non-*

[109] The defendant is better off because his after-tax cost is reduced from $100,000 (in the case of a nondeductible jury verdict of $100,000) to $60,600 (in the case of a deductible settlement of $101,000). The plaintiff is better off because her after-tax recovery increases from $60,000 (in the case of a $100,000 jury verdict) to $60,600 (in the case of a $101,000 settlement). Thus, of the $40,000 tax surplus gained from circumvention, the defendant has captured $39,400 ($100,000 – $60,600), and the plaintiff has captured $600 ($60,600 – $60,000).

[110] The defendant is better off because his after-tax cost is reduced from $100,000 (in the case of a nondeductible jury verdict of $100,000) to $99,400 (in the case of a deductible settlement of $165,667). The plaintiff is better because her after-tax recovery increases from $60,000 (in the case of a $100,000 jury verdict) to $99,400 (in the case of a $165,667 settlement). Thus, of the $40,000 tax surplus gained from circumvention, the defendant has captured $600 ($100,000 – $99,400), and the plaintiff has captured $36,400 ($99,400 – $60,000).

deductibility will have nearly the same effect on the litigants as the alternative solution of making jurors tax aware.

Accordingly, under the best case scenario of surplus sharing, where the surplus is captured mostly by plaintiffs, nondeductibility is no better than tax awareness in correcting under-punishment. In all other cases, tax awareness is better than nondeductibility. And, under the worst case scenario of surplus sharing, nondeductibility is no better than current law.

C. Collateral Issues

We have thus far argued that tax awareness appears to be the best solution to the under-punishment problem based on practical considerations of litigation dynamics and imperfect enforcement. Below we discuss a number of collateral issues that might also bear on the issue. Ultimately, they do not affect our conclusion that tax awareness is preferable to nondeductibility.

1. Administrative Complexity

a. Complications Associated with a Rule of Nondeductibility

While a rule of nondeductibility would, as we explained, be quite difficult to enforce when cases are settled before trial, the IRS would presumably try to do so in some cases.[111] The IRS would do this by attempting to allocate portions of pretrial settlements to punitive damages where the facts suggest that a jury would have awarded substantial punitive damages had the case gone to trial. Given the speculation involved in predicting what a jury would have done and the potentially large stakes involved, disputes between the IRS and defendants would inevitably arise, resulting in added costs for taxpayers and the IRS, in addition to an increased burden on courts.

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[111] Cf. Rev. Rul. 85-98, 1985-2 C.B. 51, 52 (making an allocation of a settlement in the personal injury context to determine which portion of the settlement is attributable to the excludible compensatory portion and which portion is attributable to the taxable punitive portion for the purpose of determining the plaintiff's tax consequences); see Robert W. Wood, Proposed Nondeductibility for Punitive Damages: Will It Work?, 100 Tax Notes 99, 103 (2003) (predicting that the rule of nondeductibility would lead to significant disputes between defendant-taxpayers and the IRS over allocations).

Allocations are already required in some punitive damages to determine the *plaintiff's* tax consequences from receiving damages. In cases arising out of a personal physical injury, a plaintiff's compensatory damages are excluded from gross income under Section 104(a)(2), but this exclusion does not apply to punitive damages. Accordingly, in settlements of personal physical injury claims that could have generated punitive damages, a plaintiff must make these difficult allocations, which will (at least in theory) be evaluated by the IRS. Because of this, one might argue that the marginal increase in administrative costs that would result from the solution of nondeductibility would be small. There are, however, two reasons to suspect that this marginal increase would not be insignificant. First, allocations are required to determine the plaintiff's tax consequences only in a subset of punitive damages cases, namely those cases that arise out of the plaintiff's personal physical injury.[112] In other cases, no allocation is necessary. A new rule of nondeductibility would mean that allocations would now be necessary in *all* cases where there was a possibility of a punitive damages recovery had the case proceeded to trial.

Second, even in those cases where an allocation is already necessary under current law to determine the plaintiff's tax consequences, the solution of nondeductibility would significantly increase the financial stakes of those allocations. This is because allocations would now also be significant to the defendant, whereas when punitive damages were deductible, allocations were significant only to plaintiffs. If the plaintiff and the defendant are subject to the same marginal tax rate, the stakes involved in allocations would now double.[113] By raising the stakes of allocations, more

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[112] In general, allocations must be made in cases where the claim arises out of a personal physical injury, because in those cases compensatory damages are excluded from gross income while punitive damages are included.

