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The Taxability of punitive Damages: Glass Cuts Macomber Strait-Jacket

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Neither the Constitution nor subsequent statutes define what is to constitute income within the meaning of the Sixteenth Amendment.\(^1\) Thus any solution to the problem must be gathered from court decisions.

At an early date the Supreme Court defined income as "the gain derived from capital, from labor, or from both combined" provided it be understood to include profits gained through a sale or conversion of a capital asset.\(^2\) Many fact situations have arisen since the *Eisner v. Macomber* decision in which courts have chosen to depart from the narrow definition of income attributed to that case.\(^3\) In recent cases\(^4\) involving the taxability of punitive damages, the Supreme Court has allowed another departure from the judicial strait-jacket of the *Macomber* case.

**Summary of the Cases in Question**

In *General American Investors Co. v. Commissioner*\(^5\) the court of appeals held that sums paid-over to a corporation in compliance with section 16 (b) of the Securities Exchange Act\(^6\) constituted taxable income to the corporation. Though sustaining the holding of the Tax Court that the sums represented taxable income to the corporation, the court of appeals rejected the exercise in semantics in the course of which the Tax Court stated that

\(^1\) U. S. Const. Amend. XVI. See also 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 5.01 (1942) and CAIRNS, A Note on Legal Definitions, 36 Col. L. Rev. 1099, 1102 (1936).


\(^3\) 1 MERTENS, op. cit. supra note 1, § 5.04; Note, Apparent Abandonment of a Definitive Concept of Income, 45 Harv. L. Rev. 1072 (1932).


\(^5\) 211 F. 2d 522 (2nd Cir. 1954).

such sums were "profits" because section 16(b) provided that "any profits realized shall inure to and be recoverable by the issuer." The court of appeals bluntly stated that the payments involved were not profits to the corporation. Thus it appears clear that the court of appeals rejected the narrow definitive system of the Macomber case as to what constitutes taxable income; and the decision was affirmed by the Supreme Court.

The other cases to be considered involved the question of whether punitive damages awarded under federal anti-trust laws constitute taxable income to the recipient. In Commissioner v. Glenshaw Glass Co. the court of appeals concluded that punitive damages were not within the scope of the definition of taxable income found in Eisner v. Macomber. The court of appeals distinguished the General American Investors case on the ground that the cases were factually different. The court preferred to draw an analogy to cases in which contributions made by a sovereign in the general public interest to an individual were held not to constitute taxable income. The analogy apparently drawn was that such taxpayers have recovered because the sovereign has seen fit to punish certain behavior for the good of the public which was considered to be the same theory underlying the award of damages for violation of federal anti-trust laws. The court likened exactions by the sovereign to donations made to one individual by the state by operation of law. A similar result was reached by the court of appeals in Commissioner v. William Goldman Theatres Inc., which involved a similar question of the taxability of treble damages recovered for violations of federal anti-trust laws. However, the court of appeals for the seventh circuit in Commissioner v. Obear-Nester Glass Co. reached a contrary result to that of the Glenshaw and Goldman cases though faced with a similar fact situation. Being unable to reconcile the taxability of "insiders profits" with the non-taxability of punitive damages, the court concluded that the authorities were in conflict and followed the authority holding such amounts received

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7 211 F. 2d 928 (3rd Cir. 1954).
8 211 F. 2d 928 (3rd Cir. 1954).
9 217 F. 2d 56 (7th Cir. 1954).
as damages under the federal anti-trust statutes to constitute taxable income.

Upon appeal to the Supreme Court, the Glenshaw and Goldman cases were reversed.\textsuperscript{10} The Court held that there had been an undeniable accession to wealth, clearly realized, and over which the taxpayers had complete domination. Of great significance was the limitation placed by the Court on the often quoted definition of taxable income contained in \textit{Eisner v. Macomber}. It was stated that the definition was to be limited in its application to the question before the Court in that case; viz, distribution of a corporate stock dividend.

