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TAXING ANXIETY

by

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I. INTRODUCTION

A truism of tax policy is that a good taxing regime treats similarly situated taxpayers similarly. This truism, which I concede that I have espoused in class a time or two, really does not tell us much, though.[1]

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Consider the taxation of damages. Under the current statute, many taxpayers do not pay taxes on the damages they receive either through jury awards or settlements. Other taxpayers, however, do pay taxes on such damages. The dividing line, right now, is whether the damages were received "on account of physical injury." If so, no taxes; if not, taxes.

Here is how it works, via an admittedly simplified example. Anne and Bob both work for BigAutoCo as assembly line workers. Bob's surly boss has a particularly bad day and punches Bob in the nose. [2] The punch in the nose leads to several days of missed work, some medical bills, and a few weeks of headaches. For several weeks, Bob suffers from insomnia as a result of the stress stemming from the pain and stress. Bob sues, and BigAutoCo wisely settles with Bob; the settlement includes lost wages, additional sums for pain and suffering, and even more money to compensate Bob for the indignity and reputational harm surrounding the boss's actions. Because Bob was punched in the nose, no portion of his settlement is taxable.[3]

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the 11th Annual Junior Tax Workshop, held at the University of California-Hastings School of Law, as well as participants at the Arizona State University Scholars conference including Jordan M. Barry, Andy Grewal, Mark S. Hoose, James M. Puckett, and Urska Velikonja. Valuable input was also provided by participants at a Hamline University School of Law colloquium, and Hamline Law students Jessica Stoekman, Chad Thomas, and Daniel Jones provided excellent research assistance.

1. This concept is referred to in tax literature as "horizontal equity." As scholar Louis Kaplow observes, the command of horizontal equity is "that equals be treated equally," but it remains "to determine who are the equals who should be treated equally." Louis Kaplow, *A Fundamental Objection to Tax Equity Norms: A Call for Utilitarianism*, 48 NAT'L TAX J. 497, 498, 508 (1995).

2. There is some disagreement about the interpretation of section 104(a) in the context of minor physical injury. *See, e.g.*, DOUGLAS A. KAHN & JEFFREY H. KAHN, FEDERAL INCOME TAX: A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE 101-02 (6th ed. 2011). For the purposes of simplification, let us assume that the boss is a former welter-weight boxer, and there is no question that getting punched by him is a significant physical injury. *See id.* at 99 (stating "The scope of the § 104(a)(2) exclusion from income is very broad. Once that provision applies, even amounts compensating for lost wages are excludable from gross income.").

3. Commissoner v. Schleier, 515 U.S. 323, 329 (1995) (note that although Schleier pre-dates the addition of "physical" to section 104(a)(2), its reasoning regarding the scope of the exclusion remains good law); *see also* I.R.S. Priv. Ltr. Rul. 199952080 (Jan. 1, 2000) (citing favorably the *Schleier* hypo). The Conference Committee Report indicates that Congress did not intend to change this result with its 1996 amendment. *See* H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793 (explaining that "if an action has its origin in a physical injury or physical sickness, then all damages (other than punitive) that flow therefrom are treated as payments received on account of physical injury").

Anne has the same boss. On the same day that the boss punches Bob, he calls Anne a few horrible names and tells her that he will punch her, too, if she shows up to work again. Even though Anne is a tough cookie, she decides to take her boss at his word and not show up to work for a few days (unpaid leave). Furthermore, the stress of the boss's actions causes Anne to suffer headaches and insomnia. Anne also sues, and BigAutoCo wisely reaches a settlement with her as well. BigAutoCo provides Anne with a nearly identical settlement: she receives money to compensate for the pain and suffering relating to the headaches and insomnia, reimbursement for lost wages, and an additional sum for the indignity and reputational harm surrounding these events. Anne's award, however, is entirely taxable. The take-away is that Bob walks home with about 30 percent more cash than Anne.

Anne and Bob are, at least in some ways, "similarly situated" taxpayers. And yet under the current rules relating to taxing damages, the Internal Revenue Code (the Code) treats them very differently. Anne will take home about one-third less than Bob; this is because Anne will have to pay income taxes on her settlement, while Bob will not. Anne might well have preferred a punch in the nose.

The disparity I have outlined above has led to calls for the elimination of the "physical" requirement in section 104(a)(2). Thoughtful suggestions for reform have been made by the National Taxpayer Advocate (NTA),[4] as well as the American Bar Association (ABA).[5] The NTA argues that settlement payments for mental anguish and emotional distress ought to be excluded just as payments on account of physical injury are currently excluded from gross income. Similarly, the ABA is lobbying for legislative

4. *See* NAT'L TAXPAYER ADVOCATE, 2009 ANNUAL REPORT TO CONGRESS 351-57 (2009) [hereinafter 2009 ANNUAL REPORT], http://www.irs.gov/pub/irs-utl/2_09_tas_arc_vol_1_lr.pdf; *see also* NAT'L TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS 472 (2008) [hereinafter 2008 ANNUAL REPORT], http://www.irs.gov/pub/irs-utl/08_tas_arc_mli.pdf ("Taxation of damage awards spurs litigation every year.").

5. The American Bar Association's position is summarized in the June 2010 issue of the ABA Journal. Rhonda McMillion, *Rite of Spring*, A.B.A. J., June 2010, at 65, 65 [hereinafter McMillion, *Rite of Spring*]. Others have called for reform as well. *E.g.*, Vivian Berger, *End the Inequity: Taxation of Damages*, NAT'L L.J., Sept. 17, 2007 (calling for reform similar to that called for by the NTA); Habib Hanna, Comment, *Heads I Win, Tails You Lose: The Disparate Treatment of Similarly Situated Taxpayers Under the Personal Injury Income Tax Exclusion*, 13 CHAP. L. REV. 161, 163 (2009) (arguing "that those who suffer real, verifiable physical manifestations of emotional distress injuries should receive the same favorable tax treatment received by those who suffer purely physical injuries").

changes that would exclude noneconomic damages from taxable income.[6] The ABA argues that current law penalizes taxpayers who are victims of discrimination by requiring them to pay taxes on the damages they receive.[7]

In this article, I too argue for a statutory change, though a quite different change than the NTA/ABA suggestions. I submit that nearly all damages, including damages received on account of physical injury, ought to be taxable, and that juries must be apprised of tax consequences so that they can make proper adjustments to take account of these tax consequences.[8] I will refer to this as the full inclusion proposal with jury awareness — for ease, the full inclusion proposal.

My proposed change is the more sound solution for several reasons. Full inclusion creates certainty and avoids wasteful tax gamesmanship. Furthermore, assuming informed parties, counsel, and juries, full inclusion need not harm individual taxpayers.[9] This proposal works because under it,

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6. McMillion, *Rite of Spring*, *supra* note 5, at 65. The ABA Journal describes the position as follows: "Victims of discrimination are penalized by current tax laws requiring them to pay taxes on settlements and awards of noneconomic damages, and to pay taxes at one time on income awards that might cover many years. The proposed legislation would exclude noneconomic damages from taxable income and allow income averaging for income awards covering multiple years that are paid in a lump sum." *Id.*

7. *Id.*

8. Juror tax awareness varies depending on the precise issue. For example, although juries are often informed of the non-taxability of plaintiffs' damages awards, jurors are rarely, if ever, informed that defendants can deduct punitive damage payments. *See* 1 BORRIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 13.1.4 (3d ed. 1999) ("The exclusion of recoveries for personal injuries and wrongful death is deeply entrenched in private tort law, and juries are often instructed that plaintiffs are not taxed on their awards."); Gregg D. Polsky & Dan Markel, *Taxing Punitive Damages*, 96 VA. L. REV. 1295, 1345–46 (2010) [hereinafter Polsky & Markel, *Punitive Damages*] (noting that few courts instruct jurors that defendants can deduct punitive damage payments, and arguing for jury-awareness, rather than non-deductibility of punitive damage awards, as the preferred solution to the perceived problems created by the lack of jury awareness).