[113] To illustrate, assume that a plaintiff settles a personal physical injury claim for $2,000,000 and that the valuation range of the punitive damages within that claim is $0 to $1,000,000. (Therefore, the valuation range of the compensatory claim is $1,000,000 to $2,000,000.) Under current law, assuming a marginal tax rate of 40%, the amount at stake with regard to the punitive damages allocation is $400,000. If the plaintiff were to assert successfully a $0 valuation on the punitive damages claim, all of the settlement would be considered compensatory damages, and she would owe no tax. If the IRS were to assert a $1,000,000 allocation to punitive damages, the plaintiff would owe $400,000 ($1,000,000 * 40%) in tax. If the tax law were changed such that punitive damages became nondeductible, the amount at stake would double (assuming the

time, attention, and resources will be applied to allocations by both taxpayers and the IRS. Thus, not only would a new rule of nondeductibility enlarge the scope of cases where allocations are necessary, it would also increase the stakes of allocations in those cases where allocations are already necessary under current law.

b. Complications from a Rule of Tax Awareness

Unlike the nondeductibility solution to the under-punishment problem, tax awareness does not require settlement allocations to determine the defendant's tax liability. Under a rule of tax awareness, all damages paid would be deductible, whether the damages are compensatory or punitive in nature. As a result, a rule of tax awareness would place no additional administrative costs on the IRS, defendants, or the federal tax courts in determining the defendant's tax liability.

There is, however, a different set of administrative costs associated with tax awareness: these costs would be borne by litigants and state and federal non-tax courts. Making jurors tax aware will generally require expert testimony to inform the jury as to the effect of deductibility and the mechanics of making gross-up calculations. In some cases, the defendant's expected marginal tax rate could be a subject of serious dispute, though in other cases the litigants might stipulate to this fact. Jurors or judges would have to decide the appropriate marginal tax rate (unless it is stipulated) and perform the mathematical task of grossing up intended penalties. These tasks may in certain cases be difficult and costly. The administrative burdens associated with these tasks, however, seem to pale in comparison to the administrative burdens (discussed above) of attempting to enforce a rule of nondeductibility. These administrative burdens nevertheless must be considered in deter-

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plaintiff and the defendant are subject to the same marginal tax rate). This is because the defendant and the plaintiff would then each have $400,000 at stake. That is, if the $0 valuation on the punitive damages claim prevails, the defendant would be able to deduct all $2,000,000 of the settlement, thus saving $800,000 ($2,000,000 * 40%) in taxes. But if the $1,000,000 valuation on the punitive damages claim prevails, the defendant would be able to deduct only $400,000 ($1,000,000 * 40%). Thus, the plaintiff and the defendant would each have $400,000 at stake regarding the allocation to punitive damages, whereas before the new rule of nondeductibility only the plaintiff had $400,000 at stake.

mining whether the tax-awareness solution to the under-punishment problem is worthwhile.

2. An Unintended Incentive to Settle

A rule of nondeductibility would create a tax incentive to settle in cases where the prospect exists of a jury award of punitive damages.[114] Because pre-trial settlements would generate the tax surplus described above, while post-trial resolutions would not, it can be expected that, all else being equal, a new rule of nondeductibility would result in a higher rate of settlement of punitive damages cases. This incentive to settle is an unintended byproduct of a rule of nondeductibility. By contrast, no such incentive is created under the tax-awareness solution because, under that solution, there is no possibility of a settlement-created tax surplus. This incentive to settle must therefore be considered in comparing the two solutions.

On the one hand, if one believes that settlements should be encouraged,[115] a position that is debatable, then the unintended incentive to settle resulting from nondeductibility might be considered beneficial.[116] On the other hand, if one thinks that settlements, especially in those cases involving egregious behavior, are problematic, then this incentive to settle is disconcerting.[117]

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[114] It should be noted that the joint incentive to settle early already exists in certain cases because of the differential treatment of compensatory damages and punitive damages on the plaintiff side. A rule of nondeductibility would exacerbate this incentive in cases where it already exists.

[115] One reason commentators have argued that settlements should be encouraged is to reduce deadweight litigation costs. See Richard A. Posner, Economic Analysis of Law § 21.4–.5 (7th ed. 2007); A. Mitchell Polinsky & Yeon-Koo Che, supra note 10, at 563; David Rosenberg & Steven Shavell, A Simple Proposal to Halve Litigation Costs, 91 Va. L. Rev. 1721, 1722 (2005) (proposing litigation in every other case by doubling damages and halving the costs of litigation).

[116] Since litigants do not have to pay for the full costs of running the civil justice system, taxpayers also benefit from increases in settlements, which cost less for the state than trials and appeals.

