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Taxation - Federal Income Tax - Punitive Damages and Recovered "Insider's Profits" Taxable as Income

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TAXATION—FEDERAL INCOME TAX—PUNITIVE DAMAGES AND RECOVERED “INSIDER’S PROFITS” TAXABLE AS INCOME—In previous litigation one of the defendant taxpayers received punitive damages for fraud practiced upon it and both received treble damages for injuries to business caused by conduct in violation of the federal antitrust laws. The court of appeals affirmed¹ the Tax Court’s rulings² that these receipts were not taxable as gross income. On certiorari to the Supreme Court, *held*, reversed. Money received as punitive awards is includible in gross income under section 22 (a), I.R.C. (1939).³ *Commissioner v. Glenshaw Glass Co. and William Goldman Theatres, Inc.*, 348 U.S. 426, 75 S.Ct. 473 (1955).

A third taxpayer received payment pursuant to section 16 (b) of the Securities and Exchange Act of 1934,⁴ which permits a corporation to recover from corporate officers, directors and major shareholders profits accruing to them from certain transactions in the securities of the corporation. The court of appeals affirmed⁵ the Tax Court decision⁶ that the recovery was includible in gross income. On certiorari to the Supreme Court, *held*, affirmed. Profits so recovered are taxable as gross income of the corporation under section 22 (a). *General American Investors Co. v. Commissioner*, 348 U.S. 434, 75 S.Ct. 478 (1955).

Congress, in enacting section 22 (a) of the 1939 code, specifically characterized certain receipts as gross income and also stated that gross

¹ *Commissioner v. Glenshaw Glass Co. and William Goldman Theatres, Inc.*, (3d Cir. 1954) 211 F. (2d) 928.

² *Glenshaw Glass Co.*, 18 T.C. 860 (1952); *William Goldman Theatres, Inc.*, 19 T.C. 637 (1953).

³ Now I.R.C. (1954), §61.

⁴ 48 Stat. L. 881, 15 U.S.C. (1952) §78p.

⁵ *General American Investors Co. v. Commissioner*, (2d Cir. 1954) 211 F. (2d) 522.

⁶ *General American Investors Co.*, 19 T.C. 581 (1952).

income includes "gains or profits and income derived from any source whatever. . . ." By this language, Congress clearly manifested an intent to extend the scope of its taxing powers to the constitutional limit.⁷ In *Eisner v. Macomber* the Supreme Court explored this limit and defined income as "the gain derived from capital, from labor, or from both combined. . . ."⁸ But that case also indicated that neither unrealized accretions to capital nor receipts constituting a restoration of capital could constitutionally be taxed as income.⁹ Confusion arises, therefore, when a taxpayer receives a payment which does not fall within either of the categories set up in the *Macomber* case nor within one of the statutory provisions excluding certain receipts from the gross income category. Two such receipts are punitive damages¹⁰ and penalty payments.¹¹

Until quite recently, punitive damages have been held not to constitute taxable income because they did not fall within the *Macomber* definition of that term.¹² This exclusion was based upon earlier decisions dealing with penalty payments imposed by law.¹³ However, the more recent penalty payment decisions, which are chiefly concerned with "insider profits" recovered under the Securities and Exchange Act,¹⁴ have held that such payments are included within the broad language of section 22 (a) and neither fall within any of the specific statutory exclusions from gross income nor constitute a restoration of capital.¹⁵ Those cases not only affirmatively declare that the definition of income set forth in *Eisner v. Macomber* is not exclusive, but they also state that the broad language

⁷ Principal cases. See also *Park & Tilford Distillers Corp. v. United States*, 123 Ct. Cl. 509, 107 F. Supp. 941 (1952).

⁸ 252 U.S. 189 at 207, 40 S.Ct. 189 (1919).

⁹ *Farmers' and Merchants' Bank of Catlettsburg v. Commissioner*, (6th Cir. 1932) 59 F. (2d) 912; *Edward H. Clark*, 40 B.T.A. 333 (1939); *Highland Farms Corp.*, 42 B.T.A. 1314 (1940); *Raytheon Production Corp.*, 1 T.C. 952 (1943), affd. (1st Cir. 1944) 144 F. (2d) 110; *Durkee v. Commissioner*, (6th Cir. 1947) 162 F. (2d) 184; *Nicholas W. Mathey*, 10 T.C. 1099 (1948), affd. (1st Cir. 1949) 177 F. (2d) 259; *Park & Tilford Distillers Corp. v. United States*, note 7 supra; *Commissioner v. Goldberger's Estate*, (3d Cir. 1954) 213 F. (2d) 78.

