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## *Taxable Status of Business Tort Recoveries*

*Marvin I. Kelner\**

**M**ORE NEGLECTED PERHAPS THAN ANY OTHER AREA of tax law that comes to the attention of the practicing lawyer is the taxability of damages. Damages, of course, represent the largest class of relief sought in the courts. This discussion will be limited to the taxable status of recoveries received from business torts, an area of much controversy today.

Generally, the source of authority under the Federal tax laws which determines taxability is Sec. 22(a) of the Internal Revenue Code of 1939 and Sec. 61(a) of the Internal Revenue Code of 1954. Both of these sections of the code define gross income, and more particularly, specific types of income which are includable as gross income. Outside of the special sections of both codes relating to the taxability of damages received for physical injuries and sickness,<sup>1</sup> nowhere is there mentioned the taxability of damages received from business injuries. Therefore, we must look to the courts to seek a pattern or test which will help the lawyer to determine whether or not his client has received taxable income.

The most important task for the lawyer (and the courts) is to determine the nature and character of the award received, and more particularly to classify it within the following three types of recoveries:

- (1) loss of profits
- (2) damages to property or capital
- (3) injuries to goodwill or reputation or combination of any of the three.

While the courts are not always in complete agreement, they have most often followed the principle that amounts received for loss of profits or anticipated profits are taxable, whereas damages to property or goodwill are not taxable but serve to reduce the basis of the property or goodwill damaged. If the damages to

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<sup>1</sup> I. R. C. 1954, Sec. 104.

property which are awarded exceed the basis of the property, the excess will be taxed.<sup>2</sup> The same is true of goodwill.

Examples of cases where the damages awarded were found by the courts to be for loss of profits and therefore taxable are:

- (1) amounts received from the United States Government for detention of whaling vessels;<sup>3</sup>
- (2) interference with sealing operations<sup>4</sup> (in both cases from acts done by the United States Government);
- (3) breach of contract resulting in loss of anticipated profits;<sup>5</sup>
- (4) amounts awarded by the courts for patent infringements;<sup>6</sup>
- (5) breach of agreement not to compete.<sup>7</sup>

Cases where the awards received were for damages to property and therefore non-taxable include:

- (1) a suit against a partner who had misappropriated firm funds<sup>8</sup> (determined to be damage to capital investment);
- (2) loss of property value (stock and inventory) due to lost franchise;<sup>9</sup>

<sup>2</sup> *Raytheon Production Corp. v. Commissioner*, 144 F. 2d 110 (C. C. A. 1, 1944), cert. denied 11-20-44, affirming 1 T. C. 952:

"But to say that the recovery represents a return of capital in that it takes the place of the business goodwill is not to conclude that it may not contain a taxable benefit. Although the injured party may not be desiring a profit as a result of the damage suit itself, the conversion thereby of his property into cash is a realization of any gain made over the cost or other basis of the goodwill prior to the illegal interference. Thus A buys Blackacre for \$5,000.00. It appreciates in value to \$50,000.00. B tortiously destroys it by fire. A sues and recovers \$50,000.00 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to appreciation in value of Blackacre is realized when it is turned into cash by the money damages." Cf. *Durkee v. Commissioner*, 162 F. 2d 187 (1947).

<sup>3</sup> *Knowland*, 29 B. T. A. 618 (1933).

<sup>4</sup> *Liebes & Co. v. Commissioner*, 90 F. 2d 932 (C. C. A. 9, 1937).

<sup>5</sup> *Martin Bros. Box Co. v. Commissioner*, 142 F. 2d 457 (C. C. A. 6, 1944), affirming without opinion 1 T. C. M. 999 (1943).

<sup>6</sup> *Triplex Safety Glass Co. of N. A. v. Latchum*, 131 F. 2d 1023 (C. C. A. 3, 1942); *W. W. Sly Mfg. Co.*, 24 B. T. A. 65 (1931).

<sup>7</sup> *Salvage v. Commissioner*, 76 F. 2d 112 (C. C. A. 2, 1935), affirmed 297 U. S. 106, 56 S. Ct. 375, 80 L. Ed. 511; *Cox v. Helvering*, 63 App. D. C. 264, 71 F. 2d 987 (1934); aff'g. Memo B. T. A.

In many of these cases, covenants in the original agreement will determine whether damages are for loss of profits or injury to goodwill. *Rodney B. Horton*, 13 T. C. 143, dismissed 180 F. 2d 354 (C. A. 10, 1950).

<sup>8</sup> *John A. Schofield*, 19 B. T. A. 234 (1930).