[117] See Baker, supra note 99, at 235 (concluding that settlement allows "the greatest control over the conversion of punishment into compensation" because parties can allocate the entire amount as compensatory); Owen M. Fiss, Against Settlement, 93 Yale L.J. 1073, 1075 (1984) (arguing that settlement "should neither be encouraged nor praised"); Leandra Lederman, Precedent Lost: Why Encourage Settlement, and Why Permit Non-Party Involvement in Settlements?, 75 Notre Dame L. Rev. 221, 222 (1999) (arguing that courts', commentators', and federal policy's favoritism of settlement is misplaced, and "[a]n appropriate model of the litigation process should bal-

Regardless, it must be remembered that very few cases proceed to trial under current law.[118] The unintended incentive to settle has the potential to affect only the small percentage of these "settlement-resistant" cases. Furthermore, the availability of a tax surplus would not affect even some of the settlement-resistant cases. A tax surplus is unlikely to persuade litigants with widely disparate views regarding the value of the plaintiff's claim to come to an agreement. Some plaintiffs might insist on "having their day in court" despite the fact that they could lose money doing so.[119] Thus, the incentive to settle will stimulate additional settlements only in a subset of the already small percentage of cases that do not settle under current law. Accordingly, whether one believes that additional settlements at the margin are beneficial or not, the unintended incentive to settle created by a rule of nondeductibility should not be a significant factor in choosing the solution to the under-punishment problem.

3. Federalism and Regulatory Diversity Issues

In *theory*, either of the two solutions—tax awareness or nondeductibility—would solve the under-punishment problem; however, in *practice*, tax awareness would solve the problem better, or so we have argued. Another difference between the two solutions is that tax awareness is a state law solution while nondeductibility is a federal solution. Accordingly, federalism and regulatory diversity issues are implicated in deciding between the two solutions.

These concerns push in favor of the state law solution of tax awareness. First, the goal of under-punishment reduction is to further the state's interests in effectively punishing egregious acts committed within its borders. This is a traditional state law concern, and there is no practical or legal impediment to states fixing

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ance both private and public roles in litigation, to illuminate the roles of both precedent and settlement"); Dan Markel, Retributive Damages: A Theory of Punitive Damages as Intermediate Sanction, 94 Cornell L. Rev. 239, 300–01 (2009) (identifying concerns relating to settlements of punitive damage claims).

[118] See Goldberg et al., supra note 103, at 40. The settlement rate of punitive damages cases is likely even higher than the rate for ordinary tort claims. See Baker, supra note 99, at 228 (stating that, given the benefits of settling punitive damages claims, "it is almost a wonder that any punitive damages claim goes to trial").

[119] E.g., Tamara Relis, "It's Not About the Money!": A Theory on Misconceptions of Plaintiffs' Litigation Aims, 68 U. Pitt. L. Rev. 701, 720–33 (2007).

the under-punishment problem on their own through tax awareness. It can therefore be argued that the federal government ought to give states the option to solve the problem themselves by maintaining the current tax rule of deductibility. After all, a rule of nondeductibility would foreclose the optimal state law solution (of tax awareness) by adopting the second-best solution to the under-punishment problem. Put somewhat differently, the premise behind nondeductibility proposals is that federal tax law should get out of the way of state tort law. However, the proposals would themselves actually get in the way of state tort law by preempting the optimal correction to the very problem of under-punishment that stimulated the proposals.

Second, as we have shown, under-punishment correction, whether accomplished through tax awareness or nondeductibility, inevitably comes with certain costs. For example, both proposals would increase plaintiff windfalls and would create administrative burdens. These costs should be weighed against the benefits associated with correcting under-punishment. A federal tax rule of nondeductibility would preclude the ability of states to perform this cost-benefit analysis. But if punitive damages remained deductible, states could undertake such an analysis in deciding whether or not to implement a rule of tax awareness.[120] States have undertaken, and will continue to undertake, similar cost-benefit analyses in designing and reforming their punitive damages regimes.[121] In addition, under a rule of nondeductibility, the adminis-

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[120] Consider, for example, the issue of whether punitive damages insurance coverage should be allowed. As discussed above in note 63, some states have decided that the under-punishment concern trumps the contractual expectations of the insured and have disallowed this insurance. Other states have decided that contractual expectations trump the under-punishment problem and have allowed coverage. The different approaches might be attributable to varying degrees of commitment to the goal of imposing the appropriate penalty (though it could also be attributable to varying degrees of commitment to the freedom of contract or to satisfying the rational expectations of the insured). If so, states might likewise differ on the amount of cost that is justified in correcting under-punishment.

[121] Cf. BMW of N. Am. v. Gore, 517 U.S. 559, 607 (1996) (Ginsburg, J., dissenting) ("The Court, I am convinced, unnecessarily and unwisely ventures into territory traditionally within the States' domain, and does so in the face of reform measures recently adopted or currently under consideration in legislative arenas."). Justice Ginsburg's federalism concerns cannot be dismissed simply as liberal politics; Chief Justice Rehnquist joined her dissent.

trative costs would be borne by the federal government, which would be required to police the rule, while the benefit of under-punishment correction would inure to the state (indirectly) and the plaintiff (financially). Under a tax-awareness solution, this mismatch of benefits and administrative burdens does not occur because the administrative costs of implementing a rule of tax awareness are borne entirely by the state.

