OVERCOMING TRADEOFFS IN THE TAXATION OF PUNITIVE DAMAGES

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ABSTRACT

As explained in a companion piece, there is a curious anomaly in the law of punitive damages. Jurors assess punitive damages in an amount that they believe will best "punish" the defendant. But, in fact, business defendants are not always punished to the degree that the jury intends. This is because jurors do not take into account the fact that these businesses are allowed to deduct their punitive damages awards. To solve this problem, President Obama recently proposed to make all punitive damages nondeductible, a proposal that has in the past been supported by a number of policy makers and academics. Unfortunately, the nondeductibility rule is doomed to fail in practice.

Instead, the under-punishment problem is better solved through making juries and courts aware of the tax implications of punitive damages awards. While tax awareness would better address the under-punishment problem, it would at the same time increase plaintiffs' windfalls. Sadly, there is simply no way under current punitive damages law to reduce under-punishment without simultaneously augmenting plaintiff windfalls.

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The tradeoff is a byproduct of the jumbled way current punitive damages law engrafts "public law" values on a private dispute resolution system not entirely capable of effectuating those values.

To avoid such an unfortunate tradeoff, reform of punitive damages law would be required. This Article sketches a vision of such reform and describes its corresponding tax rules. In particular, the appropriate tax treatment of tort damages should depend on the particular purpose(s) being pursued and vindicated. In this respect, the recommendations here stake out a more nuanced middle path between those scholars and policy makers touting nondeductibility for all punitive damages and those endorsing the current rule allowing a deduction for all punitive damages paid by business defendants.

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INTRODUCTION

A few years ago, an Oregon jury socked tobacco giant Philip Morris with punitive damages of almost $80 million in a case involving one person's death.[1] In another case, a trial court imposed a penalty of $5 billion in punitive damages against Exxon for its reckless conduct in the Valdez oil spill.[2] Should these corporate payments of punitive damages be tax-deductible business expenses? Perhaps surprisingly, they are; put simply, punitive damages incurred in connection with the defendant's business are tax deductible.[3]

Consequently, the intersection of tort and tax law in many jurisdictions leads to a curious under-punishment problem. On the one hand, jurors assess punitive damages in an amount that they believe will best "punish" the defendant.[4] On the other hand, defendants are not always punished to the degree that the jury intends because punitive damages paid by business defendants are tax deductible under the Internal Revenue Code.[5] As a result, these defendants often pay far less in real dollars than the jury believed they deserved to pay.

Some scholars argue that the best way to address this problem is simply to make punitive damages nondeductible in all cases.[6] Indeed, President

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1. Philip Morris USA v. Williams, 549 U.S. 346, 350 (2007) (reviewing surviving spouse's claim for deceit against defendant).

2. That award was later reduced to $1 billion by the Supreme Court. *See* Exxon Shipping Co. v. Baker, 128 S. Ct. 2605, 2634 (2008).

3. I.R.C. § 162(a) (2006) (allowing deductions for ordinary and necessary business expenses incurred in carrying on a trade or business); Rev. Rul. 80-211, 1980-2 C.B. 58 ("Amounts paid as punitive damages incurred by the taxpayer in the ordinary conduct of its business operations are deductible as an ordinary and necessary business expense under section 162 of the Code.").

4. The claims in this Article are limited to the American legal context. The punishment rationale of punitive damages has often been articulated by courts. *See Exxon Shipping Co.*, 128 S. Ct. at 2621 ("Regardless of the alternative rationales over the years, the consensus today is that punitives are aimed not at compensation but principally at retribution and deterring harmful conduct."); *Philip Morris USA*, 549 U.S. at 352 (reaffirming the Court's long-held view that it is "clear that '[p]unitive damages may properly be imposed to *further a State's legitimate interests in punishing unlawful conduct* and deterring its repetition.'" (alteration in original) (emphasis added) (quoting BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 568 (1996))); Cooper Indus., Inc. v. Leatherman Tool Grp., Inc., 532 U.S. 424, 432 (2001); City of Newport v. Fact Concerts, Inc., 453 U.S. 247, 266 (1981); Gertz v. Robert Welch, Inc., 418 U.S. 323, 350 (1974) (describing punitive damages as "private fines" designed to punish and deter "reprehensible conduct").

5. *See supra* note 3 and *infra* Part I.A.

6. *See, e.g.*, Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct*, 47 ALA. L. REV. 825, 881 (1996) (arguing that punitive damages ought to be made nondeductible); K. Todd Curry, Comment, *The Deductibility of Punitive Damages as an Ordinary and Necessary Business Expense: Reviving the Public Policy Doctrine*, 26 SAN DIEGO L. REV. 357, 369 (1989) (same); Catherine M. Del Castillo, Note, *Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine*, 68

Barack Obama in February 2010 proposed this solution as part of his fiscal year 2011 budget.[7]

As Gregg Polsky and I explained in greater detail in a companion article,[8] the tactic of using a blanket nondeductibility rule for punitive damages would not work in most situations. Defendants could easily circumvent the nondeductibility rule by disguising punitive damages as compensatory damages in settlements.[9] Instead, the under-punishment problem is best addressed at the state (not federal) level by making juries "tax aware," instead of keeping them "tax blind" regarding the fact and effect of deductibility in business-related cases.[10] Tax-aware juries would be informed of business defendants' marginal tax rates, which would enable them to adjust the amount of punitive damages to impose the desired after-tax cost to the defendant.[11] Parties seeking to settle would consequently bargain in the shadow of the (presumptively) larger award that would be made at trial if a verdict were reached.

Unfortunately, while tax awareness would solve the under-punishment problem, it would do so at the cost of enlarging plaintiff recoveries. Many scholars and lawmakers view recoveries that go beyond full compensation as undeserved and unwarranted "windfalls."[12] If characterized correctly as windfalls,[13] then these extracompensatory recoveries raise a number of

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TEX. L. REV. 819, 833–34 (1990) (same); Note, *An Economic Analysis of the Plaintiff's Windfall from Punitive Damage Litigation*, 105 HARV. L. REV. 1900 (1992) [hereinafter Note, *An Economic Analysis*] (same); *cf.* 1 LINDA L. SCHLUETER, PUNITIVE DAMAGES § 18 (5th ed. 2005) (briefly discussing certain tax issues); New York State Bar Association Tax Section, *The Deductibility of Punitive Damages*, 93 TAX NOTES 1209 (Nov. 26, 2001) [hereinafter NYSBA Report] (detailing Clinton administration proposals in 1999 and 2000); CONG. REC. 13065–66 (May 22, 2003) (noting that Conference Committee rejected Senate amendment to tax code that would deny deduction for punitive damages paid). Some commentators also challenge a proposal for nondeductibility, but their works are largely written in the vein of protecting business interests and they do not analyze the alternative strategy of tax awareness that is summarized here and developed in Gregg D. Polsky & Dan Markel, *Taxing Punitive Damages*, 96 VA. L. REV. 1295 (2010). *E.g.*, Brock D. Phillips, Note, *The Tax Consequences of a Punitive Damages Award*, 31 HASTINGS L.J. 909 (1980) (arguing that punitive damages ought to remain deductible); Robert W. Wood, *Further Thoughts on Tax Treatment of Punitive Damages*, 93 TAX NOTES 1502 (2001) [hereinafter Wood, *Further Thoughts*] (same); *cf.* Paul Feinberg, *Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions*, 42 CASE W. RES. L. REV. 339, 410 (1992) (arguing that plaintiffs should not be able to exclude punitive damages from income).

7. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 95 (2010) [hereinafter GENERAL EXPLANATIONS].

8. *See* Polsky & Markel, *supra* note 6.

9. *Id.* As explained below, compensatory damages are deductible business expenses.

10. *Id. See infra* notes 33 and 38.

11. Polsky & Markel, *supra* note 6.

12. *See, e.g.*, A. Mitchell Polinsky & Yeon-Koo Che, *Decoupling Liability: Optimal Incentives for Care and Litigation*, 22 RAND J. ECON. 562, 562 (1991).

13. To be sure, there is a venerable school of thought that views punitive damages awards to

concerns. For example, an extension of windfalls to plaintiffs risks decreasing incentives for plaintiffs to take adequate precautions and increasing incentives to bring frivolous suits.[14] Additionally, windfalls provide a kind of lottery gain that, ex ante, citizens would prefer to avoid because of their risk aversion. In other words, most people would prefer to have gains realized through lower taxes or more services as opposed to the unlikely prospect of a large windfall, even where these two options have the same risk-adjusted value. [15] Consequently, if there is a way of solving the under-punishment problem without needlessly enriching plaintiffs beyond the full scope of their losses, then that would be more desirable. [16]

This Article provides a strategy for overcoming that tradeoff. Essentially, this punishment/enrichment tradeoff could be mitigated through some basic reforms of punitive damages. Drawing on a recent reform proposal meant to disaggregate and implement the underlying and distinctive purposes of punitive damages,[17] I identify how state and federal governments can avoid this tradeoff. These reforms are predicated on the idea that punitive damages should be disaggregated so as to accommodate three distinct purposes: (a) realizing the public's interest in developing an

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plaintiffs not as a windfall, but rather as a remedy that vindicates the injury to a plaintiff's dignity interests in a manner separate from the non-economic compensatory damages a plaintiff might receive. *E.g.*, Anthony J. Sebok, *Punitive Damages: From Myth to Theory*, 92 IOWA L. REV. 957, 1023–29 (2007) (arguing that punitive damages should be regarded as "a form of state-sanctioned revenge") [hereinafter Sebok, *From Myth to Theory*]; Mark A. Geistfeld, *Punitive Damages, Retribution, and Due Process*, 81 S. CAL. L. REV. 263, 269–74, 296–309 (2008) [hereinafter Geistfeld, *Punitive Damages*]; Benjamin C. Zipursky, *A Theory of Punitive Damages*, 84 TEX. L. REV. 105 (2005); John C.P. Goldberg, *Tort Law for Federalists (and the Rest of Us): Private Law in Disguise*, 28 HARV. J.L. & PUB. POL'Y 3, 7 (2004); Marc Galanter & David Luban, *Poetic Justice: Punitive Damages and Legal Pluralism*, 42 AM. U. L. REV. 1393, 1432 (1993); Thomas B. Colby, *Clearing the Smoke from* Philip Morris v. Williams*: The Past, Present, and Future of Punitive Damages*, 118 YALE L.J. 392, 434 (2008); *see* Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 167 (1992).

14. *See* Polinsky & Che, *supra* note 12, at 562; *see also* H.R. REP. NO. 104-737 (1996); Note, *An Economic Analysis*, *supra* note 6.

15. Eric Kades, *Windfalls*, 108 YALE L.J. 1489, 1564 (1999).

16. I am sympathetic to the claim that some plaintiffs might be undercompensated and that awarding punitive damages alleviates that concern to some extent. However, I think adherents to the victim-vindication view of punitive damages should find the normative proposals in the Article relatively compatible with their goals. I also recognize that there is a substantial risk that some plaintiffs would not pursue worthy claims without extracompensatory damages. For that reason, I agree that plaintiffs should be fully compensated for suffering wrongful losses and that defendants who are found liable should be separately responsible for attorneys' fees. That rationale, however, is as plausible outside the punitive damages context (i.e., applied to mere negligence or strict liability claims) as it is inside it. This issue is further addressed in Part I.

17. *See* Dan Markel, *Retributive Damages: A Theory of Punitive Damages as Intermediate Sanction*, 94 CORNELL L. REV. 239 (2009) [hereinafter Markel, *Retributive Damages*]; Dan Markel, *How Should Punitive Damages Work?*, 157 U. PA. L. REV. 1383 (2009) [hereinafter Markel, *How Should Punitive Damages Work?*].

intermediate civil sanction designed to promote retributive justice; (b) vindicating and compensating the injury to a victim's dignity interest not already covered by noneconomic damages; and (c) facilitating the pursuit of cost internalization (optimal deterrence) to the extent permitted after the Supreme Court's important and recent decision in *Philip Morris USA v. Williams*.[18]

Per the proposal, these three interests would no longer be conflated under the umbrella term of "punitive damages." Rather, the decision maker (whether jury or judge) would scrutinize each interest separately, and the remedy for a violation of each interest would fall under the labels of retributive, aggravated, and deterrence damages, respectively.[19] Although these reforms are not principally motivated and constructed to reduce the *tax-related* tradeoff between under-punishment correction and windfall augmentation under current doctrine, one of the incidental benefits of such reforms is that they would avoid such a tradeoff.

At bottom, this Article sketches a pluralistic vision of what a reformed extracompensatory damages landscape might look like and how the tax rules should correspond. Contrary to those who would establish a sweeping rule of deductibility or nondeductibility for all forms of punitive damages, my view is that the appropriate tax treatment of civil damages should depend on the particular purpose that such damages are intended to achieve. Thus, in some respects, these recommendations can be seen as staking a middle path between those, like the President, touting the proposed rule of blanket nondeductibility for all punitive damages and those scholars endorsing the current rule permitting deductions for business-related punitive damages.[20]

The Article unfolds in three Parts. Part I furnishes some background about the taxation of punitive damages with respect to *business* defendants.[21] I begin by summarizing the concern with the under-

18. 549 U.S. 346 (2007). In *Philip Morris*, the Court held that the Due Process Clause forbids juries from including the harms to nonparties in calculating the amount of punitive damages that a defendant must pay. *Id.* at 353.

19. I explain the significance of these various terms in greater depth in Part II.

20. *Compare, e.g.*, A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 928–31 (1998) (advocating for the continued deductibility of punitive damages in the business-activity context), *and* Phillips, *supra* note 6, at 925–27 (same), *with* GENERAL EXPLANATIONS, *supra* note 7 (urging the nondeductibility of punitive damages), Pace, *supra* note 6, at 881 (same), *and* Del Castillo, *supra* note 6 (same).

21. To be clear, the argument is limited *only* to suits involving defendants whose torts arise in a business context. The qualification matters because it is only with those defendants that the potential problems associated with different tax treatment of compensatory and punitive damages arise. Individual (nonbusiness) defendants are not able to deduct the costs of either compensatory or punitive damages and, thus, the whole incentive structure they face is substantially different than the one facing

punishment problem and the proposed solution of tax awareness as a preferred method to deal with that problem under current law (rather than the nondeductibility rule endorsed by President Obama and other lawmakers and scholars). As mentioned before, regardless of the tactic used—nondeductibility or tax-aware juries and judges[22]—there is an ineluctable tradeoff between plaintiff enrichment on one hand and under-punishing business defendants on the other.

As demonstrated in Part I, while tax awareness best solves the under-punishment problem,[23] it does so at the cost of augmenting plaintiff windfalls. Fortunately, this problematic tradeoff is avoidable, provided that states are willing to reform their punitive damages laws. To that end, the next two Parts of the Article are normative and sketch a way out of this dilemma through some reforms of punitive damages law I recently proposed separately. These reforms are summarized in Part II.[24]

Against the backdrop of this pluralistic framework, Part III examines how the tax law should be structured to complement this redesign of punitive damages law. In particular, I explain why a need for a differentiated taxation approach—i.e., one that allows for deductions of extracompensatory damages with gross ups in some contexts but not necessarily in others—might be valuable and what some of the relevant costs and benefits are with respect to these options. Perhaps surprisingly, I identify the very interesting vertical and horizontal federalism concerns associated with these taxation rules and offer a perspective on how to address them. The analysis here, I hope, will be of significance to the

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defendants whose torts arise in the course of a business. Thus, unless otherwise explicitly stated, all of the examples in this Article assume that the plaintiff's claim arose out of the defendant's business. Under current law, punitive damages paid that are unconnected to the defendant's business are nondeductible. Virtually all prior commentators and policy makers do not propose changing that practice; nor do I.