Many questions are raised by these decisions. Are the courts going to abandon the definitive system of determining what constitutes taxable income? If so, what guide posts are to be used in determining whether the matter under scrutiny constitutes taxable income? Have the decisions shifted the emphasis toward the economic concept of income? What effect will the decisions have on the administration of the Federal Anti-trust statutes?

To better equip ourselves to analyze the decisions, briefly let us consider the development of the theories with respect to the taxability of damages since the now famous \textit{Eisner v. Macomber} decision.

\textbf{Taxability of Damages in General}

The primary test used by the courts in determining whether a certain item of damages is taxable or not appears to be: "in lieu of what were the damages awarded?"\textsuperscript{11} By applying such a test, it has been concluded that damages which compensate for damage to reputation or which represent a replacement of lost capital or impairment of capital are not taxable.\textsuperscript{12} The cases and administrative rulings rest on the theory that the thing in lieu of

\textsuperscript{10} Commissioner v. Glenshaw Glass Co. and William Goldman Theatres, Inc., \textit{supra} note 4.

\textsuperscript{11} Raytheon Production Corp. v. Commissioner, 144 F. 2d 110, 113 (1st Cir. 1944), \textit{cert. denied}, 323 U. S. 779 (1944); Note, \textit{The Taxability of Punitive Damages}, 101 U. of Pa. L. Rev. 1052 (1953).

\textsuperscript{12} Durkee v. Commissioner, 162 F. 2d 184 (6th Cir. 1947); Arcadia Refining Co. v. Commissioner, 118 F. 2d 1010 (5th Cir. 1941); Highland Farms Corp. v. Commissioner 42 B.T.A. 1314 (1940); Hawkins v. Commissioner, 6 B.T.A. 1023 (1927). See I MERTENS, \textit{op. cit. supra} note 1, \textsection \textsection 521 and 522.
which the damages were awarded was not taxable income; i.e., the damages merely made the injured party whole, no item of profit or gain being included in the measure of damages.\footnote{13}

However, this is not to say that all damages recovered are to be excluded from gross income. If the damages represent a reimbursement for lost profits\footnote{14} or for services rendered,\footnote{15} the previously mentioned test is met and the damages are deemed taxable income. Similar results are reached if the damages are for expenditures under a contract entered into for profit\footnote{16} or damages for loss of property in excess of the cost of the property.\footnote{17}

An area in which controversy existed is that of subsidies. Where a government pays a subsidy, a distinction has been drawn between compensation for reduced operating revenues on the one hand,\footnote{18} and compensation for construction expenses on the other.\footnote{19} In the typical situation in which chambers of commerce and similar organizations make contributions to induce new industries to settle in their districts, such contributions have been held not to be income.\footnote{20}

From the discussion above, it can be seen that the rules applicable to other types of damage awards do not provide a basis for determining whether punitive damages are taxable income. Because of the very nature of punitive damages the “in lieu of” test cannot be used. Also, the rules applied in the subsidy cases

\footnote{14} United States v. Safety Heating & Lighting Co., 297 U. S. 88 (1936); Swastika Oil and Gas Co. v. Commissioner, 123 F. 2d 382 (6th Cir. 1941), cert. denied, 317 U. S. 639 (1942); Commissioner v. Woods Machine Co., 57 F. 2d 635 (1st Cir.), cert. denied, 287 U. S. 613 (1932); Nichol v. U. S., 48 F. Supp. 662 (Ct. Cl. 1943); Nicholas W. Mathey, 10 T. C. 1099, aff'd. 177 F. 2d 259 (1st Cir. 1949).
\footnote{15} Buffalo Union Furnace Co. v. Commissioner, 23 B.T.A. 439 (1931); Blease v. Commissioner, 16 B.T.A. 972 (1929).
\footnote{17} Helvering v. William Flaccus Oak Leather Co., 313 U. S. 247 (1941); Raytheon Production Corp. v. Commissioner, 144 F. 2d 110, (1st Cir. 1944).
\footnote{18} Texas and Pacific Ry. Co. v. U. S., 286 U. S. 285 (1932); Continental Tie & Lumber Co. v. U. S., 286 U. S. 290 (1930); Baboquivari Cattle Co. v. Commissioner, 135 F. 2d 114 (9th Cir. 1943); Lykes Bros. Steamship Co., 42 B.T.A. 1395, aff'd. 126 F. 2d 725 (5th Cir. 1942); for general discussion of subsidy payments see MERTENS, op. cit. supra note 1, § 5.14 and MACILL, TAXABLE INCOME p. 385 (1945).
are of no aid in the solution of the problem. Therefore let us turn to the rules that have developed in cases involving punitive damages.