Finally, a state's "punitive" or extracompensatory damages regime might not be punishment-driven.[122] For example, the regime might be intended simply to compensate the plaintiff for intangible injuries or to effect optimal cost internalization. In those cases, under-punishment is not a concern, and the current rule of deductibility combined with juror tax blindness is generally adequate. If the federal government retains the current rule of deductibility, states can easily "opt out" of a rule of tax awareness where appropriate. The nondeductibility solution, however, is probably not as flexible. The IRS presumably would not rely exclusively on the state's label for its extracompensatory damages regime and would instead evaluate the underlying purposes of the regime in applying a nondeductibility rule. The states stand in a far better position to evaluate their own tort laws and apply a rule of tax awareness as they see fit.[123]

In short, the state law solution of tax awareness is an appropriately flexible solution to the under-punishment problem. It also puts the costs of under-punishment correction squarely on the

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[122] See, e.g., supra note 9; see also Guido Calabresi, The Complexity of Torts – The Case of Punitive Damages, *in* Exploring Tort Law 333 (M. Stuart Madden ed., 2005) (providing several non-punitive rationales for punitive damages); Sharkey, Revisiting the Noninsurable Costs, supra note 63, at 446–47 (identifying the "compensatory punitive damages states" as "Connecticut, Michigan, and, on some accounts, New Hampshire and Louisiana").

[123] For instance, consider Connecticut's approach in dealing with the issue of whether punitive damages insurance coverage should be allowed. Common-law exemplary damages in Connecticut "serve primarily to compensate the plaintiff for his injuries and, thus, are properly limited to the plaintiff's litigation expenses less taxable costs." Berry v. Loiseau, 614 A.2d 414, 435 (Conn. 1992). On the one hand, because punishment is not the goal, insurance coverage for common-law punitive damages has been held not to violate public policy. See St. Paul Fire & Marine Ins. Co. v. Shernow, 610 A.2d 1281, 1286 (Conn. 1992). On the other hand, statutory exemplary damages in Connecticut have been found to be punitive in nature and, accordingly, they are not insurable. See Tedesco v. Md. Cas. Co., 18 A.2d 357, 359 (Conn. 1941).

state, whose interests are furthered by the correction. In contrast, the frequently proposed federal solution of nondeductibility is far more blunt an instrument and creates a mismatch between the governmental entity that receives the benefit and the one that bears the administrative costs.[124]

D. A Plaintiff's Windfall Profit Tax or Split-Recovery Schemes: Possible Solutions?

We have thus far concluded that tax awareness is superior to nondeductibility in correcting under-punishment. One foreseeable but unintended byproduct of tax awareness, however, is that it would increase the windfalls received by punitive damages plaintiffs under current law. As we have shown, increased plaintiff recoveries are, as a practical matter, a necessary consequence of correcting under-punishment, regardless of whether tax awareness or nondeductibility is chosen. One might consider imposing a "windfall profits" tax on plaintiffs who receive punitive damages recoveries to ameliorate this unintended byproduct of tax awareness. Such an excise tax on punitive damage recoveries would, in theory, reduce plaintiff windfalls. The same could be said for states employing split-recovery schemes.[125]

However, like a rule of nondeductibility, such an excise tax (or split-recovery scheme) could be easily circumvented through settlement in most cases. Circumvention could be accomplished through settlements that disguise punitive damages as compensatory damages, which would not be subject to the excise tax. Gains

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[124] One might argue that a blanket national solution (nondeductibility) is preferable over a piecemeal state solution (tax awareness) because it might take some states a very long time to implement the solution and because some states might reject it completely on non-normative grounds such as complexity. We are not persuaded by this argument at this time. States ought to be given the space to implement the first-best solution of tax awareness. If it turns out that a large number of states ultimately fail to do so, at that point Congress could enact the second-best rule of nondeductibility. But if nondeductibility were implemented first and if it were easily circumvented, states would then be unable to do anything more to correct under-punishment. Thus, while the nondeductibility solution would effectively preempt the tax-awareness solution, there would be no similar preemptive effect if tax awareness were adopted by some states and rejected by others.

[125] Split-recovery schemes require that a specified percentage of punitive damages recovered by a plaintiff be paid over to the state. On split-recovery schemes, see generally Sharkey, Punitive Damages, supra note 35, at 372–89.

from circumventing the excise tax could be shared with the defendant because the defendant would have to agree to settle to achieve the gains. Thus, while an excise tax would in fact reduce the plaintiff's windfall, it would at the same time reduce the defendant's punishment below that which a jury would have awarded.[126]

In other words, an excise tax would have similar effects to a rule of nondeductibility. This is an example of the familiar tax maxim that it does not matter which party to a transaction is the nominal beneficiary of a tax benefit or the nominal victim of a tax burden because the benefit or burden can be shifted through bargaining.[127] Here part of the benefit from avoiding the excise tax would be shifted through bargaining from the plaintiff (the nominal beneficiary) to the defendant in the form of lower settlement costs. As a result, an excise tax on plaintiffs, like a rule of nondeductibility, is not advisable if one believes that a dollar of under-punishment correction is worth a dollar of windfall augmentation.[128]

III. ADDRESSING OBJECTIONS

Recent proposals seek to solve the problem of under-punishment by making punitive damages nondeductible. We have shown that the better solution is to keep the current tax rule of deductibility while making jurors tax aware. To be sure, this solution causes plaintiffs' windfalls to be higher than they would be under either a rule of nondeductibility or current practices. Nevertheless, it is a practical impossibility under current punitive damages law to achieve a reduction in under-punishment without such a tradeoff.