9. Jury awareness is critical to this proposal not only for those few cases that actually go to the jury, but for the influence on parties' settlement negotiations. *See, e.g.*, David Benjamin Oppenheimer, *Verdicts Matter: An Empirical Study of California Employment Discrimination and Wrongful Discharge Jury Verdicts Reveals Low Success Rates for Women and Minorities*, 37 U.C. DAVIS L. REV. 511, 513 (2003) [hereinafter Oppenheimer, *Verdicts Matter*] ("Verdicts matter . . . not only to the parties and their counsel in those few cases where verdicts are rendered, but also to public policy makers and lawyers evaluating that vast majority of cases that never go to trial. . . . Stories about jury verdicts can have a profound effect on public opinion and public policy.").

all settlement components are taxed the same. Jury tax awareness is critical to the proposal because it permits the jury to provide the intended (after-tax) compensation, and also because only by assuming an informed jury will parties be on equal footing for settlement negotiations. And because my policy, unlike the ABA and NTA suggestions, provides no incentive to make specious claims of emotional distress, it does not risk increasing societal skepticism of mental illness. Finally, and not of least importance, the tax preference for physical injuries has a gendered component: men, more than women, recover damages from physical injury, and therefore men, more than women, benefit from the tax rule in its current form.[10] By taxing damages for physical injury just as we tax damages for nonphysical injury, we lessen the significance of this gendered distinction.

Part II of this article sets the stage by describing the evolution of section 104(a) and the taxation of damages. In Part III, the article turns to a comprehensive, to-date discussion of how courts are treating disputes about damages. Parts IV and V discuss the possible solutions: Part IV explains the NTA and the ABA position — achieving parity by expanding the exclusion; and Part V explains the full inclusion proposal — achieving parity by eliminating the exclusion — and explains why full inclusion is the better solution. Part VI concludes.

II. A LONG (BUT NOT SO WINDING) ROAD: SECTION 104(a)

Section 104 provides an exclusion from gross income.[11] The exclusion is best understood in the context of what is included in income in the first instance. Early in our income tax evolution, the construction of income was narrow — income was thought of as gains derived from capital or labor, or both combined.[12] Workers were taxed on their salaries, and capitalists were taxed on the gains they made from their capital. That early construction proved too narrow, and over time gave way to our current understanding of "income" — a broad and flexible concept.[13] Income is any accession to wealth, clearly realized, over which the taxpayer has complete dominion.[14] This very broad understanding of income encompasses salaries and gains from the use of capital, of course, but it also includes things like

10. It is true that the NTA/ABA proposals also lessen this gendered component. For the reasons discussed in this article, however, I think my solution is more sound.

11. I.R.C. § 104(a)(2).

12. Eisner v. Macomber, 252 U.S. 189, 193 (1920).

13. *E.g.*, Joseph J. Thorndike, *The Fiscal Revolution and Taxation: The Rise of Compensatory Taxation, 1929-1938*, 73 LAW & CONTEMP. PROBS. 95, 96 (2010) (referring to the modern income tax as a "broad-based, flexible revenue instrument").

14. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429, 431 (1955).

prizes, lottery winnings, and even the value of record-breaking home run baseballs caught by fans.[15] This understanding of income amplifies the Code's cursory definition: "gross income means all income from whatever source derived."[16] Despite the brevity, the Court frequently tells us that by this definition, Congress intended to exercise the full extent of its constitutional authority to tax income.[17] In short, it is taxable unless Congress says it is not.[18]

Monetary recoveries from lawsuits and settlements that do not relate to physical injury are sometimes included in this expansive definition of income, and sometimes not. The uneasy, but seemingly settled, rule is that the recovery will be taxable if the recovery was "in lieu of" a taxable receipt.[19] Under this "in lieu of" rule, recoveries for lost profits are taxable, and recoveries representing a return of capital are not taxable.[20] For example,

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15. *E.g.*, Andrew D. Appleby, *Ball Busters: How the IRS Should Tax Record-Setting Baseballs and Other Found Property Under the Treasure Trove Regulation*, 33 VT. L. REV. 43, 44 (2008) (discussing the public debate surrounding the taxation of record-setting homerun baseballs, and ultimately proposing that we "tax the catcher of the record-setting ball immediately on the retail price of the baseball, then treat the increase in value as unrealized gain, and tax the catcher on that gain if the catcher sells the ball"); Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 4 FLA. TAX REV. 685, 729 (2000) (arguing that found items, such as record-setting baseballs are well within the definition of "income" and therefore create tax liability). *But see* Lawrence A. Zelenak & Martin J. McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299, 1308 (Aug. 30, 1999) (arguing that found objects are not within the "residual" category of taxable income and therefore should not create tax liability).

16. I.R.C. § 61(a).

17. *Glenshaw Glass Co.*, 348 U.S. at 429 (noting that "[t]his Court has frequently stated that this language was used by Congress to exert in this field 'the full measure of its taxing power.'" (citations omitted))

18. Commissioner v. Banks, 543 U.S. 426, 433 (2005) (noting that "[t]he definition [in section 61] extends broadly to all economic gains not otherwise exempted"); Commissioner v. Kowalski, 434 U.S. 77, 82-83 (1977) (holding the "starting point in the determination of the scope of 'gross income' is the cardinal principle that Congress in creating the income tax intended to use the full measure of its taxing power" and "'to tax all gains except those specifically exempted'" (internal quotations omitted).

19. Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944). *See also* Joseph M. Dodge, *Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards*, 8 FLA. TAX REV. 369, 424 (2007) [hereinafter Dodge, *Murphy and the Sixteenth Amendment*] (discussing the limited but appropriate application of the "in lieu of" test).

20. *Raytheon Prod. Corp.*, 144 F.2d at 113-14. Recoveries are taxable only to the extent that the recovery causes the taxpayer to realize a gain on the capital.

if a party to a contract dispute recovers damages for lost profits, the award will be taxable, because profits are taxable. In contrast, if the recovery instead is for damage to property — say a punk-kid smashed a delivery truck — the award is presumably not taxable, since it is merely putting the truck back to its pre-tort position — the victim is not richer, in the income-tax sense of the word.

When the recovery is for personal physical injury, however, Congress has seen fit to enact a special rule. Section 104(a) excludes from gross income recoveries for personal physical injuries.[21] The current version of section 104(a) provides that "gross income does not include . . . (2) the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness[.] . . . For the purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness."[22]

Until recently, damages received for physical injuries also had to satisfy an additional explicit requirement to be excluded: they must have been received on account of "tort or tort type rights."[23] Final regulations were issued recently removing the "tort" or "tort-like" requirement, but the removal was not intended to open the floodgates of exclusion.[24] As the Treasury explained, the "tort" or "tort-like" requirement was no longer necessary because following the 1995 case of *Commissioner v. Schleier*,[25] the Supreme Court has interpreted the statutory "on account of" test to exclude only damages directly linked to "personal" injuries or sickness,[26] and under the 1996 Act, only damages for personal physical injuries or physical sickness are excludable. In other words, the Treasury regarded the "tort" or "tort-like" requirement as redundant; the change was in no way intended to permit individuals with no physical injury to recover tax-free. Finally, one type of damages is never excluded: receipts are income to the extent they represent punitive damages.[27] Importantly, emotional distress is

21. I.R.C. § 104(a).

22. *Id.*

23. Regs. § 1.104-1(c) (2011).

24. *See* T.D. 9573, 77 Fed. Reg. 3106 (Jan. 23, 2012).

25. 515 U.S. 323 (1995).