22. Throughout the rest of the Article, however, I have assumed that a jury would decide the amount of punitive damages. This is generally the case under current tort law, although judges do sometimes perform this function (for example, when a jury trial is waived or, in some jurisdictions, where the jury decides liability for punitive damages but the judge decides the amount of punitive damages). The tax-awareness discussion would apply equally to judges in those contexts, and I am not principally committed to *who* should make that tax-aware decision, only that *whoever* makes the decision should be tax aware. *See* Polsky & Markel, *supra* note 6. The expectation stated in that piece was that jurisdictions would permit experts to assist the juries or judges in developing the correct tax-aware outcomes and thus help those decision makers overcome some of the difficulties taxpayers have thinking through even basic tax issues. *See, e.g.*, Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes* 9–10 (N.Y. Univ. Law and Economics Research Paper No. 10-37, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1661322 (noting the kinds of problems plaguing taxpayers vis-à-vis the tax system).

23. *See* Polsky & Markel, *supra* note 6.

24. *See* Markel, *How Should Punitive Damages Work?*, *supra* note 17.

broader academic and policy-making community. The timing of this analysis is especially auspicious in light of the Supreme Court's decision in *Philip Morris*,[25] which reorients the constitutional landscape for punitive damages and, by doing so, invites the federal and state governments to rethink the allocation and taxation of punitive damages.

I. CURRENT TAX LAW AND THE UNDER-PUNISHMENT PROBLEM

A. The Nature of the Under-Punishment Problem

Given the stated goals of punitive damages law in most American jurisdictions,[26] punitive damages are principally and unsurprisingly awarded to *punish* defendants for torts committed with a malicious or reckless state of mind. In crafting an appropriate financial punishment for such misconduct, jurors are typically instructed to consider, among a number of other factors, the defendant's financial condition.[27]

However, jurors are *not* currently informed of the fact that business-related punitive damages are, like other business-related expenses, deductible for federal income tax purposes.[28] Surprisingly, there are no reported cases discussing the tax awareness issue in the punitive damages context,[29] and treatises and articles have largely ignored the issue,[30] despite

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25. *See* Philip Morris USA v. Williams, 549 U.S. 346, 353 (2007).

26. Importantly, a small number of states view punitive damages as additional measures of compensation (and thus would be justified in not admitting evidence of defendants' wealth); the analysis is not intended to cover those states directly. Thus, for example, Michigan, New Hampshire, and Connecticut have in the past ascribed a "private" and compensatory function to punitive damages awards in their states. *See, e.g.*, Doroszka v. Lavine, 150 A. 692 (Conn. 1930); Wise v. Daniel, 190 N.W. 746 (Mich. 1922); Fay v. Parker, 53 N.H. 342 (1872). Additionally, four states (Louisiana, Massachusetts, Nebraska, and Washington) only allow punitive damages where expressly authorized by statute. *See* 1 SCHLUETER, *supra* note 6, § 2.2 (providing sources). By contrast, the vast majority of states use punitive damages as a jury-determined measure to achieve public state interests in retribution and deterrence. *See id.* §§ 1.3(C)–(D), 1.4(A); *see also* Exxon Shipping Co. v. Baker, 128 S. Ct. 2605, 2621 (2008).

27. *See generally* TXO Prod. Corp. v. Alliance Res. Corp., 509 U.S. 443, 462 n.28 (1993) (describing as "well-settled law" the notion that evidence related to financial condition of defendant is admissible in the context of determining punitive damages awards). For specific citations to each state's practices related to the admission of evidence related to wealth or financial position of the defendant, see Michael L. Rustad, *The Closing of Punitive Damages' Iron Cage*, 38 LOY. L.A. L. REV. 1297, 1316 n.108 (2005); SCHLUETER, *supra* note 6, § 5.3.

28. Importantly, the juries are also not informed about the state or local tax effects. Just to be clear: throughout the piece, I will be referring to *blended* tax rates that take into account federal, state, and local taxes together.

29. *See* NYSBA Report, *supra* note 6.

30. I have found scant treatment of the issues. One treatise, SCHLUETER, *supra* note 6, adverts to the issues briefly, but without any substantial argument or citation to authorities. *Id.* § 18.2; *see also id.* § 18.1(C). A few studies have referenced the issue in passing. The New York State Bar Association

the fact that state and federal courts have generally allowed such augmentations in cases applying a range of antidiscrimination laws.[31] Some discussions with plaintiffs' lawyers indicate that they, too, have not focused on the issue of tax awareness.[32] Accordingly, as a matter of practice, it appears that punitive damages jurors are not currently tax aware. Indeed, the pervasiveness of tax blindness is a factual premise of the proposals to make punitive damages nondeductible because if jurors are in fact grossing up damages, then there is no under-punishment problem to which to respond. Moreover, even if some jurors are aware of the fact and effect of deductibility, they are not presented with evidence

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Report on the Tax Deductibility of Punitive Damages noted that the state laws have not addressed the issue of admissibility of the defendant's tax consequences to rebut the notion that allowing deductibility would unduly reduce the sting of a punitive damages award. NYSBA Report, *supra* note 6. Likewise, Robert Wood has made the claim that if Congress made punitive damages awards nondeductible, the jury should be instructed on that fact; Wood implicitly assumes that juries currently gross up deductible awards. Wood, *Further Thoughts*, *supra* note 6, at 1501. However, there is no evidence to support this inference because it appears there are no cases where evidence is admitted regarding defendants' marginal tax rates. Likewise, another commentator implicitly assumes that jurors currently take into account tax deductibility of a punitive damages award in determining the size of the award to support his argument that to reduce the size of the plaintiff's windfall, awards should be nondeductible for defendants. Note, *An Economic Analysis*, *supra* note 6. As I discuss below, making punitive damages nondeductible would reduce the size of the awards *only if a jury is aware of the tax treatment of paying punitive damages*. If juries are unaware, the size of the awards would be the same whether or not awards are deductible.

31. *See generally* Gregg D. Polsky & Stephen F. Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 IOWA L. REV. 67, 91–99 (2004). The Third Circuit recently affirmed such an award under the Americans with Disabilities Act, noting that in crafting an appropriate remedy to restore the plaintiff to its ex ante economic position, these adverse tax consequences should be considered. Eshelman v. Agere Sys., Inc., 554 F.3d 426 (3d Cir. 2009). An earlier Tenth Circuit decision reached the same conclusion in a Title VII case, Sears v. Atchison, Topeka & Santa Fe Ry., Co., 749 F.2d 1451 (10th Cir. 1984), as have a number of other federal and state courts in applying various anti-discrimination laws. *See, e.g.*, O'Neill v. Sears, Roebuck & Co., 108 F. Supp. 2d 443 (E.D. Pa. 2000); Arneson v. Sullivan, 958 F. Supp. 443, 446 (E.D. Mo. 1996); *see also* Blaney v. Int'l Ass'n of Machinists & Aerospace Workers, Dist. No. 160, 87 P.3d 757 (Wash. 2004) (applying Washington discrimination law); Ferrante v. Sciaretta, 839 A.2d 993 (N.J. Super. Ct. Law Div. 2003) (applying New Jersey discrimination law).

32. One nationally prominent plaintiffs' class action lawyer explained reluctance to press the tax argument based on the surmise that there was case law precluding admission of tax treatment evidence along the lines of the case law excluding admission of insurance coverage. I have seen no case law to that effect, but Professor Polsky and I address the underlying analogy to insurance coverage in the companion piece to this one, Polsky & Markel, *supra* note 6, at pt. I.B.5. Another prominent class action plaintiffs' lawyer thought we were spot on in identifying the oversight of the plaintiffs' bar. In any event, Professor Polsky and I would welcome more empirical information one way or the other. The best evidence of this neglect, which admittedly only allows a weakened inference, is that there is virtually no discussion of the matter in the published cases or scholarship. *See also* Lawrence Zelenak, *Of Punitive Damages, Tax Deductions, and Tax-Aware Juries: A Response to Polsky and Markel*, 96 VA. L. REV. IN BRIEF 61, 68 (2010) (suggesting that the failure of plaintiffs' lawyers to make juries tax aware is a puzzle that "should be high on the research agenda of anthropologists of the legal profession").

such as the marginal tax rate of the defendant, so they never can make truly tax-aware decisions.[33]

As a result, when punitive damages are deductible as business expenses, as they are now to business defendants, the true cost of a punitive damages award is typically and substantially less than the nominal amount of the award. As a result, business defendants in punitive damages cases are typically under-punished relative to the jury's intentions where the jury is making a determination based on the defendant's wealth.[34]

To illustrate, assume that a jury determines that a defendant's net worth is $1,000,000 and decides that the defendant should pay 10% of its net worth in order to impose an appropriate punishment. If the jury is not aware of the fact that the defendant is able to deduct the punitive damages award, it would render an award of $100,000. However, if the defendant's marginal tax rate is 40%, then the after-tax cost of a deductible punitive damages award levied is only $60,000, which is $40,000 less than what the jury had intended.[35] Accordingly, assuming the defendant has $100,000 of taxable income to offset, the after-tax cost to the defendant is only $60,000.[36] Under these facts, the under-punishment argument is forceful because the jury's intended punishment is blunted by the unforeseen tax deduction.

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33. The premise of tax blindness also seems reasonable given that most of the students (and law professors) I spoke with about this were surprised to learn that punitive damages incurred in connection with a business are deductible. *Cf.* Comm'rs of Inland Revenue v. Alexander von Glehn & Co., [1920] 2 K.B. 553 at 571 (Eng.) (stating that the answer to the question of whether a defendant can deduct fines from his business income is an "obvious" no).

34. The argument for admitting marginal tax rates is limited to those penalties that are *wealth*-adjusted rather than *net income*–adjusted, because net income is already a "tax-informed" measurement. So, to be clear, I am in favor of "universal" tax awareness by juries. Thus, for example, if juries, in crafting an award, are permitted or required to take into account the amount of profits generated by an activity or during a specific period, these profits should be expressed in after-tax terms.

35. Forty percent is roughly the top effective marginal federal, state, and local income tax rate that could currently apply to a given defendant. Tax scholarship typically uses this figure in examples. *See, e.g.*, Michael S. Knoll, Compaq *Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 26 VA. TAX REV. 821, 833 (2007).

36. This is similar to the "matching contribution" effect resulting from the charitable contribution deduction. *See* Gregg D. Polsky, *A Tax Lawyer's Perspective on Section 527 Organizations*, 28 CARDOZO L. REV. 1773, 1776–77 (2007) (showing that a $1,000 deductible contribution costs a 35% marginal tax bracket donor only $650, with the remaining $350 effectively paid by the government).

B. Overcoming Under-Punishment

The companion article I wrote with Professor Polsky considers this problem and its potential solutions under current law in depth.[37] I summarize those findings here to lay the foundation for showing why the tradeoff between punishment and plaintiff enrichment cannot be overcome under existing structures of tort law, and why reforms to punitive damages are needed for this reason, among others.

1. Two Tactics: Nondeductibility vs. Tax Awareness

To begin with, the under-punishment concern arises as a result of the assumption that the typical jury's understanding of federal tax law is inconsistent with how the tax law actually operates.[38] This inconsistency could be resolved in two independent ways. One option would be to change federal tax law by making punitive damages nondeductible in all cases. This is the reform touted by President Obama and others.[39] While the under-punishment effect is problematic, this proposed solution does not help.

Instead, the alternative approach of tax awareness, which has been hitherto ignored in this context, though not all others,[40] ought to be

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37. Polsky & Markel, *supra* note 6.

38. The assumption that a jury is tax-blind is made for a few reasons. This "tax blindness" will be true when jurors, in determining the amount of an award, either: (a) do not think about the tax consequences of paying punitive damages at all; or (b) do think about the tax consequences of paying punitive damages but incorrectly assume that punitive damages are nondeductible in all instances. Jurors who do think about taxes may assume nondeductibility for a number of reasons. They may simply assume that punitive payments would be nondeductible. Alternatively, jurors may be aware that statutory fines and penalties are nondeductible, just like kickbacks and bribes. *See* I.R.C. § 162(c)(3), (f) (2006). As a result, they may assume that, by analogy, punitive damages are as well. Finally, some jurors may infer nondeductibility from the fact that they, under current practices, are not given information about the defendant's marginal tax rate, a fact which would be necessary to calculate a proper gross up. Hypothetically, someone could be utterly ignorant of the prevailing tax effects of punitive damages and yet guess that such damages would be deductible. Most people, however, are not likely to know that punitive damages can be paid with pre-tax dollars by some defendants but not others.

39. *See supra* notes 6–7 and accompanying text.

40. *See, e.g.*, Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490, 493, 497–98 (1980) (holding that the impact of § 104(a)(2) of the Internal Revenue Code, which allows physically injured plaintiffs to exclude compensatory damages from gross income, must be considered by courts in determining an award under the Federal Employers' Liability Act (FELA)); Kirchgessner v. United States, 958 F.2d 158, 161 (6th Cir. 1992) (plaintiff's tax consequences may be introduced under the Federal Tort Claims Act); Davis v. Little, 851 F.2d 605, 611 (2d Cir. 1988) (plaintiff's tax consequences may be introduced in claims arising under 42 U.S.C. § 1983); Fanetti v. Hellenic Lines Ltd., 678 F.2d 424, 431 (2d Cir. 1982) (stating that the tax-awareness rule in *Liepelt* for FELA actions applies at least to all federal law claims for future lost wages).

adopted. Under current tort law and practice, jurors are effectively "tax blind" regarding the fact and effect of deductibility in business-related cases. If jurors were actually made tax aware, they would be able to adjust or gross up a punitive damages award to reflect the fact of deductibility. Indeed, once properly grossed up, a punitive damages award would inflict the jury's desired "sting," ensuring that their intended financial sanction is in fact borne by the defendant. By implication, once juries are tax aware, the under-punishment argument in favor of making punitive damages nondeductible dissolves. Like net worth evidence and other similar evidence relating to the defendant's financial condition, evidence regarding the fact and effect of deductibility is relevant in calculating the size of an appropriate punitive damages award.[41]

To illustrate, a tax-aware jury in the scenario presented in Part I.A would issue a $167,000 punitive damages award to impose an after-tax penalty on the defendant in the amount of $100,000.[42] This grossed-up award of $167,000 would result in an after-tax cost of $100,000 ($167,000 x .60), which is 10% of the defendant's net worth, consistent with the jury's intentions. More generally, the amount of a given intended penalty would be grossed up by dividing the intended penalty amount by (1-*t*), where *t* is the defendant's marginal tax rate.[43]

2. An Overview of the Case for Tax Awareness

Tax awareness is preferable for several reasons. First, as explained below, the choice between these two approaches depends largely on how easily defendants could circumvent a rule of nondeductibility through settlements that disguise punitive damages as compensatory damages,

41. For purposes of this Article, I adopt, without arguing, the conventional assumption that business defendants are permissibly punished in a way similar to individuals and that wealth-adjusted penalties are reasonably imposed on business entities. (A normative justification for this claim is offered in Dan Markel *Punishing Entities (Civilly)* (unpublished manuscript) (on file with author).) To be sure, some scholars reject the notion that businesses (or at least, public corporations) can sensibly be punished even though they think they can be deterred. *See, e.g.*, Polinsky & Shavell, *supra* note 20, at 948–54. Thus, it is possible that such scholars will view the resulting "under-punishment" as a good thing if it turns out that the amount of punitive damages awarded is sufficient but not excessive in relation to the optimal deterrence signal.

42. $167,000 in pre-tax dollars is necessary to create $100,000 post-tax dollars on the assumption of the application of a 40% marginal tax rate. Except in a few examples later on where greater specificity is required, I have rounded up to the closest thousand dollars.

43. It might appear that this math could be difficult for a lay jury to perform correctly. As alluded to earlier, I am relatively indifferent regarding whether the jury or the judge is the fact finder vis-à-vis the marginal tax rate and the calculation of the gross up. For simplicity's sake, I will generally refer to jury tax awareness, but the discussion below applies equally to judges if they are the relevant fact finder.

which would remain deductible under either approach.[44] It turns out that circumvention is relatively easy in most cases. Moreover, tax awareness furnishes a way for states to better implement their own visions for tort law. This is good both as a matter of respecting states' rights under a federal constitution, as well as providing some regulatory diversity in the ambit of punitive damages, which itself allows for states to experiment and learn from each other. A federal tax rule of nondeductibility undermines those values.

a. The Circumvention Problem

Imagine two possible scenarios, one where the IRS can enforce the rule of nondeductibility perfectly and one where it cannot. In the former scenario, this would mean that the IRS would readily be able to determine the value of the punitive damages portions of settlements. The IRS could then deny deductions for that portion of the defendant's settlement payments.