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[126] Tom Baker has previously recognized that split-recovery regimes create a strong incentive to settle because "a punitive damages verdict would cost the defendant more than the plaintiff would collect." See Baker, supra note 99, at 235. Because it can be expected that this settlement surplus will be shared by the parties, under-punishment will result. The same effect would result from a federal excise tax on punitive damages recoveries.

[127] See Harvey S. Rosen & Ted Gayer, Public Finance 302 (McGraw-Hill Irwin 9th ed. 2010) ("The statutory incidence of a tax indicates who is legally responsible for the tax.... Because prices may change in response to the tax, knowledge of statutory incidence tells us *essentially nothing* about who really pays the tax.").

[128] As we have previously discussed, if one believes that a dollar of under-punishment correction is not worth a dollar of windfall augmentation, then current law—deductibility without tax awareness—should simply be left in place. See supra Subsection II.B.2.

Consequently, we believe that the recent proposals to make punitive damages nondeductible ought to be rejected. Instead, the federal government should give states the option to solve the under-punishment problem on their own through tax awareness. By maintaining the current rule of deductibility, the federal government would allow states to (i) perform a cost-benefit analysis to determine whether correcting the under-punishment problem is beneficial and (ii) implement the optimal correction to that problem.

In this Part we address potential objections to these conclusions. While these objections are plausible, they ultimately do not persuade us that tax awareness is not the better solution to the under-punishment problem.

A. Expressive Concerns

In recent decades, legal theorists have focused not only on the direct effects of law, but also on the messages and values that laws express and convey.[129] In this vein, an "expressivist" might object to our recommendation for preserving deductibility (albeit with tax awareness) based on the concern that deductibility of punitive damages would signal a permissive attitude by the federal government towards reckless or malicious conduct. It would be better, on this account, to adopt a nondeductibility rule which would signal condemnation.[130]

We believe, however, that any expressive benefit to be gained by making punitive damages nondeductible is minimal. Punitive damages are currently deductible by business defendants, and yet it seems clear that this treatment does not mitigate the public scorn that punitive damages frequently trigger. Even with the current rule of deductibility, punitive damages bring negative publicity for business defendants and invite scrutiny of officers' actions by irate shareholders, insurers, and creditors. Thus, there appears no need

[129] See, e.g., Elizabeth Anderson & Richard Pildes, Expressive Theories of Law: A General Restatement, 148 U. Pa. L. Rev. 1503 (2000).

[130] To support this view, expressivists might analogize punitive damages to government fines, which are expressly nondeductible under the tax code. As we explain below, the analogy to fines is imperfect.

to change the tax rule to make the point that actions that trigger punitive damages are condemnable.

In addition, it is doubtful that changing the tax treatment of punitive damages would be an expression that society realistically would care about too deeply. The problem of under-punishment stems from the fact that jurors, who are ordinary members of society, are unaware of the fact and effect of deductibility under current law. If punitive damages were nondeductible, we fully expect that nearly all members of society would remain largely ignorant of the tax treatment of punitive damages.

Finally, and most importantly, one of the ways we express our values is by trying to shape the real-world effects of a legal practice.[131] In this context, our proposal is designed to better implement the values associated with the jury's goal of meting out an appropriate level of punishment. As we said at the outset, we share President Obama's concern that the goals of punitive damages are being stymied by current practice. Our proposal is more effective in addressing this problem because nondeductibility is, as a practical matter, so easily avoided. A concern for the expressive values of a law should not require self-defeating policies.

B. Are Gross Ups Too Difficult for Juries to Calculate?

Some people may argue that lay jurors would be unable to calculate tax gross ups on account of their complexity. Recall that, once the defendant's marginal tax rate (t) is determined, the intended penalty simply needs to be divided by $(1 - t)$. We do not believe this to be terribly difficult relative to the *other* mathematical tasks that jurors regularly perform with the assistance of expert testimony.[132]

But if it were too difficult for juries, then judges could perform the mathematical calculation, after the jury has determined the marginal tax rate (unless the rate has been stipulated to by the parties). In addition, courts could separate or bifurcate issues associ-

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[131] Cf. Cass R. Sunstein, On the Expressive Function of Law, 144 U. Pa. L. Rev. 2021, 2045 (1996) (explaining why good expressivists should care about consequences too).

