Michigan Law Review

Volume 52 | Issue 1

1953

Taxation - Federal Income Tax - Exemplary Damages as Taxable Income to Recipient

Eliot Gerber S.Ed.
University of Michigan Law School

TAXATION — FEDERAL INCOME TAX — EXEMPLARY DAMAGES AS TAXABLE INCOME TO RECIPIENT — Petitioner, a motion picture exhibitor, sued certain motion picture distributors under the private remedy provisions of the federal antitrust acts. Judgment was had against the distributors for treble damages.

Upon failure of petitioner to report as income the amount recovered above its actual loss of profits, the Commissioner determined deficiencies in petitioner's income tax. *Held,* the amount recovered above actual loss of profits was exemplary damages and not taxable income. *William Goldman Theatres, Inc.,* 19 T.C. 637 (1953).

Exemplary damages, given by statute,[1] are on the borderline between taxable income and non-taxable gifts. Under a literal reading of the Internal Revenue Code exemplary damages are taxable income since they are ". . . income derived from any source whatever."[2] But under the Supreme Court's definition laid down in *Eisner v. Macomber,* income to be taxable must be derived "from capital, from labor, or from both combined."[3] An analysis of the types of receipts which are analogous to exemplary damages reveals four factors which may possibly be of importance in determining whether or not taxable income results. These factors are (1) whether the source of the receipt is private or governmental; (2) whether the receipts are transferred voluntarily or by operation of law; (3) whether there are any restrictions upon the use of the receipts; and (4) whether labor or capital must be expended in order to qualify for the receipt. Gifts are voluntary transfers from private sources, generally without restrictions upon their use, and are obtained without expenditure of capital or labor by the recipient.[4] Subsidies and statutory rewards for information come from the government by operation of law, without restrictions upon use, and require compliance with conditions precedent. Exemplary damages, like net profits recovered from actual or constructive trustees who misappropriate property, are transferred from private sources by operation of law, without restrictions on their use, and result from a successful suit or a settlement. Gifts are not taxable to the recipient.[5] Rewards for information are taxable income.[6] The cases on the taxability of subsidies[7] and of profits recovered from misappropriating trustees[8] are in conflict.

It would seem clear that the source of the receipt is immaterial. Consequently, the argument that the income tax statute conflicts with the incentive reward of the antitrust acts by reducing the net award to private prosecutors should carry little weight, since a similar argument has been rejected in the case of a government subsidy.[9] The fact that in all the analogous types of receipts mentioned there are no restrictions upon use casts doubt on the distinction

[1] For other examples of exemplary damages see McCORMICK, DAMAGES 277 (1935).

[2] I.R.C., §22(a).

[3] 252 U.S. 189 at 207, 40 S.Ct. 189 (1920).

[4] Gray v. Barton, 55 N.Y. 68 (1873).

[5] Treas. Reg. 118, §39.22(b)(3)-1.

[6] For the amount of consideration given by the recipient capable of transforming receipts into taxable income see Edwin C. Brandenburg, 4 B.T.A. 108 (1926).

[7] Edwards v. Cuba R. Co., 268 U.S. 628, 45 S.Ct. 614 (1925), criticized in MAGILL, TAXABLE INCOME 341 et seq. (1936), and Mandell, "Do Subsidies Constitute Taxable Income?" 26 TAXES 323 (1948). See also Lykes Brothers Steamship Co. v. Commissioner, (5th Cir. 1942) 126 F. (2d) 725.

[8] Central R. Co. of New Jersey v. Commissioner, (3d Cir. 1935) 79 F. (2d) 697, affirming 29 B.T.A. 14 (1933). *Contra:* Arcadia Refining Co. v. Commissioner, (1st Cir. 1941) 118 F. (2d) 1010; General American Investors Co., 19 T.C. 581 (1952).

[9] Baboquivari Cattle Co. v. Commissioner, (9th Cir. 1943) 135 F. (2d) 114.

between a contribution to capital and a contribution to income. This distinction has been made in cases dealing with subsidies,[10] but in any event it is immaterial here since only stockholders can make a contribution to corporate capital.[11] The two elements of importance, therefore, are the intent of the transferor and the activity of the transferee. Only in the gift situation does the transferor have a donative intent.[12] And only the gift is vested in the recipient without activity on his part to meet conditions precedent.[13] It is true that in theory there is a distinction between the giving of consideration to meet the terms of a contractual offer, as in the case of a reward for information, and the compliance with conditions precedent to the receipt of a subsidy, the award of exemplary damages, or the recovery of profits from a malfeasant trustee. But in terms of actual expenditure of labor and capital the distinction does not exist. It may require a greater expenditure of labor and capital to fight a private statutory remedy suit through appellate litigation to final judgment in order to recover exemplary damages than to give information to meet a contractual offer. Since the only consistent and meaningful distinction between these analogous types of receipts is the intent of the transferor, the line between gifts and taxable income should be drawn at that point. Exemplary damages, while in theory a windfall, are actually a hard fought-for receipt and thus should be taxable income to the recipient.[14]

Eliot Gerber, S.Ed.

[10] 1 MONTGOMERY, FEDERAL TAXES 173 (1952).

[11] See Mandell, "Do Subsidies Constitute Taxable Income?" 26 TAXES 323 (1948).

[12] The definition of gift for purposes of the gift tax goes beyond the donative intent of the donor. Commissioner v. Wemyss, 324 U.S. 303, 65 S.Ct. 652 (1945); Merrill v. Fahs, 324 U.S. 308, 65 S.Ct. 655 (1945). This definition was necessitated by tax avoidance schemes and does not reflect the basic distinction between gifts and other transactions.

[13] It would seem that suit must rarely be brought to gain possession of a gift after title has passed to the donee, and therefore bringing a cause of action is not generally considered a condition precedent to perfect a gift.

[14] Other cases holding exemplary damages non-taxable as income are Glenshaw Glass Co., 18 T.C. 860 (1952); and Highland Farms Corporation, 42 B.T.A. 1314 (1940).