26. T.D. 9573, 77 Fed. Reg. 3106, 3107 (Jan. 23, 2012).

27. I.R.C. § 104(a)(2) (the parenthetical language of section 104(a) provides as such). As a rule, punitive damages are taxable with possible minor exceptions not relevant here. *See* Glenda G. Cochran & John S. Campbell, *Taxability of Punitive Damages*, 58 ALA. LAW. 96, 96 (1997) (explaining that the 1996 amendment to section 104(a) clarifies that most punitive damages are taxable, though noting one minor exception — punitive damages awarded for wrongful death are exempt from taxation if awarded in a state in which state law regarding wrongful death provides for no remedy other than punitive damages). *See also* Notice 2012-12, 2012-6 I.R.B.

specifically excluded from the definition of physical injury or sickness, even if the emotional distress leads to physical injury.[28] The anomalous result is that damages for emotional distress arising from a physical injury or sickness are *excluded* from gross income, while damages for physical manifestations of emotional distress are *included* in gross income.[29]

The section 104 exclusion has a long history in our Code. Its predecessor was first enacted as part of the Revenue Act of 1918, which excluded from gross income "[a]mounts received . . . as compensation for personal injuries or sickness," as well as "any damages received . . . on account of such injuries and sickness."[30] Although the legislative history does not offer a definitive rationale for the adoption of the exclusion, the exception was enacted just as the Court was struggling with the understanding of the breadth of "income" for federal tax purposes. Congress created the exception on the heels of a series of Supreme Court decisions holding that restoration of capital was not income; it is quite possible that these decisions influenced the congressional understanding of income and that the 1918 Congress understood damages from physical injury as similarly

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365 (advising that restitution payments to victims of human trafficking, which arguably have a punitive component, are not taxable).

28. I.R.C. § 104(a).

29. *See, e.g.*, Stadnyk v. Commissioner, 96 T.C.M. (CCH) 475, 476, T.C.M. (RIA) ¶ 2008-289 at 1576 (2008), *aff'd*, 367 F. App'x 586 (6th Cir. 2010) ("For purposes of section 104(a)(2), emotional distress is not treated as a physical injury or physical sickness, except for damages not in excess of the cost of medical care attributable to emotional distress.) Note the minor exception explained by the court: Taxpayers may exclude damages received for physical manifestations of emotional distress, but only to the extent those damages offset unreimbursed medical expenses that were not deducted. *Id.* This exception is likely to become less important if the Patient Protection and Affordable Care Act results in fewer individuals lacking health care coverage.

30. Revenue Act of 1918, Pub. L. No. 254, § 213(b)(6), 40 Stat. 1066 (1919). Recall that the Sixteenth Amendment passed in 1913, so the exclusion has been part of the income tax almost as long as we have had an income tax. Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 19, at 372 (noting that Congress proposed the Sixteenth amendment in 1909, and it was ratified in 1913). "In the early years of this tax (1918-31), only 5.6 percent of the United States population filed income-tax returns with a tax due." Sergio Pareja, *Taxation Without Liquidation: Rethinking "Ability to Pay,"* 2008 WIS. L. REV. 841, 851 (2008) (citing MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 86 (2008)). It was not until World War I that the income tax became a tax "on the masses." Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 19, at 385.

falling outside the definition of 'income' upon which they could lawfully impose a tax.[31]

These early cases, and the commentary from the executive and legislative branches, suggest that the exception for damages was carved out in part because the conception of "income" was quite narrow: Congress was unsure that damages could in fact be taxed. This early understanding of the scope of permissible taxable income, as evidenced in the cases from the 1910s, has evolved. Most modern scholars and the Court have abandoned the notion that income is limited to receipts from capital or labor or both combined. An oft-cited turning point in the evolution of our understanding of income and of what is constitutionally subject to tax is found in *Commissioner v. Glenshaw Glass*.[32] Although the Court in *Glenshaw Glass* noted that damages for personal injury would not be included in income, the Court articulated a more expansive understanding of income when it held that punitive damages were well within Congress's constitutional taxing power.[33]

Despite the long-standing nature of the exclusion, Congress has never articulated the policy reason for the section 104(a)(2) exclusion, and commentators presume that the exception rests at least in part on compassion.[34] In casting about for theoretical justifications for the exclusion, courts have surmised that the exclusion serves to make the taxpayer whole for the "loss of personal rights:"[35] these awards, as one court noted "in effect . . . restore a loss to capital."[36] However, the argument that damages for personal injury are simply a return of capital and thus not taxable has been

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31. *See* O'Gilvie v. United States, 519 U.S. 79, 84 (1996) (explaining that just prior to the enactment of section 104's predecessor, "this Court had recently decided several cases based on the principle that a restoration of capital was not income; hence it fell outside the definition of 'income' upon which the law imposed a tax." (citing Doyle v. Mitchell Brothers Co., 247 U.S. 179, 187 (1918); S. Pacific Co. v. Lowe, 247 U.S. 330, 335 (1918))). The House of Representatives, the Attorney General, and the Department of the Treasury made similar findings. *O'Gilvie*, 519 U.S. at 85–86 (quoting H.R. REP. NO. 767, at 9–10 (1918); 31 Op. Atty. Gen. 304, 308 (1918); T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918)).

32. 348 U.S. 426, 432, n.8. *See also* Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 19, at 383 (discussing *Glenshaw Glass*, and discussing that the Supreme Court reversed the lower court's reliance on *Macomber* because although "the *Macomber* definition may have been useful in earlier days in order to distinguish capital from income, [it] did not constitute a comprehensive definition of income").

33. 348 U.S. 426, 432–33.

34. J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 183 (9th ed. 2010) [hereinafter BURKE & FRIEL, TAXATION].

35. Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962).

36. *Id.*

recently, and firmly, rejected.[37] Scholar Joseph Dodge explains the "bankruptcy" of the theory that damages for personal injury must be excluded from gross income because such damages are not "gain" but are a replacement of capital.[38] As Dodge summarizes:

> The embarrassing truth is that there has never been a "replacement" requirement under section 104 or any of the non-statutory authority for excluding personal injury damages. Shorn of any relevance to facts or even broad (non-tax) notions of capital, the replacement-of-capital theory appears to be nothing more than a new cover draped over the "no (economic) gain" theory.[39]

The "no (economic) gain" theory fares no better under Dodge's withering gaze, however. He carefully dismantles the notion that damages for physical or emotional injury must be excluded because they do not result in economic gain.[40]

This lack of theoretical justification does not change the fact of the exclusion. And for decades, courts read the exclusion in section 104(a)(2) to mean that "personal injuries" for section 104 purposes included nonphysical injuries.[41]In 1989, Congress toyed with an amendment that would have required a physical injury before damages were excluded from income,[42] but the conference committee rejected the amendment. Instead, in 1989 Congress added its imprimatur to the expansive reading of the exclusion by amending section 104(a) to exclude from the provision "punitive damages in connection with a case not involving physical injury or physical sickness."[43]

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37. Murphy v. United States, 493 F.3d 170 (D.C. Cir. 2007), *reversing*, Murphy v. United States, 460 F.3d 79 (D.C. Cir. 2006). For a full discussion of the *Murphy* case and the controversy surrounding the first panel decision, see Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 19, at 426–27.

38. Dodge, *Murphy and the Sixteenth Amendment*, *supra* note 19, at 391, 417.

39. *Id.* at 417.

40. *Id.* at 418–23.

41. Hawkins v. Commissioner, 6 B.T.A. 1023, 1024–25, (1927). *But see* BURKE & FRIEL, TAXATION, *supra* note 34, at 184 (noting that "Congress likely intended to exclude only those damages received on account of physical injuries.").