[132] Specific examples could also be provided such as: "if you wish to impose a penalty of $100,000, and if you find the defendant's marginal tax rate is 40%, the proper award is $167,000."

ated with tax evidence from the core punitive damage issues decided by the jury.[133] States might reasonably differ about who should be making these calculations but to us, it is critical that *someone* do it. Otherwise, the defendant's marginal tax rate is always effectively assumed to be zero, which would be erroneous in many cases.[134]

C. Should Evidence of Anticipated Collateral Consequences Be Admitted?

If decisionmakers should be fully informed as to the tax consequences of a punitive damages award, one might also wonder if they should hear evidence that a defendant might seek to admit regarding the non-tax consequences of a punitive damages award. For example, should a defendant be able to argue to a tax-aware jury that it will have to pay additional amounts of money for enhanced insurance premiums or make advertising and public relations expenditures to mitigate damage from publicity of the punitive award?

Presumably, if the jurisdiction wanted the jury to adopt a view where juries were informed of the "whole suffering" of the defendant,[135] the defendant could seek to admit this evidence in mitigation. The plaintiff would then counter with protestations that these expenditures are speculative and that there is no guarantee that the defendant will follow through on those potential expenditures.[136]

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[133] Tax evidence could be presented only after the jury has determined that an award of punitive damages is appropriate and calculated the amount of such award. At that point, jurors would determine the defendant's marginal tax rate. Then the jury or the judge would perform the mathematical calculation to arrive at the final punitive damages award.

[134] See supra Subsection I.B.2 (noting that the effect of tax blindness is an assumed defendant marginal tax rate of zero).

[135] Cf., e.g., Adam Kolber, The Subjective Experience of Punishment, 109 Colum. L. Rev. 182 (2009).

[136] One might respond to the uncertainty problem, however, by requiring that defendants put such "collateral consequences" funds in escrow immediately after the jury verdict. The problem with this response is that the size of those collateral consequences funds are likely to be a *function* of the jury's verdict, in which case the defendant (or its expert witnesses) would not be able to properly estimate the size of the necessary "collateral consequences" fund until *after* the imposition of the punitive damages award.

By contrast, the jury can be certain of the government's imposition of taxes and the defendant's obligation to pay them. Courts might simply and reasonably head this path off by noting that such mitigation evidence is outside the province of the jury's function. Specifically, in the realm of punitive damages, the jury is acting as the *public's* deputy in imposing a punitive damages award, and the after-tax effects of such an award are relevant to shaping the decision of how much that award should be. By contrast, how private parties contingently decide to respond to the imposition of that award is normatively outside the responsibility of the public's consideration, and that of its deputy (here, the jury or court).[137]

D. Analogizing Punitive Damages to Government Fines

Some might object to our proposal by pointing to the tax law's treatment of government fines. Under Section 162(e) of the Code, these fines are expressly nondeductible. By analogy, one could argue, punitive damages should likewise be nondeductible.[138] There are two critical distinctions, however, between government fines and punitive damages. First, government fines are often imposed without regard to the individual attributes, such as financial condition, of the wrongdoer; instead these fines are typically "scheduled." By contrast, punitive damages are usually determined by the jury in a highly individualized manner, with great sensitivity to the

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Another related concern about anticipated consequences relates to the possibility of a defendant manipulating its current marginal tax rate to reduce the amount of a grossed-up award. For example, a defendant could accelerate deductions or losses. Such a possibility, while in theory a concern, should not be a significant problem. Taxpayers already have an incentive to lower their current marginal tax rate at the expense of increasing future marginal tax rates due to the time value of money. Thus, taxpayers ordinarily lower their current marginal tax rate to the maximum extent feasible, even absent punitive damages considerations.

[137] See Dan Markel & Chad Flanders, Bentham on Stilts: The Bare Relevance of Subjectivity to Retributive Justice, 98 Cal. L. Rev. (forthcoming June 2010). As suggested in the text by reference to the contingent nature of these collateral consequences, there is also a forseeability problem, which raises normative and practical questions: for example, what if, because of the punitive damages award, the defendant revises its policies and ends up making more profit? There is a limit on how much the jury and the law can do to anticipate the future; our proposal, by contrast, recognizes the authority of the familiar proverb that taxes, like death, are reasonably certain.

[138] This argument assumes that the current nondeductible tax treatment of government fines is normatively appropriate. We assume *arguendo* that it is, but there might be situations where it is not.

financial condition of the defendant. Thus, while punitive damages could relatively easily be grossed up to account for tax effects, civil fine regimes often lack the ability to do so.

Second, in tort cases, the payee of punitive damages, the plaintiff, is also entitled to compensatory damages. This duality allows for easy circumvention of a rule of nondeductibility because punitive damages can be readily disguised as compensatory damages. In the context of civil fines, the payee, the government, is not typically entitled to any other type of payment. Thus, the nondeductibility of fines cannot ordinary be circumvented by disguising the fines as another type of (deductible) payment.

