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## Designing the Tax Treatment of Litigation-Related Costs

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# FLORIDA TAX REVIEW

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## DESIGNING THE TAX TREATMENT OF LITIGATION-RELATED COSTS

by

Sachin S. Pandya\* and Stephen Utz\*\*

### ABSTRACT

*Defendants often deduct for income tax purposes their litigation-related costs, such as attorney fees and payments to settle claims or satisfy judgments. The result is often a large gap between the sticker price of settlements or judgments and their after-tax cost—what defendants really pay out of pocket. The problem: For every dollar that a defendant avoids in tax liability by, for example, deducting the damage awards it pays, the civil justice system falls that much short of its corrective-justice or optimal-deterrence goals in that case. For this reason, the entire civil justice system should care about this question: How should income tax law treat litigation-related costs? This Article identifies the critical tax-design choices that must be faced but that prior commentary has largely ignored: How to attribute litigation-related costs to an income-producing activity; whether to treat liability insurer payments made on a defendant's behalf as income to that defendant; whether to coordinate the tax treatment of a payor's damages payments with the tax treatment of those receipts to the payee; and whether litigation-related costs should be treated as capital expenditures. Then, the Article offers a new default rule for settlement agreements: Unless a settlement agreement expressly indicates otherwise, a settling defendant promises not to seek an allowable tax deduction for litigation-related costs. In so doing, this Article reveals the issues that lawyers, judges, and scholars must*

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*no longer ignore when they argue over how an income tax system could or should treat litigation-related costs.*

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## **I. INTRODUCTION**

Defendants can often deduct from income tax their litigation-related costs, such as attorney fees and payments to settle claims or satisfy judgments. This remains controversial. Consider for example the billion-dollar settlements by some financial institutions for their role in the 2008 financial crisis. Some have pointed out that despite the high nominal settlement price, those financial institutions really paid a much lower *after-tax* settlement price.<sup>1</sup> Or consider that while British Petroleum agreed to a \$20 billion settlement of claims arising from the Deepwater Horizon oil spill, by one estimate, \$15.3 billion of that amount was

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1. Gretchen Morgenson, *Paying the Price, But Often Deducting It*, N.Y. TIMES (Jan. 12, 2013), <http://www.nytimes.com/2013/01/13/business/paying-the-price-in-settlements-but-often-deducting-it.html>; Michael Rapoport & Dan Fitzpatrick, *J.P. Morgan's \$5.1 Billion Settlement Is Tax Deductible; Bank Could Save Nearly \$1.5 Billion in Taxes*, WALL ST. J. (Oct. 29, 2013), <https://www.wsj.com/articles/jp-morgan8217s-51-billion-settlement-is-tax-deductible-1383082213>; Michael Rapoport & Christina Rexrode, *Citigroup to Get Tax Silver Lining in \$7 Billion Settlement*, WALL ST. J.: MONEYBEAT (July 14, 2014), <https://blogs.wsj.com/moneybeat/2014/07/14/citigroup-to-get-tax-silver-lining-in-7-billion-settlement/>.

tax-deductible.<sup>2</sup> A more recent example: When U.S. President Donald Trump recently settled lawsuits alleging fraud in his former “Trump University” business, Trump agreed to pay \$25 million in restitution. Neither Trump, nor the private plaintiffs, nor the New York Attorney General mentioned that because most of this \$25 million was tax-deductible, Trump’s after-tax settlement price was a lot less.<sup>3</sup>

Similarly, when defendants settle with government agencies, there is this worry: Both defendants and government regulators highlight the settlement sticker price, not the much lower after-tax settlement price; as a result, settling defendants inflate their contrition, regulators inflate their law-enforcement zeal, and both thereby mislead the public.<sup>4</sup> Such concerns also fuel the long-standing controversy over the tax deductibility of punitive damages awards.<sup>5</sup>

These controversies, however, depend on your answer to this harder question: How *should* income tax law treat litigation-related

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2. Robert W. Wood, *In BP's Final \$20 Billion Gulf Settlement, U.S. Taxpayers Subsidize \$15.3 Billion*, FORBES (Apr. 6, 2016), <https://www.forbes.com/sites/robertwood/2016/04/06/in-bps-final-20-billion-gulf-settlement-u-s-taxpayers-subsidize-15-3-billion/#745d79ae36b2>.

3. Stipulation of Class Action Settlement, Exhibit 1 to Joint Motion for Preliminary Approval of Class Action Settlement, *Low v. Trump University LLC*, No. 3:10-cv-00940-GPC(WVG) (S.D. Cal., Dec. 19, 2016), ECF No. 583-1; Robert W. Wood, *Trump Gets \$25 Million Tax Write-Off for Trump University Settlement*, FORBES (Nov. 18, 2016), <https://www.forbes.com/sites/robertwood/2016/11/18/trump-gets-25-million-tax-write-off-for-trump-university-settlement/>.

4. *E.g.*, PHINEAS BAXANDALL & MICHELLE SURKA, U.S. PUB. INTEREST RESEARCH GRP. EDUC. FUND, *SETTLING FOR A LACK OF ACCOUNTABILITY?: WHICH FEDERAL AGENCIES ALLOW COMPANIES TO WRITE OFF OUT-OF-COURT SETTLEMENTS AS TAX DEDUCTIONS, AND WHICH ARE TRANSPARENT ABOUT IT 1–2* (Dec. 2015). In response, some have proposed limiting, or requiring better reporting of, the tax-deductibility of settlements with public agencies. *E.g.*, Truth in Settlements Act of 2015, S. 1109, 114th Cong. (2015); Government Settlement Transparency and Reform Act, S. 1654, 113th Cong. (2013).

5. Harriet M. King, *The Insurability of Punitive Damages: A New Solution to an Old Dilemma*, 16 WAKE FOREST L. REV. 345 (1980); Dan Markel, *Overcoming Tradeoffs in the Taxation of Punitive Damages*, 88 WASH. U. L. REV. 609 (2011); Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct?*, 47 ALA. L. REV. 825 (1996); Robert W. Wood, *Why Punitive Damages Should Remain Deductible*, 124 TAX NOTES 149 (July 13, 2009).

costs? On this question, prior commentary offers two main answers. Some oppose deductibility, fearing that it reduces how well monetary sanctions can enhance social welfare or proportionally match a defendant's moral responsibility for illegal activity.<sup>6</sup> For every dollar a defendant avoids in tax liability by deducting damages, the civil justice system becomes that much less effective in meeting its goals in that defendant's case. For this reason, the tax treatment of litigation-related costs matters to the purposes, scope, and effect of the entire civil justice system.

Others, however, favor deductibility so that personal income tax burdens can more closely depend on *net* personal income (one's gross receipts minus one's cost of producing those receipts). If so, their argument goes, income tax law would tend not to affect what a taxpayer does to produce income and would also make personal income tax burdens roughly proportional to taxpayers' actual buying power.<sup>7</sup> This implies that an income tax code should calibrate tax burdens by accounting for all the costs of receipts-producing activity, including litigation-related costs, even if such activity is illegal or socially disfavored.<sup>8</sup>

The problem is that despite the high stakes for the entire civil justice system, prior commentary on this question has largely ignored some critical tax-design issues.<sup>9</sup> Put simply, taxing only net income does not *entail* allowing deduction of all litigation-related costs. How should we structure litigation-cost deductibility? It depends on a series of complex and interconnected tax-design choices, such as how to attribute income to taxpayer activity; how to treat liability insurance payments; whether to coordinate the tax consequences of defendant-payors and plaintiff-payees; and how much tax authorities and taxpayers should be expected to do to enforce or comply with income tax law, respectively.

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6. On the other hand, some models suggest that the deductibility of litigation-related costs may increase social welfare. *E.g.*, Jacob Nussim & Abraham D. Tabbach, *Deterrence and Tax Treatment of Monetary Sanctions and Litigation Costs*, 29 INT'L REV. L. & ECON. 1, 7 (2009); I.P.L. Png & Eric M. Zolt, *Efficient Deterrence and the Tax Treatment of Monetary Sanctions*, 9 INT'L REV. L. & ECON. 209, 216–17 (1989).

7. *E.g.*, James W. Colliton, *The Tax Treatment of Criminal and Disapproved Payments*, 9 VA. TAX REV. 273 (1989).

8. Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

9. See Stephen Utz, *Tax Design Goals and How to Use Them*, 157 TAX NOTES 1759, 1763–66 (Dec. 18, 2017) (discussing tax design elements and tax design goals).

These design choices are distinct. They do not necessarily follow from any specific redistributive goals for the tax system or from corrective justice or social-welfare-maximization goals for imposing monetary legal sanctions. And yet, for progress and clarity to occur, lawyers, judges, and scholars must no longer ignore these issues.

This Article identifies these tax-design choices. The Article proceeds as follows. Part II briefly surveys the relevant tax law in seven countries, focusing on the relevant U.S. tax law. The Article then turns to the key tax-design issues. Part III discusses the complexity associated with attributing litigation-related costs to an income-producing activity. Part IV discusses whether to treat liability insurer payments made on a defendant's behalf as income to that defendant. Part V identifies grounds for coordinating the tax treatment of a defendant-payor's damages payments with the tax treatment of those receipts to the plaintiff-payee, namely, that these payments are part of bilateral exchanges in which the defendant pays the plaintiff for a loss or for the value of property the defendant still has and uses. Part VI concerns whether some litigation-related costs should be treated as capital expenditures related to the right to receipts established or sought to be established by the litigation itself.

Finally, Part VII proposes a new default rule for settlement agreements: Unless expressly indicated otherwise by agreement or statute, a settling defendant promises, as a term of the settlement, not to *seek* an otherwise allowable tax deduction for litigation-related costs. Under current U.S. law, parties can already enforce such a settlement term, and a few have done so. By adopting such a term as a default rule, lawyers for private parties and the government would be more accountable in their settlements. If settlement agreements contain an express term *allowing* a party to seek a tax deduction for litigation-related costs, such agreements would credibly signal to judges and the public that the settling parties were *aware* of the gap between the nominal and the after-tax settlement price, and settled anyway. Accordingly, policymakers would be forced to grapple with whether and how to abrogate that default rule when they enact or amend causes of action.