42. H.R. REP. NO. 101-247, at 1354–55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2824–25.

43. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989). In other words, this amendment clarified that punitive damages were included in income. *See* Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical but Leaves the Exclusion Emotionally*

By clarifying that punitive damages for personal injuries not involving physical injury or sickness were included in taxable income, Congress implied that compensatory damages for such injuries were excluded through section 104(a).[44] Following this amendment, then, it was settled law that section 104(a)(2) excluded from income damages for personal injuries, as defined by the regulations, regardless of whether those damages stemmed from physical or emotional injuries.[45]

Congress took up the issue again in 1996, and this time, the change was radical. As part of the Small Business Job Protection Act, Congress added the current requirements — that excluded damages be a result of physical injury. At the same time, Congress clarified that damages arising from emotional distress are not excludable from gross income under section 104(a).[46] The legislative history for the 1996 amendment is scant but indicates an intent to exclude from the exclusion — in other words, to include in income — "damages received . . . based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress."[47] Although the legislative history is not revealing, the amendment might be seen as a codification of the holdings in two cases, *Commissioner v. Schleier*[48] and *United States v. Burke*,[49] in which the Court held that damages received in Age Discrimination in Employment Act ("ADEA") and Title VII cases, respectively, were not excluded from gross income under section 104(a)(2). In *Burke*, the Court held that the words "on account of personal injuries" in section 102(a)(2) required that damages be received due to an underlying tort to be excluded.[50] The Court reasoned the remedies associated with a tort were meant to compensate a victim for a personal injury;

Distressed, 76 NEB. LAW REV. 51, 74 (1997) [hereinafter Hobbs, *Congress Gets Physical*] (calling the 1989 amendment "an unusual imprimatur").

44. Hobbs, *Congress Gets Physical*, *supra* note 43, at 75.

45. United States v. Burke, 504 U.S. 229, 236 n.6 (1992) (noting congressional "support for the notion that 'personal injuries' includes physical as well as nonphysical injuries").

46. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838-39 (1996).

47. H.R. REP. NO. 104-737, at 300–01 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1792–93.

48. 515 U.S. 323, 336–37 (1995) (cited in H.R. REP. NO. 104-737, *supra* note 47, at 300 n.55, *reprinted in* 1996 U.S.C.C.A.N. at 1792).

49. 504 U.S. 229, 237 (1992).

50. *Burke*, 504 U.S. at 242. Employees of the Tennessee Valley Authority filed a Title VII action alleging wage discrimination on the basis of sex. *Id*. at 230–31. A settlement was reached in which employment taxes were withheld. *Id*. The taxpayers commenced an action claiming the settlement was on account of personal injury or sickness and, therefore, should be excluded from gross income. *Id*. at 232.

however, remedies available in cases such as *Burke* under Title VII did not compensate for a personal injury, but were exclusively for back wages.[51]

The Court added another layer in *Schleier*, an ADEA case, when the Court held that to be excluded, the taxpayer must not only demonstrate that his or her claim was premised on tort, or tort-like injury (as required by *Burke*) but must in addition "show that the damages were received 'on account of personal injuries or sickness.'"[52] Even assuming the taxpayer in *Schleier* met the "tort" requirement, the Court reasoned that damages awarded to a victim of age discrimination do not meet the statutory "personal injury or sickness" requirement because, the Court explained, "[w]hether one treats respondent's attaining the age of 60 or his being laid off on account of his age as the proximate cause of respondent's loss of income, neither the birthday nor the discharge can fairly be described as a 'personal injury or 'sickness.'"[53] The Court distinguished victims of age discrimination with a hypothetical victim of a motor vehicle accident who recovered $30,000 for her medical expenses, lost wages and pain, suffering and emotional distress.[54] In the case of the car accident victim the Court explained that the entire $30,000 would be excludable under section 104(a)(2) because in that instance, all the damages received were "on account of personal injuries."[55]

The critical point this hypothetical illustrates is that each element of the settlement is recoverable not simply because the taxpayer received a tort settlement, but rather because each element of the settlement satisfies the requirement set forth in § 104(a)(2) . . . that the damages were received "on account of personal injuries or sickness."[56]

One final Supreme Court case merits discussion. In its 1996 decision in *O'Gilvie v. United States*[57] the Court held that punitive damages received by the surviving spouse and the children of a victim of toxic shock syndrome were not excluded from income by section 104(a). The *O'Gilvie* Court focused its attention on the meaning of the phrase "on account of" and held that the phrase requires more than simply "but for" causation. It was not enough, the Court reasoned, that "but for the personal injury there would be

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51. *Id*. at 235, 238.

52. *Schleier*, 515 U.S. at 337.

53. *Id*. at 330.

54. *Id*. at 329.

55. *Id*. at 329–30.

56. *Id*. at 330.

57. 519 U.S. 79 (1996). In 1996, Congress modified section 104(a) and clarified that punitive damages are not excluded from income by the section. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838–39 (1996). The *O'Gilvie* Court was addressing the 1989 version of section 104(a), which provided in relevant part that "(2) the amount of any damages received . . . on account of personal injuries or sickness" are excluded from income. I.R.C. § 104(a)(2) (1989).

no lawsuit, and but for the lawsuit, there would be no damages."[58] To be excluded, the Court continued, the damages must have been awarded "by reason of, or because of, the personal injuries."[59] The damages awarded to the victim's family in this case did not fit the exception, since they were given to punish the defendant's reprehensible conduct.[60]

Although each of these cases was decided under the pre-1996 section 104(a)(2), the cases are important not only as precursors to the 1996 amendment — Congress amended the section in the shadow of the Court's various interpretations — but also because the 1996 amendment was not a rejection of any of these cases. The amendment instead provided some clarification, but, as the discussion below makes clear, left much up to courts. As the courts have struggled with interpreting the scope of the modified exception, the trilogy of cases — *Burke*, *Schleier*,[61] and *O'Gilvie* — provide some guidance.

III. CONFUSION IN THE COURTS: SECTION 104(a)(2) IN ACTION

Despite the amendments to section 104(a), and the guidance provided by the cases discussed above, litigation and uncertainty persist.[62]

58. *O'Gilvie*, 519 U.S. at 82.

59. *Id.* at 83.

60. *Id*.

61. The two-part *Schleier* test has since been extended to apply to the amended version of section 104, although the second prong now requires proof that the personal injuries or sickness for which the damages were received were physical in nature. *See, e.g.*, Venable v. Commissioner, 86 T.C.M. (CCH) 254, T.C.M. (RIA) ¶ 2003-240 (2003), (citing relevant cases) and cases cited therein; Oyelola v. Commissioner, T.C. Summ. Op. 2004-28, 9 (Mar. 12, 2004).

62. This uncertainly is not surprising, given Congress's "hedging" on several important aspects of section 104(a)(2). *See* Hobbs, *Congress Gets Physical*, *supra* note 43, at 83 (complaining that "the new provision raises both interpretive and theoretical questions" such as how to draw the line between physical and nonphysical, and what to do with mixed awards). As will be shown below, the litigation following section 104(a)(2) proves Professor Hobbs prescient. This confusion is not new, and I am certainly not the first scholar to recognize it. *See, e.g.*, Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U. L. REV. 61, 79 (1997) ("For nearly eighty years, taxpayers, their advisors, and the government have wrestled with the scope of the personal injury exclusion."); F. Philip Manns Jr., *Restoring Tortiously Damaged Human Capital Tax-Free Under Internal Revenue Code Section 104(a)(2)'s New Physical Injury Requirement*, 46 BUFF. L. REV. 347, 351 (1998) [hereinafter Manns, *Restoring Human Capital*] (complaining that the section 104(a)(2) "cases can be described only in an ad hoc manner"). It is not only academics who raise the issue. The NTA has flagged it on at least two occasions. 2009 ANNUAL REPORT, *supra* note 4, at 351–54; 2008 ANNUAL

This section focuses on significant problems revealed through close examination of the section 104(a) cases. First, a fundamental definitional problem: the understanding of "physical injury" in the section 104(a) context has courts flummoxed. Second and closely related, despite the Court's discussion in *O'Gilvie*, litigants and courts face continuing challenges applying the statutory language "on account of." And finally, this section examines the differing approaches the courts have taken with respect to allocation of settlement proceeds.