Because of these two distinctions, disparate tax treatment of civil fines and punitive damages is justified. It would ordinarily be difficult to gross up civil fines without changing the process by which they are imposed, and there is typically no risk of circumvention in the civil fine context.[139]

E. The Impact of Insurance

Finally, it might be argued that insurers could adequately monitor pre-trial settlements to ensure that they are characterized accurately for tax purposes.[140] As previously mentioned, some states

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[139] In addition, even if there were a risk of circumvention (because, for example, part or all of the payment to the government could plausibly be characterized as restitution or remediation), the federal government could protect itself in cases where the civil sanction was imposed by a federal statute and where there is some variability in the amount of the sanction. It could do this by considering tax effects in determining the amount of the payment it seeks from the taxpayer. See, e.g., Letter from Chuck Grassley, Senator, to Christopher Cox, SEC Chairman (Aug. 15, 2008) (on file with author), available at http://grassley.senate.gov/news/Article.cfm?customel_dataPage ID_1502=16331 (encouraging the SEC to consider grossing up sanctions in order to offset the benefit of tax deductibility). Alternatively, the federal government could require, as a condition of settlement, that the taxpayer (defendant) agree not to claim the sanction as a deduction. Accordingly, in the case of federal civil sanctions, there is no circumvention issue because there are only two parties involved: the federal government (as the "fine" collector and tax collector) and the taxpayer. In the case of punitive damages or state or local civil sanctions, there are three parties involved: the plaintiff or state/local government (as fine collector), the federal government (as tax collector), and the taxpayer (defendant).

[140] See Mark Geistfeld, Tax Breaks for Bad Behavior? On the Relation Between Income Taxes, Punitive Damages, and Liability Insurance, TortsProf Blog (May 3, 2010), http://lawprofessors.typepad.com/tortsprof/2010/05/geistfeld-on-tax-breaks-for-bad-behavior-on-the-relation-between-income-taxes-punitive-damages-and-l.html.

disallow punitive damages insurance coverage on public policy grounds.[141] Even in states that allow this coverage, some policies might explicitly exclude coverage for punitive damages, though such an exclusion is apparently rare.[142] In these cases, insurance companies would not be legally responsible to pay the punitive damages portion of any settlement. Accordingly, insurance companies should in theory resist paying any more than the compensatory value of the plaintiff's claim. If so, under a nondeductibility regime, the IRS could free-ride on the insurance company's monitoring efforts.[143]

Before considering whether insurance companies are in fact effective monitors, it should be noted that the free-riding argument applies only in cases involving an insurance company that has an incentive to monitor. Some defendants, particularly in high-risk businesses, are self-insured.[144] Others buy insurance coverage from related, captive insurance companies, who would have little if any incentive to monitor because they are part of a single economic unit that includes the defendant. In other cases, the compensatory portion of the plaintiff's damages might equal or exceed the limits of the insurance policy. If so, then the defendant's contributions to the settlement could plausibly be characterized as additional compensatory damages. Finally, a common clause in insurance contracts excludes coverage for "intentional or expected" harms; to the extent the exclusion applies, the defendant will in effect be self-insured.[145] In all of these situations, either there is no insurance

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[141] See supra note 63 and accompanying text.

[142] See Tom Baker, Reconsidering Insurance for Punitive Damages, 1998 Wis. L. Rev. 101, 122 (1998).

[143] In other words, if insurance companies were good monitors, the IRS could be confident that only amounts paid by the otherwise-insured defendant were punitive in nature.

[144] See, e.g., Guy Chazan, BP's Escalating Costs Put Investors on Edge, Wall St. J. (May 1, 2010), http://online.wsj.com/article/SB10001424052748704093204575216341707748822.html (noting that BP is self-insured).

[145] See Sharkey, Revisiting the Noninsurable Costs, supra note 63, at 434 ("Insurance policies typically contain exclusions for 'expected' or 'intended' acts."). However, as Tom Baker has explained, because of the practical blurriness of the line between intentional versus unintentional conduct and strategic behavior by plaintiff and defense counsel, insurance companies often have difficulty enforcing this exclusion. See Baker, supra note 99, at 223–25 (explaining the "underlitigation strategy" employed by plaintiff and defense counsel in order to ensure coverage of acts that might be excluded by the intended or expected exclusion).

company monitoring the settlement or it has little incentive to do so. As a result, the IRS will not be able to take advantage of the insurance company's monitoring in reviewing the defendant's settlement allocation. Likewise, the monitoring argument has no force where punitive damages are fully covered by insurance because, in those cases, the insurance company does not care whether amounts are characterized as compensatory or punitive in nature as it is responsible to cover both types.