This Article substantially advances the prior commentary (which is largely descriptive or outdated)<sup>10</sup> in several ways. It both

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10. See, e.g., ROBERT W. WOOD, *TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS* (4th ed. 2012); Valentine Brookes, *Litigation Expenses and the Income Tax*, 12 *TAX L. REV.* 241 (1957); John C. Bruton, *The Deductibility*

extends and takes issue with prior work on whether to treat liability insurer payments made on a defendant's behalf as income to that defendant.<sup>11</sup> It examines and complicates the grounds for prior arguments that litigation-related costs should be treated as capital expenditures. Finally, the Article offers a novel default rule that would make policy-makers more likely to fully and openly grapple with the tax-design choices identified here.

## II. BACKGROUND

In at least seven jurisdictions (United States, Canada, France, South Africa, Australia, Germany, United Kingdom), income tax law, at least on paper, generally permits deductions for payments for attorney fees and payments to settle or satisfy claims, provided such payments are sufficiently connected to income-producing activity, particularly trade or business activity.<sup>12</sup> Taxpayers generally cannot deduct fines and penalties payable to the government, either because of an express statutory prohibition (e.g., United States, Canada, France, South Africa, Australia) or a general judicial and agency authority to disallow deductions on a case-by-case basis (e.g., Germany, United Kingdom).<sup>13</sup> Moreover,

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*of Legal Expenses in Computing Income Tax*, 3 S.C. L.Q. 107 (1950); Donald H. Gordon, *The Public Policy Limitation on Deductions from Gross Income: A Conceptual Analysis*, 43 IND. L.J. 406 (1968); William T. Plumb Jr., *Income Tax on Gains and Losses in Litigation*, 26 CORNELL L.Q. 16 (1940); Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108 (1962).

11. Jeffrey H. Kahn, *Hedging the IRS—A Policy Justification for Excluding Liability and Insurance Proceeds*, 26 YALE J. ON REG. 1, 15–16 (2009); King, *supra* note 5, at 367–72.

12. *FC of T v Rowe* (1995) 95 ATC 4691 (Austl.); *McKnight v. Sheppard* [1999] 71 TC (HL) 419 (U.K.); Income Tax Act 58 of 1962 § 11(c) (S. Afr.); Can. Customs & Rev. Agency, Bulletin IT-99R5 (Consol.) (2000); S. Afr. Rev. Serv., Interpretation Note: No. 54 (Feb. 26, 2010); PETER W. HOGG ET AL., *PRINCIPLES OF CANADIAN INCOME TAX LAW* 224–29 (8th ed. 2013); 5 MERTENS LAW OF FEDERAL INCOME TAXATION § 24A:18 (Westlaw 2018) (U.S.); WOOD, *supra* note 10, at ch. 6 (U.S.). See generally HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 288–90 (3d ed. 2010).

13. *Income Tax Assessment Act 1997* (Cth) s 26-5 (Austl.); Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) § 67.6 (Can.); Code Général des Impôts

some taxpayers pay litigation-related costs to acquire, dispose of, or defend title to an asset, such as a parcel of land, a patent, or a professional license.<sup>14</sup> If so, they cannot deduct such costs when paid or incurred (as is permitted for an ordinary expense). Instead, those costs must be added to the asset's "basis," or in a non-U.S. jurisdiction, to the asset's tax book value. Then, when one sells or otherwise disposes of the asset, that basis is subtracted from the proceeds, resulting in either a net gain or a loss.

In the United States, since at least the Revenue Act of 1913,<sup>15</sup> U.S. courts and the government have largely considered attorney fees

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[Tax Code] art. 39 § 2 (Fr.); Einkommensteuergesetz [EStG] [Income Tax Act], Oct. 8, 2009, BGBL I at 3384–85, § 4, no. (5)<sup>10</sup> (Ger.); Income Tax Act 58 of 1962 § 23(o)(ii) (S. Afr.); *McKnight v. Sheppard* [1999] 71 TC (HL) 419 (U.K.); I.R.C. § 162(f) (U.S.).

14. Income Tax Act 58 of 1962 § 11(c) (S. Afr.); *Comm'r for Inland Rev. v. Nemojim (Pty) Ltd* 1983 (4) SA 935 (S. Afr.); *Re Taxpayer & Comm'r of Tax'n* (2013) 97 ATR 680, 693–94, [2013] AATA 783 ¶ 72 (Austl.); Can. Customs & Rev. Agency, *supra* note 12, at ¶¶ 14–15.

15. During the first U.S. federal income tax (1861–72) (see HAROLD Q. LANGENDERFER, *THE FEDERAL INCOME TAX 1861–1872*, at 239–448 (1980)), in 1865, the Commissioner of Internal Revenue ruled by letter: “No deduction can be made from income for money paid on a judgment of any court against the tax-payer,” though payments received to satisfy settled claims or court judgments were exempt from income. Letter from E.A. Rollins, Deputy Comm'r (May 1, 1865), in *Damages Recovered in Actions Not Taxable, Etc.*, 1 INTERNAL REV. RECORDER & CUSTOMS J. 155 (1865). A year later, the Deputy Commissioner of Internal Revenue declared, responding to an inquiry “relative to the deduction of fines and penalties from income,” that “penalties imposed for violations of excise law, are legitimate offsets to the profits of the business in connection with which they were incurred; but they cannot be allowed as deductions from income actually realized from other pursuits.” Letter from Thomas Harland, Deputy Comm'r (July 27, 1866), in *Deductions of Fines and Penalties in Estimating Income*, 4 INTERNAL REV. RECORDER & CUSTOMS J. 46 (1866). At the same time, federal tax assessors were instructed: “Costs of suits and other legal proceedings arising from ordinary business are to be treated as other expenses of such business, and may be deducted from the gross profits thereof.” Office of Internal Rev., *United States Internal Revenue—Instructions to United States Assessors, Concerning the Assessment of Incomes, Articles in Schedule A, and Licenses, for the Year 1866*, 3 INTERNAL REV. RECORDER & CUSTOMS J. 147, 147 ¶ 12 (1866). Under the short-lived Revenue Act of 1894 (1894–1895), a Treasury regulation adopted a close variant of this business expense deduction for



and other expenses paid or incurred to defend against a lawsuit as “ordinary and necessary” business expenses. Today, Code section 162(a) provides that a taxpayer may deduct “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”<sup>16</sup> As read by courts and government tax officials, section 162(a) and its statutory antecedents treat as “ordinary and necessary” what a taxpayer pays or incurs to settle a claim or satisfy a judgment—including portions of a judgment awarding punitive damages to private parties,<sup>17</sup> as well as attorney fees paid or incurred to defend against a lawsuit—provided that such expenses were paid or incurred “in carrying on any trade or business.” When a taxpayer pays to cover another’s expenses, however, those expenses do not usually count as that taxpayer’s “ordinary” expenses under section 162(a) on the premise that businesses do not customarily pay off the debts of others.<sup>18</sup>

In 1942, Congress added the predecessor to Code section 212, which allows an *individual* to deduct “all the ordinary and necessary

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“costs of suits.” ROGER FOSTER & EVERETT V. ABBOT, A TREATISE ON THE FEDERAL INCOME TAX UNDER THE ACT OF 1894, at 492 ¶ 9 (1895).

16. I.R.C. § 162(a); *see also* Reg. § 1.162-1(a).

17. Rev. Rul. 80-211, 1980-2 C.B. 57.

18. *See* Deputy v. du Pont, 308 U.S. 488, 497 (1940); John R. Dorocak, *The Clintons’ Legal Defense Fund: Income from Payment of Legal Expenses by Another and Deductibility of Such Expenses*, 104 W. VA. L. REV. 1, 16-27 (2001). Exceptions include employer payments to cover their employees’ legal expenses pursuant to an indemnification agreement (Rev. Rul. 78-210, 1978-1 C.B. 39; *see also* Larchfield Corp. v. United States, 373 F.2d 159, 167 (2d Cir. 1966)); premiums for work-related liability insurance for corporate directors and officers as promised in their employment agreements (Rev. Rul. 69-491, 1969-2 C.B. 22; *see also* Rev. Rul. 76-277, 1976-2 C.B. 41); and “where the original obligor is unable to make payment and the taxpayer satisfies the obligation to protect its own business interests,” as indicated by a showing that the obligor’s inability to pay would have had a “direct and proximate” adverse impact on the taxpayer’s business (*W. Covina Motors, Inc. v. Comm’r*, T.C. Memo 2008-237, 2008 WL 4706469, at \*4 (2008); *see also* *Hood v. Comm’r*, 115 T.C. 172, 180-81 (2000) (corporate taxpayer paid legal fees of its sole shareholder); *Lohrke v. Comm’r*, 48 T.C. 679 (1967)), which matters in cases where a corporate taxpayer claims a deduction under section 162(a) for the attorney fees incurred by that corporate taxpayer’s employee, officer, or shareholder for defending against a civil suit or criminal prosecution (*see* *Capital Video Corp. v. Comm’r*, 311 F.3d 458, 464 (1st Cir. 2002)).

expenses paid or incurred during the taxable year” for producing or collecting income, including managing, conserving, or maintaining property “held for the production of income,” as well as expenses “in connection with the determination, collection, or refund of any tax.”<sup>19</sup> To deduct litigation-related costs under section 212, those costs have to be attributed to a legal claim that arose in connection with the individual taxpayer’s profit-seeking activity.<sup>20</sup>

In 1969, Congress amended Code section 162 to expressly disallow some kinds of expenses otherwise deductible under section 162(a), including a “fine or similar penalty paid to a government for the violation of any law.”<sup>21</sup> Thereafter, courts and the IRS take Congress to have stripped courts and the IRS of discretion to disallow a section 162(a) deduction because such deduction would frustrate “public policy.” The IRS has on its own extended some of section 162’s disallowances to cover deductions under Code section 212.<sup>22</sup> More recently, Congress amended section 162 to disallow deductions for “any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement,” as well as to disallow any deductions for “attorney’s fees related to such a settlement or payment.”<sup>23</sup>

Finally, amounts paid “to defend or perfect” title to property are *not* deductible but must be “capitalized” or added to the basis of the property.<sup>24</sup> Capitalized costs—called “expenditures” instead of “expenses”—include amounts paid to defend or perfect title to not only real and personal property but also to intangible property, such as

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19. I.R.C. § 212.

