Roemer v. Commissioner, T.C. Memo. 1983-443

Damages received for libel are taxable as ordinary income if they compensate for injury to business or professional reputation and lost profits, but may be excludable under Section 104(a)(2) if they compensate for personal injury to reputation.

Summary

Paul F. Roemer, Jr., an insurance broker, received compensatory and punitive damages from a libel suit against Retail Credit Co. Retail Credit issued a defamatory report that damaged Roemer's business reputation, causing him to lose business opportunities. The Tax Court considered whether these damages were excludable from gross income under Section 104(a)(2) as "damages received…on account of personal injuries." The court held that the compensatory and punitive damages were taxable as ordinary income because they primarily compensated Roemer for damage to his business and professional reputation and lost profits, not for personal injury. The court emphasized the distinction between personal and business reputation in determining taxability of libel damages.

Facts

Paul F. Roemer, Jr., an insurance broker, had a successful business. Retail Credit Co. issued a grossly defamatory credit report about Roemer to Penn Mutual Life Insurance Co. and other insurance companies during Roemer's application for an agency license to sell life insurance. The report falsely accused Roemer of dishonesty, incompetence, and neglecting clients. As a result, Penn Mutual and other companies denied Roemer licenses, damaging his existing business relationships and ability to attract new clients, leading to diminished profits. Roemer sued Retail Credit for libel in California state court.

Procedural History

Roemer sued Retail Credit in the Superior Court for Alameda County, California, alleging damage to his business reputation and seeking compensatory and punitive damages. A jury trial resulted in a verdict for Roemer, awarding $40,000 in compensatory damages and $250,000 in punitive damages. Roemer reported a portion of the damages as income on his 1975 federal income tax return but later amended his petition claiming the damages were incorrectly reported. The Commissioner of Internal Revenue determined a deficiency, arguing the entire judgment was includable in gross income. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether compensatory damages of $40,000 received from a libel suit are excludable from gross income under Section 104(a)(2) as received on account of personal injuries.

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2. Whether punitive damages of $250,000 from the same libel suit are excludable from gross income as received on account of personal injuries.
3. If the damages are includable, whether they should be treated as ordinary income or capital gain.
4. Whether costs of $7,751 are includable in gross income and deductible under Section 212.

Holding

1. No, because the compensatory damages were primarily awarded to compensate for damage to Roemer's business and professional reputation and lost profits, not for personal injury to his personal reputation.
2. No, because the punitive damages were not awarded on account of personal injuries, as they followed from the compensatory damages which were business-related.
3. The damages are taxable as ordinary income because they represent compensation for lost profits and not a replacement of capital or goodwill.
4. The issue of costs is moot because whether included in income with an offsetting deduction or excluded, there is no adverse tax consequence in this case.

Court's Reasoning

The court reasoned that under Section 104(a)(2), damages are excludable from gross income only if received "on account of personal injuries." The tax consequences depend on the nature of the claim and the origin of the adjudicated claims. The court distinguished between libel that injures personal reputation and libel that injures business or professional reputation affecting income. Analyzing Roemer's complaints, trial testimony, and evidence in the libel suit, the court concluded that the predominant nature of his claims was damage to his business and professional reputation. Roemer's focus was on lost business opportunities and income due to the defamatory report within the insurance industry. The jury instructions and arguments in the libel suit also centered on business damages. The court quoted the jury instruction defining libel as including injury to occupation. Regarding punitive damages, the court cited *Commissioner v. Glenshaw Glass Co.*, stating punitive damages are not a restoration of capital and are generally taxable. While acknowledging Rev. Rul. 75-45, which allows exclusion for punitive damages arising from personal injury, the court found that because the compensatory damages were business-related, the punitive damages also failed to qualify for exclusion under Section 104(a)(2). Finally, the court determined the damages were ordinary income because they compensated for lost profits, not the destruction of a capital asset like goodwill. The court noted Roemer did not present evidence of goodwill loss in the libel suit or initially on his tax return.

Practical Implications

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Roemer v. Commissioner clarifies that the tax exclusion for damages received on account of personal injuries under Section 104(a)(2) does not automatically extend to all libel awards. Attorneys must carefully analyze the nature of the injury being compensated in defamation cases. If damages primarily compensate for lost business income or professional reputation damage, they are likely taxable as ordinary income. To argue for exclusion, the focus must be on demonstrable injury to personal reputation, distinct from professional or business harm. This case highlights the importance of clearly defining the type of damages sought and presenting evidence in court to support the desired tax treatment. Subsequent cases will likely scrutinize the pleadings, evidence, and jury instructions from the underlying litigation to determine the true nature of the damages awarded for tax purposes. This case underscores that simply labeling a lawsuit as a "personal injury" action is insufficient to secure tax exclusion under Section 104(a)(2); the substance of the claim and the actual compensation must relate to genuine personal injury.

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