

Golden Gate University Law Review

Volume 14

Issue 1 *Ninth Circuit Survey*

Article 12

January 1984

Tax Law

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Recommended Citation

Laurie Ann Hedrich, *Tax Law*, 14 Golden Gate U. L. Rev. (1984).
<http://digitalcommons.law.ggu.edu/ggulrev/vol14/iss1/12>

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TAX LAW

DEVELOPMENTS IN TAX LAW

A. *I.R.C. Section 104(a)(2) and Awards For Defamation*

In *Roemer v. C.I.R.*¹ the Ninth Circuit held, in reserving the decision of the tax court,² that compensatory and punitive damages awarded in taxpayers' defamation suit were excludable from gross income under I.R.C. § 104(a)(2).³

In 1965, Paul F. Roemer,⁴ an insurance broker, applied for an agency license from Penn Mutual Life Insurance Company to sell life insurance. In the course of reviewing the application, Penn Mutual obtained a creditor report on Roemer prepared by Retail Credit Company. The credit report was clearly defamatory.⁵ Upon learning of the defamatory report, Roemer demanded a retraction. However, the purported retraction contained further defamatory statements about Roemer's general business and personal character and about his fitness as an insurance agent. Based on the Retail Credit's report, Penn Mutual denied Roemer's application to an agency license.

Roemer sued Retail Credit for libel under section 45 of the California Civil Code.⁶ Roemer alleged that Retail Credit pub-

1. 716 F.2d 693 (9th Cir. 1983); (per Alarcon, J.; the other panel members were Canby and Reinhardt, JJ.).

2. 70 T.C. 390 (1983), (per Dowson, J.; Forrester, J., Korner, J., and Wilbur J., dissenting).

3. Section 104(a)(2) excludes from gross income "the amount of any damages received (whether by suit or agreement on account of personal injuries or sickness)."

4. Marcia E. Roemer was a party to the proceeding solely because she filed a joint tax return with her husband. 716 F.2d at 694.

5. *Id.* at 695. The credit report falsely stated that Roemer was ignorant in insurance matters, neglected his clients' affairs, was recently fired from his position as president of the insurance firm, and intentionally defaced property belonging to others. The report also implied that Roemer misappropriated funds and questioned Roemer's honesty. *Id.*

6. California Civil Code section 45 provides that "Libel is a false and unprivileged publication by writing, printing, picture, effigy, or other fixed representation to the eye, which exposes any person to hatred, contempt, ridicule, or obloquy, or which has a tendency to injury him in his occupation."

lished false statements intending to damage his reputation, and to injure him in his business profession and occupation.⁷ At trial, the jury awarded Roemer \$40,000 in compensatory damages and \$250,000 in punitive damages, together with costs.⁸ The jury made no indication whether the damages were awarded as compensation for injury to Roemer's personal or professional reputation.

Roemer received his damage award in 1975. His total net recovery was \$147,140.⁹ On his federal income tax return, Roemer reported \$16,020 of the damage portion of the recovery as income.¹⁰ The Commissioner determined that the entire award should have been included in gross income with a deduction for all costs and attorneys fees because the injury was primarily to Roemer's professional reputation.

Initially, the Tax Court decided that, in determining the applicability of section 104(a)(2), a distinction should be drawn between defamatory injury to personal reputation and defamatory injury to an individual's business or professional reputation, to the extent it affects that individual's income. The Tax Court determined that the taxability of a damage award depended on the actual basis of recovery. Therefore, the court held that the compensatory damages were excludable from gross income to the extent that the taxpayer could establish that the amounts recovered for damages resulted from injury to personal reputation.

7. 716 F.2d at 695.