If the IRS were able to perfectly enforce a rule of nondeductibility, the defendant would be indifferent between a rule of nondeductibility and a tax-aware jury because the defendant would pay the same after-tax cost. The parties who would care more about the shift to a rule of nondeductibility would be the federal government, which benefits from a perfectly enforced nondeductibility rule, and the plaintiff, who benefits from a tax-aware jury.[45]

Who should get that gain? Well, given the competition between the government and the plaintiff for the extra money paid by the defendant, there is no compelling reason to enlarge the plaintiff's windfall by choosing the tax-awareness solution.[46] After all, as long as sufficient

44. I do not believe that a rule of nondeductibility for compensatory damages would seriously be entertained by Congress. Such a rule would result in significant overdeterrence because ex ante precautionary measures would be deductible while compensatory damages would not. While current punitive damages law is not concerned with the risk of overdeterrence, nonpunitive damages tort law is concerned with this risk. In any event, none of the prior proposals for nondeductibility have suggested making compensatory damages nondeductible, and making compensatory damages nondeductible would have significant rippling effects traveling far beyond the world of punitive damages. Accordingly, I assume throughout that the taxation of compensatory damages would remain unchanged. *But cf.* Alfred F. Conard, *Who Pays in the End for Injury Compensation? Reflections on Wealth Transfers from the Innocent*, 30 SAN DIEGO L. REV. 283 (1993) (exploring the argument that even compensatory damages should be nondeductible).

45. The rationales for these conclusions are elaborated at length in Polsky and Markel, *supra* note 6, at pt. II.

46. *See* Note, *An Economic Analysis*, *supra* note 6, at 1917 (discussing social disadvantages of windfalls associated with plaintiffs' recoveries of punitive damages).

incentives exist under the current tax-blind rule for plaintiffs to prosecute worthy punitive damages cases, the federal government could, by making punitive damages nondeductible, simultaneously correct under-punishment while also generating additional tax revenues without any resulting deadweight loss to society.[47]

While elegant and attractive under an assumption of perfect enforcement, the nondeductibility rule is not a practical option once the assumption of perfect enforcement is relaxed. Indeed, under that far more likely scenario, it is likely that circumvention of a nondeductibility rule would be easy in the vast majority of cases where plaintiffs seek punitive damages as a remedy. As explained in greater depth in my companion piece with Professor Polsky, there are a number of conceptual and practical impediments to the IRS's ability to enforce a rule of nondeductibility.[48]

Indeed, under a rule of nondeductibility, defendants would be able to participate in the tax gains from circumvention in the form of lower after-tax settlement costs.[49] Settlement agreements routinely expressly allocate the entire amount to compensatory damages.[50] Given the mutually self-serving nature of these allocations, they should not be assumed to reflect the true nature of the plaintiff's claims. However, courts have given these self-serving, agreed-upon allocations some degree of weight.[51] These courts neglect to consider the fact that, no matter how adversarial the parties are throughout most of the litigation, at the point of settlement, the

47. Kades, *supra* note 15, at 1564.

48. Polsky & Markel, *supra* note 6, at pt. II.

49. *See* Bagley v. Comm'r, 121 F.3d 393, 396 (8th Cir. 1997) ("It will almost never be to a defendant's advantage to allocate part of a lump-sum settlement to punitive damages, and it will often be disadvantageous. Often, insurance policies will not cover such awards, and punitive-damage awards result in worse publicity than compensatory awards. Most plaintiffs will not want specific allocations to punitive damages in their settlement agreements, because punitive damages are taxable."); ROBERT W. WOOD, 522-3D TAX MANAGEMENT: TAX ASPECTS OF SETTLEMENTS & JUDGMENTS, at A-33 (2006) (noting that, even leaving aside tax considerations, "it would be highly atypical for a settlement agreement to acknowledge that any portion of the settlement was being paid on account of punitive damages," and that "[v]irtually no defendant would agree to such a characterization").

50. *See* WOOD, *supra* note 49, at A-33; *see also Bagley*, 121 F.3d at 396 n.7 (noting that the defendant's attorney, "an experienced Iowa litigator, told the Tax Court that he could recall no settlement with which he had been involved that specifically allocated a certain amount to punitive damages in the settlement agreement").

51. *See, e.g.*, McKay v. Comm'r, 102 T.C. 465, 482 (1994), *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996) (noting that an express allocation in a settlement agreement is the "most important factor" in allocating pretrial settlements); Byrne v. Comm'r, 90 T.C. 1000 (1988) (same); *see also* I.R.S. Field Serv. Adv. Mem. 200146008, at 5 (Nov. 11, 2001) (acknowledgement by the IRS that courts "have tended to uphold the characterization or allocations in a settlement agreement where the record indicates there was a negotiated and bona fide settlement, arrived at in an adversarial proceeding at arm's length and in good faith").

parties' interests in reducing the tax burdens of the settlement are perfectly aligned.[52] As a result, to challenge a defendant's self-serving allocation, the IRS would be forced to relitigate the plaintiff's underlying claims long after the case was settled and without the benefit of a financially interested plaintiff. Thus, even if the IRS were somehow able to find good settlements to challenge, these pragmatic evidentiary problems would make it very difficult for the IRS to be successful in winning these challenges.

An extremely large percentage of tort cases already settle under current law,[53] and a rule of nondeductibility should serve only to increase the settlement rate.[54] Accordingly, circumvention through disguised settlements would be the norm, rather than the exception, under a rule of nondeductibility.[55]

The effect of this circumvention would result in precisely the same under-punishment effect that nondeductibility is intended to correct. Accordingly, if circumvention is in fact relatively easy, the tax-awareness approach (which is not subject to circumvention) is the preferred solution to the under-punishment problem.

On the other hand, the alternative solution to the under-punishment problem—making jurors tax aware—is not easily circumvented through settlement. Gross ups, in addition to increasing jury verdicts, would increase settlement values because litigants determine these values in the shadow of what a jury would be expected to award. Thus, defendants

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52. Not all courts fall victim to this problem. *See, e.g.*, *Bagley*, 121 F.3d at 396 (noting that "when the time comes to settle a case, no matter how adversarial the proceedings have been to that point, the parties will almost always be in agreement that no part of a settlement agreement should be explicitly allocated to punitive damages").

53. *See* GOLDBERG, SEBOK & ZIPURSKY, TORT LAW: RESPONSIBILITIES AND REDRESS 40 (2004) (observing that only 3% of all torts suits reach a jury verdict and that settlements or dismissal resolves the rest of claims).

54. *See* Polsky & Markel, *supra* note 6, at pt. II.C.2.

55. That said, in some cases, circumvention of the nondeductibility rule might not be possible. For example, if the "settlement gap" (i.e., the gap between what the plaintiff thinks the case is worth and what the defendant thinks the case is worth) is large enough, the gains from circumvention would not be large enough to induce litigants to settle. Likewise, if the plaintiff has a strong enough desire to "have her day in court," the gains from circumvention might not be large enough to sway the plaintiff. In addition, if the maximum amount of compensatory damages can be easily ascertained, putting at least a minimum value on the punitive damages portion of a settlement would be easy. Thus, for example, if a plaintiff is defrauded out of $10,000, and the case settles for $100,000, it would be easy for the IRS to assert that at least $90,000 of the settlement is attributable to punitive damages (assuming that there is no possibility that the plaintiff would have recovered attorney's fees and ignoring the possibility of prejudgment interest). In personal injury cases, however, the amount of compensatory damages is usually not easy to ascertain primarily because pain and suffering awards are very difficult to predict, but also because the amount of lost wages and future medical costs are often the subject of much dispute.

could not avoid any part of the under-punishment correction resulting from gross ups simply by settling before trial.

Assuming circumvention is relatively easy (as Polsky and I argued), the critical issue is whether reducing a given dollar amount of under-punishment is worth giving the same dollar amount of added windfall. If so, then one can conclude that (i) a rule of nondeductibility is an improvement over current law, but (ii) a rule of tax awareness with gross ups is even better. If not, then the proper inference is that current law should be unchanged because the cost of either solution to the under-punishment problem (i.e., augmented plaintiff windfalls) would exceed the benefit (reduced under-punishments). Accordingly, a rule of nondeductibility is never the optimal rule.

b. Federalism and Regulatory Diversity

In addition to the concerns about circumvention, federalism and regulatory diversity concerns also support choosing the tax-awareness approach. First, the goal of under-punishment reduction is to further the state's interests in effectively punishing egregious acts committed within its borders. This is a traditional state law concern, and there is no practical or legal impediment to states fixing the under-punishment problem on their own through tax awareness. It can therefore be argued that the federal government ought to give states the option to solve the problem themselves by maintaining the current tax rule of deductibility. After all, a rule of nondeductibility would foreclose the optimal state-law solution (tax awareness) by adopting the second-best solution, as accompanied by the aforementioned problems resulting from imperfect enforcement of the under-punishment problem. Put somewhat differently, the premise behind nondeductibility proposals is that federal tax law should get out of the way of state tort law. However, the proposals would themselves actually get in the way of state tort law by preempting the optimal correction to the very problem (i.e., under-punishment) that stimulated the proposals.

Second, as Professor Polsky and I have shown elsewhere and as I summarize below, under-punishment correction, whether accomplished through tax awareness or nondeductibility, inevitably comes with certain costs. For example, both proposals would increase plaintiff windfalls and would create administrative burdens. These costs must be weighed against the benefits associated with correcting under-punishment. A federal tax rule of nondeductibility would take away the ability of states to perform this cost-benefit analysis. On the other hand, if punitive damages remained deductible, states could undertake such an analysis in deciding whether to

implement a rule of tax awareness. States have undertaken and will continue to undertake similar cost-benefit analyses in designing and reforming their punitive damages regimes.[56]

In addition, the administrative costs of a rule of nondeductibility would be borne by the federal government as a result of having to police the rule, while the benefit of under-punishment correction would inure to the state. Under a tax-awareness solution, this mismatch of benefits and administrative burdens does not occur because the administrative costs of implementing a rule of tax awareness are borne entirely by the state.

Finally, a state's "punitive" or extracompensatory damages regime might not be motivated by concerns of punishment.[57] For example, the regime might be intended simply to compensate the plaintiff for intangible injuries or to effect optimal cost internalization. In those cases, there is no under-punishment problem to be solved, and the current rule of deductibility, combined with juror tax blindness, is generally adequate. If the current rule of deductibility were retained, states could easily opt out of a rule of tax awareness where appropriate. The states would be in a far better position to evaluate their own tort laws and then apply a rule of tax awareness as they see fit. Using a nondeductibility rule assumes that states want to use extracompensatory damages strictly to punish, which deprives them of the choice to fashion their rules as they see fit.

In short, the state-law solution of tax awareness is an appropriately flexible solution to the under-punishment problem. It also puts the costs of under-punishment correction squarely on the state, whose interests are furthered by the correction. By contrast, the frequently proposed federal solution of nondeductibility is far more blunt an instrument and creates a mismatch between the governmental entity that receives the benefit and the one that bears the administrative costs.

3. Windfalls and the Dark Side of Tax Awareness

As discussed above, tax awareness is the better solution. Nonetheless, tax awareness is not without its potential difficulties or objections. There

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56. *Cf.* BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 607 (1996) (Ginsburg, J., dissenting) ("The Court, I am convinced, unnecessarily and unwisely ventures into territory traditionally within the States' domain, and does so in the face of reform measures recently adopted or currently under consideration in legislative arenas."). Justice Ginsburg's federalism concerns cannot be dismissed simply as liberal politics; Chief Justice Rehnquist joined her dissent. *Id.*

57. *See, e.g.*, *supra* note 26; *see also* Guido Calabresi, *The Complexity of Torts: The Case of Punitive Damages*, *in* EXPLORING TORT LAW 333 (M. Stuart Madden ed., 2005) (providing several nonpunitive rationales for punitive damages).

are some administrative costs associated with having the jury or the court determine the marginal tax rates and apply the appropriate gross up.[58] Perhaps most pressing is this: while a rule of tax awareness would best solve the under-punishment problem, it does so at the cost of increasing what a variety of scholars believe to be "windfall" gains to plaintiffs.[59] As mentioned in the Introduction, such windfall gains raise several kinds of concerns related to fairness and efficiency. Some economists argue that extending windfalls to plaintiffs risks decreasing incentives for plaintiffs to take adequate precautions and increasing incentives to bring frivolous suits.[60]

Perhaps those concerns seem somewhat speculative. After all, lawyers would not typically want to invest their time in frivolous suits for both economic and noneconomic reasons. And plaintiffs typically want to avoid being tort victims (especially subject to the kind of torts leading to punitive damages), so the question would be whether there are some scenarios where they accept more marginal risk on the assumption that there could be a punitive damages payoff.

Nonetheless, damages that go beyond full recovery do provide a windfall, and windfalls provide a kind of lottery gain that, ex ante, most citizens would probably prefer to avoid if it could alternatively be enjoyed more certainly through lower taxes or more services.[61]

Moreover, the gross up of punitive damages under a tax-awareness rule would be a good response for undercompensation of plaintiffs more generally. For even if one believes that plaintiffs are systematically undercompensated under current tort law because of litigation costs, this problem is best resolved directly and comprehensively, not through punitive damages gross ups because such punitive damages are relatively uncommon.[62] Indeed, gross ups would only mitigate the undercompensation problem in an even smaller subset of cases: those punitive damages cases arising out of the defendant's business. In all other

58. In the companion article, Professor Polsky and I consider a range of other objections and find them unpersuasive upon scrutiny. *See* Polsky & Markel, *supra* note 6, at pt. III.

59. Congressional legislative history suggests that this is Congress's view also. H.R. REP. NO. 104-737 (1996); *see also* Note, *An Economic Analysis*, *supra* note 6.

60. *See* Polinsky & Che, *supra* note 12, at 562; *see also* H.R. REP. NO. 104-737 (1996); Note, *An Economic Analysis*, *supra* note 6.

61. Kades, *supra* note 15, at 1564.

62. *See generally* Theodore Eisenberg, Michael Heise, Nicole L. Waters & Martin T. Wells, *The Decision to Award Punitive Damages: An Empirical Study*, 2 J. LEGAL ANALYSIS (forthcoming 2010) (manuscript at 22–24), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1412864 (reporting findings that challenge the claim that punitive damages are unduly high, frequent, or erratic).

punitive damages cases, the plaintiff's recovery would be unaffected. Finally, since the amount of gross ups depends on the defendant's marginal tax rate, the amount of undercompensation relief would vary from plaintiff to plaintiff, even in cases arising out of the defendant's business.

4. An Ineliminable Tradeoff?

Thus, at bottom, a tradeoff persists under current law: every dollar paid from the defendant (which thereby addresses the under-punishment problem) ends up going to the plaintiff (and thereby creates recoveries that could plausibly be characterized as windfalls). Unfortunately, this tradeoff applies even if the government were to impose a "windfall profits" tax on plaintiffs who receive punitive damages recoveries to ameliorate this unintended byproduct of tax awareness. Alternatively, a split-recovery scheme, where the state takes a portion of the recovery of punitive damages, might be considered.[63] Such efforts by the state to offset punitive damage recoveries would theoretically reduce plaintiff windfalls.

However, like a rule of nondeductibility, these efforts would be easily circumvented through settlement in most cases. Circumvention would be accomplished through settlements that disguise punitive damages as compensatory damages, which would not be subject to the windfall profits tax. Gains from circumventing the windfall profits tax would be shared with the defendant because the defendant must agree to settle to achieve the gains.[64] Thus, while a windfall profits tax would in fact reduce the windfall of the plaintiff, it would at the same time reduce the defendant's punishment to below that which a jury would have awarded.