20. *United States v. Gilmore*, 372 U.S. 39, 48–49 (1963).

21. I.R.C. § 162(f). For discussion, see F. Phillip Manns Jr., *Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?*, 13 VA. TAX REV. 271 (1993).

22. Reg. § 1.212–1(p) (disallowing section 212 deduction “if the payment is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense”). Unlike section 162(a), the casualty loss deduction under Code section 165 remains subject to the frustration-of-public-policy doctrine. *Stephens v. Comm’r*, 905 F.2d 667, 671 (2d Cir. 1990); *Medeiros v. Comm’r*, 77 T.C. 1255, 1262 (1981); Rev. Rul. 77–126, 1977–1 C.B. 47.

23. Pub. L. No. 115-97, § 13307(a), 131 Stat. 2054 (2017) (codified at I.R.C. § 162(q)).

24. Reg. § 1.263(a)–2(e)(1); *see* I.R.C. § 263(a).

patents, licenses, easement rights, and even the corporate charter of the corporate taxpayer that incurs the expenditures when there is no other suitable asset to which they can be capitalized.<sup>25</sup> Such litigation-related costs become part of the “basis” of the asset. Then, to determine whether a taxpayer has a net gain or loss upon selling or otherwise disposing of the asset, the asset’s basis must be subtracted from the “amount realized” on the asset’s sale/disposition—roughly the proceeds of the sale, as adjusted to reflect tax considerations.<sup>26</sup>

### III. ATTRIBUTING LITIGATION-RELATED COSTS TO INCOME-PRODUCING ACTIVITY

Because taxing new wealth, net of costs, is the essence of the income tax, the costs of income production must be deducted from gross income in calculating taxable income. As a result, deductions for litigation-related costs depend on rules that *attribute* those costs to a taxpayer’s income-producing activity as closely related to it. How should we write those attribution rules? This is the first tax-design choice.

In the seven jurisdictions surveyed above, there are roughly two approaches to making such an attribution: (1) whether the taxpayer incurred the expense with a bona fide purpose of producing income—which usually does not apply to *defendants*—and (2) whether the expense was, though unplanned, “caused” by an event, possibly unexpected and even adverse, but typical of the taxpayer’s income-producing activity.<sup>27</sup>

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25. Reg. §§ 1.263(a)-2(e)(1),—4(d)(9)(i),—4(d)(9)(iii) (illustrative example),—4(e)(5); Reg. § 1.212-1(k). The “origin-of-the-claim standard” must be used to decide whether litigation-related costs are nondeductible capital expenditures. *Woodward v. Comm’r*, 397 U.S. 572, 578–79 (1970); *Ash Grove Cement Co. v. United States*, 562 F. App’x 697, 699–701 (10th Cir. 2014) (legal fees and settlement paid to settle shareholder class action lawsuit were capital expenditures because incurred to defend and maintain corporate reorganization); *see Clark Oil & Ref. Corp. v. United States*, 473 F.2d 1217, 1220–21 (7th Cir. 1973) (amounts paid to settle nuisance action brought to establish price of property, were capital expenditures).

26. I.R.C. § 1001(a).

27. I.R.C. § 162(a) (“ordinary and necessary” to the taxpayer’s income-producing activity); *Income Tax Assessment Act 1997* (Cth) s 8-1 (Austl.); *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) § 18(1)(a) (Can.) (no deduction for outlay or “expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or

For the latter approach, complexity arises because the probability of getting sued varies by type of income-producing activity. For example, an obstetrics medical practice might be more likely to be sued, all else equal, than a medical practice specializing in ear, nose, and throat conditions; a retailer seller of canned spinach; or anyone engaged in *any* type of income-producing activity because of the distinctive risks of adverse medical events associated with childbirth as compared to other hospital events or running any kind of business.

To illustrate further, suppose we credibly believe from experience that every living individual adult (or other taxable unit) in the society has a one percent probability of getting sued given basic background conditions like being subject to the law of the jurisdiction during the relevant time. Suppose further that for the subset of people in the society that engage in *some* income-producing activity (e.g., operating a medical practice, running a bakery) the probability of getting sued rises to two percent. Now consider the subset of people in the society who operate an obstetrics medical practice. If *their* probability of getting sued is, all else equal, less than or equal to two percent, it cannot be concluded that the costs of getting sued are causally connected to the taxpayer's choice of pursuing an obstetrics practice *in particular*. The more that probability exceeds two percent, the greater the confidence we might have about attributing the cost of getting sued to that particular activity.

The conceptual difficulty: We can *always* describe the taxpayer's income-producing activity to make it belong to *more than one* type.

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property”); Income Tax Act 58 of 1962 § 11(c) (S. Afr.) (deduction for legal expenses actually incurred by the taxpayer “in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade”); Income Tax (Trading and Other Income) Act 2005, c. 4, § 34(1)(a) (U.K.) (for calculating trade profit, disallowing “expenses not incurred wholly and exclusively for the purposes of the trade”); Frais et charges - Conditions générales de déduction - Frais et charges exposés dans l'intérêt de l'entreprise, BOI-BIC-CHG-10-10-20120912, BULL. OFFICIEL DES FINANCES PUBLIQUES-IMPÔTS (Fr.) (company deductible expenses: “Il faut notamment que ces dépenses soient exposées dans l'intérêt de l'exploitation ou dans le cadre d'une gestion normale de l'entreprise.”); Detlef R. Stapperfend, § 4 *EStG*, in HERRMANN/HEUER/RAUPACH *EStG/KStG KOMMENTAR*, 283 [HERRMANN/HEUER/RAUPACH *INCOME TAX AND CORPORATE TAX ACT, COMMENT*], ¶¶ 791–93, 815, 832 (Dec. 2017) (Ger.) (business expense must have causal relationship with the activity it serves).

An obstetrics practice may belong simultaneously to the set “all activities involving the provision of medical services,” the set of “medical practices provided” in a particular state, and the set of “medical providers of assistance during childbirth”—all of which are subsets of the general set of “income-producing activities.” If the probability of getting sued varies for each subset, and no one such subset self-evidently describes that taxpayer’s “type” of activity, then which subset (and thus which probability) do we choose? This is an instance of the general reference-class problem.<sup>28</sup> To overcome that problem, we would need second-order rules for matching a taxpayer’s income-producing activity with pre-set activity categories (e.g., occupational classifications) and with accompanying estimates of the probability of getting sued.<sup>29</sup>

An alternative approach: *Ignore* any variation in the probability of getting sued associated with the type of income-producing activity. Instead, estimate the probability of getting sued regardless of the *type* of income-producing activity and then just *assume* that, if sued, the taxpayer is more likely than not to suffer some litigation-related costs as a result.

For example, under Code section 162(a), only “ordinary and necessary” expenses are deductible. Reading this threshold qualification as type-insensitive, it may be interpreted to classify an expense as “necessary” if “appropriate and helpful” “for the development of the [taxpayer’s] business,” and “ordinary” even if rarely incurred by a taxpayer.<sup>30</sup> As the U.S. Supreme Court declared in *Welch v. Helvering*:

A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount

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28. See generally Alan Hájek, *The Reference Class Problem Is Your Problem Too*, 156 SYNTHÈSE 563 (2007).

29. The reference class problem also makes it hard to coherently determine (on non-normative grounds alone) the size of the subsidy to the taxpayer that results when, because of the deductibility of litigation costs, that taxpayer’s net (after-tax) cost of settlement decreases.

30. *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

is large or small, are the common and accepted means of defense against attack.<sup>31</sup>

This alternative approach has two advantages. First, it may be too hard for a tax system to judge the accuracy or reliability of taxpayer estimates (or its own estimates) of the probability of being sued, given a particular income-producing activity, in deciding whether the taxpayer's litigation-related costs are properly attributed to that activity. The U.S. approach avoids this difficulty—including any reference class problem with defining the “types” of income-producing activities—by relying on the taxpayer's bona fide but subjective judgment that a cost is appropriate and helpful to its income-producing activity. U.S. tax authorities appear to generally but not invariably defer to taxpayer judgment in this regard,<sup>32</sup> as do U.S. courts.<sup>33</sup> Second, it may be just cheaper to enforce and comply with tax law by pursuing so-called book-tax conformity—that is, by limiting the extent to which tax accounting

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31. *Id.* at 114; *accord* *Comm'r v. Heininger*, 320 U.S. 467, 471–72 (1943); *see also* *Kornhauser v. United States*, 276 U.S. 145, 152 (1928) (attorney fees to defend against lawsuit brought by his former business partner were “ordinary and necessary” expenses: “a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel and payment of his charges”).

32. *See* Reg. § 1.183–2(b) (nine factors for determining whether a taxpayer has bona fide expectation of realizing a profit from an activity for which cost deductions are claimed).

33. *See, e.g.,* *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983) (taxpayer couple could deduct expenses of very passive investment activity based solely on their claim that they spent 40 hours a week working at the activity); *Nickerson v. Comm'r*, 700 F.2d 402 (7th Cir. 1983) (taxpayer's operating losses on bona fide but part-time efforts to rehabilitate farm were deductible, because the “ordinary and necessary” standard does not require a realistic prospect of profit); *Misko v. Comm'r*, T.C. Memo. 2005-166, 2005 WL 1580809 (2005) (practicing lawyer allowed to deduct expenses arising from non-profitable rentals of video equipment he also used himself in making videos for use at trial). *But see* *Chaganti v. Comm'r*, T.C. Memo. 2013-285, 2013 WL 6638844 (2013) (payments made to opposing counsel by taxpayer attorney as required by 28 U.S.C. § 1927, authorizing payments to cover costs incurred because of unreasonable and vexatious litigation, are necessarily not “ordinary and necessary” to the practice of law under I.R.C. § 162(a)).