A. What is "Physical Injury" for Section 104(a)(2) Purposes?

Congress has decreed, and the courts consistently hold, that to be excluded from income, the settlement or award must be on account of a physical injury or sickness. But Congress provided no guidance as to what constitutes a physical injury. Sometimes, the answer is easy, as it was for example in *Chappell v. International Steel Group.*[63] In that case, the taxpayer suffered a low-back injury following a motor vehicle accident, and through settlement he received compensation for previously paid medical bills, lost wages, and pain and suffering as well as future medical bills and pain.[64] The court readily held that this claim fit exactly under section 104(a)(2) as amplified by *Schleier*: the underlying claim was tort, and further, each element of the settlement was awarded because of that physical injury, not to punish the tortfeasor or deter further tortious conduct.[65]

Few reported cases are as easy as *Chappell*, and courts have struggled at the margins of "physical injury."[66] Some courts have determined that a physical injury requires more than a mere involvement of the taxpayer's physical body. An interesting recent example is the Sixth Circuit

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REPORT, *supra* note 4, at 471 ("Taxation of damage awards spurs litigation every year.").

63. 105 A.F.T.R.2d (RIA) 2010-1229, 1230 (N.D. Ind. 2010) (deeming the settlement was excludable as it was based upon the taxpayer's lower back injury and no relief was sought for nonphysical type).

64. *Id*.

65. *Id*.

66. In only a few cases have the courts provided a definite decision on what is not a physical injury in a particular instance. For example, in Bond v. Commissioner, the Tax Court deemed that depression is not a physical injury. 90 T.C.M. (CCH) 445, 446-47, T.C.M. (RIA) ¶ 2005-25 at 1860 (2005). This appears to be a legal, not a medical, conclusion. In Wells v. Commissioner, the Court rejected a taxpayer's argument that since depression is not specifically listed in the Tax Code as an emotional injury damages awarded in relation to that depression should be excluded from gross income. 99 T.C.M. (CCH) 1032, 1034, T.C.M. (RIA) ¶ 2005-5 at 47 (2010).

decision in *Stadnvk v. Commissioner*,[67] in which the taxpayer recovered damages after being wrongly accused of writing a bad check and being falsely imprisoned. While the false imprisonment certainly impacted the taxpayer's physical body (she was arrested and handcuffed, and confined to a cell), the Court determined that the arrest did not constitute a physical injury for section 104(a) purposes because there was no causal connection between the physicality and the damages.[68] Similarly, in *Shelton v. Commissioner*, [69] the Tax Court held a physical injury must include more than an effect on one's physical body. In *Shelton*, the taxpayer argued that her settlement ought to be excluded from gross income since "after being harassed she was not the same person physically."[70] Although current brain science suggests she might well be correct,[71] the court rejected this argument.[72]

Even taxpayers who show manifest physical injury, such as bruising, do not always succeed in excluding damages. In some cases, the courts dismiss minor physical injuries, implicitly holding that "physical injury" has an unwritten requirement that the injury be major or significant. In *Hansen v. Commissioner*,[73] for example, the Tax Court held that a taxpayer who recovered damages after being physically assaulted twice by his supervisor did not qualify for the exclusion. In the first assault, the supervisor pushed the taxpayer, a mineworker, to the ground, and then rubbed the taxpayer's

67. 367 F. App'x 586, 587–89 (6th Cir. 2010).

68. *Id.* at 594.

69. 97 T.C.M. (CCH) 1592, 1593-94, T.C.M. (RIA) ¶ 2009-116 at 849 (2009).

70. 97 T.C.M. (CCH) at 1594, T.C.M (RIA) ¶ 2009-116 at 849.

71. Diane Ackerman, *The Brain on Love*, NEW YORK TIMES OPINIONATOR (March 24, 2012, 4:28 PM), http://opinionator.blogs.nytimes.com/2012/03/24/the-brain-on-love/ (noting that imaging studies of brains done by UCLA neuroscientist Naomi Eisenberg show that the same areas of the brain that register physical pain are active when someone feels socially rejected, and the same area of the brain registers both rejection and physical assault. Ackerman continues, "That's why being spurned by a lover hurts all over the body, but in no place you can point to. Or rather, you'd need to point to the dorsal anterior cingulated cortex in the brain, the front of a collar wrapped around the corpus callosum, the bundle of nerve fibers zinging messages between the hemispheres that register both rejection and physical assault."). *See also* David DePianto, *The Hedonic Impact of "Stand-Alone" Emotional Harms — An Analysis of Survey Data*, 36 LAW & PSYCHOL. REV. 115, 117 (2012) [hereinafter DePianto, *The Hedonic Impact*] (noting that "this negative view of 'mental' and 'emotional' health — which covers anxiety, inability to concentrate, depression, anguish, grief, psychosis, humiliation, fright, shock and other negative emotions distinct from physical pain — is a legal concept, not a medical one").

72. *Shelton*, 97 T.C.M. (CCH) at 1594, T.C.M (RIA) ¶ 2009-116 at 849.

73. 97 T.C.M. (CCH) 1447, 1450-51, T.C.M. (RIA) ¶ 2009-87 at 644–45 (2009).

face in the limestone with sufficient force to cause bruising.[74] On a different date, the same supervisor again assaulted the taxpayer; this second assault resulted in a cut on the taxpayer's foot.[75] The taxpayer successfully negotiated a settlement after suing on an employment discrimination theory.[76] Despite the undisputed physical injury, the Tax Court held the settlement was not excluded from gross income because the complaint and agreement did not specify that the settlement was on account of the physical injuries.[77] Similarly, in another case the Tax Court held that when a supervisor bumped his elbow into the employee-taxpayer's breast, the resulting bruise did not constitute a physical injury for section 104(a)(2) exclusion purposes.[78] A kick to the groin, however, might be another story. In an earlier case, *Amos v. Commissioner*,[79] the court excluded a portion of the taxpayer's settlement proceeds, despite questionable evidence of physical injury. The taxpayer suffered a kick to the groin; he sought medical care twice, but no evidence of an injury was found, no treatment was prescribed, and the taxpayer declined pain medication.[80] The court nonetheless attributed $120,000 of the $200,000 settlement to the physical injury.[81]

As *Amos* demonstrates, taxpayers are not always on the losing end of this "physical injury" confusion. In fact, in at least two recent cases, discussed in the next section, taxpayers have successfully excluded portions of their recovery of damages even in the total absence of physical contact.[82]

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74. 97 T.C.M. (CCH) at 1447, T.C.M. (RIA) ¶ 2009-87 at 639–40.

75. 97 T.C.M. (CCH) at 1447, T.C.M. (RIA) ¶ 2009-87 at 640.

76. 97 T.C.M. (CCH) at 1448, T.C.M. (RIA) ¶ 2009-87 at 641.

77. 97 T.C.M. (CCH) at 1450-51, T.C.M. (RIA) ¶ 2009-87 at 644–45.

78. Nield v. Commissioner, T.C. Summ. Op. 2002-12, 2, 19-20 (Aug. 27, 2002). *Accord* Mumy v. Commissioner, T.C. Summ. Op. 2005-122, 2-3, 14-15 (Aug. 24, 2005) (denying section 104(a)(2) exclusion to taxpayer who recovered for claim of sexual harassment despite the fact that the taxpayer's claim that she suffered a physical assault was not refuted, and reasoning that because the taxpayer did not seek medical treatment and did not suffer any long-term physical manifestation, she did not qualify for the section 104(a) exclusion).

