T.C. Memo. 1995-486

Punitive damages received in settlement or judgment are generally not excludable from gross income under Section 104(a)(2); contingent legal fees are typically treated as miscellaneous itemized deductions, not reductions in income.

Summary

In *Bagley v. Commissioner*, the Tax Court addressed the taxability of a settlement and punitive damages award received by Hughes Bagley from Iowa Beef Processors, Inc. (IBP) stemming from defamation and related tort claims. The court determined the allocation of the settlement between compensatory and punitive damages, holding that punitive damages are not excludable from income under Section 104(a)(2) following the Supreme Court's decision in *Commissioner v. Schleier*. Additionally, the court ruled that contingent legal fees are miscellaneous itemized deductions, not an offset against the settlement or judgment amount, and that interest on the judgment is taxable income.

Facts

Hughes Bagley, former VP at IBP, was terminated in 1975. He took documents and later testified against IBP before a Congressional subcommittee. IBP sued Bagley for breach of fiduciary duty. Bagley countersued IBP for abuse of process, tortious interference with employment, libel, and invasion of privacy, seeking compensatory and punitive damages. A jury awarded Bagley both compensatory and substantial punitive damages across multiple claims. IBP appealed, and the libel claim was remanded for retrial. Prior to retrial, Bagley and IBP settled for $1.5 million, with a settlement agreement characterizing the payment as for "personal injuries." Bagley also received a separate payment of $983,281.23 related to the tortious interference claim, which included compensatory and punitive damages awarded by the jury and affirmed on appeal.

Procedural History

District Court, Northern District of Iowa: Jury verdict in favor of Bagley on multiple claims, awarding both compensatory and punitive damages. The court later granted IBP's motion JNOV on the invasion of privacy claim as duplicative of the libel claim.

Court of Appeals for the Eighth Circuit: Affirmed in part and reversed in part. Reversed the judgment on the libel claim and remanded for a new trial due to erroneous jury instructions. Affirmed the judgment on tortious interference with present employment. Affirmed liability but remanded for damages on tortious interference with future employment pending libel retrial outcome.

District Court (on remand): Entered judgment on tortious interference with present employment per 8th Circuit opinion. Denied Bagley's motion to reinstate invasion of privacy award as premature, pending libel retrial or abandonment.

Tax Court: Petition filed by Bagley contesting the IRS deficiency assessment related to the taxability of the settlement, punitive damages, and deductibility of legal fees.

Issue(s)

1. Whether a portion of the $1.5 million settlement payment should be allocated to punitive damages.
2. Whether punitive damages, including those from the settlement and the prior judgment, are excludable from gross income under Section 104(a)(2) as damages received on account of personal injuries.
3. Whether contingent legal fees paid by Bagley are properly offset against the recovery amount or are miscellaneous itemized deductions subject to the 2% AGI limitation.
4. Whether the hourly-based portion of legal fees is deductible as a Schedule C business expense or as an itemized deduction.
5. Whether prejudgment and postjudgment interest paid to Bagley are includable in gross income.

Holding

1. Yes, $500,000 of the $1.5 million settlement is allocable to punitive damages because the court inferred that IBP, considering the potential for punitive damages on retrial and prior awards, would have factored this into the settlement amount, even though the agreement language focused on compensatory damages.
2. No, punitive damages are not excludable from gross income under Section 104(a)(2) because, following *Commissioner v. Schleier*, the Supreme Court clarified that only compensatory damages related to personal injury are excludable, and punitive damages under Iowa law are non-compensatory, intended to punish and deter, not to compensate the injured party.
3. No, contingent legal fees are not an offset against the recovery; they are miscellaneous itemized deductions subject to the 2% AGI limitation because the fee arrangement did not create a partnership or joint venture between Bagley and his attorney.
4. Itemized deductions. The hourly legal fees are also miscellaneous itemized deductions, not Schedule C business expenses, as Bagley did not demonstrate a connection to a consulting business.
5. Yes, prejudgment and postjudgment interest are includable in gross income because interest is considered compensation for the delay in payment, not damages for personal injury, and is therefore taxable.

Court’s Reasoning

Settlement Allocation: The court considered the settlement negotiations, the jury's prior punitive damage awards, and IBP's desire to limit exposure. Despite the settlement agreement's language, the court inferred that both parties considered the risk of punitive damages in the libel retrial and the potential reinstatement of punitive damages from other claims. The court allocated $1 million to compensatory damages and $500,000 to punitive damages, finding a reasonable balance between the jury's compensatory award and the potential punitive exposure.

Taxability of Punitive Damages: The court explicitly overruled its prior stance in *Horton v. Commissioner*, acknowledging the Supreme Court's decision in *Commissioner v. Schleier*. *Schleier* clarified that for damages to be excludable under Section 104(a)(2), they must be "on account of personal injuries or sickness" and compensatory in nature. The court analyzed Iowa law, determining that punitive damages in Iowa are intended to punish the wrongdoer and deter misconduct, not to compensate the victim. Therefore, the punitive damages received by Bagley, both from the judgment and settlement, were deemed non-compensatory and thus taxable.

Legal Fees: The court rejected Bagley's argument that the contingent fee arrangement created a partnership, finding no evidence of intent to form a partnership. The court reiterated that legal fees related to the production of income or as employee business expenses are miscellaneous itemized deductions, subject to the 2% AGI limitation.

Interest: Citing precedent, the court held that interest on personal injury awards is not excludable under Section 104(a)(2) and is taxable as ordinary income.

Practical Implications

Bagley v. Commissioner, decided in the wake of *Commissioner v. Schleier*, underscores the now-established principle that punitive damages are generally taxable under federal income tax law. The case highlights the importance of analyzing the nature of damages under relevant state law to determine taxability. For legal practitioners, this case reinforces the need to advise clients that punitive damage awards and portions of settlements allocated to punitive damages will likely be subject to income tax. Furthermore, it clarifies that contingent legal fees, while deductible, are typically miscellaneous itemized deductions, which may limit their tax benefit due to the 2% AGI threshold. This decision impacts case settlement strategies and tax planning for plaintiffs in personal injury and related tort litigation, requiring careful consideration of the tax consequences of both damage awards and legal expenses.