In other words, the tax would have similar effects to those resulting from a rule of nondeductibility. This is an example of the Coase-like tax maxim that it does not matter which party to a transaction is the nominal beneficiary of a tax benefit (or the nominal victim of a tax burden) because the benefit (or burden) can be shifted through bargaining.[65] Here, part of the benefit from avoiding the excise tax would be shifted through bargaining from the plaintiff (the nominal beneficiary) to the defendant in the form of lower settlement costs. As a result, like a rule of

63. A few states have adopted such split-recovery schemes. *See generally* Catherine M. Sharkey, *Punitive Damages as Societal Damages*, 113 YALE L.J. 347, 390 n.152 (2003) [hereinafter Sharkey, *Punitive Damages*].

64. Because defendants must agree to disguise the damages as compensatory damages, they will be able to bargain with the plaintiffs for a smaller overall payment.

65. *Cf.* Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

nondeductibility, an excise tax on plaintiffs is not advisable if one believes that a dollar of under-punishment correction is worth a dollar of windfall augmentation.[66]

As explained in the companion article, those policies would simply incentivize cooperation between plaintiffs and defendants, but it would do so at costs that are lower for the defendant than when the defendant is either subject to a tax-aware jury or bargains in the shadow of a tax-aware jury.[67] In other words, if you tax the plaintiff's receipt of punitive damages or force the defendant to pay something like half the punitive damages to the government, you encourage the parties to settle their claims quietly as compensation, thereby depriving the government of the recovery these measures are intended to achieve, and all the while allowing the defendant to settle at a lower price than it would have faced under a tax-awareness regime.[68]

While this tradeoff might be lamented, it is unavoidable under current punitive damages doctrine because of the way in which parties currently have close to unfettered discretion to settle, even in cases affecting public health and safety. Moreover, because punitive damages doctrine is focused on the *defendant*'s culpable wrongdoing, courts tend not to concern themselves too much about enriching plaintiffs. Thus, for example, a victim injured by a wealthy and malicious tortfeasor will, all else being equal, receive a larger windfall than that received by a poor and malicious tortfeasor's victim. Yet, this possibility has not prevented the fact of the tortfeasor's wealth from being introduced to the jury. Likewise, the prospect of augmented plaintiffs' windfalls would not be a satisfactory basis to preclude the fact of deductibility from being admitted into evidence so as to give the jury the requisite tools to impose a financial penalty on the defendant that it deems appropriate.[69]

As I argue in the following Parts, the tradeoff can be overcome if states are willing to undertake some basic reforms to their punitive damages schemes. These reforms are not designed solely with the objective of alleviating this tradeoff resulting from the current tax laws. They can be

66. As I have previously discussed, if one believes that a dollar of under-punishment correction is not worth a dollar of windfall augmentation, then current law (i.e., deductibility without tax awareness) should simply be left in place.

67. Polsky & Markel, *supra* note 6, at pt. II.

68. Of course, while increased settlement facilitates circumvention of the desired tax result, it will also marginally reduce the cost of litigation to society, so we'd need to find out if there's a substantial gain to society from reduced litigation costs that are borne by the public.

69. Indeed, awards of punitive damages, even when augmented, would still be subject to judicial review for compliance with constitutional legal norms.

defended, in other words, on a number of other grounds (and, in fact, have been so defended).[70] Nonetheless, these same reforms would also help states overcome the tradeoff I have identified here in the tax context.

II. RETHINKING EXTRACOMPENSATORY DAMAGES: A NORMATIVE VISION

The preceding Part exposed a tax-driven tension between the overenrichment of plaintiffs, on the one hand, and the "correct" punishment for defendants, on the other hand, under prevailing tort procedures commonly found throughout the country. This tradeoff is largely inevitable given the way punitive damages law engrafts, for the most part, public-law values (e.g., retribution and complete deterrence) upon a private tort law system.

The next two Parts, however, consider how punitive damages should be taxed if redesigning the structure of punitive damages law at the state level. Responding to various criticisms that punitive damages law and practice are muddled, unpredictable, unfair, and ineffective,[71] I have previously tried to carefully reconstruct the punitive damages landscape, first, by changing the name to extracompensatory damages, and, second, by disaggregating the various purposes such remedies might serve—while still feasibly situating these remedies within the constitutional constraints articulated by the Supreme Court.[72] This Part is designed to sketch in brief both the motivation and the structure of this redesigned civil damages regime.[73] Following this, Part III will discuss the tax rules that should apply to the reformed landscape. Before we head down that path, a little background on punitive damages theory is necessary.

A. Recent Normative Theories of Punitive Damages

The complex and rapidly evolving nature of punitive damages law has attracted the attention of scholars from a variety of disciplines.[74] In terms

70. *See* Markel, *How Should Punitive Damages Work?*, *supra* note 17.

71. *E.g.*, Exxon Shipping Co. v. Baker, 128 S. Ct. 2605, 2624 (2008) ("American punitive damages have been the target of audible criticism in recent decades"); *Developments in the Law—The Paths of Civil Litigation*, 113 HARV. L. REV. 1752, 1784–88 (2000) (providing examples of and citations to such critiques).

72. *See* sources cited *supra* note 17.

73. In so doing, this Part draws upon and gently revises aspects of my work, sources cited *supra* note 17, which itself tries to learn from the achievements and mistakes of earlier scholarly work trying to reconfigure a rational policy for punitive damages.

74. *See, e.g.*, Markel, *Retributive Damages*, *supra* note 17 at 242–43 nn.4–9 (providing citations to scholars of various disciplines interested in studying punitive damages law and practice).

of normative approaches to punitive damages, numerous scholars, including Professors Polinsky and Shavell, think that punitive damages should focus on advancing the goal of optimal deterrence (or what I also call, hereafter, "cost internalization" or "deterrence").[75] Under this framework, and contrary to current doctrine, a defendant's culpability or state of mind is immaterial to her obligation to pay for the tortious harms that she causes.[76] Instead, what matters is whether any likelihood exists that the defendant would evade paying compensation for the harms she caused. If there is such a possibility, then the amount of damages should be calibrated accordingly.[77] A small number of judges have endorsed the basic insight undergirding this approach,[78] but, for the most part, it is not a widely embraced strategy by courts or juries.[79] Moreover, as Professor Sharkey points out, a total cost-internalization approach focused on extracting money from the defendant would not necessarily ensure compensation to victims for all their losses since, theoretically, the state might apply those payments to reducing future risk of harm rather than compensating past victims.[80]

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75. *See* Polinsky & Shavell, *supra* note 20, at 897–98. A few sundry points about deterrence here: First, I recognize that by conflating deterrence with optimal deterrence (or cost internalization), I am implicitly obscuring the work of some economists who view this law through the prism of *complete* deterrence. *See, e.g.*, Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties*, 87 GEO. L.J. 421, 421 (1998) (arguing that the optimal-deterrence model should be used in limited cases and that complete deterrence should be the goal in most situations). The rationale for making this choice is partially explained at *infra* note 108. Second, the discussion in the text about optimal deterrence is normative; it doesn't undermine the earlier descriptive claim that the kind of deterrence emphasized by the Supreme Court in its case law is complete deterrence, not optimal deterrence. Third, while I distinguish between optimal and complete deterrence, I note that other scholars have used different terms to mark the distinction. *See, e.g.*, GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 68–69 (1970) (distinguishing between general (permissive) deterrence and specific (prohibitory) deterrence); Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1524–31 (1984).

76. *See* Polinsky & Shavell, *supra* note 20, at 887–96.

77. *See* Polinsky & Shavell, *supra* note 20, at 887 ("[I]f a defendant can sometimes escape liability for the harm for which he is responsible, the proper magnitude of damages is the harm the defendant has caused, multiplied by a factor reflecting the probability of his escaping liability." (emphasis omitted)). *But see* Richard Craswell, *Deterrence and Damages: The Multiplier Principle and Its Alternatives*, 97 MICH. L. REV. 2185 (1999) (providing critique of the multiplier principle); Keith N. Hylton & Thomas J. Miceli, *Should Tort Damages Be Multiplied?*, 21 J.L. ECON & ORG. 388 (2005) (registering skepticism to use of the multiplier approach in the context of civil damages); Sharkey, *Punitive Damages*, *supra* note 63, at 368–70 (identifying problems with the use of a strict punitive damages multiplier, such as the failure to include cases involving "diffuse" harms).

78. *See* Sharkey, *Punitive Damages*, *supra* note 63 , at 372 n.71 (collecting cases).

79. *See, e.g.*, Cass R. Sunstein et al., *Do People Want Optimal Deterrence?*, 29 J. LEGAL STUD. 237, 250 (2000) (finding that people who were asked neither think in terms of optimal deterrence nor find much value in it).

80. *See* Sharkey, *Punitive Damages*, *supra* note 63, at 390–91.

In addition to the cost-internalization approach, some other scholars analyze and seek to justify the practice of punitive damages in terms of how such a remedy empowers individual victims, and thus serves to *vindicate* a victim's dignity and autonomy interests that may have been injured or insulted by the defendant's misconduct.[81] Since these victim-vindication approaches effectively legitimize the utilization of enhanced awards to repair the injury that the defendant's misconduct caused to the plaintiff's dignity, they are more precisely labeled "aggravated" damages, as they are sometimes called in various jurisdictions.[82] The notion is that these damages repair an injury not recognized by the noneconomic aspects of modern compensatory damages.[83]

Some victim-vindication theorists have defended large parts of current punitive damages common law on the grounds that these practices serve as vehicles by which victims or their allies can persuade juries to avenge victims' interests through ad hoc, and therefore unpredictable, awards of money damages.[84] Indeed, for some social justice tort theorists, common law jury-driven punitive damages practices serve as a means for ordinary people to fight malfeasant entities and their lobbyists seeking business-friendly tort reform.[85]

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81. *See, e.g.*, sources cited *supra* note 13.

82. *See* Bruce Chapman & Michael Trebilcock, *Punitive Damages: Divergence in Search of a Rationale*, 40 ALA. L. REV. 741, 763 (1989) ("Where there is already injury in place that the law recognizes as damages, this added 'insult' to injury would count more accurately as 'aggravated,' than as punitive, damages.").

83. Anthony J. Sebok, *What Did Punitive Damages Do? Why Misunderstanding the History of Punitive Damages Matters Today*, 78 CHI.-KENT L. REV. 163, 205 (2003) [hereinafter Sebok, *What Did Punitive Damages Do?*] ("If punitive damages served a compensatory function [in early cases], it would have been for a category of injury that is still not considered compensable by contemporary tort law, namely the injury of insult that wounds or dishonors.").

84. *See, e.g.*, Kaimipono David Wenger & David A. Hoffman, *Nullificatory Juries*, 2003 WIS. L. REV. 1115, 1119 (defending the role of juries in "protect[ing] us from rule by legal economists" through "relatively unconstrained punitive awards"). Professors Galanter and Luban also endorse (at least implicitly) a jury imposing punitive damages against a defendant in a single case for all the harm that the defendant's misconduct caused persons in similar situations. *See, e.g.*, Galanter & Luban, *supra* note 13, at 1436–38 (providing examples of "expressive defeat" of defendants through punitive damages). They also think that judges should extend "great deference" to jury determinations because of juries' special competence in articulating "the community's 'message' through the medium of damages." *Id.* at 1439. *But see infra* Part II.B (describing the proposed limitations on jury decision making). Theoretically, cost-internalization proponents should support the payment of aggravated damages as a way to force defendants to pay for the full scope of harm they have caused, but the textures of the rationales and implications of these approaches to civil damages are quite different from each other in various respects. Importantly, I view them as similar enough to warrant the same tax treatment. *See infra* Part III.C.

85. *See* Rustad, *supra* note 27, at 1301 (characterizing tort reform of punitive damages as "special legislation to help corporate America"); *see also* THOMAS H. KOENIG & MICHAEL L. RUSTAD, IN DEFENSE OF TORT LAW (2001); Richard L. Abel, *Questioning the Counter-Majoritarian Thesis:*

Interestingly, by drawing on the work of Jean Hampton's victim-vindication justification for punishment,[86] many of these scholars, such as Professors Galanter and Luban, view themselves as committed to realizing the goals and values of retributive justice.[87] But, as emphasized in the insightful interpretive accounts of tort law and punitive damages by Professors Zipursky and Sebok, the tort system conventionally empowers victims to either *pursue* punitive damages or *forbear from pursuing* such damages.[88] This critical point demonstrates that no one forces punitive damages on the victim in the common law approach. Rather, the decision to seek legal recourse permits the victim to exercise her autonomy and seek repair to her dignity interests. The same may be said for allowing victims to have almost unfettered control over settlements with defendants.

These two practices (concerning discretion to settle or not sue altogether) reveal an important gap between victim-vindication accounts and the interests underlying a properly understood retributivist account. Retributivists, as explained in *Retributive Damages*, have strong reasons to give weight to the reduction of both Type I false-positive errors (in which people are mistakenly punished or excessively punished) and Type II false-negative errors (in which wrongdoers escape their punishment altogether or receive too lenient a punishment).[89] Importantly, the victim-vindication accounts say little about the need for building a system that tries to reduce all four kinds of Type I and Type II errors having to do with under- and over-punishment.[90]

The Case of Torts, 49 DEPAUL L. REV. 533 (1999); David F. Partlett, *The Republican Model and Punitive Damages*, 41 SAN DIEGO L. REV. 1409 (2004) (defending a robust role for juries in punitive damages awards on the basis of republican theory).

86. *See, e.g.*, Jean Hampton, *Correcting Harms Versus Righting Wrongs: The Goal of Retribution*, 39 UCLA L. REV. 1659, 1685–98 (1992) (arguing that conduct that expresses disrespect and does damage to the "value of the victim" warrants a punitive response to vindicate the victim's moral worth).

87. *See* Galanter & Luban, *supra* note 13, at 1432–35. The same can largely be said for the other scholars, including Professors Colby, Geistfeld, Goldberg, Sebok, and Zipursky, most of whom have also claimed being influenced by Professor Hampton's work. *See* sources cited *supra* note 13.

88. *See* Sebok, *From Myth to Theory*, *supra* note 13, at 1005 ("Plaintiffs who may have a valid legal claim for punitive damages are under no obligation to pursue them."); *id.* at 1029 (stressing "the active role of the victim in determining the appropriate remedy"); Zipursky, *supra* note 13, at 152 ("[T]he state is not in the driver's seat."). *See generally* Benjamin C. Zipursky, *Civil Recourse, Not Corrective Justice*, 91 GEO. L.J. 695, 733–37 (2003).

89. *See* Markel, *Retributive Damages*, *supra* note 17, at 247, 266.

90. Thus, Galanter and Luban's account of punitive damages is best seen as primarily (though not exclusively) a victim-vindication account, not a retributive justice account. *See* Markel, *Retributive Damages*, *supra* note 17, at 255 n.62. The same can largely be said for the other victim-vindication proponents cited *supra* note 13. In truth, their interests and values are better described as consistent

Indeed, to the extent that victim-vindication supporters invoke retributive justice values to bolster their accounts, this silence is a significant weakness.[91] After all, the failures to defend procedural safeguards and to create meaningful guidelines for cabining jury discretion and judicial review are recipes for Type I error creation in the context of punitive damages. Moreover, giving only victims the right to pursue punitive damages or giving all victim-plaintiffs the unfettered authority to settle a case involving allegations of reckless or malicious misconduct enables a higher risk of Type II errors.[92] This should be of concern to nonretributivists as well: certainty of punishment, perhaps more than severity of punishment, has for the last generation or so been thought to have an appreciable effect on reducing misconduct.[93]

Thus, a publicly minded "retributivist" scheme of punitive damages must reflect some concern for reducing both Type I and Type II errors in a manner that can roughly achieve some form of evenhandedness across similar kinds of cases.[94] Of course, states may decide they also want a

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with "victim vindication" and less so with retributive justice, at least when the latter is understood as a practice of state punishment interested in developing institutions that promote equality and rule of law values in the reduction of Type I and Type II punishment errors. Of course, that's not to say victims have no role to play in the effectuation of retributive justice; they do, but it is a limited one. *See* Dan Markel, *State, Be Not Proud: A Retributivist Defense of the Commutation of Death Row and the Abolition of the Death Penalty*, 40 HARV. C.R.-C.L. L. REV. 407, 452–57 (2005) [hereinafter Markel, *State, Be Not Proud*].