Rules as to Taxability of Punitive Damages

Since 1940, the Tax Court has held that punitive damages are not income, while the commissioner has continued to tax them as such. There are two foundation cases for the Tax Court's view. The Tax Court's position was originally based on Central Ry. Co. of New Jersey v. Commissioner, in which it was held that a recovery by the taxpayer from one of its former officers who had surreptitously created a corporation with operations adverse to the taxpayer's interest was not taxable income. In reversing the Board of Tax Appeals, the circuit court stated that the property received could not be traced to a "gain derived from capital, from labor, or from both combined," nor could it be said to be a gain from a sale of a capital asset. The recovery was deemed to be a "windfall" or a "penalty imposed by law on a faithless fiduciary, a gain granted gratuitously because of the necessity of keeping persons in positions of trust beyond the temptations of double dealing."

The second foundation case, Highland Farms Corp. v. Commissioner, was the first case to deal specifically with the taxability of punitive damages. Though the Central Railway case was cited, the opinion of the Board of Tax Appeals that punitive damages were not taxable income was not based on the theory that such sums were "windfalls" but rather that the sums did not come within the definitive test of Eisner v. Macomber.

With the law in such a state the courts were presented with the Glenshaw and Obernester cases previously discussed. But during the same period Park & Tilford Distillers Corp. v. U. S. and the

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22 79 F. 2d 697 (3rd Cir. 1935).
23 42 B.T.A. 1314 (1940).
24 107 F. Supp. 941 (Ct. Cl. 1952) cert. denied.
General American Investors cases were establishing another doctrine. In the Park & Tilford case, the Court of Claims held “insiders profits” recovered by the taxpayer pursuant to section 16(b) of the Securities Exchange Act of 1934 to be taxable income. The court was unwilling to surmise that the Supreme Court by their language in Eisner v. Macomber intended to read-out of the income tax statute language which Congress had inserted with great deliberation and for important reasons, viz, “income derived from any source whatever.” Faced with a similar problem, the Tax Court reached the same result in General American Investors but based their conclusion on different grounds.

Therefore, the stage was arranged for the entrance of the Supreme Court into the drama in the following manner: the Glenshaw, Highland Farms, and Central Ry. Co., cases, joined by the Goldman case, had established authority for the proposition that punitive damages were not within the purview of Eisner v. Macomber and were not taxable income; but, the Park & Tilford and General American Investors cases, joined later by the Obernester Glass Co. case, constituted authority for holding punitive damages to be taxable income. With the stage thus set, the Supreme Court, because of the frequent recurrence of the question and the differing interpretations by the lower courts, granted certiorari in the Glenshaw Glass, Goldman Theatres and General American Investors cases. The Court held the sums involved constituted taxable income on the basis that a liberal construction must be given to the broad phraseology of section 22(a) of the Internal Revenue Code of 1939 and that the language of Eisner v. Macomber was never intended “to provide a touchstone to all future gross income questions.