8. The jury was not instructed to, and gave no indication of the basis upon which they arrived at the amount of the award, nor was the jury instructed to allocate the award between the injury to Roemer's personal or professional reputation. *Id.*

9. 70 T.C. 390, 403 n.2. The net recovery was calculated as follows:

Compensatory damages	\$40,000	
Punitive damages	\$250,000	
Interests and Costs	<u>\$85,601</u>	
		\$375,601
Less		
Attorneys' Fees	\$220,710	
Costs	<u>7,751</u>	
		<u>\$228,461</u>
Net to Roemer		\$147,140

10. Roemer also reported \$7,751 for costs and \$23,371 for interest received as income. In his amended petition to the Tax Court, Roemer alleged that \$16,020 of the damage portion of the award and \$7,751 for costs were incorrectly reported on this 1975 tax return.

Since the evidence from the trial tended to show that the compensatory damages awarded Roemer were for injury to his professional reputation and the jury had not been instructed to make an allocation between personal and professional elements of the damage award, the Tax Court concluded that the whole award was taxable. Thus, having determined that the compensatory damages were not excludable under section 104(a)(2), the Tax Court also concluded that the punitive damages were includable in gross income.¹¹

In reversing the Tax Court's decision, the Ninth Circuit held that the Tax Court improperly distinguished physical from non-physical personal injuries in determining the applicability of section 104(a)(2). The court noted that when an individual receives a damage award for a physical personal injury, the whole amount of the award would be excludable under section 104(a)(2), even though the predominant result of the injury was the loss of income. However, when a nonphysical injury, such as defamation, results in an award for economic and non-economic losses, the majority in the Tax Court would view the whole award as taxable, except to the extent that the individual could show that a portion of the award was received for non-economic personal injury. The Ninth Circuit perceived the proper distinction as whether the injuries were personal or nonpersonal, since section 104(a)(2) excludes damages received for a personal injury.

The Ninth Circuit determined that the issue of the taxability of Roemer's award could be resolved by analyzing the nature of the tort of defamation as it developed under California law.¹² After examining the historical development of the law of defamation, the court observed that under the California Civil

11. In a footnote, the Tax Court implied that since under California law punitive damages are imposed against a defendant to warn others not to engage in the same conduct or behavior (Cal. Civ. Code sec. 3294) and relate to the defendant's oppression, fraud, and malice, that by statute they can never be directly related to personal injuries suffered by a plaintiff, and by implication not excludable under section 104(a)(2). 70 T.C. 390, 408 n.4.

12. As the Ninth Circuit noted when there is no controlling federal law, or controlling definitions in the tax code, the court must analyze the nature of the claim litigated under the appropriate state law. *U.S. v. Mitchell* (1971) 304 U.S. 64 (quoting *Burnet v. Harmel*, (1932) 287 U.S. 103).

Code,¹³ California "recognizes a general personal right to be protected from defamation. In contrast, California law also provides for related torts of disparagement or trade libel that will remedy an attack on the quality of the plaintiff's products or services."¹⁴ The court pointed out that all defamatory statements attack a person's character, and that the injury should not be confused with the consequences that may flow from a defamatory attack.¹⁵ The most probative evidence of the extent of the injury suffered by an individual may be the violence of the non-personal consequences of a defamatory statement, but that evidence should not be allowed to define the nature of the injury. The court concluded that compensatory damages received in defamation actions were excludable from gross income under section 104(a)(2).

The court also determined that the punitive damages received by Roemer were not taxable. The court noted that an amount awarded as punitive damages is generally includable in gross income as ordinary income.¹⁶ However, the court, relying on Revenue Ruling 75-45,¹⁷ pointed out that it has been the Commissioner's policy to interpret section 104(a)(2) to exclude both compensatory and punitive damages received when there has been a personal injury. Thus, since Roemer's compensatory damages were excludable, the punitive damages were also excludable.¹⁸

CONCLUSION

Under the Ninth Circuit's analysis, defamation awards, both compensatory and punitive, will be excluded from gross income

13. California Civil Code section 43.

14. 716 F.2d at 699.