79. 86 T.C.M. (CCH) 663, 667, T.C.M. (RIA) ¶ 2003-329 at 1899–1900 (2003). The *Amos* case is relatively well known, because the tortfeasor was NBA star Dennis Rodman. Mr. Amos, a professional photographer, was working the game. Rodman became frustrated with an aspect of the game and took his frustration out on the nearest person — who happened to be Mr. Amos sitting courtside. 86 T.C.M. (CCH) at 663, T.C.M. (RIA) ¶ 2003-329 at 1894. Video of the kick is readily found on YouTube, and makes a great Tax I teaching tool.

80. 86 T.C.M. (CCH) at 663–64, T.C.M. (RIA) ¶ 2003-329 at 1894–95.

81. 86 T.C.M. (CCH) at 667, T.C.M. (RIA) ¶ 2003-329 at 1899.

82. *See* Domeny v. Commissoner, 99 T.C.M. (CCH) 1047, T.C.M. (RIA) ¶ 2010-009 (2010); Parkinson v. Commissioner, 99 T.C.M. (CCH) 1583, T.C.M. (RIA) ¶ 2010-142 (2010) *See also infra* Part II.B.

B. When is an Award "on Account of" Physical Injury or Sickness

Just as Congress declined to delineate the scope of "physical injury," section 104(a)(2) does not define the relationship between the physical injury and the tort that is required for exclusion of a damages award. The statutory language provides simply that to exclude damages under section 104(a)(2), those damages must be "received . . . on account of personal injuries or physical sickness."[83] While all courts begin with this language, they vary in their discussions of how the physical injury and the underlying cause of action must interrelate to satisfy the "on account of" language. Those differing discussions have led to frequent taxpayer error in excluding from income awards that the courts later hold must be included. The lack of clear guidance has also led, however, to a handful of taxpayers succeeding in excluding damage awards in cases that are nearly indistinguishable from cases in which the IRS has prevailed. Two recent tax court decisions in which the taxpayer successfully excluded damages merit attention: *Domeny v. Commissioner*[84] and *Parkinson v. Commissioner*.[85] In both cases, sympathetic plaintiffs succeeded in excluding portions of their damage awards under section 104(a)(2) after negotiating successful settlements of particularly egregious conduct by their respective employers.

In *Domeny*, the taxpayer worked for a nonprofit dedicated to helping children with autism.[86] The taxpayer became aware that her new supervisor was embezzling funds, and approached the board of directors with that information. Several months later, the supervisor was still on the job, and the escalating tension that taxpayer felt following her whistle-blowing exacerbated her pre-existing multiple sclerosis.[87] Eventually the symptoms of her MS became debilitating and she was forced to take a leave from her job.[88] During that leave, her supervisor telephoned her and informed her that she was fired.[89] Petitioner contacted an attorney, who agreed she had a cause of action, and the attorney successfully negotiated a settlement.[90]

The settlement agreement recited that the taxpayer was releasing eight possible rights or causes of action: the first seven comprised a variety of employment claims, such as Americans with Disabilities Act ("ADA"), ADEA and Family and Medical Leave Act ("FMLA") claims.[91] The final

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83. I.R.C. § 104(a)(2); Regs. § 1.104-1(c).
84. 99 T.C.M. (CCH) 1047, T.C.M. (RIA) ¶ 2010-009 (2010).
85. 99 T.C.M. (CCH) 1583, T.C.M. (RIA) ¶ 2010-142 (2010).
86. *Domeny*, 99 T.C.M. (CCH) at 1048, T.C.M. (RIA) ¶ 2010-009 at 67.
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. Specifically, the first seven claims released included the following:

cause of action released was that for "any and all claims for breach of contract, breach of the covenant of good faith and fair dealing, invasion of privacy, infliction of emotional distress, defamation and misrepresentation."[92] The settlement was for about $33,000, of that amount around $8,000 was wages due, and an additional $8,000 went to the plaintiff's attorney.[93] The tax treatment of those first two amounts was not in dispute; instead, the dispute centered on whether the remaining amount — about $16,000 — was properly excluded under section 104(a)(2).[94] The settlement agreement was silent as to the purpose of the payment.[95] Such silence is often fatal to the exclusion of damages under section 104(a)(2),[96]

> (a) any and all rights and claims relating to or in any manner arising from the * * * [petitioner's] employment or the termination of her employment;
> (b) any and all rights and claims arising under the California Fair Employment and Housing Act * * *;
> (c) any and all claims arising under the Civil Rights Act of 1964 * * *;
> (d) any and all rights and claims arising under the Americans with Disabilities Act;
> (e) any and all rights and claims arising [sic] the Age Discrimination in Employment Act of 1967 * * *;
> (f) any and all rights and claims arising under the Family and Medical Leave Act or the California Family Rights Act;
> (g) any and all claims for violation of the Fair Labor Standards Act, the California Labor Code, or the California Wage Orders.

99 T.C.M. (CCH) at 1048, T.C.M. (RIA) ¶ 2010-009 at 68.

92. *Id.*

93. *Id.*

94. 99 T.C.M. (CCH) at 1049, T.C.M. (RIA) ¶ 2010-009 at 68.

95. *Domeny*, 99 T.C.M. (CCH) at 1049, T.C.M. (RIA) ¶ 2010-009 at 68 (noting that "[i]n all respects, the settlement agreement is ambiguous regarding any specific reason for the payment").

96. *See e.g.*, Hellesen v. Commissioner, 97 T.C.M. (CCH) 1810, 1813, T.C.M. (RIA) ¶ 2009-143 at 1170 (2009) (noting that "[w]ithout such an allocation, no amount of the settlement may be excluded from income"). Even with a specific allocation in a settlement agreement, damage awards might nonetheless be included in income. *E.g.*, Goode v. Commissioner, 91 T.C.M. (CCH) 901, 903-05, T.C.M. (RIA) ¶ 2006-048 at 378–81 (2006), *appeal dismissed per stipulation*, No. 06-1219, 2008 WL 435520 (D.C. Cir. 2008) (including the award and upholding the penalty despite express allocations in settlement agreements because although express identification of payment amounts deemed eligible for "compensation for injuries or sickness" exclusion from income are generally upheld, allocations that do not arise from arm's length negotiations are not conclusive); Vincent v. Commissioner, 89 T.C.M. (CCH) 1119, T.C.M. (RIA) ¶ 2005-095 at 667 (2005) ("We are not bound by a settlement agreement's characterization or division of settlement amounts, particularly where it appears that one party may not have had a strong motivation to negotiate at arm's length as to the characterization and/or division of the settlement amounts.").

but in this case, the court permitted exclusion from income, reasoning that the payment was "on account of" the physical injuries — in particular, the exacerbated multiple sclerosis.[97]

Domeny is not unique. In a similar case, *Parkinson v. Commissioner*,[98] the taxpayer successfully excluded a portion of his settlement from income on the basis of a physical injury. In *Parkinson*, just like *Domeny*, the taxpayer's pre-existing health condition was exacerbated due to stress brought on by a hostile work environment. Mr. Parkinson was a hospital-based ultrasound technician who had supervisory responsibilities. Harassment by colleagues and stressful conditions at work contributed to an initial heart attack. Upon his return to work not only did his employer fail to provide reasonable accommodations but in fact permitted the harassment to escalate such that Mr. Parkinson suffered a second heart attack.[99] He eventually filed suit in state court, alleging claims of intentional infliction of severe emotional distress and invasion of privacy. A day after the jury trial began, the parties reached a $350,000 settlement for "noneconomic damages and not as wages or other income."[100]

Mr. Parkinson received a portion of the settlement and did not report any as income. The court ultimately agreed the payment was properly excluded, and in so doing, rejected the IRS's argument that the payment was on account of emotional distress, and not physical injury.[101] Citing legislative history, the court distinguished between subjective physical *symptoms* resulting from emotional distress — such as "insomnia, headaches, stomach disorders" and objective *signs* of physical injury manifesting from emotional distress.[102] Damages received on account of the subjective *symptoms* are includable in income, while damages received on account of objective *signs* of physical injury are properly excluded pursuant to section 104(a)(2). The court concluded that Mr. Parkinson's settlement was properly excluded because "a heart attack and its physical aftereffects constitute physical injury

97. 99 T.C.M. (CCH) at 1049–50, T.C.M. (RIA) ¶ 2010-009 at 68–70.