Soundness of the Supreme Court Decisions

In truth, all that can be done by way of definition is to chart the course of growth of the income tax law. In the Macomber

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27 MERTENS, op. cit. supra note 1, § 5.03 at 163.
case, the Supreme Court attempted a definition of income that was to serve as a guiding principle for the future.\textsuperscript{28} Such an attempt was destined to failure. It is apparent that “constitutionally taxable income” is not a term that can be successfully defined so as to be binding for all time. The law of income taxation, like constitutional law in general, is dynamic, not static. It must constantly change and develop to meet the changes in the economic and political life, to say nothing of meeting the ingenious devices for tax avoidance devised by brilliant tax attorneys. In abandoning the definitive system of solving the problem of what is income, the Court is registering its approval of Mr. Justice Holmes’ remark “We see nothing to be gained by the discussion of judicial definitions.”\textsuperscript{29} Thus from the viewpoint of legal practicality the decisions seem to be sound.

Furthermore, it is difficult to believe that the Supreme Court intended that a narrow construction be placed on the sweeping terms of Section 22a as a result of their decision in \textit{Eisner v. Macomber}.\textsuperscript{30} Except as the particular revenue statutes may “exempt” income from tax or “postpone” its recognition, it may be assumed that Congress intended to embrace within the scope of the tax all income which it might constitutionally tax.\textsuperscript{31} In fact, the Supreme Court has frequently stated that the language of Section 22a was used by Congress to exert “the full measure of its taxing power.”\textsuperscript{32} Such decisions demonstrate that the catch-all provision of Section 22a, “gains or profits and income derived from any source whatever,” was never intended to be confined within narrow limits by a case that dealt only with the taxability of stock dividends.

There is still another legal theory which will serve as a strong foundation for the decisions. It has been stated that the meaning of the word “income” is that given it in common speech and

\textsuperscript{28} Mertens, \textit{op. cit. supra} note 1, § 5.03 at 160.
\textsuperscript{29} Mr. Justice Holmes, in \textit{U. S. v. Kirby Lumber Co.,} 284 U. S. 1 (1931).
\textsuperscript{32} See footnote 30.
every day usage. It is highly problematical that the ordinary layman would consider the gains realized from “insider’s profits or from the recovery of a judgment for treble damages other than “income."

If the soundness of the Supreme Court decisions be tested from a jurisprudential point of view, the discussion by the Court of Appeals in Commissioner v. Obear-Nester Glass Co. in regard to taxation according to ability to pay is of interest. As stated by the court:

We do not believe that the Supreme Court intended to define income exclusively according to its source. The great argument which resulted in this country’s adoption of an income tax, and the fundamental principle upon which that tax is still based, is that individuals will be taxed according to their ability to pay. There is no rational connection between the source of the taxpayer’s gain and his ability to pay. The question is: has he realized an economic gain, from whatever source, which leaves him better able to contribute to the support of this government. . . . If gain not derived from capital or labor is excluded from taxation, the burden on income that is derived from these sources, will of course, be all the greater.

Undoubtedly, an individual’s ability to pay is enhanced by the recovery of punitive damages. If the “ability to pay” concept is still to be professed to be one of the underlying bases for the present tax structure, it may likewise serve as a jurisprudential justification for the taxation of punitive damages.

Questions Raised by the Decisions

Previously, it was stated that several questions were raised as a result of the decisions. Since the Supreme Court has opened the way for a case by case consideration of what may come within the term “taxable income,” an academic question might arise as to whether the courts will move closer to the economic concept of income. For example, one economist defined income as “... the money value of the net accretion to economic power between two

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33 Brown Shoe Co. v. Commissioner, 133 F. 2d 582 (8th Cir. 1943); Helvering v. Edison Bros. Stores, Inc., 133 F. 2d 575 (8th Cir. 1943); U. S. v. Oregon-Washington R. R. & Nav. Co., 251 Fed. 211 (2nd Cir. 1918).
34 217 F. 2d 56 (7th Cir. 1954).
35 217 F. 2d 56, 61.
points of time." The distinction between such a definition of income and the general rule as to what constitutes taxable income is that in the former there is no requirement that the accretion be realized. The normal requirement of realization is an administrative limitation imposed for the sake of expediency in the administration of the taxing statutes. It is very doubtful that it would be possible to administer in this country a statute which required an exact evaluation of every taxpayer's assets at the beginning and end of each taxable period with the imposition of a tax on the difference thus disclosed. However, the language of the Supreme Court in the Glenshaw case should dispel any fears that the courts will drift toward a system of taxation without the requirement of realization as a result of their recent decisions. In the Glenshaw case, the Court stated: "Here we have instances of undeniable accession to wealth, clearly realized, and over which the taxpayer's have complete dominion."