<sup>9</sup> *M. Berbiglia v. Commissioner*, 10 T. C. M. 413 (1951).

- (3) suit against a corporation for mismanagement which resulted in damage to the value of the stock.<sup>10</sup>

Analysis of the cases involving goodwill seems to indicate that no general classification of them can be made, as the facts in each case differ greatly.

Miscellaneous types of recoveries which have been determined to be taxable (by the courts) include:

- (1) punitive damages received for patent infringement;<sup>11</sup>
- (2) a suit by the stockholders against corporate officers for insiders' profits which violated the S. E. C. regulations;<sup>12</sup>
- (3) amounts received for cancellation of an employment contract.<sup>13</sup>

Two interesting features which result from this artificial classification are:

- (1) the recovery may be allocated (by the tax court) between loss of profits and damages to capital; and
- (2) the nature of the recovery may determine whether it is taxed as ordinary income or capital gain.

An example of (1) is the case of *Raytheon Production Corp. v. Commissioner*, 144 F. 2d 110 (C. C. A. 1, 1944), cert. denied 11-20-44, affirming 1 T. C. 952, a suit under the Federal Anti-Trust laws, where the total amount received was \$410,000.00. The Tax Court in this case determined that \$60,000.00 was allocable to injuries to capital and \$350,000.00 to payments due for patent and licensing rights. The burden of allocation, of course, must be proved by the taxpayer, and if there is no evidence for allocation the whole amount may be taxable.

In most cases where the amount awarded is for damages to capital, property or goodwill, the excess of the amount awarded over the basis of the property will be taxed as a capital gain, subject to complying with all of the capital gains section of the code.<sup>14</sup>

<sup>10</sup> Boehm v. Commissioner, 146 F. 2d 553 (C. C. A. 2, 1945).

<sup>11</sup> Glenshaw Glass Co., 348 U. S. 426, 75 S. Ct. 473, 211 F. 2d 928, 18 T. C. 860 (C. A. 3, 1952).

<sup>12</sup> General American Investors Co., Inc. v. Commissioner, 348 U. S. 434, 75 S. Ct. 478 (1955), 1955 Ct. D. 1784, 1 R. B. 1955-17, aff'g. 211 F. 2d 522 (C. A. 2, 1954), which had affirmed 19 T. C. 581.

<sup>13</sup> George K. Gann v. Commissioner, 41 B. T. A. 388 (1940).

<sup>14</sup> In some cases where the amount received is greater than the basis, there may not be a recognized gain if Code Sec. 1033 (I. R. C. 1954), relating to involuntary conversions, is applicable.

In cases involving damages to goodwill, the basis must be proved by the taxpayer.<sup>15</sup> But even in those cases where there is no basis for goodwill, it will be advantageous to have the court determine that the recovery was for damages to goodwill (if, in fact, it was) so that the capital gain provisions of the code can be used.

*Mertens'* text, Volume 1, Sec. 5.21, discusses most of the decided cases on the subject of damages, both in its original edition and in the Pocket Supplement (1955 Cum., by Philip Zimet). Especially clear is the broad principle stated in the original edition, which is as true today as when it was written in 1942:

"It has been broadly held that since profits from business are taxable, the proceeds of litigation based upon a loss of profits by reason of some act of the defendant are likewise taxable."

### Conclusion

As can be discerned from the preceding discussion, the most difficult task for the lawyer is to determine the nature of the recovery awarded and to convince the Tax Court that the damages were awarded not for loss of profits but for damages to goodwill or property, if this be the case. In most instances, the courts will look to the trial or appellate court's proceedings to determine what was the nature of the recovery.<sup>16</sup> Many times, the trial court's record will not be clear or explanatory on the point in question, and the Tax Court will have to analyse the circumstances which gave rise to the action for damages, and in many cases go back to the original instrument from whence came the breach or tort.

When this happens, it is then that the ingenuity, thoroughness and foresight of the practicing *non-tax* lawyer will be either loudly acclaimed or bitterly assailed. While at all times it is the protection of the client, and the legal sufficiency of the instrument to insure this goal, which should be foremost in the lawyer's mind, there are many times when an additional sentence or paragraph will cause a Tax Court case to turn one way or the other; will make an award taxable or non-taxable by giving full explanation of the client's aims and desires.

<sup>15</sup> *Armstrong Knitting Mills v. Commissioner*, 19 B. T. A. 318 (1930).

<sup>16</sup> *Telefilm, Inc. v. Commissioner* (order rev'g. & rem'g. T. C.), 21 T. C. 693 (C. A. 9, 1955), Cf. *Raytheon Production Corp. v. Comm.*, *supra*, n. 2.