(either in general or for litigation-related costs in particular) diverges from financial accounting.<sup>34</sup>

#### IV. LIABILITY INSURANCE PROCEEDS

Many defendants have liability insurance to cover litigation-related costs such as damage awards, settlements, and attorney fees. Accordingly, the second design choice: How should income tax law treat payments a liability insurer makes on behalf of the taxpayer to satisfy a settlement or judgment against that taxpayer? We identify two equally availing starting premises: (1) align the tax consequences of such payments to what the tax consequences would have been if that taxpayer had *self*-insured, or (2) treat those payments like any other gain realized on a contract. We then consider views that turn on treating liability insurer payments as discharging debt arising from litigation.

We first consider as a design premise here that, all else being equal, income tax law should treat a taxpayer who self-insures—sets aside funds in reserve to cover litigation-related costs and then pays out-of-pocket—no differently than a taxpayer for whom a liability insurer pays those costs. The reason is simple: Neutrality—treating like transactions alike—in taxing net income entails no greater tax burden on the self-insuring taxpayer than the liability-insuring taxpayer, and vice-versa.<sup>35</sup>

If so, whether the liability insurer's payment (made on the insured's behalf) is included in the taxpayer-insured's income should depend on whether the taxpayer could have deducted them if that taxpayer itself had paid those amounts. If liability insurance payments cover such costs that, absent insurance, the insured would have paid or incurred

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34. On how tax and financial accounting rules relate in the United States, United Kingdom, and Australia, see Thomas M. Porcano & Alfred V. Tran, *Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries*, 33 INT'L J. ACCT. 433 (1998).

35. Fairness—treating like taxpayers alike—may also require that the tax system be indifferent to whether the taxpayer buys liability insurance or self-insures. Payments to self-insure, however, are not usually deductible. *Clougherty Packing Co. v. Comm'r*, 811 F.2d 1297, 1303–04 (9th Cir. 1987) (collecting cases). In U.S. tax law, self-insurance is distinguished from insurance, which requires actual risk-shifting and risk-distributing. *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941).

those costs directly, and therefore could have deducted them, then excluding the insurance proceeds from the insured's income measures the insured's *net* income no differently than had the taxpayer self-insured and deducted those expenses when paid or incurred. But if the insured could *not* have deducted the expenses that the liability insurance proceeds are supposed to cover, then such proceeds should be included in the insured's income. In this respect, the answer (to whether a taxpayer should exclude liability insurance proceeds from its income) rises and falls with *the same* justification—whatever it is—for the deductibility of the insured costs that the taxpayer, had it self-insured, would have paid.

Consider, however, a different starting premise: Treat a liability-insurance recovery like any other gain realized on a contract. By paying the insurance premium, the insured performs its side of the contract, i.e., the insurance policy. The insurer has promised to pay if an event requiring recovery in fact happens during the time interval of that insurance policy. (If not, then depending on the jurisdiction's tax law, the insured may have a loss on the contract that may or may not be deductible.) Like any other realized gain from a contract, every insured's realized gain on an insurance contract must be included in gross income, absent another rule to the contrary. Indeed, a single contract may serve as the point of reference for determining whether there is income on a set of transactions that could each be considered separately, as for example a selling-short contract. Similarly, a taxpayer's liability insurance policy may serve as the point of reference for determining whether there is income on *multiple* insurance recoveries arising from the same policy. Under this approach, the taxpayer's gross income would include the total insurance recovery amount, albeit reducible by deduction if other conditions are met.

This approach, however, departs from how income tax laws typically treat recoveries under first-party property insurance contracts. To illustrate, suppose an insurer paid an insured an amount to cover the destruction of the insured's property. That recovery is usually excluded from the insured's gross income to the extent of the "basis" in U.S. terms, or tax-adjusted book value, of that property before it was destroyed.<sup>36</sup>

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36. For U.S. tax purposes, the exclusion is only cursorily mentioned in the Code, where the amount of any deductible loss is reduced by insurance or other compensation received for the loss. I.R.C. § 165(a). Gain on the sale or exchange of property is the difference between the "amount realized," or



Basis is sometimes said to be the owner's "tax investment" in property, an amount that may be deducted in gain or loss measurement.<sup>37</sup> Only the portion of the insurance recovery in *excess* of that amount is treated as a gain to the insured of the same character (i.e., capital or ordinary) of any gain that would have occurred had the insured sold or otherwise disposed of that property. Viewed another way, any insurance recovery is first included in gross income, as an amount received in exchange for the property, which is then reduced by the property's basis.

To underscore this conventional view of how insurance proceeds offset loss or gain, consider by contrast Kahn's argument that all liability-insurer payments to satisfy a judgment against the insured should be excluded from the insured's income.<sup>38</sup> Kahn reasons that by paying for liability insurance, the insured has invested in an arrangement whereby the liability insurer, not the insured, is the primary obligor for any debt owed because of the insured's illegal activity.<sup>39</sup> When the liability insurance policy pays out, the liability insurance proceeds "replace dollars" that the insured did pay (or would have paid) to satisfy its judgment-debt:

The replacement of dollars is equivalent to the replacement of basis, and so does not cause the insured to realize any income. Indeed, the justification for excluding from income amounts received (1) on the sale of an item, (2) as damages, or (3) as property insurance, to the extent these amounts do not exceed basis, is that they are a return of the cash that the owner had invested in the

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proceeds of the sale or exchange adjusted for relevant tax considerations and the property's basis. I.R.C. § 1001(a). The Code does not define "amount realized." Basis is incompletely defined, but there is no serious controversy about the use of the term in most contexts. By comparison, for German tax purposes, the term equivalent to basis is *steuerliches Buchwert* or tax book value. German tax accounting principles are more fully spelled out in *Bilanzrecht* or balance-sheet law, than are the corresponding U.S. tax accounting principles.

37. See, e.g., *Topic Number 703 - Basis of Assets*, IRS.gov, <https://www.irs.gov/taxtopics/tc703> (last updated Feb. 1, 2018) ("Basis is generally the amount of your capital investment in property for tax purposes.").

38. Kahn, *supra* note 11, at 15–16.

39. *Id.*

property. When the item replaced is the cash itself, it is obvious that it is not taxable to the recipient.<sup>40</sup>

This argument, however, assumes that an insured should be deemed to have a “basis” in a liability insurance policy—just like a basis in a patent or other (intangible) capital asset—that *always* equals the amount of the insurance proceeds. To illustrate, suppose *A* pays for liability insurance for three years at a price of \$100 per year. Near the end of year three, *B* sues *A*, and *A* files a claim with its liability insurer, who promptly pays \$300 to satisfy the terms of a settlement agreement between *A* and *B*. *A* has paid \$300 in insurance premiums and has constructively received (reaped an economic benefit under that policy) \$300 from its liability insurer. If we assume that, in paying \$300 in premiums, *A* had a “basis” of \$300 in the liability insurer’s legal duty to indemnify *A* under the insurance policy, then we offset *A*’s gain of \$300 by that amount. The result: *net* zero gain—the same result if we had just treated the \$300 paid by the liability insurer as excluded from *A*’s income.

Suppose, however, that the liability insurer paid \$1,000 to cover the insured’s judgment-debt. If so, then \$700 of that \$1,000 (\$1,000 *less* the \$300 in “basis”) should be *included* in *A*’s income. To exclude insurance proceeds from income altogether, one must deem a liability insurance policy’s “basis” as *always* equal to the full amount of the insurance proceeds. If so, then liability insurance is the unusual asset for which we cannot know the amount invested *in* it until *after* it produces a “return” on that investment.

More importantly, this argument assumes that the insured had not already deducted the premium paid for the liability insurance as a cost attributable to its income-producing activity. Had it done so, then by also excluding liability insurance proceeds from the insured’s income,

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40. *Id.* at 16 (footnotes omitted). Dodge argues that excluding liability insurance proceeds from the insured’s income is implicit in U.S. tax law, because U.S. tax law is best understood to implicitly treat the liability insurer’s payment made on the insured’s behalf “as a capital expenditure by the insured that is instantly offset against the deemed receipt by the insured of the economic benefit of having a liability satisfied.” Joseph M. Dodge, *The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress from Disallowing Such Costs*, 27 VA. TAX REV. 297, 339 (2007).

tax law would in effect let that insured deduct its liability insurance premiums twice—once as a separate deductible expense when paid or incurred, and then again as part of the liability insurance policy’s “basis” when the liability insurance policy pays out. To avoid such inaccuracy in measuring the insured’s income, therefore, either the liability insurance proceeds (if not excludable on other grounds) must be *included* in the insured’s income in their entirety—no adjustment for “basis”—or the tax law should disallow a deduction for the premiums paid or incurred by the insured.

Finally, since liability insurers pay to satisfy litigation-related debts incurred by the insured (such as damages owed to a prevailing plaintiff), one could argue that liability insurance payments should count as discharge-of-indebtedness income to the insured.<sup>41</sup> In contrast, Kahn assumes without discussion that a litigation-based liability of an insured is “primarily that of the insurer.”<sup>42</sup> It appears that he believes any compromise of the obligation cannot therefore result in discharge-of-indebtedness income to the insured. The liability insurer, however, is not the party originally liable for the insured’s obligation. Therefore, the insurance contract does not shift the potential for discharge-of-indebtedness income from the insured to the insurer.<sup>43</sup>

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41. *E.g.*, King, *supra* note 5, at 367–68.

42. Kahn, *supra* note 11, at 15.

43. Similarly, King offers the view that a liability insurer is a *secondary* obligor of judgment-debt, but that the insurance contract results in the insured being only contingently liable for the part of the liability the insurer is not obligated to pay under the insurance policy’s terms of coverage. King, *supra* note 5, at 369 n.96. As a result, liability insurance payments on the insured’s behalf could arguably be excluded from the insured’s income, because “[i]t is well established that the discharge of a contingent liability by virtue of its full payment by another is not income to the contingently liable taxpayer.” *Id.* at 369. The revenue ruling King cites, however, is inapposite. It only says that when a corporation redeems a retiring shareholder’s stock, the release of a continuing shareholder’s obligation to purchase any retiring shareholder’s stock if it had been necessary for the solvency of the corporation, is not cancellation-of-indebtedness income to the released shareholder. *See* Rev. Rul. 69–608, 1969–2 C.B. 42. However, when a liability insurer pays, the insured’s obligations (e.g., damages, attorney fees) are *fixed*, not still contingent, and the insured would be liable if, say, the liability insurer became insolvent and therefore could not pay as the insurance policy requires.