In regard to the Federal Anti-Trust laws, the Supreme Court decision that punitive damages are taxable income should not be criticized as diminishing the benefits given to the individual bringing the anti-trust action. The primary purpose of the anti-trust laws is to protect the public, the private remedy being merely incidental. The right granted to individual suitors to seek reparation is secondary and subordinate in purpose. However, in view of the fact that the provision for treble damages was designed to supply an ancillary force of private investigators to supplement the Department of Justice in law enforcement, the effect of making the recoveries taxable should cause concern. Will the lessening of the net benefits to be gained from the successful prosecu-

36 HAIG, THE FEDERAL INCOME TAX (Columbia University Lectures, 1920) p. 27.
37 MAGILL, TAXABLE INCOME 21-24.
39 99 L. Ed. 361, 365 (Advance Sheet No. 9).
41 Fedderson Motors v. Ward, 180 F. 2d 519, 521 (10th Cir. 1950); Glenn Coal Co. v. Dickinson Fuel Co. 72 F. 2d 885 (4th Cir. 1934).
tion of an anti-trust suit have the effect of reducing the number of suits brought? The answer would seem to depend on many differing factors; e.g., is the complainant an individual or a corporation? In what tax bracket is he, if an individual? Depending on the circumstances, it might well be that a portion or all of the actual damages recovered are nontaxable; and, when coupled with the amount of punitive damages the injured party still retains after taxes are paid, such sum may remain an effective incentive to bring the action.

However, if the increased tax burden does act as deterring feature, it should be noted that the burden is increased due to the fact that a large amount of income will be grouped into one tax period. If the grouping of income could be avoided, the tax burden would be lessened; and correspondingly the deterrent effect of such a tax burden would be lessened. Because of the nature of the recovery it does not appear that an individual or a partnership could utilize the spreading provisions of section 1301, relating to compensation received for services rendered over thirty-six months or more, or 1302, relating to income from an invention or artistic work. However, aside from other considerations which might make it undesirable to do so, a careful wording of the judgment so as to make the amount of the judgment recoverable over a specified number of years could accomplish a tax-leveling and saving.

Conclusion

In legal theory the Supreme Court decisions are upon a firm and reasonable basis. Possibly the decisions will have adverse effects on the administration of the anti-trust laws; but, for such an isolated instance as is presented in that type case, the proper

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43 Int. Rev. Code §§ 1301 and 1302. Under similar provisions in the 1939 Code, the amount received as proceeds from compromised litigation for infringement of a copyright was not considered to constitute compensation for personal services. Jack Rosenzweig, et al., 1 T. C. 24 (1942).

44 Tax benefits are often gained by careful wording of divorce decrees for example. 1 Mertens, Law of Federal Income Taxation, § 5.23. Such a course of action would probably accomplish its purpose in regard to cash basis taxpayers, but accrual basis taxpayers might be considered to have present income in the discounted amount of the judgment.
remedy would seem to lie in an exemption or relief provision to the code.\textsuperscript{45} In relation to the general field of taxable income, the decisions are a judicial step forward in freeing the courts from the judicial straight-jacket of \textit{Eisner v. Macomber}.

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\textsuperscript{45} Such a provision could take the form of a complete exemption, or provide that recoveries will be given capital gains treatment, or provide for a spreading back or forward with limitations on the total amounts of taxes to be paid attributable to the recovery.