91. To its credit, Professor Sebok's state-sanctioned revenge account is consistent with a desire to reduce "piling on" (or Type I overpunishment) errors that occur through introducing evidence of harms to strangers to the litigation. *See* Sebok, *From Myth to Theory*, *supra* note 13, at 1031–35. But Sebok fails to address the *public's* interest in reducing Type II errors of either sort or the procedural safeguards necessary to prevent Type I errors of the mistaken-punishment sort. Similarly, for cases involving fatal risks, the methodology proposed by Professor Geistfeld is helpful in ensuring some evenhandedness across cases involving certain tort victims. *See* Geistfeld, *Punitive Damages*, *supra* note 13. That said, this methodology says little about how to reduce the gamut of Type I and Type II errors outside the relatively narrow but important context he focuses on; moreover, even in the context of fatal risks, Geistfeld's proposal provides no manner by which to address the public's interest in reducing Type II errors involving nonpunishment.

92. Such Type II errors leading to underenforcement are rife. *See* Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—and Why Not?*, 140 U. PA. L. REV. 1147, 1183 (1992) ("A great many potential plaintiffs are never heard from by the injurers or their insurers."); *see also* Richard L. Abel, *The Real Torts Crisis—Too Few Claims*, 48 OHIO ST. L.J. 443 (1987); Marc Galanter, *Real World Torts: An Antidote to Anecdote*, 55 MD. L. REV. 1093, 1159 (1996) (noting that "relatively few" tort claims are brought to court).

93. *See* ANDREW VON HIRSCH ET AL., CRIMINAL DETERRENCE AND SENTENCE SEVERITY: AN ANALYSIS OF RECENT RESEARCH 45–48 (1999); Jeffrey Grogger, *Certainty vs. Severity of Punishment*, 29 ECON. INQUIRY 297, 308 (1991). *But see* Raymond Paternoster, *The Deterrent Effect of the Perceived Certainty and Severity of Punishment: A Review of the Evidence and Issues*, 4 JUST. Q. 173, 176–86, 188–92, 214–15 (1987) (taking a more skeptical view upon review of the evidence).

94. *Cf.* Exxon Shipping Co. v. Baker, 128 S. Ct. 2605, 2627 (2008) ("Thus, a penalty should be reasonably predictable in its severity, so that even Justice Holmes's 'bad man' can look ahead with

pluralistic scheme of extracompensatory damages, one that provides space for the pursuit of cost internalization or victim vindication or both as well. Part II.C says more about how to create that pluralistic framework.[95] That said, I am not arguing here that states *must* pursue all three purposes (retribution, victim vindication, and cost internalization) through their extracompensatory damages regimes. Rather, I want to give them options about how to do so and how to think about the relevant tax rules. But before heading too far down that path, we need a better sense of what public retributive justice theory entails for the implementation of punitive damages. The following section provides a summary of the basic structure of retributive damages.

B. The Basic Structure of Retributive Damages: A Recap

While this Section outlines the basic structure of retributive damages, it does not explain in detail the rationale underlying this structure or why this structure is desirable vis-à-vis other remedial or penal options. Those issues are both addressed and defended at length in *Retributive Damages*.[96] As demonstrated there, retributive justice theory offers not only a reason for reconfiguring punitive damages, but also a set of constraints.[97] After all, once properly understood, retributive justice is tethered to concerns for equality, modesty, accuracy, proportionality, impartiality, and the rule of law; such notions are largely missing not only from current common law punitive damages practices but also, to varying degrees, from the accounts of those scholars emphasizing punitive damages as vehicles for vindicating a private plaintiff's interest in "poetic justice"[98] or revenge,[99] or a jury's interest in ventilating its outrage.[100] In some respects, this public retributive interest means ensuring modest and fair sanctions *across*

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some ability to know what the stakes are in choosing one course of action or another. . . . And when the bad man's counterparts turn up from time to time, the penalty scheme they face ought to threaten them with a fair probability of suffering in like degree when they wreak like damage.").

95. The following caveat is necessary: in identifying three plausible forms of extracompensatory damages (retributive, deterrence, and aggravated), I recognize that I am merely adopting certain scholars' views on how to conceptualize and implement what I am calling aggravated and deterrence damages. This caveat seems necessary in light of the fact that there are disagreements within the cost-internalization school and within the victim-vindication camp over various details. The goal has been to give an overview of these various objectives as they would influence a state operating in a post–*Philip Morris* world.

96. *See* Markel, *Retributive Damages*, *supra* note 17.

97. *See id.* at 304–09.

98. *See* Galanter & Luban, *supra* note 13, *passim*.

99. *See* Colby, *supra* note 13, at 433; Sebok, *From Myth to Theory*, *supra* note 13, at 1031.

100. *See* Wenger & Hoffman, *supra* note 84, at 1138–40.

the realm of similarly situated defendants; in other respects, it means ensuring safeguards to achieve accuracy, impartiality, and proportionality *in a particular case*.

In *Retributive Damages*, these claims were advanced largely on the back of an account of punishment earlier called the *confrontational conception of retributivism* (CCR).[101] The CCR seeks to communicate to defendants our seriousness about particular interests by applying some level of coercive condemnatory setback on account of her violating the state's law. In the retributive damages context, the statute describing the scope of retributive damages is the dictate of law. Hence, someone who violates that statute stands in a similar position, vis-à-vis the CCR, as someone who, for example, violates a typical criminal prohibition against theft or fraud. The offense warrants a coercive response by the state that adequately and parsimoniously communicates condemnation of that offense to the offender. Assuming that the offender is without further justification or excuse, that person ought to be punished through retributive damages because doing so helps instantiate our commitments that we are moral agents capable of conforming our behavior to law and being held responsible; that, under the law, we all are entitled to enjoy the same cluster of equal liberty; and that we will defend our democratic sovereignty regarding that package of liberty against usurpations by offenders. By extending punishment against violators of this retributive damages statute, we continue to vindicate the value of persons' rights and interests, as well as our belief in the moral competence of persons to act freely within a zone created by those protected rights and interests.

One virtue of this account, when fully fleshed out, is its ability to explain both the internal intelligibility of retributive justice within a liberal democracy and the limits that may reasonably be placed on that social practice to help distinguish it from naked revenge. Significantly, this account explains the need for reducing both Type I and Type II errors. Accounts of both retributive justice and retributive damages ought to offer

101. *See* Markel, *Retributive Damages*, *supra* note 17, at pt. II. My prior works have addressed how this theory applies to other policy issues. *See generally* Dan Markel, *Against Mercy*, 88 MINN. L. REV. 1421 (2004); Dan Markel, *Are Shaming Punishments Beautifully Retributive? Retributivism and the Implications for the Alternative Sanctions Debate*, 54 VAND. L. REV. 2157 (2001); Markel, *State, Be Not Proud*, *supra* note 90, at 457–77; Dan Markel, *The Justice of Amnesty? Towards a Theory of Retributivism in Recovering States*, 49 U. TORONTO L.J. 389, 392 (1999). More recently, this theory was extended to the Supreme Court's Eighth Amendment jurisprudence, *see* Dan Markel, *Executing Retributivism:* Panetti *and the Future of the Eighth Amendment*, 103 NW. U. L. REV. 1163 (2009), and the role that a defendant's family status should play in her criminal liability and punishment. *See* DAN MARKEL, JENNIFER M. COLLINS & ETHAN J. LEIB, PRIVILEGE OR PUNISH: CRIMINAL JUSTICE AND THE CHALLENGE OF FAMILY TIES (2009).

sustained reflection on the reasonable reduction of all of these errors. As mentioned earlier, and by contrast, victim-vindication and cost-internalization accounts lack the conceptual resources to do so effectively.[102]

Hence, under the retributive damages framework, when people defy certain legal obligations, the state may either seek to punish them through traditional criminal law or make available the sanction of retributive damages. Such damages would be credited against any further criminal sanctions imposed by the state for the same misconduct. Retributive damages statutes would empower victims—or, in some cases, after public declinations to prosecute, private attorneys general (PAGs)[103]—to act on behalf of the state to seek the imposition of an "intermediate sanction." These penalties are basically a stripped-down civil fine; they neither trigger the status of a conviction nor do they instigate any collateral consequences or future disabilities as a result of retributive damages liability.

Under this scheme, the amount of the penalty is determined largely by the reprehensibility of the defendant's misconduct. Specifically, the fine's amount is informed by two kinds of measurements. The first measurement is a number on a reprehensibility scale, while the second translates that reprehensibility score to an amount of damages corresponding, in the case of an individual defendant, to a percentage of wealth or some other relevant metric of financial position.[104] As a preliminary matter, the state legislature or sentencing commission would devise a set of guidelines and commentaries for juries (or judges in bench trials) to help them objectively assess how reprehensible the misconduct is.[105] These commentaries would include hypothetical examples of misconduct that fell on various places on the scale.

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102. The victim-vindication accounts, sources cited *supra* note 13, say little about how to achieve consistency and predictability across cases. Furthermore, the dominant cost-internalization accounts do not typically require inquiry into and judgment of the reprehensibility of the defendant's actions, so its proponents are not really interested in communicating condemnation to offenders. *See, e.g.*, Thomas C. Galligan, Jr., *Augmented Awards: The Efficient Evolution of Punitive Damages*, 51 LA. L. REV. 3 (1990); Polinsky & Shavell, *supra* note 20.

103. In *Retributive Damages*, I explain why and how nonvictims should have a role in facilitating the punishment of misconduct that involved harmless wrongdoing or wrongs that victims themselves did not seek to vindicate (fully). *See* Markel, *Retributive Damages*, *supra* note 17, at 279–86.

104. For business entities, the metric would probably focus on net value, using the kinds of valuation techniques frequently deployed in the context of mergers and acquisitions.

105. *See generally* Paul H. Robinson & Robert Kurzban, *Concordance and Conflict in Intuitions of Justice*, 91 MINN. L. REV. 1829 (2007); Cass R. Sunstein et al., *Assessing Punitive Damages (with Notes on Cognition and Valuation in Law)*, 107 YALE L.J. 2071, 2077–78 (1998) (noting consistency of moral judgments but inconsistency in translating outrage into dollars).

Equipped with these guidelines, juries would calibrate reprehensibility along a scale, perhaps from one to twenty with twenty being the worst, using many of the factors that courts currently use to evaluate the defendant's reprehensibility.[106] Some factors, such as a defendant's history of past adjudicated misconduct, might increase reprehensibility. Other factors, such as preexisting compliance programs or remedial actions and restitution measures taken by the defendant upon discovery of the misconduct, might mitigate reprehensibility. Importantly, the jury would only determine the reprehensibility level. (The court would then link the reprehensibility score to the percentage of the defendant's wealth or value established by the state.) Thus, to use an example, a jury finding of two on the scale of reprehensibility could lead to a retributive damages award of 1% of the defendant's net wealth, and a finding of twenty could lead to 10% of the defendant's assets being assessed.[107]

To ensure that the defendant does not benefit from the misconduct against the plaintiff, the total retributive damages penalty should also strip the defendant of any gains in excess of compensatory damages that are owed to the plaintiff and that arose from the misconduct. These payments (the gains and the reprehensibility-based penalty) go to the state.[108] The defendant should also pay the plaintiff's lawyers' fees (for the amounts related to the marginal labor necessary to prove the defendant's reprehensibility) and a modest and fixed award (a finder's fee) to the plaintiff—perhaps something in the range of $10,000—for bringing the

106. This scaling approach addresses some of the concerns raised by Cass Sunstein. *See, e.g.*, Cass R. Sunstein, *On the Psychology of Punishment*, 11 SUP. CT. ECON. REV. 171, 179–81 (2004) (recognizing the value of guidelines and benchmarks for improved cognition and fairness in punitive damages awards across cases).

107. *Cf.* Markel, *Retributive Damages*, *supra* note 17, at 289–96 (offering rationales for "scaling fines to the defendant's financial position"). To be sure, using flat percentages of wealth or net value would not necessarily do the same work in addressing "diminishing marginal utility of money" as a progressively increasing set of percentage-based fines. *See id.* at 292–93. But there are some reasons to think that such "progressivity" is inapposite to a system meant to express a commitment to the idea that we are equal under the law. *See id.* at 293.

108. The gain-stripping aspect of the retributive damages structure makes this approach largely if not always consistent with the "complete deterrence" approach advocated by economists such as Keith Hylton. *See* Hylton, *supra* note 75, at 464–67 (stressing that the penalty system for illicit gains should eliminate the prospect of gain by the offender); *see also* David D. Haddock et al., *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CALIF. L. REV. 1, 20 (1990). But the retributive damages penalty also includes a wealth- and reprehensibility-informed monetary penalty that puts the defendant in a *worse* position than she was at the status quo ante. Complete deterrence models permit but do not require that setback, which is part of how the retributive message of condemnation is communicated. *See* Markel, *Retributive Damages*, *supra* note 17, at 242–43 (contrasting the messages of complete deterrence and retribution). Moreover, complete deterrence models would not require an adherence to proportionality as an independent value in the setting of the financial setback.

case to the public's attention.[109] These payments together (to the state, the plaintiff, and the lawyer) constitute one sensible way, perhaps among others, to structure extracompensatory damages designed to advance the goals of retributive justice.[110] Of course, the jurisdiction could also permit the plaintiff to receive aggravated damages if compensatory damages in that jurisdiction did not already account for an injury to dignity.

Consistent with the notion that retributive damages are supposed to serve as an *intermediate* sanction on the public's behalf in order to punish rather than destroy, legislatures may authorize courts to order defendants to pay the damages amount as a percentage of profits in coming years in situations where a defendant has reason to doubt her livelihood's viability if required to pay one lump sum. Additionally, if one is concerned that a defendant committed grave misconduct and then restructured her finances to make it appear that she could not pay the amount owed, the courts might adjust the retributive damages based on the financial condition of the defendant at the time the misconduct (last) occurred.[111]

The regime described above furnishes potential defendants little basis for complaining that the amount or award of retributive damages is a surprise, since the standards that would be applied to them are no different than the guidelines that have now become familiar in many jurisdictions when assessing criminal liability and sentencing.[112] Of course, defendants in criminal cases have more procedural safeguards in place, and thus, if we are deputizing plaintiffs to facilitate the imposition of an intermediate civil sanction, then we should enhance at least some of the procedural protections available in retributive damages cases, an aspect of the argument developed in *How Should Punitive Damages Work?*[113]

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109. I will say more about this distribution later, but now I just point out that the flat amount avoids the lottery effects that a plaintiff would enjoy from having the good "fortune" of having a wealthy injurer.

110. Other valuation methodologies might also be consistent with retributive justice values. *See* Geistfeld, *Punitive Damages*, *supra* note 13, at 286–92, 306 (proposing for torts involving fatal risks a damages valuation that examines government data regarding the monetization of fatal risks); Markel, *Retributive Damages*, *supra* note 17, at 287 n.166, 290 n.181 (explaining why a multiplier of compensatory damages for torts involving purely financial losses might also comply with retributive justice values). Despite some open-mindedness toward these alternative methods of assessing retributive damages, I note that if they were to be used, the amounts imposed would also need to satisfy the retributive goals of stripping the gain and imposing an adequate, proportionate, and nondestructive setback on the defendant.

111. Indeed, depending on the circumstances, the restructuring to evade payment could arguably be a factor used to raise one's reprehensibility score.

112. *See generally, e.g.*, Richard S. Frase, *State Sentencing Guidelines: Diversity, Consensus, and Unresolved Policy Issues*, 105 COLUM. L. REV. 1190, 1194–1208 (2005).

113. *See generally* Markel, *How Should Punitive Damages Work?*, *supra* note 17.

C. Building a Pluralistic Structure: A Summary

As indicated earlier, while retributive damages are important, they are not meant to displace extracompensatory damages that reasonably achieve other goals.[114] Rather, under such a framework, extracompensatory damages would be available separately if necessary for retributive, cost-internalization, and victim-vindication purposes. Respectively, there would be three kinds of extracompensatory damages: retributive, deterrence, and aggravated damages. Consistent with that pluralistic approach, different procedural safeguards and standards of review would be appropriate for each kind of extracompensatory damages. States could choose one, two, or all three of these measures.