Nonetheless, Kahn argues that because a liability insurer agrees to ultimately bear some subset of the insured's litigation-related debts, the insurer is the "primary obligor" of those debts; as a result, an insured should "not be taxed on the insurer's satisfaction of a liability that is primarily that of the insurer."<sup>44</sup> Whether an obligor is primary or secondary, however, only denotes whom of two parties a creditor must first demand payment of an obligation. For tax purposes, that distinction alone does not matter. If a taxpayer gives her unconditional guaranty of a controlled corporation's potential obligation to a third party, she can be made to pay the obligation when it arises, even if no one has demanded payment against the corporation. When a taxpayer gratuitously guarantees another taxpayer's inchoate obligation, the guarantor's obligation is only that which she ultimately pays under the guarantee; hence, no cancellation-of-indebtedness can be attributed to the guarantor by reason of the guarantee alone.<sup>45</sup> To be sure, a party with some or equal responsibility of another's obligation could guarantee that obligation for the commercial security of the creditor. If the creditor then forgave part of that obligation, the guarantor might indeed have gross income. The guarantee itself, however, does not entail that result.

## V. COORDINATION OF TAX CONSEQUENCES OF DAMAGES PAYMENTS

In general, whether a defendant-payor may deduct payments from its gross income to satisfy a judgment or settlement does *not* turn on whether the payee must include the damage payment in its gross income.<sup>46</sup> Thus, the third tax-design choice is this: Should payor and payee tax consequences be coordinated? That is, should the payor generally not be allowed to deduct those payments if they are excluded from the payee's

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44. Kahn, *supra* note 11, at 15; *see id.* ("The fact that the insured could be required to pay the victims of his actions does not make the insured the primary obligor, since the insured would be entitled to reimbursement from the insurer if he pays.").

45. *Aftergood v. Comm'r*, 21 T.C. 60, 63 (1953). To be sure, Kahn offers "an analogous circumstance where an employee's negligence causes harm to a third party who recovers damages from the employer. Even though the employee also was liable for the injury, the employer's payment is not income to the employee." Kahn, *supra* note 11, at 15. This is not analogous if, given joint and several liability, the employer and employee, as co-defendants, are *equally* responsible for satisfying the entire judgment-debt.

46. *E.g.*, Can. Customs & Rev. Agency, Bulletin 467R2, at ¶ 9 (2002).

income but be allowed to deduct them if they are included in the payee's income?

It turns out that answering this question depends in large part on *the core* issue in income tax law: What should count as the measure of taxpayer "income"? Under the popular Haig-Simons definition of taxpayer income, no payor-payee coordination is necessary, because under it, accessions to separate taxpayers' economic power always count as income. Simons favored measuring individual income to ignore a taxpayer's utility gains or losses.<sup>47</sup> Instead he restricted the concept of individual income to market-based gains and losses in "economic power."<sup>48</sup>

Suppose that we proceed instead under the alternative view that any measure of personal income must, when aggregated, match the total product from a society's capital and labor. Simons criticized this view, including as it appeared in Lotz.<sup>49</sup> Warren is an exemplar of this argument in the U.S. tax literature.<sup>50</sup> This exchange approach matters if we act *as if* judgment and settlement payments are bilateral exchanges between defendant-payors and plaintiff-payees. We show here how that view, along with some second-order design choices, might justify coordinating payor-payee tax consequences of judgment and settlement payments. In so doing, we also identify a plausible ground for taking the general Warren-Lotz exchange view more seriously than has prior commentary.

### A. *The Equal-Amounts-Realized Rule*

To see how this works, let's start first with tax law's equal-amounts-realized rule (EAR). The EAR applies when a taxpayer sells a property

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47. HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* (1938).

48. *Id.* at 221, 229.

49. *Id.* at 44–48, 71–74; see WALTHER LOTZ, *FINANZWISSENSCHAFT* 445–46 (Tübingen 1917); see also NICHOLAS KALDOR, *AN EXPENDITURE TAX* 70–72 (1955) (raising other concerns).

50. Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 *YALE L.J.* 1081, 1085–93 (1980). For discussion, see Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 *TAX L. REV.* 679, 690–93 (1988), and see also Joseph M. Dodge, *The Story of Glenshaw Glass: Towards a Modern Concept of Gross Income?*, in *TAX STORIES* 38–39 (Paul L. Caron ed., 2d ed. 2009) (largely dismissing this argument, as applied to the income taxation of punitive damages, as inconsistent with current U.S. tax law).

interest to produce income, either by selling the use of property, such as in leasing or licensing agreements, in exchange for payment (rent or royalties), or selling interests in property of indefinite duration, including the unqualified ownership of the property itself.<sup>51</sup> In such transactions, income tax law tends to treat the respective values of items of property exchanged at arm's length as *equal*.<sup>52</sup> This is the equal-amounts-realized (EAR) rule. Put another way, if you and I exchange between us one or more such items and in return get another item or several other items, the lots exchanged are deemed to be of equal value.<sup>53</sup> Suppose an arms-length exchange in which Alice trades her stamp collection—which cost her \$2,500—for Bob's car—currently worth \$10,000. Bob had paid \$12,000 for the car and had never suffered a casualty loss. Although Alice gains \$7,500 (= \$10,000–\$2,500) and Bob loses \$2,000 (= \$10,000–\$12,000), for income tax purposes, Alice and Bob each realize the same amount (\$10,000) on the exchange.

The EAR rule, however, stands in tension with the idea that people contract with each other only because they sincerely believe that the transaction, once completed, will yield a net personal gain for them. Each contracting party puts a higher value on what the other party has promised to do as compared to what he or she has promised to do. For example, if they agree to exchange property, then each estimates the value of the property he or she will get to be more than the property he or she will give up. Neither party is necessarily wrong to believe this. After all, utility is “subjective,” so the parties can differ as to the utility of what they have promised to exchange. In our example, we infer that Alice and Bob each enjoy a utility gain on the exchange; otherwise, she would not trade her stamps for his car, and vice-versa.

Nevertheless, because of the EAR rule, income tax law does *not* take either party's utility gain into account. This may seem surprising,

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51. The U.S. tax code refers to such transactions as “dealings in property.” See, e.g., I.R.C. § 61(a)(3).

52. See, e.g., *Phila. Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

53. In the terms of U.S. tax law, the “amount realized” by one party to an exchange is always the same as that realized by the other party (I.R.C. § 1001(a) [contextual definition of “amount realized”]). In contrast, a gift is not an exchange at all. And a “bargain sale” is treated as two associated but distinct transactions, one donative and the other arm's length, and hence subject to the assumption of equal values exchanged.

given how income tax law elsewhere accounts for taxpayer utility.<sup>54</sup> First, taxing income—instead of wealth or consumption—can account for differences in taxpayer’s utility schedules in the pursuit of horizontal and vertical equity. Many point to the diminishing marginal utility of income to help them justify proportional or progressive income tax rates.<sup>55</sup> Second, the tax authorities and courts generally defer to taxpayers’ subjective choices in framing their income-seeking activities by allowing taxpayers to deduct the costs and losses of these activities as long as they were incurred in good faith for the production of income—hence, whether incurred for objectively good reasons or not.<sup>56</sup> This seems to occur even though, on paper, income tax laws make deductibility depend on an *objective* relationship between the expenses incurred and the reasonableness of any income-oriented activity the expenses are supposed to serve.<sup>57</sup>

In any event, the EAR rule matters here, because we can treat payments to satisfy a settlement *as if* they were exchanges of items of property between plaintiff and defendant. To see why, consider the following illustrative examples.

*Example 1:* Charles sues Ace Automobile Co., alleging that Ace sold him for \$30,000 a defectively designed supercharged diesel car. Ace and Charles settle this claim: Ace agrees to pay Charles \$35,000, and Charles agrees to return the car to Ace. Viewed as an exchange, Charles has given up property in which he had a basis of \$30,000, and he has realized \$35,000, for a gain of \$5,000, which should be treated as gross income to Charles. Ace has realized an equal amount, \$35,000, under EAR. Its basis in what it gives up in the exchange

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54. Commentators rarely identify this internal tension in general, let alone as relevant to the tax treatment of defendants’ litigation-related costs. At best, a few have exemplified this tension by simultaneously criticizing *and* relying upon utility-based analysis. *E.g.*, DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 155–56, 166 (1986); LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 41–43, 348–49 (2008).

55. *See, e.g.*, BRADFORD, *supra* note 54, at 150–51; RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY* 90–115 (1959); SVEN STEINMO, *TAXATION & DEMOCRACY: SWEDISH, BRITISH AND AMERICAN APPROACHES TO FINANCING THE MODERN STATE* 50–52 (1993).

56. *See supra* note 33.

57. *See supra* note 27.

is a bit mysterious but could include litigation costs Ace has not yet deducted—the latter would not be included in the basis of what it gave up because they were not capitalized. The rest of what Ace realized appears to be gain and should be included in Ace's gross income.

*Example 2:* Same as Example 1, except Ace settles Charles's claim for a physical injury he suffered while driving the car. He does not surrender the car as part of the settlement. Both parties still each realize \$35,000. Charles may be thought to have a basis in that aspect of his well-being that was injured, because he could have enjoyed his uninjured body without ever having to pay tax on that enjoyment.<sup>58</sup> Ace still has only a basis in the ideal asset it exchanges that is equal to its previously capitalized litigation costs. The tax consequences for Ace are the same as in Example 1.

*Example 3:* Ace Automobile Co. settles for \$100,000 a claim brought by Bash Automobile Co., alleging Ace's destruction of Bash's goodwill by illegal competitive practices. Bash would have \$100,000 in gross income, if it has a zero basis in the goodwill. If Ace's alleged misconduct increased the value of its own goodwill—adding to it, so to speak—then Ace should not be allowed to deduct the settlement amount but should instead capitalize it to its goodwill. This amount could later reduce Ace's gain on selling its business to another. It could also reduce Ace's gain, or result in a deductible loss for Ace, if a competitor settled Ace's claim for destroying Ace's goodwill.