15. Some injuries that may result are the loss of reputation in the community and any resulting loss of income, impairment of personal and professional relationships, loss of business opportunity.

16. *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

17. 1975-1 C.B. 47.

18. The Ninth Circuit also concluded that litigation expenses in a litigation action are not deductible under I.R.C. § 212, because the expenses were not paid for the production of income. However, the court applied its origin of the claim litigated standard to amount of reimbursed expenses, and concluded since the expenses were incurred because of a personal injury, they should be excluded from gross income as well. 716 F.2d at 700.

under section 104(a)(2), provided that the applicable statute recognizes defamation as a personal action. Because it is often difficult to draw distinctions between disparaging and defamatory statements, the choice of action will rest with the injured plaintiff.

B. I.R.C. Section 104a(2) and Lump Sum Personal Injury Awards

In *Niles v. United States*,¹ the Ninth Circuit held that the IRS may not allocate any portion of a lump-sum personal injury award to disallow the deduction of future medical expenses under I.R.C. § 213(a).²

In 1970, Kelly Niles was injured in a playground accident. Subsequent negligent medical treatment left him with irreparable brain damage. As a result, Niles, a quadriplegic, will require continuing medical and physical care throughout his life.

A personal injury suit recovered a lump-sum jury award of \$4,025,000.³ The defendants appealed, contending that the award was excessive. On appeal, Niles' counsel presented "a detailed, hypothetical itemization of the award, allocating \$1,588,176 to future medical expenses"⁴ to rebut the challenge of excessiveness. The California Court of Appeal affirmed the jury's

1. 710 F.2d 1391 (9th Cir. 1983) (per Choy, J.; the other members of the panel were Duniway and Alarcon, JJ.).

2. Section 213(a)(1976)(amended 1983) provides that:

There shall be allowed as a deduction the following amounts, not compensated for by insurance or otherwise—

(1) the amount by which the amount of the expenses paid during the taxable year (reduced by any amount deductible under paragraph (2) for medical care of the taxpayer, his spouse, and dependents (as defined in section 152) exceeds 3 percent of the adjusted gross income, and

(2) an amount (not exceeding \$150) equal to one-half of the expenses paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

3. 710 F.3d at 1392. Although at trial Niles' counsel presented evidence as to each specific portion of Niles' total economic loss, the jury was not requested to specifically allocate any portion of the award. If such an allocation to future medical expenses had been made, then under Rev. Rul. 75-232, 1975-1 C.B. 941 the expenses would have been deductible to the extent compensated by the award. *Id.* at 1394 n.7.

4. *Id.*

award.⁵

Niles excluded the full amount of the award from his gross income because under I.R.C. § 104(a) (2)⁶ personal injury awards from a jury or by settlement is non-taxable.

In 1975, Niles took a medical deduction for his ongoing medical expenses. The IRS, attempting to change its long standing policy of not allocating lump-sum personal injury awards, disallowed the deduction.⁷ Instead, adopting Niles' hypothetical apportionment of \$1,588,176 for the cost of future medical services, the IRS concluded that that portion of the award represented compensation under I.R.C. § 213(a). Therefore, the Service ruled that Niles could not deduct future medical expenses under 213(a) until the aggregate accrued amount of expenses exceeded \$1,588,176. The IRS reasoned that a contrary interpretation would allow Niles to receive a deduction on monies already excluded from gross income which would allow him to gain a double tax benefit.⁸

Niles paid the assessed deficiency and sued for a tax refund in federal district court.⁹ At trial, the court granted summary judgment for Niles, and held that the IRS had no authority to allocate a portion of a lump-sum jury award to future medical expenses, because the allocation could not be accomplished with reasonable certainty.¹⁰ The IRS appealed to the Ninth Circuit.

The Ninth Circuit began its analysis by noting that the Service's attempt to allocate the lump-sum award was without stat-

5. *Niles v. City of San Rafael*, 42 Cal. App. 3d 230 (1974).