Because much work has already been done conceptualizing the policies of aggravated and deterrence damages,[115] the focus of this Section is on the relatively less familiar genre of retributive damages. Importantly, the heightened level of safeguards for retributive damages would be responsive to the concern raised by some who have argued that punitive damages, insofar as they are serving public retributive (or complete deterrence) goals, are unconstitutional because defendants facing punitive damages lack any of the procedural safeguards provided in criminal cases.[116] As explained elsewhere,[117] the problem with this challenge is that it mistakenly implies that criminal procedural safeguards apply like a binary switch that toggles between on or off. In fact, as criminal procedure scholars are well aware, the extent of protection provided by many procedural safeguards operates on a continuum marked by the severity of the punishment imposed.[118] The same logic should apply to retributive damages.

Consequently, the extent of such protections would fall roughly between the extent of protection we confer to defendants in cases involving compensatory damages and the extent we confer to defendants in criminal cases involving modest sanctions such as criminal fines. But

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114. *Cf.* Galanter & Luban, *supra* note 13, at 1451 ("Efficiency plays no role in the normative universe of punitive damages as we conceive of it.").

115. *See* sources cited *supra* note 13 (focusing on aggravated damages); Polinsky & Shavell, *supra* note 20 (focusing on deterrence damages); Markel, *How Should Punitive Damages Work?*, *supra* note 17, at 1387 n.5 (collecting sources generally).

116. *See, e.g.*, Colby, *supra* note 13; Jeffery W. Grass, *The Penal Dimensions of Punitive Damages*, 12 HASTINGS CONST. L.Q. 241 (1985); John Calvin Jeffries, Jr., *A Comment on the Constitutionality of Punitive Damages*, 72 VA. L. REV. 139 (1986); Malcolm E. Wheeler, *The Constitutional Case for Reforming Punitive Damages Procedures*, 69 VA. L. REV. 269 (1983).

117. Markel, *How Should Punitive Damages Work?*, *supra* note 17.

118. *See generally* WAYNE R. LAFAVE ET AL., 1 CRIMINAL PROCEDURE § 1.8(c), (e) (2d ed. 1999).

consistency with constitutional mandates is not the only goal; the level of procedural protections should also be faithful to the basic values underlying retributive justice.

Accordingly, some safeguards would be necessary for the *justified* imposition of retributive damages as an intermediate civil sanction. Per the proposal, defendants facing retributive damages would receive:

> A. more protection than currently permitted with respect to duplicative punishment;
>
> B. a heightened standard of proof (clear and convincing evidence) with respect to the mens rea of the defendant;
>
> C. a standard of appellate review that distinguishes between the factual predicates (for which deference is owed) and the evaluative assessments of the jury (for which deference is not owed because the key is consistency with the guidelines and commentaries provided by the legislature); and
>
> D. a right to have bifurcated trial proceedings regarding wealth and liability.[119]

By contrast, the same precautionary measures do not necessarily apply when defendants are facing *nonretributive* extracompensatory damages. Of course, some measures and safeguards for deterrence and aggravated damages are warranted to ensure fidelity to constitutional principles associated with federalism and basic procedural fairness. Thus, it is very likely that the rulings of *Philip Morris* would still govern aggravated and deterrence damages. Contrary to some scholars,[120] my view is that deterrence damages would be limited to an inquiry regarding the likelihood that the defendant would evade compensation to the plaintiff(s) only, and not strangers to the litigation. Evidence of "other acts" toward

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119. With respect to the intermediate civil sanction of retributive damages, a heightened level of procedural safeguards made more sense because it showed greater concern for Type I errors involving mistaken or excessively high damages than would be appropriate under compensatory damages. That heightened level was still cognizant of the fact that retributive damages would not be as severe a sanction as a criminal fine. Indeed, the retributive damages sanction would be a penalty that falls on the civil side, and thus would trigger no state-imposed collateral consequences and no status of "conviction." A useful paradigm for thinking about these issues is the burden of proof. There should be a heightened level of proof required to secure retributive damages (clear and convincing—not preponderance of the evidence, but not beyond a reasonable doubt). That would show what is meant by an intermediate level of procedural safeguards to accompany an intermediate sanction. Of course, using the kinds of guidelines and commentaries mentioned earlier would also work toward a more evenhanded and predictable distribution of retributive damages across cases.

120. *See, e.g.*, Colby, *supra* note 13; Sharkey, *Punitive Damages*, *supra* note 63.

others would still be permissible to establish that the defendant acted as part of a plan or deliberate strategy rather than some mistake, but per *Philip Morris*, the defendant would not be punished based on harms to others against whom the defendant might have valid defenses. Under such a rule, states would not be able to deputize plaintiffs to use aggravated or deterrence damages to regulate conduct outside their jurisdiction. Other due process constraints already articulated by the Supreme Court would still apply: thus, defendants would be entitled to post-trial and appellate review of aggravated and deterrence damages;[121] such review would be *de novo* in federal cases;[122] and the amount of such damages would be subjected to the "guideposts" analysis offered in *BMW* and *State Farm.*[123] Indeed, where juries impose retributive damages, as well as aggravated or deterrence damages, judicial review of all the types of damages should be especially searching to ensure the juries' calculations are reasonable.

Even with these various safeguards, a pluralistic approach has to be mindful of the difficulties associated with realizing public goals in private litigation. With respect to settlement of claims involving the potential for retributive damages in particular, where the government is the principal recipient of the penalty paid by the defendant, various checks should be placed on litigants. This is the case because, as described in Part I in the context of how parties might try to circumvent the effects of a nondeductibility rule, private parties have strong incentives to engage in settlements that disguise punishment as compensation and thus prevent the government from collecting its share of the retributive penalty. As elaborated in Part III, various mechanisms can be used to increase the likelihood that the retributive portion of any settlement is correctly classified as such.[124] In other words, these checks are important because they are tactics available to protect the public's interest with respect to retributive damages and the correct taxation thereof.

In sum, under this proposal, retributive damages would be one of three extracompensatory remedies available. Importantly, the retributive damages penalty requires more public governmental input and oversight

121. *See* Honda Motor Co. v. Oberg, 512 U.S. 415, 434–35 (1994).

122. Cooper Indus., Inc. v. Leatherman Tool Grp., Inc., 532 U.S. 424, 443 (2001).

123. BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996); State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408 (2003).

124. *See infra* notes 150–56 and accompanying text (discussing requirements to (a) allege requisite culpability for retributive damages in initial complaint; (b) have judicial supervision and transparency over suits involving retributive damages; and (c) ensure that the relevant government agency signs off on any pre-filing settlement to ensure defendant acquires repose from possible private attorney general actions).

because it is the civil damages measure that most clearly speaks in the public's interest and is also the most vulnerable to manipulation in private-party litigation. By contrast, the responsibility for realizing the goals of optimal deterrence (at least in a post–*Philip Morris* world) and victim vindication can reasonably be left to the parties themselves. I will say a bit more about that possibility of private ordering in the next Part, where the focus shines on the appropriate tax rules that should be used to correspond to this trifurcated scheme of extracompensatory damages.

III. TAXING EXTRACOMPENSATORY DAMAGES PROPERLY

In this Part, I discuss the tax rules that should apply to the extracompensatory damages structure described in Part II. Specifically, I try to show what the appropriate tax rules are for retributive, aggravated, and deterrence damages designed to achieve retributive justice, victim vindication, and optimal deterrence, respectively.

A. Taxing Retributive Damages

1. Retributive Damages and Federalism Tradeoffs

Assume that a state implements a retributive damages regime similar to the one proposed in Part II. Should defendants paying those penalties in the context of business-related torts be permitted to deduct those penalties? Or should these payments be nondeductible?

Under current tax law, civil fines are nondeductible when those fines are paid to a government.[125] Because the retributive penalty is analogous to a civil fine in that it is both a sanction and paid to the government, it could be argued that retributive penalties likewise ought to be nondeductible, at least under current law.

However, here I am addressing the proper normative tax treatment of the retributive damages penalty, and it is not clear that the current tax treatment of civil fines is necessarily the correct normative approach. For example, civil fines are distinct from the retributive penalty in a very important respect. Fines are often imposed without regard to the individual attributes, such as financial condition of the wrongdoer. On the other hand, the amount of the retributive penalty is determined in a highly

125. *See* I.R.C. § 162(f) (2006).

individualized manner. As a result, a retributive penalty could easily be adjusted to take into account tax effects.[126]

Moreover, a retributive damages penalty system could provide a schedule of intended penalty amounts and then require the decision maker to gross up these amounts where appropriate.[127] Existing civil fine regimes ordinarily lack this flexibility.[128]

Note that if gross ups were calculated properly, defendants would be indifferent as to whether the retributive penalty is deductible or not. This is because a proper gross up would precisely offset the benefit of a deduction. The same indifference to the tax rule holds true for plaintiffs; plaintiffs would be indifferent to the deductibility rule for defendants because, under the proposal mentioned in Part II, plaintiffs would receive only a flat finder's fee (as opposed to a percentage of the retributive penalty).[129] The plaintiff's lawyers would similarly be indifferent to the tax treatment of the defendant because their fees are based on the time, expense, risk, and expertise involved, and not on the amount of the recovery.[130]

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126. Two side notes: First, defendants might try to manipulate their marginal tax rates in response to such tax-adjusted penalties. Professor Polsky and I address this concern elsewhere. *See* Polsky & Markel, *supra* note 6, at 1354 n.136. Second, one also must consider the tax rules associated with the defendant's payments of amounts related to the retributive penalty such as gain stripping, payment of the finder's fee for plaintiff, and reimbursement of the plaintiff's attorney's fees. With respect to post–*Philip Morris* gain stripping, which focuses on removing the profit the defendant made vis-à-vis the activity toward this plaintiff, there is no need for the jury to use a tax-aware approach unless the gain were also calculated and shown to a jury in an after-tax manner. Vis-à-vis the reimbursement of a plaintiff's attorney's fees for the retributive portion of the recovery and the finder's fee portions, I view these as part of the "retributive damages," and thus they should be treated in a manner consistent with the wealth-adjusted setback, as discussed in the text. On the plaintiff's side, the finder's fee compensates the plaintiff for bringing the underlying action and prosecuting the retributive claim, and should thus be included in the plaintiff's gross income, just like other accessions to wealth.

127. As noted earlier, the gross-up calculation is relatively mechanical after one determines the amount of the intended after-tax penalty and the defendant's marginal tax rate. A chart would provide the amount of the intended after-tax penalty along with the facts found by the jury or judge. The jury (as fact finders) would determine the defendant's marginal tax rate. In addition, the jury would decide the issue of deductibility in cases where it may be disputed (e.g., in a case where the plaintiff's claim is arguably not connected to the defendant's business). That said, the proposal admittedly raises some "second generation" questions associated with inquiries into marginal tax rates: for example, what do you do with marginal tax rates that change year to year; should we average the marginal tax rates across a number of years? And what if there's a recalculation? I leave the full articulation of these challenges, and their possible resolutions, to more talented tax scholars.

128. Of course, jurisdictions might also wish to consider whether to make their fines tax aware.

129. If plaintiffs were entitled to a percentage of the retributive penalty, then plaintiffs would likely prefer a deductible regime because then they would receive a percentage of the grossed-up amount.

130. Amounts received by plaintiffs and their lawyers for seeking retributive damages would be taxed as income, just like other accessions to wealth.

While the issue of deductibility would have little impact on the litigants, it *would* significantly impact the federal government and the states in which the cases are litigated.[131] If defendants were allowed to deduct the retributive penalty, the effect is a wealth transfer from the federal government to the state. To illustrate this effect, consider a case where the legislature intended that the defendant experience a wealth-adjusted financial setback of $100,000. Assume further that a $10,000 finder's fee inures to the plaintiff and that this fee comes out of the defendant's penalty. If the retributive penalty were nondeductible, then the penalty imposed against the defendant equals $100,000. By contrast, if the retributive penalties were deductible, then the penalty would equal $167,000 because of the gross up (assuming the same 40% tax bracket).[132]

Notice what happens here: under a nondeductible regime, the state would recover $90,000 ($100,000 penalty–$10,000 finder's fee). Under a deductible regime, the state would recover $157,000 ($167,000 penalty–$10,000 finder's fee). The plaintiff recovers $6,000 after tax ($10,000–40%) in either case. In a deductible regime, the federal government effectively pays the $67,000 difference to the state. That is the amount of the reduction in the defendant's federal tax liability as a result of being able to deduct the $167,000 amount of the retributive penalty.[133] The chart below summarizes these results:

Regime	Nominal Amount of Retributive Penalty	Plaintiff's After-Tax Recovery	Defendant's After-Tax Cost	State's Recovery	Change in Federal Revenues in Switching from a Nondeductible Regime to Deductible Regime
Nondeductible	$100,000	$6,000	($100,000)	$90,000	N/A
Deductible	$167,000	$6,000	($100,000)	$157,000	($67,000)

The effect of making the retributive penalty deductible in this case is to transfer $67,000 of wealth from the federal government (in the form of reduced federal tax revenues) to the state (in the form of an augmented retributive penalty). Generalizing more broadly, the amount of the wealth transfer to the state will equal the amount of the gross up.

Is such a wealth transfer from the federal to the state government appropriate? To answer that, there are a number of issues to consider.

131. For this example, I assume the retributive-damages structure would take place in a state court based on a state cause of action.

132. Assuming a 40% marginal tax rate, an intended $100,000 dollar "after-tax" penalty would require $167,000 of the defendant's gross pre-tax income. I have rounded up to the nearest $1000.

133. $167,000 x 40% = $67,000. Again, here I have rounded up to the nearest $1000.

First, one could contend that by discussing a wealth transfer from the federal to the state government, I have assumed improperly that the baseline of nondeductibility for retributive damages is neutral and natural.[134] Some scholars, such as Professor Eric Zolt, might say that the rule disallowing deductions for such damages (as embodied in the Code's § 162(f)) is in fact a departure from a more neutral baseline allowing deductions for expenses incurred in the course of running a business.[135] On this view, the more neutral way to present this issue would be to simply present both scenarios, that is, the putative wealth transfer from federal to state occurring under a deductibility rule and the putative wealth transfer from state to federal coffers that occurs under a nondeductibility rule. I think this point makes sense if we're talking about achieving optimal deterrence, but I'm less sure it makes sense when we're talking about government penalties for wrongdoing. Indeed, as Professor Zolt himself acknowledges, prior to the passage of § 162(f), courts regularly denied deductions for fines or other penalties paid to the government for wrongdoing.[136] So the selection of this baseline doesn't seem especially controversial to me in the context of a retributive sanction speaking in the language of condemnation, as opposed to an optimal-deterrence sanction interested in calibrating private and public incentives to reach an optimal level of harm.

Of course, as we'll see shortly, not much rides on this selection of the baseline; my goal is to figure out the normatively most attractive way to deal with such damages from a tax perspective so I'm not beholden to reinforcing the baseline anyway.[137]

Let's turn to that specific issue now. From a distributive-justice perspective, informed by public choice and economics principles, the issue is not easy to resolve without further study. All other things being equal, a deductibility rule (i.e., one that transfers money from the federal to the

134. I am grateful to Larry Zelenak for his help with this point.

135. *See, e.g.*, Eric Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 352–53 (1989).

136. *Id.* at 350 (noting usage of "public policy" doctrine to disallow various related deductions in court decisions prior to 1969 when the Code's treatment was clarified by Congress).

137. In this respect, it bears emphasis that I am making another assumption, which may not be altogether realistic, though perhaps it is permissible in the context of trying to design the right policies under ideal conditions: i.e., that states will set the retributive penalty formula solely with an eye to appropriate after-tax punishment levels (under either of the possible tax regimes), so that the choice of tax regime has no impact on defendants, but only on the state and the federal government. At least one of my learned readers of an earlier draft thought that revenue concerns would play some role in the setting of retributive penalty formulas; to the extent that surmise is right, defendants would be quite interested in the choice between deductibility and nondeductibility.

state government) would cause people in (say) Colorado to receive fewer federal services or higher federal taxes in order for the federal government to subsidize the creation and operation of retributive damages regimes in (say) Alabama.[138] Perhaps this could be justified if there was a positive benefit Coloradans enjoyed from enforcement measures taken in Alabama—maybe companies facing retributive damages in Alabama will improve the safety or marketing of their products in Colorado or nationwide as a result. On the other hand, if the action for retributive damages in question was purely local and unlikely to have positive ripple effects outside the state in which they are imposed, then that would be an argument for making retributive damages nondeductible.