Thus, the monitoring argument is relevant only in the remaining cases, where, under the law and the facts, an insurance company will be liable only for compensatory damages and the unrelated insured defendant only for punitive damages. In those cases, the issue is whether insurance companies in practice refuse to pay the punitive portions of pre-trial settlements. Based on numerous interviews with prominent personal injury lawyers, Tom Baker has found that insurance companies routinely pay the punitive components of settlements even when they are not legally obligated to do so. In other words, insurance companies rarely refuse to settle a case based on the ground that the settlement includes a premium

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Mark Geistfeld has suggested that the tax code should be amended to disallow deductions for all damages, whether compensatory or punitive, stemming from "expected or intended" harms, and that the IRS could free-ride off of the insurance company's efforts in policing the line between intentional/expected (non-covered) conduct and unintentional/unexpected (covered) conduct. See Geistfeld, supra note 140.

But there are several problems with this approach. First, as explained above, Baker has shown that insurance companies are themselves unable to effectively police this line. Second, even if insurers could police effectively, the specific contractual language in the majority of insurance policies might differ from the language in the tax code denying the deduction for damages. Even if the language were similar now, insurance policies might evolve to allow for the taxpayer argument that conduct excluded from coverage by the policy is nevertheless eligible for a deduction under the tax statute that Geistfeld envisions. Third, in close cases the insurance company might settle by agreeing to cover part of the settlement. Such an outcome would not provide much guidance to the IRS as to whether the conduct was intentional or not. Finally, a tax law standard based on the intentional/expected standard would apply to all defendants, including those that are actually or effectively self-insured or those whose insurance policy uses a different standard for exclusion. In those cases, the IRS would have no ability to free-ride and would be required to police the intentional/expected versus reckless/negligent line on its own. This task would be extremely difficult to do, as insurers can attest. Cf. Nw. Nat'l Cas. Co. v. McNulty, 307 F.2d 432, 444 (5th Cir. 1962) (Gewin, J., concurring) ("The borderline between willful and wanton injury and injury as the result of simple negligence, is often a hairline distinction.").

reflecting the prospect of a punitive damages recovery if the case were to go to trial. In part, this is because of the difficulty in valuing the compensatory versus punitive portions of the plaintiff's claim.[146] Baker also suggests that this is because insurers are wary of a bad-faith lawsuit should they reject what turns out (with the benefit of hindsight) to have been a favorable, within-limits settlement offer.[147] Baker explains how plaintiff and defense counsel (and sometimes judges) use this wariness to pressure insurance companies to settle aggravated fault cases at a premium. Consequently, "insurance companies in effect provide insurance for punitive damages even in states . . . that formally prohibit such insurance."[148] It therefore seems unlikely that the IRS would be able to free-ride on the monitoring efforts of insurance companies even in those limited situations where it theoretically could.

CONCLUSION

Current legal practices result in the significant underpunishment of business defendants because punitive damages jurors do not take into account the fact that these defendants are allowed to deduct their punitive damages awards. To solve this problem, the Obama administration recently proposed making all punitive damages nondeductible, a proposal that has in the past been supported by a number of policymakers and academics.

Proponents of blanket nondeductibility, however, have neglected to consider three critical, interconnected facts. First, underpunishment could readily be solved by states simply by making jurors (or judges) aware of the tax consequences of punitive damages payments. Thus, federal intervention in state punitive damages law is not absolutely necessary and it is potentially counterproductive. Second, current punitive damages law seems to allow plaintiffs' lawyers to make jurors tax aware; if it does, the under-punishment problem could be resolved without passing state legislation. Third, a rule of nondeductibility would be very difficult for the IRS to en-

[146] See Baker, supra note 99, at 228 (noting that insurers are aware that plaintiffs' lawyers can quite readily transform punitive damages into additional compensatory damages in aggravated fault cases).

[147] See id. at 228–34.

[148] Id. at 235.

force effectively because litigants could, through settlement, readily disguise punitive damages as compensatory damages.

By overlooking these facts, proponents of a nondeductibility rule have failed to analyze correctly the under-punishment problem and its potential solutions. Properly evaluated, the under-punishment problem can, at least in theory, be corrected either by making jurors tax aware or by making all punitive damages nondeductible. Ultimately, however, the choice between these mutually exclusive solutions depends on how easily a rule of nondeductibility could be circumvented through settlements. If a rule of nondeductibility is easily circumvented, as we are confident it would be, a rule of tax awareness is always the better solution to the under-punishment problem. This is primarily because, when a rule of nondeductibility is circumvented through settlement, defendants would participate in the gains from circumvention in the form of lower after-tax settlement costs, resulting in precisely the same under-punishment problem that nondeductibility is intended to correct. There is no similar risk of circumvention under the alternative solution of tax awareness, however. For that reason, we think the tax-awareness solution advanced herein is preferable to both current practice and the reform proposed by the Obama administration.[149]

[149] We leave for another day consideration of how tax and torts rules could better be reformed to mitigate the ineluctable tradeoff we identified under current law between the enrichment of plaintiffs and the under-punishment of business defendants. See Dan Markel, Overcoming Tradeoffs in the Taxation of Punitive Damages, 88 Wash. U. L.R. (forthcoming 2011).