98. 99 T.C.M. (CCH) 1583, T.C.M. (RIA) ¶ 2010-142 (2010).

99. 99 T.C.M. (CCH) at 1584, T.C.M (RIA) ¶ 2010-142 at 853. The alleged harassment was indeed extreme. For example, the taxpayer suffered a second heart attack at work; he was taken to the emergency room, but he could not escape harassment even there. As the taxpayer was "receiving treatment in the emergency room, one of [his co-workers] reached him by telephone and demanded that he return to work or [else] face disciplinary action." *Id*. at 1584, T.C.M. (RIA) ¶ 2010-142 at 853.

100. 99 T.C.M. (CCH) at 1584–85, T.C.M (RIA) ¶ 2010-142 at 853.

101. 99 T.C.M. (CCH) at 1587, T.C.M (RIA) ¶ 2010-142 at 857

102. *Parkinson*, 99 T.C.M. (CCH) at 1586, T.C.M (RIA) ¶ 2010-142 at 855–56 (citing and quoting H.R. REP. NO. 104-737, *supra* note 47, *reprinted in* 1996 U.S.C.C.A.N. 1677).

or sickness rather than mere subjective sensations or symptoms of emotional distress."[103]

Few taxpayers fare so well with similar claims.[104] For example, in *Pettit v. Commissioner*,[105] the taxpayer's pre-existing condition, irritable bowel syndrome,[106] was exacerbated by a wrongful discharge. However, unlike the courts in *Domeny* and *Parkinson*, the *Pettit* court held that the settlement was not "on account of" a physical injury or sickness as required for the section 104(a)(2) exclusion.[107] Another difficult to distinguish case is *Hellesen v. Commissioner*.[108] In *Hellesen*, the taxpayer and his wife worked as claims attorneys for the same company. The couple recovered about $500,000 in settlement of their claims for discrimination. The taxpayer husband alleged various physical ailments, including chest pains, stomach

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103. 99 T.C.M. (CCH) at 1586, T.C.M (RIA) ¶ 2010-142 at 856. The "symptom versus sign" distinction can be found throughout the tax cases, with taxpayers' bids to exclude damages more frequently being rejected because the courts interpret certain injuries as "symptoms" rather than "signs." *E.g.*, Lindsey v. Commissioner, 422 F.3d 684, 688–89 (8th Cir. 2005) (taxpayer suffered hypertension and periodic impotency, insomnia, fatigue, occasional indigestion and urinary incontinence, but the award was taxable because these were symptoms rather than a physical injury or sickness); Sanford v. Commissioner, 95 T.C.M. (CCH) 1618, 1620, T.C.M. (RIA) ¶ 2008-158 at 870 (2008) (physical injuries of "asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression" were symptoms related to the underlying sexual harassment and discrimination and therefore the award was taxable). *See also* Prinster v. Commissioner, T.C. Summ. Op. 2009-99, 8 (June 30, 2009) (taxpayer suffered exacerbation of hyperlipidemia and hypertension caused by his wrongful termination; the court held these were "symptoms related to emotional distress rather than physical sickness").

104. For example, in Prasil v. Commissioner, the taxpayer claimed that the sexual harassment for which she recovered damages had exacerbated her condition of Sweet's syndrome, but the court determined that because her medical records did not sufficiently document her claim, her entire settlement was taxed. 85 T.C.M. (CCH) 1124, T.C.M. (RIA) ¶ 2003-100 (2003). "Sweet's syndrome . . . is a rare skin condition marked by fever and painful skin lesions that appear mainly on your arms, neck, face and back." *Health Information*, MAYO CLINIC, http://www.mayoclinic.com/health/sweets-syndrome/DS00752 (last visited Jan. 27, 2013).

105. 95 T.C.M. (CCH) 1341, T.C.M. (RIA) ¶ 2008-087 (2008).

106. "Irritable bowel syndrome or IBS affects up to 55 million Americans, mostly women. IBS causes are unknown. IBS symptoms include diarrhea, constipation, and abdominal cramps. There are IBS treatments such as diet and lifestyle changes and medications that can help." WEBMD, http://www.webmd.com/ibs/default.htm (last visited Jan. 27, 2013).

107. *Pettit*, 95 T.C.M. (CCH) 1341, 1344, T.C.M. (RIA) ¶ 2008-087 at 475–76 (noting that no medical records tied the physical injury to the cause of action).

108. 97 T.C.M. (CCH) 1810, T.C.M. (RIA) ¶ 2009-143 (2009).

problems, and significant weight loss.[109] The court reasoned, though, that the settlement must be fully included in income since none of the seven causes of action claimed in the lawsuit alleged physical injury or sickness, even though the settlement agreement was broad and encompassed physical injuries.[110] The court hinted that the taxpayer might have salvaged his argument, had the settlement made a specific allocation as compensation for physical injuries or physical sickness, but "[w]ithout such an allocation, no amount of the settlement may be excluded from income."[111]

The proper interpretation of the "on account of" requirement is not the only challenge facing taxpayers and the courts in their efforts to divine the proper parameters of section 104(a)(2). In particular, courts vary in what the requirements of the taxpayer's underlying claim must be — for example, denying the exclusion even where there is undisputed evidence of physical injury because the underlying cause of action was not sufficiently "tort-like."[112] And yet another outstanding issue is whether the taxpayer must allege some physical contact by the payor that leads to the physical injury, regardless of the underlying claim, before the exception will apply.[113]

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109. 97 T.C.M. (CCH) at 1811, T.C.M. (RIA) ¶ 2009-143 at 1168.

110. 97 T.C.M. (CCH) at 1813, T.C.M. (RIA) ¶ 2009-143 at 1170.

111. 97 T.C.M. 9CCH) at 1813, T.C.M. (RIA) ¶ 2009-143 at 1170. Numerous cases reason similarly. *See, e.g.*, Hawkins v. Commissioner, 386 Fed. App'x 697 (9th Cir. 2010) (holding the settlement fully included in income because the taxpayer's claim was for wage and hour discrimination, not personal injury, even though she alleged physical and mental distress); Tamberella v. Commissioner, 139 Fed. App'x 319 (2d Cir. 2005) (whether damages are excludable under section 104(a)(2) turns on the nature of the claim underlying the award of damages); Longoria v. Commissioner, 98 T.C.M. (CCH) 11, 15, T.C.M. (RIA) ¶ 2009-162 at 1279 (2009) (reasoning that first a court should examine the nature of the claim based upon the claims asserted in the lawsuit and then should look to the intent of the payor as to why the settlement amounts were actually paid); Green v. Commissioner, 93 T.C.M. (CCH) 917, 919-20, T.C.M. (RIA) ¶ 2007-039 at 387–88 (2007) (holding that since the complaint did not allege any physical injury and the award did not reference a physical injury or sickness, the award for retaliation for filing a discrimination suit could not have been on account any physical injuries); Peck v. Commissioner, T.C. Summ. Op. 2006-86, 6 (May 23, 2006) (holding that "[t]here is nothing in the record linking the settlement proceeds to petitioner's diabetes or other physical injuries," the settlement was consequently not excludable under section 104(a)(2)); Medina v. Commissioner, T.C. Summ. Op. 2003-148 (Oct. 7, 2003).