In other words, if retributive damages actions create positive externalities outside the state, then a federal subsidy via a deductibility rule could be justified because the subsidy would, on the margins, stimulate states to develop and enforce retributive damages schemes. The question from this perspective is whether retributive damages schemes are underprovided from a social perspective; if they are, then deductibility could be justified. By contrast, if the benefits of such actions are localized, or if retributive damages actions are likely to be "overproduced," perhaps because of the political power of the plaintiffs' bar at state level, then additional subsidies to the state via a deductibility rule would be counterproductive.[139]

There are other considerations as well. On the one hand, it may seem arbitrary for the federal government to effectively allocate money to states based on torts enforcement activity. After all, if the state had decided to take the money it would use to subsidize the tort system and instead put it in the criminal justice system, the criminal fines it would collect there would be nondeductible (at least under current tax law). Hence, if the state thought a $100,000 fine with after-tax dollars against a defendant were appropriate, it would only collect $100,000 of the defendant's after-tax dollars. Making retributive damages deductible thus encourages states to invest in retributive damages regimes (with gross ups) instead of allocating more money to the criminal justice system.[140]

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138. Alas, there is one other (pernicious and all too familiar) option: no tax increases or cuts in spending but rather just continued deficit spending that will hurt future generations.

139. *Cf.* Brian Galle, *A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code*, 82 IND. L.J. 673, 687–91 (2007) (discussing use of federal deduction for state and local taxes paid as a means for encouraging states to produce positive externalities for other states).

140. Some states might nonetheless prefer the greater certainty of getting their money through a mechanism of a fine instead of retributive damages on the theory that the jury might not figure out

On the other hand, and more persuasively, it is and should be the *state's* choice to decide to supervise retributive damages cases and provide courts for these disputes, so it is not unreasonable for the states to capture more of the money here if they prefer to spend more on tort enforcement and less on criminal prosecutions. Indeed, the effect of a deductibility rule would be to provide a marginal incentive to states to encourage forums for retributive damages.[141]

That said, in light of the fact that states would already be capturing a significant portion of the retributive damages in a nondeductible regime (e.g., $90,000), it seems as if they are already operating under a significant incentive. Moreover, a nondeductible regime of retributive damages spreads the damages across the levels of government to a broader set of political constituents.[142]

That is the theoretical lay of the land. In the abstract, it is difficult to predict with certainty whether a nondeductibility rule for retributive damages would be more beneficial than a rule permitting deductibility and gross ups. The deductibility rule makes more sense when the defendant is a business that either substantially engages in or affects interstate commerce.[143] If the deductibility rule for retributive damages is embraced based on that assumption, it would require amending § 162(f) of the Internal Revenue Code. Conversely, it would make sense to leave the Code's relevant language the same as it is now if nondeductibility for retributive damages were embraced on the (probably unlikely) assumption that most economic activity does not involve interstate commerce. Such a distinction might be hard to implement, though, and in any event, one

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what it should do and since the state might think criminal justice would be less complicated. That concern could largely be obviated by having judges do the gross ups. *See supra* note 22.

141. The deductibility rule might also encourage states to lobby for a change to the tax rule regarding fines (i.e., make them deductible also), and then have the defendant's financial position and marginal tax rate affect the fines as well. Whether the states will *successfully* lobby the federal government on this issue is another matter.

142. This diversified spread might reduce the likelihood of states and local juries being corrupted by the prospect of enriching their state's coffers with lucre from retributive damages. This concern, however, might be hard to credit. Given that the state will be enriched from retributive damages even under a nondeductibility rule, it is hard to know if the marginal incentive achieved by deductibility with gross ups is enough to cause concern about corruption. After all, the incentive arises from a relatively obscure aspect of tax law and thus is one that most lay persons cannot be expected to readily appreciate.

143. One possible and rough proxy for determining the extent to which the business defendant engages in or substantially affects interstate commerce is whether the defendant is obligated to comply with the employment laws of Title VII. *See, e.g.*, 42 U.S.C. § 2000e(b) (2006) (defining affected employers as those employing fifteen or more employees within a specific period).

must still consider how settlement and administrative issues might affect the analysis further, especially if the PAG framework is also embraced.[144]

2. Circumvention

Part I explained that making punitive damages nondeductible would result in significant opportunities for circumvention. These opportunities would exist because of the different tax treatment that would be applied to punitive damages (nondeductible) and the related compensatory damages (deductible).

If a state implemented a retributive damages regime and Congress made these payments nondeductible, would the same circumvention opportunities arise? At first glance, it might appear so because payments of deductible compensatory damages would be tax preferred relative to the nondeductible retributive penalty. Thus, litigants would appear to have the same joint incentive to "transform punishment into compensation" during settlement.[145]

However, the reform proposal for retributive damages briefly summarized in Part II has three features that are designed to preclude such collusion. First, plaintiffs must signal in their *initial* complaint that they are seeking retributive damages,[146] and they must also lodge a copy of the initial complaint with a state attorney general's representative.[147] Second, courts must scrutinize and make transparent all settlements of suits where plaintiffs lodge retributive damages claims in the initial complaint. Third, the state attorney general's representative either has to agree to the settlement or buy the plaintiffs' retributive damages claims (for the finder's fee) so that the state can prosecute the retributive damages aspect of the litigation. These rules would prevent private parties from settling in a way that deprives the public of potentially critical information involving public misconduct and would convey to the court (and the state) a basis for scrutinizing any settlements that arise regarding the nature of the misconduct.[148]

144. For further discussion and analysis of the PAG aspect of the policy, see Markel, *Retributive Damages*, *supra* note 17, at 279–86.

145. Tom Baker, *Transforming Punishment into Compensation: In the Shadow of Punitive Damages*, 1998 WIS. L. REV. 211, 229.

146. This would be in contrast to those jurisdictions that permit claims for punitive damages only after a hearing. *See* Rustad, *supra* note 27, at 1313.

147. Leave to amend the complaint would be granted only in the rarest of circumstances, such as situations where the plaintiff could not have known earlier about the recklessness or malice associated with the defendant's action.

148. Of course, these rules also marginally reduce the incentive for plaintiffs to allege retributive

These various anticollusion strategies are a critical aspect of the retributive damages proposal because plaintiffs and defendants would otherwise have extremely strong reasons to "collude" to downplay the value of the retributive claim.[149] Under the proposal, but without those anticollusion measures, the following scenario could occur: plaintiffs would get to keep all of their compensatory damages but only the relatively small finder's fee portion of the retributive penalty. Defendants meanwhile would have the incentive to settle for as little as possible and would not particularly care whether the state or the plaintiff gets the money. Because disguising retributive penalties as compensatory damages improves the plaintiff's economic position and because such a disguise requires cooperation between the litigants, defendants could expect to participate in such gain in the form of a reduced settlement amount.[150] Thus, the anticollusion safeguards are vital to ensure that the retributive portion of any settlement is correctly classified.

Of course, if plaintiffs decided to go ahead and allege retributive damages in the initial complaint, they would not be prohibited from settling. But the anticollusion safeguards in place for this scenario would require plaintiffs to secure governmental approval to settle, and it would force defendants to either (i) admit responsibility and pay some acceptable amount of retributive damages to the state or (ii) deny responsibility. If the defendant denied responsibility, she would have to convince the state attorney general's representative that this particular claim lacked merit. Otherwise, the state—or conceivably another PAG if the state declined—could decide to litigate against the defendant.[151] Once these safeguards (and possible future threats) are in place, the settlement dynamics would change because defendants would have little incentive to settle unless they

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damages claims in their complaints if they expect to benefit more from an opaque settlement over which they would presumably exercise greater control. That said, defendants might prefer to pay money to the state via retributive damages rather than through an opaque settlement to plaintiffs because, at least that way, they will acquire a guarantee of repose for past misconduct instead of facing the threat of lingering PAG liability for retributive damages.

149. *See* Markel, *How Should Punitive Damages Work?*, *supra* note 17. To be sure, these safeguards also raise administrative costs, which, one hopes, would be outweighed by the public's capture of most of the amount of retributive damages. Whether the safeguards also trigger distinctive reasons for anxiety about political corruption in the state attorney general's office (on the assumption that decisionmakers in that office would be unduly influenced or corrupted by special interests), I have not addressed before, but, to my mind, these concerns are better addressed through comprehensive anticorruption mechanisms rather than removing otherwise good policy options from the table. Perhaps this is naïve.

150. That is, the settlement amount would be lower than if the retributive penalty was paid entirely to the plaintiff.

151. *See* Markel, *Retributive Damages*, *supra* note 17, at 279–86.

were prepared to admit liability and settle with the state, too. Plaintiffs, in turn, would know defendants have diminished incentives to settle quietly, and therefore should be less likely to bring suits merely for the purpose of harassment.

Collusive settlements might also seem tempting *prior* to the filing of a complaint. But because of the PAG structure available for retributive damages,[152] the incentives for pre-filing collusion between plaintiffs and defendants against the state are also substantially reduced. After all, under this scheme a defendant can certainly settle (with much more freedom) any nonretributive damages alleged by a plaintiff before and after filing a complaint. However, with respect to retributive damages, the defendant will not be able to enjoy repose because a PAG may still seek retributive damages for claims brought subsequent to the pre-filing settlement—unless the defendant acquires repose—by having the state ratify the settlement between the litigants and collect an amount it deems appropriate relative to the retributive damages setback that would otherwise be imposed.[153]

To the extent that these safeguards effectively discourage this non-tax-motivated collusion, they should also discourage the *tax-motivated* collusion that would be available if the retributive penalty were nondeductible. This is because the potential tax gains from circumventing a nondeductibility rule will often pale in comparison to the potential nontax gains from circumventing the rule that the state gets the vast majority of the retributive penalty. By making retributive penalties flow entirely to the state except for a relatively small finder's fee, the effect is a near 100% state tax on the plaintiff with respect to the retributive penalty.[154] By comparison, making the retributive penalty nondeductible would in effect impose, at most, a roughly 40% tax on the defendant's retributive penalty. If the safeguards effectively inhibit collusion to avoid

152. *See* Markel, *How Should Punitive Damages Work?*, *supra* note 17.

153. When the state settles with defendants, the defendants will have to make a formal record of that settlement and its scope to prevent PAGs from needlessly filing suit. PAGs will have to check these records before they can proceed with their suits. By including in the Class Action Fairness Act (CAFA) a provision that requires defendants to notify the state attorneys general of settlements affecting citizens of their state, Congress has created an example to be emulated or tweaked for the retributive damages structure. *See* 28 U.S.C. § 1715 (2006). For a trenchant analysis of this CAFA provision, see Catherine M. Sharkey, *CAFA Settlement Notice Provision: Optimal Regulatory Policy?*, 156 U. PA. L. REV. 1971 (2008).

154. For example, if the retributive penalty is $1,000,000 and the finder's fee is $10,000, the effect of the finder's fee regime is a 99% tax on the retributive penalty. Under current punitive damages law, the plaintiff would receive substantially more (though not all $1,000,000, of course, because the plaintiff would still have to pay legal fees and taxes on the remainder).

the near 100% tax on the plaintiff, they should be effective to avoid collusion to circumvent a decidedly smaller tax on the defendant.[155] Thus, if effective, these safeguards should ensure enforcement of a nondeductibility regime. If so, the IRS could effectively free ride off the state's efforts in policing the retributive penalty regime.[156]

In sum, whether the retributive damages penalty should be deductible depends primarily on how it should be shared between the state that imposes the penalties and the federal government. My sense is that the choice between a deductibility or nondeductibility rule should turn on whether retributive damages will produce positive spillover benefits across state lines. Importantly, the decision to make retributive damages deductible or nondeductible should not turn on the likelihood for circumvention through settlement. That conclusion, however, assumes that the anti-collusion safeguards discussed above are both implemented and reasonably effective.[157]

B. Taxing Aggravated Damages

As explained earlier, aggravated damages for the purpose of victim vindication serve as an analogue to compensatory damages in that plaintiffs should have the authority to decide whether to seek them against defendants whose actions injure or insult the plaintiff's dignity. The rationale for aggravated damages rests on the premise that the plaintiff's injury is not covered by the noneconomic damages normally awarded under a broadened rubric of compensatory damages. The idea of vindicating this insult to the plaintiff's dignity monetarily is one possibility, but as explained in an earlier companion piece,[158] the jury

155. It is true that making the retributive penalty nondeductible would increase the incentive to collude at the margin. Nevertheless, the nontax incentive to collude is so significant that I believe the marginal effect of nondeductibility to be negligible.

156. It should be noted that if retributive damages were deductible, there would be additional administrative burdens placed on courts and defendants. These relate to potential difficulties in calculating a proper gross up, which Professor Polsky and I have discussed in our companion article. *See* Polsky & Markel, *supra* note 6, at pt. II.C.

157. It bears emphasis that improvement of state tort law will not necessarily be foremost on the minds of the federal policy makers when confronting tax issues, though such a goal was in fact invoked by the Obama administration. *See* GENERAL EXPLANATIONS, *supra* note 7; *cf.* Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-of-Proof Rules*, 84 IOWA L. REV. 413, 415 (1999) (noting that Congress frequently is tempted to "desire to garner political advantage by chastising or curbing the IRS").

158. *See* Markel, *How Should Punitive Damages Work?*, *supra* note 17.

might also think that the injury to dignity could be repaired through other nonpecuniary measures, such as an apology or other remedial efforts.[159]

Assuming arguendo that the jury believes that aggravated monetary damages are appropriate as an extra measure of compensation for an otherwise uncompensated injury to the plaintiff, then the logic of such damages works in favor of treating these aggravated damages similarly to compensatory damages, at least for tax purposes. In other words, because aggravated damages are plausibly viewed as an aspect of damages meant to fully compensate the victim,[160] they ought to be treated in the same manner as compensatory damages for tax purposes.[161]

If current tax law is used as our lodestar for this proposition, then payment of aggravated damages would be deductible by the defendant if the plaintiff's claim arose in the context of the defendant's business.

159. *Id.*

160. This is a source of controversy. Some scholars, like Arthur Ripstein, Tony Sebok, and Tom Colby, specifically reject the equation between "vindicating" the plaintiff's interest in dignity repair and "compensating" the plaintiff for the injury to her dignity, claiming that dignity is not something that is "compensable." *See, e.g.*, Colby, *supra* note 13, at 435–36, 436 n.187 (citing Ripstein and Sebok with approval). *But see* Ernest J. Weinrib, *Punishment and Disgorgement as Contract Remedies*, 78 CHI.-KENT L. REV. 55, 91 (2003) ("The courts properly regard such [aggravated] damages as compensatory rather than punitive, since they repair a loss, albeit an intangible one.").

161. A brief but relevant digression: one can imagine someone saying that virtually all torts are a product of unreasonable behavior. *See, e.g.*, Jason M. Solomon, *Equal Accountability Through Tort Law*, 103 NW. U. L. REV. 1765 (2009). If one held the view that all torts are unreasonable and should thus be discouraged under the tax law, then, generally speaking, one might also think tort damages of any stripe should not be tax deductible by the defendant. *See, e.g.*, Conard, *supra* note 44. There are, however, some strong reasons to think compensatory damages should stay deductible. *See, e.g.*, discussion *supra* note 44 (discussing various reasons why Congress is not likely to seriously entertain a nondeductibility rule for all damages). In any event, supporters of aggravated damages, *e.g.*, sources cited *supra* note 13, do not have to go as far as saying that all compensatory damages should also be nondeductible. They might well prefer that the taxation rule for aggravated damages reflects the underlying view that aggravated damages are meant to sanction and condemn, not price, and thereby permit or condone the injury to the plaintiff's dignity. *Cf.* Cooter, *supra* note 75. The problem with this view is that asking for a "condemnatory signal" through taxation (by making aggravated damages nondeductible, for example, and more analogous to fines and bribes) undermines these scholars' claims that the tort law system is fundamentally and only a private law system designed to permit parties to resolve disputes to their mutual satisfaction. If plaintiffs are asking for a public sanction (indirectly through the use of a particular kind of tax rule), they are opening up aggravated damages to the charge that they are just retributive damages in the guise of a windfall to the plaintiff. *See* Markel, *How Should Punitive Damages Work?*, *supra* note 17, at 1416. In short, if aggravated damages are meant to go to the plaintiff and be subject to the plaintiff's autonomous choices to pursue or not pursue, then the award of aggravated damages sits in tension with a signal of public condemnation. Making aggravated damages analogous to nondeductible fines or grossed-up and deductible retributive damages would dilute the "private" nature of the interest the remedy was meant to vindicate. Either the defendant's misconduct requires public condemnation (via retributive damages, criminal law, or perhaps other public regulatory devices) for her violation of the rights of persons, or the victim's vindication of her interests against the defendants are subject to private ordering. The victim-vindication proponents cannot simultaneously prioritize both values.