### *B. The Social Product*

This exchange view of judgments and settlements accords well with, and may even support, the more general view that any measure of personal income must, when aggregated, match the total product from a society's capital and labor ("social product"). Accordingly, to elaborate the exchange view of judgments and settlements, consider first how the Lotz-Warren exchange view applies generally.

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58. I.R.C. § 104(a)(2) seems to reflect this reasoning by excluding the amount of judgments and settlements received for personal physical injury.



To illustrate, imagine a hypothetical society with three members ( $A$ ,  $B$ , and  $C$ ). In this society, a collective cornfield is the only source of gain, and thus, working on that cornfield is the only productive activity. If during a certain accounting period the total yield of that corn field is, say, 1,000 ears of corn, then that society's social product for that period is 1,000 ears of corn ( $S=1,000$ ). If we tax the cornfield's total yield at, say, a 5% tax rate ( $t_s=0.05$ ), then the total tax on the social product is 50 ears of corn ( $t_s(S)=0.05 \times 1,000=50$ ). To make this calculation, we do not need the Haig-Simons definition of personal income for each member of the society ( $I_A, I_B, I_C$ ), if we can tax the social product at its source (at the corn field, before the corn is distributed to  $A$ ,  $B$ , and  $C$ ) and if we do not care how much of it each person in the society receives.

If, however, one wants tax burdens to vary by person (say, to achieve a desired redistribution of the social product), or if it is too hard to collect the tax at the source, the Haig-Simons definition matters. That definition starts with the person or other taxable unit of analysis and, in effect, identifies how much of the social product "has ended up in each taxable unit."<sup>59</sup> Thus, in our hypothetical three-member society, each person's personal income tax rate ( $t_A, t_B, t_C$ ) can vary by how many ears of corn each person receives during the accounting period. However, the sum of the tax imposed on each person's Haig-Simons income should ideally still equal the revenue of an income tax on the entire social product ( $t_s(S)=t_A(I_A)+t_B(I_B)+t_C(I_C)=50$ ).<sup>60</sup> In the simplest case, if everyone ( $A$ ,  $B$ , and  $C$ ) has their Haig-Simons income subject to the same tax rate, then the sum of Haig-Simons income of each taxable unit in the society should match that society's social product, because the requirement  $t(S)=t(I_A)+t(I_B)+t(I_C)$  reduces to the requirement  $S=I_A+I_B+I_C$ .

If so, the ideal income tax must treat the *non-productive* transfers of items of value by offsetting any recognized gain to the transferee with a reduction in the income of the transferor for the accounting period. Otherwise, the sum of personal income would inaccurately estimate the social product.

To see why, suppose again aggregate yield in the three-member hypothetical society's collective corn field is 1,000 ears of corn. This corn is distributed among  $A$ ,  $B$ , and  $C$ . Thereafter, person  $A$  misplaces

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59. Warren, *supra* note 50, at 1086.

60. More generally, for every taxable person  $p$  in the society with  $n$  members, the ideal personal income tax  $t_p$  satisfies the condition that  $t_s(S)=\sum_{p=1}^n t_p(I_p)$ .

100 ears and person *B* finds those 100 ears. As a result, *B*'s Haig-Simons income increases by 100 ears. If we did not reduce *A*'s Haig-Simons income by 100 ears, then even in the simplest case (where tax rates do not vary by personal income), the sum of personal income would overestimate the social product ( $S < I_A + I_B + I_C$ ) by 100 ears (at 1,100 ears).<sup>61</sup>

To be sure, under this approach, we can debate whether a transfer is productive, i.e., whether the transfer produced a return (from capital, labor, or whatever source) and thereby increased the social product.<sup>62</sup> This ambiguity—about when a transfer affects the social product—matters for the tax treatment of damage payments. On the one hand, damage payments can be deemed *non-productive* transfers from losing (or settling) defendants to winning (or settling) plaintiffs. After all, defendants do not undertake such transfers *themselves* to produce personal gain. If defendants could avoid damages payments altogether, they would.

On the other hand, damages payments, in the aggregate, may cause the social product to be larger than it otherwise would have been. For example, some argue that negligence law is (or is best justified as) a way to reduce the society's overall accident costs—the sum of what accident victims suffer and what people pay to avoid accidents: By encouraging private actors to take only cost-justified accident precautions, negligence law demands transfers from tortfeasors to tort victims

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61. Warren, *supra* note 50, at 1087–88. For Koppelman (*supra* note 50, at 691–92), this approach implies that payors in productive transfers must be denied a deduction.

62. Koppelman (*supra* note 50, at 693) concluded that Warren “appears arbitrary” in how he treats personal expenditures, absent “some reason for distinguishing among various personal uses [of resources] in this manner.” Similarly, Simons (*supra* note 47, at 46) complained of similar antecedent ideas that although “it is impossible to distinguish sharply between uses of resources which involve production, predation, and mere waste,” the idea of a “social income” requires “[s]uch distinctions.” Simons went further: The idea of social income necessarily collapses into a “welfare conception,” because finding an increase in it amounts to an “ethical or aesthetic judgment” that there was more of, or more efficient use of, “things which must be economized.” *Id.* On the other hand, while it will be unclear in some cases whether a particular transfer increased the social product, the number of such ambiguous cases could be tolerable as close to or less than the number of ambiguous cases arising from other tax-law concepts (e.g., “realized” gain vs. other appreciation).

only under circumstances that, in the aggregate, reduce both accidents and accident-precaution costs.

If current negligence law does this, then absent damage payments to resolve negligence lawsuits, the members of the society would have had fewer resources to devote to corn-growing and other activities whose aggregate yield comprises the social product. However, such an effect on the social product might be an emergent property of the legal processing of accident claims as a whole. On this view, damage payments might increase the social product—by causing the collective corn-field yield to be bigger than it otherwise would be—but, for any particular damage payment, the individual payor reaps no net gain that can be traced back to that payment. If damage payments are deemed “productive” transfers on this ground, the social product can be more than the sum of individual income ( $S \geq I_A + I_B + I_C$ ), thus departing from a necessary condition of the social-product approach.

To avoid this result, we could treat damage payments as non-productive transfers and attribute the aggregate effect of such payments to durable features of the social institutions that process legal claims. Thus, the legal system, like roads and bridges, is an item of infrastructure—a societal investment to facilitate increases in social product. After all, even in an accounting period where no damage payments in fact occur, the prospect of such payments may still push people to adjust how carefully or how often they act, thus reducing overall accidents costs and, as a result, causing the social product to be larger than it otherwise would.

### *C. Coordination*

To simplify, let us assume that damages payments do not generally increase the social product. Then, accurately matching the sum of Haig-Simons personal income with the social product requires (1) offsetting gains to plaintiffs’ Haig-Simons income from damage payments by reducing defendants’ Haig-Simons income, or (2) offsetting exclusions of such transfers from plaintiff’s income by refusing to reduce the defendant’s Haig-Simons income by that transfer amount. Both plaintiff and defendant can deduct losses, if any are incurred before or as a result of claim settlement or judgment. Nothing in this approach precludes, however, assigning the offset to a *random* taxpayer in the society, though second-order considerations may motivate coordinating the offset as between plaintiff-payees and defendant-payors.

To see why, consider again the simplest case of our three-member hypothetical society in which tax rates do not vary by person and aggregate yield in the collective cornfield (the only social product) is 1,000 ears of corn. After the pre-tax distribution of those ears of corn, person *A* loses 100 ears of corn in an unexpected fire. *B* is found to have set the fire and is liable to *A* for damages caused by the fire. Therefore *B* pays 100 ears to *A*. If the tax law recognized *A*'s personal income as increasing by 100 ears but did not treat *B*'s income as reduced by 100 ears, then the sum of Haig-Simons personal income would *overestimate* total yield ( $S < I_A + I_B + I_C$ ) by 100 ears (at 1,100 ears). If, however, the tax law did not recognize *A*'s Haig-Simons income as increasing by 100 ears, then all else equal, letting *B* deduct 100 ears from its Haig-Simons income would cause the sum of Haig-Simons personal income to *underestimate* the social product ( $S > I_A + I_B + I_C$ ) by 100 ears (at 900 ears). This reasoning, however, does not apply to fines or similar payments made to the government. If *B* only paid 100 ears of corn to the government as a civil penalty for setting the fire, then *A* has no gain from *B* to offset.

Thus far, however, the argument is indifferent as to *who* bears the burden or benefit from the offset, so long as *some* other person or taxable unit in the society does. For example, if *B* pays *A* 100 ears of corn in damages; the tax law recognizes *A*'s personal income as increasing by 100 ears; but if that tax law only lets *C*, not *B*, deduct 100 ears from *C*'s income, then, all else equal, we still satisfy the condition that  $S = I_A + I_B + I_C$ . To be sure, *B* might complain that it, not *C*, should be allowed to take the deduction, but that complaint turns on how much that result deviates from the desired (and separately justified) redistribution of the social product among *A*, *B*, and *C* that the income tax aims to accomplish.<sup>63</sup>

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63. More generally, for any taxable person *p* in the society (with *n* members) that receives a damages payment that is treated as included in its income, we could offset the gain to that person by *randomly* awarding a deduction in the same amount to any other taxable person in the society, so long as the fact or prospect of such random assignment does not itself cause a departure from the condition that  $t_s(S) = \sum_{p=1}^n t_p(I_p)$ . Absent any such coordinated offset for *someone*, it is, all else equal, more likely that the sum of Haig-Simons personal income will inaccurately measure the social product during the accounting period. If there is, as a result, a difference with the aggregated revenue of an ideal personal income tax ( $|t_s(S) - \sum_{p=1}^n t_p(I_p)| \neq 0$ ), that difference amounts to over-taxation or under-taxation of the social product that must be independently justified.

Nonetheless, here are two second-order reasons for assigning the offset to the payor. First, compared to randomly awarding it, we may need to award the offset (the deduction) to the defendant-payor to achieve the desired after-tax distribution of the social product. Second, it may today be cheaper for tax administration (particularly where tax rates vary by person), because the defendant-payor is the best situated to know how much it paid and thus how large of an offset (deduction) to seek.