6. Section 104 (a)(2)(1976)(amended 1983) in relevant part provides that:

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include . . . the amount of damages received (whether by suit or agreement) on account of personal injuries or sickness.

7. The IRS also asserted income tax deficiencies for the years 1973, 1974 and 1976. Prior to the start of litigation the parties resolved their differences, so those issues were not before the court. 710 F.2d at 1392.

8. *Id.*

9. *Niles v. United States*, 520 F. Supp. 808 (N.D.Cal. 1981).

10. 520 F. Supp. at 814-815.

utory authority or prior case law.¹¹ Historically, it has never been the practice of the IRS to apportion part of a personal injury lump-sum award to future medical expenses.¹² The court stated that “the nonallocability of lump-sum awards . . . has been a basic presumption of litigants in thousands of personal injury suits over the years.”¹³ The court stressed that it looked unfavorably on the Service’s administrative attempts to change firmly entrenched tax principles, particularly by “ajudication in a particular audit.”¹⁴

The IRS contended that its prior practice of nonallocation was justified because of the speculative nature of the lump-sum personal injury awards. However, the Service attempted to distinguish this case by arguing that allocation would not be speculative since it could be based on the apportionment used by Niles’ counsel to defend the reasonableness of the award. In denying the Service’s contention, the court noted that such a distinction would require unequal tax treatment based only upon the success of a taxpayer’s attorney in defending a personal injury award.¹⁵ The court concluded that the differing tax treatment would be without rational foundation.

Even if such disparate tax treatment could be justified, the court pointed out that the Niles award was still speculative. The inquiry must be focused on what did the jury mean to allocate to future medical expenses. The Court noted that the mere defense of an award by an attorney on appeal provides no proof of the amount a jury intended to allocate as future medical expenses.¹⁶

Further, the Ninth Circuit suggested a number of ramifica-

11. 710 F.2d at 1393. The court noted that although Rev. Rul. 79-427, 1979-2 C.B. 120 specifically addressed the issues in this case, that it would be improper to rely on the ruling since it was based on the facts of *Niles* and was promulgated during the pendency of the audit. 710 F.2d at 1393 n.3 12.

12. 710 F.2d at 1393-94. See Sol. Op. 132, I-1 C.B. 92 (1922) (there can be no correct estimate of the value of invaded rights); Letter Rulings 620731480A (1962) and 6510284440A (1965) (Taxpayers may deduct future medical expenses when lump-sum damage award or unallocated settlement is received on account of a personal injury). *Id.* at 1394 n.4.

13. *Id.* at 1394.

14. *Id.* at 1394, quoting in part *Commissioner v. Greenspun*, 670 F.2d 123, 126 (9th Cir. 1982).

15. *Id.*

16. *Id.*

tions of permitting the IRS to allocate lump-sum personal injury awards. First, the federal courts would be forced to determine whether the Service's allocation correlated with the jury's intent in awarding the appropriate measure of damages. The court feared that there would also be an abundance of refund suits whenever the IRS attempted to apportion a previous lump-sum award. A second possible result would be that plaintiffs in personal injury actions would deliberately give vague and speculative estimates of future medical expenses to escape IRS apportionment of an award. Finally, the court expressed concern that if the IRS was permitted to allocate awards, plaintiffs would forum shop, selecting a forum in which the most favorable tax information regarding the taxability of awards might be conveyed to jurors.¹⁷

The Ninth Circuit held that a taxpayer's medical expenses are not compensated for by any part of a previous lump-sum personal injury award. In reaching this narrow conclusion, the court acknowledged that Niles would be receiving a double tax benefit that had been sanctioned by historical IRS practices. The court determined that Congress, and not the IRS or the judiciary, should be responsible for redefining a long-standing administrative practice.¹⁸

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17. *Id.* at 1395.

18. *Id.* at 1395, quoting in part *United States v. Byrum*, 408 U.S. 125, 135 (1972).

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