Conversely, the plaintiff would not have to pay taxes on the recovery of aggravated damages if the underlying claim involved a physical injury.[162] However, the recovery of aggravated damages would be taxable (just like compensatory damages are) in cases not involving torts causing physical injury.[163]

Consistent treatment between compensatory and aggravated damages would also avoid the difficulty of making allocations of settlements between traditional compensatory damages and aggravated monetary damages.

C. Taxing Deterrence Damages

Earlier, we saw that current punitive damages law is not designed to achieve optimal deterrence.[164] Various law and economics scholars, however, have argued that current law ought to be redesigned such that it would effectuate optimal deterrence, or what might also be called cost internalization.[165] In general, such a redesigned system would require that extracompensatory damages be imposed on the defendant in cases where the defendant might have escaped liability for her conduct (because of the chance that the plaintiff would have chosen not to bring the action because of inconvenience, mercy, or some other reason). The extracompensatory damages meant to achieve optimal deterrence (what Part II calls "deterrence damages") would be determined by multiplying the amount of compensatory damages payable by a multiplier that is based on the likelihood of the defendant escaping compensation to that plaintiff.[166] For example, if there was a two-in-three chance that the defendant would have escaped liability to this plaintiff, the amount of the extracompensatory damages would be twice the amount of the plaintiff's compensatory damages.[167] This would achieve cost internalization (vis-à-vis that

162. *See* I.R.C. § 104(a)(2) (2006).

163. *Id.*

164. *See supra* Part II.A.

165. The leading account of this point of view is Polinsky & Shavell, *supra* note 20. For discussion, see *supra* Part II.A.

166. This characterization skips over the interesting but, for our purposes, nonessential discussion about the relationship between cost internalization (writ large) and the Supreme Court's decision in *Philip Morris USA v. Williams*, 549 U.S. 346, 353–54 (2007). Here, I am presuming that deterrence damages could not, post–*Philip Morris*, take into account the defendant's likelihood of evading compensation to strangers to the instant litigation who may also have been harmed. For a general overview and my take on this, see Markel, *How Should Punitive Damages Work?*, *supra* note 17, at 1407–10 (discussing the prospects of cost internalization after *Philip Morris*).

167. *See* Polinsky & Shavell, *supra* note 20, at 889–91 (providing illustrations of the use of the "total damages multiplier" to determine the amount of punitive damages based upon the likelihood of

plaintiff) because the defendant, in choosing whether to engage in the conduct at issue, would have to take into account the harm that it causes the plaintiff, not just the harm to the plaintiff as discounted by the prospect of nonenforcement.[168]

Should deterrence damages paid by defendants be deductible? Professors Polinsky and Shavell argue that to achieve optimal deterrence, such deterrence damages ought to be deductible because precautionary measures are deductible.[169] Making ex post deterrence damages nondeductible, they argue, would make ex ante precautionary measures tax preferred relative to the ex post payment of damages. This would, according to Polinsky and Shavell, tip the scales in favor of ex ante precautionary measures, resulting in overdeterrence rather than optimal deterrence.[170]

While this observation makes good sense, a couple of points are in order. First, even if deterrence damages remained deductible for business-related torts (as Polinsky and Shavell propose), current tax law still favors ex ante precautionary measures over ex post damages. The costs of precautionary measures (e.g., employee training expenses, equipment repairs, research and development costs) are typically deductible immediately,[171] while ex post damages are deductible only when paid.[172] Because precautionary measures are immediately deductible, the taxpayer's return on these expenditures is effectively tax free.[173] If a

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the wrongdoer escaping liability).

168. Of course, what is described in the text is not the same thing as "full" or "total" cost internalization because the inquiry is localized to the plaintiff, and not all the possible harmed parties. Total cost internalization, though, remains feasible (even post–*Philip Morris*) to the extent that jurisdictions make available class actions or other aggregative-litigation strategies that protect the rights of defendants; once a class is certified, the people who were previously nonparties become parties to the litigation.

169. Polinsky & Shavell, *supra* note 20, at 929–31; *see also* Zelenak, *supra* note 32, at 66 (similarly arguing that safety precautions should not be tax preferred, from an optimal deterrence perspective, to damages). Under Polinsky and Shavell's regime, juries would not need to be tax aware nor would they need to gross up deterrence damages to arrive at the proper amount of deterrence damages. This is because the amount of deterrence damages is determined simply by applying a multiplier to the pre-tax amount of compensatory harm suffered by the plaintiff. If done properly, this would generally result in optimal deterrence; thus, there would be no need for any further adjustment.

170. Polinsky & Shavell, *supra* note 20, at 929–31.

171. Treas. Reg. §§ 1.263A-4, -5 (2008); Ethan Yale, *The Final* INDOPCO *Regulations*, 105 TAX NOTES 435 (2004). While the generalization in the text is largely correct, it bears mention that the costs of some precautionary measures—such as purchasing new and safer equipment—are not immediately deductible but are instead recoverable through depreciation deductions.

172. I.R.C. § 461(h) (2006).

173. *See* Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019 (1989) (explaining that allowing an immediate deduction for expenditures that provide a future benefit has the effect of exempting the yield on the expenditure from tax).

taxpayer chooses to forgo the precautionary measure, the taxpayer would have to fund the resulting ex post damage liability with investments that would generate taxable returns. The result is an existing, implicit tax incentive for ex ante precautionary measures over ex post damages.[174]

This tax incentive in favor of precautionary measures is not intentional; rather, it results from the impossibility of accounting for the two alternative transactions (i.e., the purchase of ex ante precautionary measures or the payment of ex post damages) more precisely.[175] Nevertheless, the tax incentive exists; therefore, deterrence-minded scholars, such as Polinsky, Shavell, and Zelenak, should have argued that making deterrence damages nondeductible would exacerbate (rather than cause) an existing tax preference for ex ante precautionary measures over ex post damages.[176]

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174. *See* George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1192–1205 (1987) (discussing the implicit tax preference in favor of intangible capital expenditures compared to economically similar tangible capital expenditures). To illustrate the implicit tax incentive in favor of ex ante precautions, consider a business that has a choice of paying $100 in precautionary measures immediately or $106 of damages in exactly one year. Assume that the prevailing discount rate is 6%. In a world without taxes, the business would be perfectly indifferent between the two options. It could pay the $100 in precautionary measures now or it could invest the $100 in a reserve at 6%. In the latter case, the account would grow at the end of year one to $106, the amount of damages for which the business would be liable. Once income taxes are introduced, however, this indifference is disrupted. Assuming a 40% tax rate, and that there is sufficient income to offset, the business's after-tax cost of the precautionary measures is $60. Because the precautionary expense is immediately deductible, the business's federal tax liability is $40 ($100 x 40%) less than it would have been had it not paid for the precautionary measures. Therefore, the after-tax cost of the precautionary measures is only $60 (the excess of the pre-tax cost ($100) over the value of the deduction ($40)). Had the business instead invested the $60 after-tax in a reserve fund, the fund would grow to $62.16 at the end of one year. The $60 investment would earn $3.60 ($60 x 6%) pre-tax. The tax on the $3.60 would be $1.44 ($3.60 x 40%), leaving $2.16 of after-tax yield. The $62.16 reserve fund would yield a damage award of $103.60. This is because the damage award is deductible when paid; a payment of $103.60 of damages would cost $62.16 after tax because a $103.60 deduction is worth $41.44 ($103.60 x 40%). This $103.60 payment would be insufficient to cover the $106 of damages. To fully fund the $106 damages liability, the business would have had to originally invest $61.39 in the reserve fund, which is $1.39 more than the after-tax cost of the precautionary measures. (This $61.39 would grow to $63.60 in one year when it is invested at a 3.60% after-tax rate. The resulting $63.60 equals $106 after it is increased to take into account the $42.40 ($106 x 40%) value of the $106 deduction upon payment.) Thus, once taxes are introduced, the business would prefer to pay for the ex ante precautionary measures (which costs only $60 after tax) to the ex post damages (which would need to be funded with $61.30 of after-tax dollars). To be sure, there are complications having to do with the mess of real life, but the upshot is that the tax advantage for ex ante precautionary measures will have a bigger effect on defendants' choices between ex ante and ex post approaches when the timing and extent of possible damages liability is foreseeable. Moreover, the significance of the tax advantage in actual cases would depend upon a number of other factors, including the type of precaution taken, the chronological separation between the year of precaution and the year of liability, and the defendant's applicable tax rate.

175. *See id.* at 1192–99 (explaining that the preference in favor of expenditures for business intangible capital arises from the difficulty in accounting for these expenditures accurately).

176. I am grateful to Professor Polsky for bringing this issue to my attention and helping elaborate

Second, some could argue that because the receipt of compensatory damages in personal injury cases is the result of a conversion of human capital to cash that is wholly involuntary on the part of the plaintiff, there ought to be some social preference for ex ante precautionary measures over ex post damages.[177] In other words, given the involuntariness of a tort "transaction," the law arguably should systemically err on the side of overdeterrence by preferring ex ante precautionary measures. This preference could be implemented in the form of a multiplier (e.g., 110%) on the compensatory damages amount or it could be accomplished by making deterrence damages nondeductible. Either option would provide a "kicker" to induce precautionary measures.

Notice that if the multiplier approach were used, the kicker would inure to the benefit of the plaintiff in the form of additional damages. If a rule of nondeductibility were used, the kicker would redound to the benefit of the federal government in the form of additional tax paid by the defendant.

One significant concern with implementing the kicker through the nondeductibility approach is that the amount of the kicker would vary based on the defendant's marginal tax rate. Moreover, under the nondeductibility approach, there would be no kicker whatsoever in cases where the plaintiff's claim did not arise out of the defendant's business — in that case, the cost of ex ante precautionary measures would also be nondeductible. These disparate effects are very difficult to support. After all, if a kicker is deemed necessary to encourage ex ante precautions, the kicker should apply in all cases.

Administratively, it would ordinarily be quite difficult in cases that settle to separate deterrence damages from traditional compensatory damages, which would remain deductible. Because of the recent Supreme Court decision in *Philip Morris*, I proposed that deterrence damages would normally be limited by the probability that the defendant would evade compensating the instant plaintiff, and, consequently, I suggested that such deterrence damages be paid to the plaintiff.[178] If so, the state would have

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it in this Article. Professor Zelenak has also adverted to my attention the possibility that, to the extent prejudgment interest is not available to plaintiffs, that would create a nontax incentive in favor of damages and against precautions, which the tax incentive in the opposite direction would only partially counteract. Of course, juries might essentially but unwittingly provide prejudgment interest by thinking in terms of "today's dollars" when awarding pain and suffering or other noneconomic damages even where, technically, prejudgment interest is unavailable. So this would be another factor that would complicate the analysis in the text.

177. The argument is somewhat stronger in cases involving physical injury or sickness, as opposed to fraud. Fraud or other financial torts can be readily remedied through money; torts involving physical injury or sickness are harder if not impossible to recompense financially.

178. I base this judgment on account of the inference that *Philip Morris* would require that the

no role in policing allocations between deterrence damages and compensatory damages—in contrast to its more robust role in the retributive damages context. Thus, a rule of nondeductibility for deterrence damages would require the IRS to separate these damages from traditional compensatory damages, which would be extremely difficult. On the other hand, if deterrence damages were paid to the state (on the theory that the deterrence damages would result in a pure windfall to plaintiffs if paid to them), the state would then have an interest in policing settlements. In that case, a rule of nondeductibility could possibly be more feasibly administered because the IRS could free ride off the state's policing efforts.[179]

In the end, deterrence damages should be deductible. Even if one believes that ex ante precautions should be tax preferred relative to ex post damages, such a tax preference already exists. Furthermore, administering a nondeductible regime would be nearly impossible unless deterrence damages were paid to the state.

In sum, if states passed reforms of the nature described in Part II, then aggravated and deterrence damages ought to be deductible, and, therefore, § 162(f) of the Code would likely need no adjustment.[180] The appropriate treatment is less clear with respect to retributive damages. I have suggested some ways that policy makers might go about assessing this issue and how one might resolve that challenge once better information became available. Assuming that we want retributive damages to be deductible for the reasons already adumbrated, then statutory amendment would be required; if policy makers thought that, on balance, a nondeductibility rule was preferable for retributive damages, then no amendment to the Internal Revenue Code is required.[181]

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deterrence damages be limited in scope (i.e., the question is what is the likelihood that the defendant would have evaded compensating this plaintiff), and, thus, the amount of deterrence damages would normally be directed to the plaintiff (as opposed to a general fund for future/other victims). *See supra* note 166.

179. Making the deterrence damages go to the state, while still allowing their deductibility, would likely require a revision to § 162(f) of the Internal Revenue Code, which currently disallows deductions of any fines "or similar penalty paid to a government for the violation of any law." I.R.C. § 162(f) (2006). The issue would be whether deterrence damages fit comfortably under this rubric; one could say, however, that deterrence damages are not meant to assign any condemnatory signal, unlike a fine.

180. *But see supra* note 179 (considering statutory implications if deterrence damages were to go to the state instead of the plaintiff).

181. As a result, if Congress approaches the possibility of revising the statute with retributive damages in mind, it may make the error of writing just one tax rule for states across the nation; a sounder approach would be to contemplate legislative diversity at the state level, and say something like: the taxation of retributive damages will be contingent upon X or Y factors.

CONCLUSION

Current legal practices result in the significant under-punishment of business defendants because punitive damages jurors do not take into account the fact that these defendants are allowed to deduct their punitive damages awards. To solve this problem, President Obama recently proposed to make all punitive damages nondeductible—a proposal that has in the past been supported by a number of policy makers and academics.[182]

Properly evaluated, the under-punishment problem can, at least in theory, be corrected either by making jurors tax aware or by making all punitive damages nondeductible. Practically, though, the choice between these mutually exclusive solutions depends on how easily a rule of nondeductibility would be circumvented through preverdict settlements. If a rule of nondeductibility is easily circumvented, as it is likely to be, a rule of tax awareness is always the better solution to the under-punishment problem. This is primarily because, when a rule of nondeductibility is circumvented through settlement, defendants would participate in the gains from circumvention in the form of lower after-tax settlement costs, resulting in precisely the same under-punishment problem that nondeductibility was intended to correct. On the other hand, there is no similar risk of circumvention under the alternative solution of making jurors tax aware.

While tax awareness would best solve the under-punishment problem, it would simultaneously increase the windfalls of punitive damages plaintiffs. However, there is simply no way under current punitive damages law to reduce under-punishment without simultaneously augmenting plaintiff windfalls. The tradeoff is a byproduct of the jumbled way current punitive damages law engrafts "public law" values on a private dispute resolution system not entirely capable of effectuating those values.

To avoid such an unfortunate tradeoff, reform of punitive damages law would be required. This Article sketches a vision of such a reform and describes its corresponding tax rules. As explained before, the appropriate tax treatment of tort damages should depend on the particular purpose being pursued and vindicated. In this respect, the recommendations herein stake out a more nuanced middle ground between those scholars and policy makers touting nondeductibility for all punitive damages and those

182. *See* sources cited *supra* note 6.

endorsing the current rule allowing a deduction for all punitive damages paid by business defendants.