Here is a reason for *not* coordinating the tax treatment of damage payments and receipts: Doing so may produce legal uncertainty for whoever is assigned the offset, as well as for the tax authorities who must settle their tax liability. For example, suppose the tax law assigns the offset to the payor. If *A* paid damages to *B*, *A*'s deduction for that damage payment turns on whether the tax authorities do *in fact* treat *B*'s receipt as included or excluded from *B*'s income. But if the tax treatment of *B*'s receipt is uncertain, *A* cannot confidently estimate its after-tax cost of the productive activity that gave rise to the damages payment. This causes greater uncertainty for *A* and for any court that has to decide whether *A*'s deduction is allowable. Conversely, suppose that including a damage-payment receipt as part of *B*'s gross income turns on whether *A*'s deduction for that payment is allowable. If the tax treatment of *A*'s deduction is uncertain, then *B* suffers greater uncertainty as to its gross income, as does any court called on to measure *B*'s gross income.

To avoid this result, we could design the tax law to allow defendant-payors (or someone else) to deduct their damage payments without regard to whether the payee could or did exclude such receipts from gross income. If so, then all else equal, the sum of Haig-Simons personal income would underestimate the social product, resulting in a certain amount of foregone tax revenue.<sup>64</sup> Such forgone revenue may be best understood as a social expenditure (*a tax expenditure*) to reduce the costs borne by taxpayers of inaccurately estimating the after-tax cost of their income-producing activities.

Finally, if we do decide to coordinate the tax treatment of damage payments and receipts, we must disallow a deduction for the payor (or a randomly selected third party) if there are independent reasons for letting the payee exclude its receipt of that payment from its income. Consider, for example, damage payments that are tied to payee losses in the sense that the payee, once paid, is deemed thereby to have gotten

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64. That is, foregone revenue in an amount that equals  $t_s(S) - \sum_{p=1}^n t_p(I_p)$ .

back the item lost. Suppose someone illegally took away your widget, today worth \$100. In a competitive market for widgets with zero product differentiation, you may be indifferent between getting a new (identical) widget (worth \$100) or getting back the old widget (or its cash value, \$100). For tax design, however, getting back the item of value (here, the widget or its cash equivalent) increases your wealth if you already took a deduction for that loss.

To illustrate, imagine that personal wealth for an individual *A* is his or her current stock of widgets. (Wealth is a fixed quantity of purchasing power of which income is any positive change.) If *A* suffers a “loss” when *B* steals one of *A*’s widgets, *A* suffers a decrease in wealth—one less widget in *A*’s stock. If *A* gets its widget back (or its equivalent in damages, \$100), *A*’s wealth increases, but that increase is calibrated to offset the loss, so there is no net personal gain for *A*. This implies that damage payments calibrated to cover such losses—sometimes called “compensatory damages”—should be excluded from the payee’s income.

Suppose, however, *A* had already taken a deduction for that loss. (Doing so may be necessary to accurately measure *A*’s net income in cases where *B* steals *A*’s widget in an accounting period before *A* gets the widget back.) If so, then *A*’s wealth increases as result. That increase, however, would not offset the loss—the deduction already was supposed to have accounted for that. Thus, what *A* received, though nominally just to “compensate” for *A*’s loss, should be included in *A*’s income.

Meanwhile, should *B* be allowed to deduct the compensatory payment to *A*? Under the Haig-Simons definition of income, the answer must be yes. Upon paying *A*, *B*’s economic power goes down and that reduction should be reflected in *B*’s income for the period. After all, the broader purpose of *B*’s activity—stealing the widget from *A*—was to produce income (albeit by illegal means). In contrast, under the exchange approach, since restitution is a non-productive transfer, the transferor (*B*, in our illustration) should not be permitted to deduct a restitutive payment. Otherwise, the income tax system will systematically mismeasure the social product.<sup>65</sup>

In turn, under either approach, some losses are or should arguably be deductible by the payee—and thus “compensatory” payments

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65. The German income tax expressly disallows the deduction of damages payments that are not restitutive but allows those that are. Einkommensteuergesetz [EStG] [Income Tax Act], Oct. 8, 2009, BGBL I at 3384–85, § 4 (Ger.).

received for them should be excluded from payee income—because such deductions are necessary to accurately measure payee net income. For example, an income tax system should exclude from a payee's income those damage payments that are supposed to replace payee items that were already taxed as income—for example, wages that, but for the defendant-payor's conduct, would have been taxed at the source before disbursed to the payee. Otherwise, the payee would be taxed twice on the same receipt.

Another example: If damage payments are supposed to cover losses to endowments that payees are taken to have had since birth (e.g., health or human dignity), then we should exclude those payments from payee income. The reason: Those endowments cannot reasonably be taxed at all, which is the same as acting as if they had already been taxed. Otherwise, the taxpayer who receives a damages payment to cover the loss of an eye or limb will, all else equal, face a greater tax burden than she would in a world in which she had never lost that eye or limb. The reason: In that counterfactual world, she never would have faced an income tax bill on those items.

## VI. LITIGATION-RELATED COSTS AS CAPITAL EXPENDITURES

This section identifies the implications of treating litigation-related costs as capital expenditures tied to a right to receipts pursuant to a court judgment or settlement agreement, or a legal claim, that is, a *conditional* right to such receipts. In general, income tax law treats litigation-related costs as general outlays associated with whatever activity gives rise to the litigation, not costs incurred to buy a specific economic benefit that can only be obtained by litigation.<sup>66</sup> However, Dodge, following Davenport, has argued that, under U.S. tax law, a plaintiff's litigation costs should be treated as capital expenditures attributed to the legal rights that the plaintiff's litigation may establish, such as the plaintiff's *right* to recover damages that is established when a court enters a judgment for damages in the plaintiff's favor.<sup>67</sup> Once established, this right is itself an asset, i.e., a right to future receipts (or, in the case of a settlement agreement for periodic payments, a stream of receipts). Accordingly,

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66. *E.g.*, Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) § 8(b) (Can.).

67. Dodge, *supra* note 40; Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents, *Comm'r v. Banks*, 543 U.S. 426 (2005) (Nos. 03-892, 03-907), 2004 WL 1860016, at \*12.

Dodge argues, U.S. tax law should permit the plaintiff to offset capitalized litigation-related costs against those future receipts, including the costs incurred to create the right (litigation-related costs to secure the judgment) and to secure the asset after its creation (e.g., the cost of securing a judgment lien in case the defendant refuses to satisfy the judgment).<sup>68</sup>

Dodge's argument presupposes that plaintiffs' litigation-related costs should be deductible *at all* if paid as the costs of income-producing activity (here, for example, attorney fees to secure the right to damages receipts). Dodge, however, does not adequately explain why this should be so. It is not enough to answer that the right to a judgment is just as much an "asset" or "property" as land or a patent, because "asset" and "property" are not self-defining except in aid to *why* the costs to acquire such an "asset" or "property" should be deductible at all.

In general, treating certain costs of income-producing activity as capital expenditures is a way to match those costs with the receipts of the accounting period to which they are properly attributable, thereby resulting in a more accurate calculation of net income. In this respect, treating costs as capital expenditures matters for *when* and *how* a deduction for such costs may be taken (i.e., at the time of asset disposition and as an offset to any resulting gain from disposition), not whether they should be deductible at all. Thus, if litigation-related costs are *not* properly attributable to income-producing activity, then those costs should not affect the calculation of net personal income, and that should hold regardless of whether the tax law treats those costs as deductible expenses or capital expenditures. We need to figure out why we ought to attribute those costs to an income-producing activity *before* we choose whether to treat those costs as capital expenditures.

Yet, let us assume *arguendo* that we do choose to treat a plaintiff's right to receipts from a judgment or settlement as a capital asset, and by extension a legal claim as a conditional right to such receipts. That choice also implies treating as capital expenditures a *defendant's* litigation-related costs to pursue a legal *defense* to the plaintiff's claim in the plaintiff's lawsuit. The parties to a lawsuit pursue claims *and* defenses with an eye toward gain. For a legal defense, that gain comes in the form of a total or partial offset against the debt that, but for the successfully established defense, a defendant would otherwise owe the plaintiff. A defense to liability, if successful, reduces what the defendant

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68. Dodge, *supra* note 40, at 298–304.



would otherwise owe the plaintiff to zero. A defense to remedy, if successful, reduces but does not eliminate the defendant's judgment-debt that it would otherwise owe.

In this respect, capitalizing the costs of a legal defense is like capitalizing the cost of buying coupons that will reduce the cost of other items. To some extent, both coupons and legal defenses represent options to reduce the price of an item or activity. The cost of coupons is not deductible when incurred but when later events occur, because the capitalization of the cost of a coupon under the U.S. income tax generally follows the treatment of employee stock options and other forfeitable property interests acquired in connection with the performance of services.<sup>69</sup>

Just as coupons lower the price of a potential future purchase, legal defenses reduce or eliminate a potential judgment-debt. To be sure, unlike the benefit of buying coupons, the size of any offset due to a legal defense must be discounted by its probability of success on that defense in the lawsuit. This is sometimes hard to estimate and may only be partially affected by the defendant's efforts in pursuing that defense.

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69. The value of "property" transferred to a taxpayer in connection with the performance of services (less what the taxpayer paid to acquire it) is included in her gross income, albeit only when any condition of forfeiture related to those services lapses. I.R.C. § 83(a). Section 83's term "property" includes "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Reg. § 1.83-3(e); see Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1125-39 (2005) (arguing that exclusion in Reg. § 1.83-3(e) for "unfunded and unsecured promise to pay" only covers promise to pay by service recipient, not by a third party, including stock options (see Reg. § 1.83-7)). Before section 83 was adopted, the Supreme Court had already held that the value of a stock option may not be included in an employee's gross income until the option was exercised, and then only to the extent of the difference between the market value and the option exercise price. *Comm'r v. LoBue*, 351 U.S. 243, 247-49 (1956). The exclusion of any amount a taxpayer has paid for an option makes explicit that the holding in *LoBue* would exclude pre-payment by the taxpayer of part of the stock price. "If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant," Reg. § 1.83-7(a) provides, "sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time."