¹⁰ Including the punitive two-thirds portion of a treble damage recovery in an anti-trust action.

¹¹ I.e., "Insider profits" recovered under the Securities and Exchange Act [*William F. Davis*, 17 T.C. 549 (1951)] and damages recovered for breach of trust [*Central R. Co. of New Jersey v. Commissioner*, (3d Cir. 1935) 79 F. (2d) 697].

¹² *Highland Farms Corp.*, note 9 supra; *Telefilm, Inc.*, 21 T.C. 688 (1954); *Obear-Nester Glass Co.*, 20 T.C. 1102 (1953), revd. (7th Cir. 1954) 217 F. (2d) 56; *Glenshaw Glass Co.*, 18 T.C. 860 (1952), affd. (3d Cir. 1954) 211 F. (2d) 928, revd. 348 U.S. 426, 75 S.Ct. 473 (1955); *William Goldman Theatres, Inc.*, 19 T.C. 637 (1953), affd. (3d Cir. 1954) 211 F. (2d) 928, revd. 348 U.S. 426, 75 S.Ct. 473 (1955).

¹³ *Central R. Co. of New Jersey v. Commissioner*, note 11 supra; *Highland Farms Corp.*, note 9 supra; 53 COL. L. REV. 565 at 566 (1953). *Contra*, *Arcadia Refining Co. v. Commissioner*, (5th Cir. 1941) 118 F. (2d) 1010.

¹⁴ See *William F. Davis*, note 11 supra, and *Commissioner v. Obear-Nester Glass Co.*, (7th Cir. 1954) 217 F. (2d) 56, to the effect that such payments are punitive in nature.

¹⁵ *Park & Tilford Distillers Corp. v. United States*, note 7 supra; *Commissioner v. Obear-Nester Glass Co.*, note 14 supra; *General American Investors Co.*, 19 T.C. 581 (1952), affd. (2d Cir. 1954) 211 F. (2d) 522, affd. 348 U.S. 434, 75 S.Ct. 478 (1955).

of section 22 (a) includes in gross income all receipts which are not excluded from that category by statutory or constitutional exemption. Decisions involving punitive damages have now held them to be includible in gross income upon the same theory.¹⁶

The language of the Court in the principal cases might be construed to mean that the receipts are included in gross income simply because they constitute income within the meaning of the Sixteenth Amendment and therefore come within the scope of the catch-all phrase of section 22 (a). It is more likely, however, that the Court in the principal cases included the receipts in gross income on the theory that they could constitutionally be taxed absent the Sixteenth Amendment, and that Congress intended section 22 (a) to include not only those receipts which constituted income within the meaning of the Sixteenth Amendment, but also those receipts which it could constitutionally tax without it. The Sixteenth Amendment was enacted to enable Congress to levy direct taxes without apportionment among the several states.¹⁷ Direct taxes include taxes levied on real or personal property and taxes on the income from such property.¹⁸ Since a tax on punitive damages or other penalty payments would not fall within the category of a direct tax, it is unnecessary to find that such payments constitute income to the recipient within the meaning of the Sixteenth Amendment in order for Congress constitutionally to levy a tax.¹⁹ And since such payments constitute gain to the recipient within the meaning of section 22 (a), it is clear that the Court in the principal cases was justified in including them in gross income. Indeed the rationale of *Glenshaw* case seems to suggest that as long as the punitive damages are not a restoration of capital, they are taxable as income regardless of whether any companion compensatory damages are also taxable.

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¹⁶ Principal cases; *Commissioner v. Ohear-Nester Glass Co.*, note 14 supra.

¹⁷ U.S. CONST., art. 1, §2, requires that direct taxes be apportioned among the states.

¹⁸ *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 15 S.Ct. 673 (1895); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342 (1911).

¹⁹ This much was admitted by the taxpayers in the *Glenshaw* case.