Nonetheless, any such contingency with legal defenses also holds for legal claims. After all, a legal claim is a right to receipts from the defendant that is conditional on both whether the plaintiff wins the lawsuit and how much the judge or jury awards the plaintiff.

## VII. DEFAULT RULE: SETTling DEFENDANT PROMISES NOT TO SEEK DEDUCTION

This section proposes a novel default rule for settlement agreements: Unless a settlement agreement expressly indicates otherwise, a settling defendant promises not to seek an otherwise allowable tax deduction for litigation-related costs. This section shows why such a settlement term is enforceable under current U.S. law, and why a default rule to this effect would encourage more discussion of the tax-design choices that this Article identifies.

For such a settlement term to be enforceable, two conditions must hold: (1) the jurisdiction's income tax law allows deductions for the taxpayer's litigation-related costs, but does not require that taxpayer to take those deductions; and (2) where the defendant breaks a promise in a settlement agreement or consent decree not to seek that deduction, the plaintiff-counterparty is entitled to monetary recovery based on defendant's *net* gain as a result of conscious breach of that promise, i.e., the value of the deduction's tax benefit to the defendant.

First, in general, the tax law itself does not necessarily prohibit promises not to seek available deductions, because such law does or should treat deductions as optional, not mandatory, for the taxpayer. Maule argues that, in general, most U.S. tax deductions and credits are optional, not mandatory, for the taxpayer.<sup>70</sup> He points to the phrase "shall be allowed" in various Code provisions authorizing a deduction, and argues that this phrase can and should be read to make deductions and credits optional (i.e., must be allowed only if claimed on the tax return), unless the Code expressly indicates otherwise.<sup>71</sup> Such a reading permits a taxpayer to elect to forsake a more accurate measure of its net income in favor of some other tax advantage or *non-tax* advantage, such as favorable publicity or reduced probability of a tax audit. More importantly, we can think of no general tax-design reason to force a taxpayer to take

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70. James Edward Maule, *No Thanks, Uncle Sam, You Can Keep Your Tax Break*, 31 SETON HALL LEGIS. J. 81 (2006).

71. *Id.* at 95–96.

a deduction, given taxpayer knowledge of and consent to the implications of forsaking that deduction.

Second, if a defendant breaches a promise not to seek a tax deduction for its litigation-related costs, the plaintiff may still be entitled to restitution damages equal to the value of the defendant's reduced tax liability because of the deduction. By seeking that deduction, that defendant has committed an *opportunistic* breach of contract, for which disgorgement of the defendant's net profits as a result is recognized, for example, in the United States as an appropriate remedy in the common law of many States.<sup>72</sup>

Such a disgorgement remedy is even more likely where the settlement terms become the terms of a court approved consent decree that, as a result, may be enforced by contempt sanctions. For example, in the United States, federal courts have recognized disgorgement of profits as a remedy for compensatory civil contempt.<sup>73</sup> The States, however, vary. Many States do not recognize *any* damages remedy in a civil contempt proceeding under either the relevant statutory authority for contempt or under State common law.<sup>74</sup> Some States do, either on motion for contempt, a separate motion for damages in the same proceeding, or in a separate damages action,<sup>75</sup> but only sometimes is it clear that such damages include disgorgement.<sup>76</sup> Moreover, unlike in a contract action, in most U.S. jurisdictions, the trial judge in a civil contempt proceeding may award attorney fees to the prevailing party.<sup>77</sup>

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72 For discussion, see the commentary to RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 (AM. LAW INST. 2011).

73. *Leman v. Krentler-Arnold Hinge Last Co.*, 284 U.S. 448, 457 (1932); *Marshak v. Treadwell*, 595 F.3d 478, 495 (3d Cir. 2009); *Jerry's Famous Deli, Inc. v. Papanicolaou*, 383 F.3d 998, 1004 (9th Cir. 2004); *Howard Johnson Co. v. Khimani*, 892 F.2d 1512, 1521 (11th Cir. 1990); *Manhattan Indus. v. Sweater Bee by Banff, Ltd.*, 885 F.2d 1, 5–7 (2d Cir. 1989); *Connolly v. J.T. Ventures*, 851 F.2d 930, 932 (7th Cir. 1988).

74. Annotation, *Right of Injured Party to Award of Compensatory Damages or Fine in Contempt Proceedings*, 85 A.L.R.3d 895, § 5 (2018).

75. *Lightsey v. Kensington Mortg. & Fin. Corp.*, 315 So.2d 431, 437 (Ala. 1975).

76. *E.g.*, *Mitchells Salon & Day Spa, Inc. v. Bustle*, 931 N.E.2d 1172 (Ohio Ct. App. 2010) (disgorgement of profits as contempt remedy for non-compete provision in consent judgment).

77. A.S. Klein, Annotation, *Allowance of Attorneys' Fees in Civil Contempt Proceedings*, 43 A.L.R.3d 793, § 3(a) (2018).

Even if enforceable, settling parties are still unlikely to adopt such a settlement term on their own. The gap between nominal and after-tax settlement price is usually invisible to the public, and perhaps even to some judges who must decide whether to approve a settlement. The settling plaintiff (the settlement payment recipient) has little reason to press the issue, since a likely result is that the settling defendant lowers its nominal settlement price accordingly. To be sure, in recent years, U.S. securities regulators have included in some settlement agreements or consent orders a provision in which the defendant promises not to *seek* a tax deduction or credit under any tax law for any payment amount that the agreement designates as a penalty.<sup>78</sup>

Here, we care about settlement agreements in which the defendant agrees not to seek deductions for litigation-related payments *not* designated as penalties. Some plaintiffs, such as litigation advocacy groups, may want defendants to pay any negotiated pre-tax settlement price—to accomplish the deterrence effect of compensatory settlement payments, for example—but lack a government’s power to impose (non-deductible) penalties. Sometimes plaintiffs have enough leverage to force defendants to agree to such terms. For example, in its 2014 plea agreement with Credit Suisse on criminal charges of tax fraud, federal prosecutors included a term that no part of “the fine or other payment[.]” required by the plea agreement—including a \$666.5 million restitution payment to the IRS—“will serve as a basis for Credit Suisse AG to claim,

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78. *E.g.*, Consent of Defendant Bear, Stearns & Co. at ¶ 6, SEC v. Bear, Stearns & Co., 03 Civ. 2937 (S.D.N.Y. 2003), <https://www.sec.gov/litigation/litreleases/consentbear.pdf>; Settlement Agreement at 4, *People v. UBS Fin. Servs., Inc.*, No. 06/405236 (N.Y. Sup. Ct. July 16, 2007); Consent Order Between Mass. Sec. Div. and Deutsche Bank Securities at § IX(F), *In re Deutsche Bank Securities, Inc.*, No. 2012-0020 (Mar. 13, 2013). Other settlements limit a defendant’s designation of settlement payments as penalties. *E.g.*, Consent Judgment at Ex. B: Distribution of Funds ¶ 1(b)(ii), *United States v. Bank of Am. Corp.*, No. 1:12-cv-00361-RMC (D.D.C. Apr. 4, 2012). These provisions matter, because under U.S. tax law, how the parties characterize the nature of the payments (e.g., fine or compensation) in the settlement agreement can affect how the tax authority treats such payments, or at least expects them to be reported, under I.R.C. § 162(f), which disallows fines and similar penalties paid to government for a violation of law. *See* WOOD, *supra* note 10, at ch. 5. *But cf.* *Fresenius Med. Care Holdings v. United States*, 763 F.3d 64, 70–71 (1st Cir. 2014) (focusing on “economic reality” of the settlement, where parties do not agree on how settlement should be treated for tax purposes).

assert, or apply for, either directly or indirectly, any tax deduction, any tax credit, or any other offset against any U.S. federal, state, or local tax or taxable income.”<sup>79</sup> The problem: Many plaintiffs either cannot or do not care to demand such a settlement term.

One solution is for a court or legislature to adopt this default rule for *interpreting* settlement agreements: Unless a settlement agreement expressly indicates otherwise, courts must take as an implicit settlement term that the settling defendant promises not to seek an otherwise allowable tax deduction for litigation-related costs. This default rule has one key advantage: The gap between nominal and after-tax settlement price—though it may remain as before—becomes substantially more visible. To escape the default rule, settling parties would have to include in settlement agreements an express term *allowing* a party to seek a tax deduction for litigation-related costs. In turn, when they find an express term in a settlement, judges and other could credibly infer that the settling parties were *aware* of the gap between the nominal and the after-tax settlement price, and settled anyway.

Thus, in deciding whether to approve a settlement, the presence of the express term would nudge judges to expressly inquire into what the after-tax settlement price would be. The same would hold for policymakers and the public who are concerned about the nominal settlement price announced by government regulators and settling defendants. If the concern becomes particularly acute for some subset of cases, policymakers would then be forced to grapple with whether and how to abrogate that default rule when they enact or amend causes of action. The desired result: more extensive dialogue about the kind of tax-design choices this Article identifies.

## VIII. CONCLUSION

This Article extends the prior literature on the deductibility of litigation costs by showing that deductibility of these costs may affect fundamental income tax design. In particular, this Article identified a series of design choices that are analytically distinct from particular redistributive goals of the tax system or from any corrective justice or social welfare maximization goals behind imposing monetary sanctions for illegal conduct: (1) how to attribute litigation-related costs to any particular

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79. Plea Agreement at ¶ 7(B)(6), *United States v. Credit Suisse AG*, No. 1:14-cr-188-RBS (E.D. Va. May 19, 2014).

income-producing activity; (2) how to treat liability insurer payments made on a defendant's behalf as income to that defendant; (3) grounds for coordinating the tax treatment of a payor's damages payments with the tax treatment of those receipts to the payee; and (4) whether litigation-related costs should be treated as capital expenditures related to the right to receipts established or sought to be established by the litigation itself. Finally, we showed how, under current law, parties may enforce settlement agreements under which a settling defendant promises not to seek a tax deduction for litigation-related costs. We proposed adopting such a settlement term as a default rule for settlement agreements. Such default rule would make more visible the gap between nominal and after-tax settlement price and would, as a result, motivate policymakers and commentators to grapple more fully with the tax-design choices associated with litigation-related costs, including the issues we identify here.