112. *See* cases in note 111, *supra*.

113. *E.g.*, Gibson v. Commissioner, 94 T.C.M. (CCH) 164, T.C.M. (RIA) ¶ 2007-224 (2007). In *Gibson*, the taxpayer and his family inherited a house in Sun City, California. At the time, Sun City's housing code permitted only senior citizens to reside in the district. The taxpayer and his family members were subject to significant harassment from their neighbors, and they eventually sued various

Furthermore, in some but not all cases, the court has required that particular language appear in the settlement agreement for the exclusion to apply. In *Longoria v. Commissioner*,[114] for example, the taxpayer, a former state trooper, suffered from several physical injuries related to the racial discrimination for which he ultimately recovered damages. The taxpayer's physical injuries were a subject of the negotiation, but mention of those physical injuries did not appear in the complaint or ultimate settlement agreement.[115] This absence, according to the court, was fatal to the exclusion of any of the award.[116] In contrast, as discussed above, the court did not apply such a requirement in the *Domeny* case.[117]

C. Allocation Anguish

Finally, the courts have added to the confusion by differing in their approaches to allocating recoveries. As described below, treatments range from cases in which the court summarily accepts the taxpayer's allocation, to the tax court inventing its own allocation.[118]

In the majority of reported decisions, if no allocation is indicated, the court will consider the entire settlement or award taxable.[119] A characteristic remark is that "[i]n the absence of a basis for allocation, we presume the entire amount is not excludable."[120]

Even in cases in which the allocation between physical and non-physical damages is specific, the courts may not respect the allocation. In

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defendants under a theory of housing discrimination. The taxpayer claimed headaches, stomachaches, and breathing problems, and eventually recovered $350,000. 94 T.C.M. (CCH) at 165–66, T.C.M. (RIA) ¶ 2007-22.4 at 1397–98. The court did not question the taxpayer's veracity but held the entire recovery nonetheless includable because the taxpayer failed to show that any of the payors actually caused his physical injury. 94 T.C.M. (CCH) at 167, T.C.M. (RIA) ¶ 2007-22.4 at 1399–1400.

114. 98 T.C.M. (CCH) 11, T.C.M. (RIA) ¶ 2009-162. Mr. Longoria suffered injuries during his trooper training and additional injuries during his tenure as a trooper. As one example, "Mr. Longoria's locker was top-loaded by a group of renegade troopers. . . . The arrangement had its intended effect when Mr. Longoria opened the locker, it fell on him, and he injured his back." 98 T.M.C. (CCH) at 11, 12, T.C.M. (RIA) ¶ 2009-162 at 1275.

115. 98 T.C.M. (CCH) at 15, T.C.M. (RIA) ¶ 2009-162 at 1279.

116. 98 T.C.M. (CCH) at 15–17, T.C.M. (RIA) ¶ 2009-162 at 1279–81.

117. Domeny v. Commissioner, 99 T.C.M. (CCH) 1047, T.C.M. (RIA) ¶ 2010-009 (2010).

118. This of course sets aside those cases in which the court summarily includes an award in its entirety.

119. *See* cases in note 111, *supra*.

120. Prinster v. Commissioner, T.C. Summ. Op. 2009-99, 9 (2009).

Burditt v. Commissioner,[121] for example, a settlement agreement allocated a portion of the settlement to physical damages. However, the allocation came about after the taxpayer asked his attorney to insert "the proper personal injury language" and hence his attorney included boilerplate language.[122] The court held that because of this the allocation was tax-motivated and did not reflect the realities of the settlement, the entire award was taxable.[123]

Finally, in a handful of reported cases, the courts have taken it upon themselves to allocate or re-allocate. In *Parkinson*, discussed above, the parties did not make a specific allocation.[124] In this instance, the absence did not automatically dictate inclusion. Instead, the court surmised that half of the settlement was for physical injuries and thus excludable from gross income.[125] Similarly in *Amos v. Commissioner*,[126] the court allocated the settlement on its own, in the absence of a specific allocation. Though the settlement agreement used generic language of "to resolve any potential claims," the court imputed the taxpayer's dominant reasons for making the settlement based upon the settlement agreement, a declaration by Dennis Rodman (the tortfeasor), the payor, and the taxpayer's testimony. Ultimately, the court excluded $120,000 of the $200,000 settlement under section 104(a)(2).[127]

IV. SECTION 104(a)(2) NEEDS REFORM

The NTA[128] has urged a modification to section 104(a),[129] and the ABA has added its significant voice to the call for reform. The NTA would reform section 104(a)(2) to eliminate the "physical" requirements. Presumably, any damages received on account of physical or emotional

121. 77 T.C.M. (CCH) 1767, T.C.M. (RIA) ¶ 1999-117 (1999).

122. 77 T.C.M. (CCH) at 1772, T.C.M. (RIA) ¶ 1999-117 at 99–714 (1999).

123. 77 T.C.M. (CCH) at 1772-73, T.C.M. (RIA) ¶ 1999-117 at 99–714.

124. Parkinson v. Commissioner, 99 T.C.M. (CCH) 1583, 1586, T.C.M. (RIA) ¶ 2010-142 at 855 (2010).

125. 99 T.C.M. (CCH) at 1587, T.C.M. (RIA) ¶ 2010-142 at 857.

126. 86 T.C.M. (CCH) 663, 667, T.C.M. (RIA) ¶ 2003-329 at 1899 (2003).

127. 87 T.C.M. (CCH) at 667, T.C.M. (RIA) ¶ 2003-329 at 1899 (2003).

128. According to the Taxpayer Advocate Services' (TAS) website, Nina E. Olson, the National Taxpayer Advocate, leads an office which "serves as an advocate for taxpayers to the IRS and Congress." *See About TAS*: *TAS Leadership*, TAXPAYER ADVOCATE SERVICES, http://www.taxpayeradvocate.irs.gov/About-TAS/TAS-Leadership (last visited Jan. 27, 2013). The TAS is "a nationwide organization of approximately 2,000 taxpayer advocates who help U.S. taxpayers resolve problems and work with the IRS to correct systemic and procedural problems." *Id.*

129. 2009 ANNUAL REPORT, *supra* note 4.

injury would be non-taxable. The ABA sketches out a possibly more ambitious exclusion. The ABA would modify section 104(a)(2) so as to exclude from income not only those monies received on account of injury, but all "noneconomic damages."[130] As I discuss below, it is unclear how these reforms would eliminate the significant problems plaguing the taxation of damages. First, however, I will amplify the NTA/ABA discussion of the problems of the current regime.

The 2008 and 2009 NTA Annual Reports detailed some of the problems with the current treatment of damages.[131] For example, the NTA's 2008 Annual Report noted that continuous litigation plagues section 104(a).[132] Since the NTA reports, that litigation has not let up.[133] That continuous litigation is a drawback need not be belabored. Litigation is stressful to taxpayers; it is expensive not only to the taxpayers, but also to the IRS and the courts.[134] Though some taxpayers represent themselves pro se in tax court, all taxpayers sink a significant amount of time and energy into their representation. Further, some taxpayers secure representation in tax court, and no doubt incur additional costs for that representation. Although not expressly mentioned by the NTA, in section 102(a)(2) cases, the IRS frequently seeks penalties.[135] In the sample of cases examined, penalties are

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130. McMillion, *Rite of Spring*, *supra* note 5, at 65 (explaining the ABA position regarding the Civil Rights Tax Relief Act as follows: "Victims of discrimination are penalized by current tax laws requiring them to pay taxes on settlements and awards of noneconomic damages, and to pay taxes at one time on income awards that might cover many years. The proposed legislation would exclude noneconomic damages from taxable income and allow income averaging for income awards covering multiple years that are paid in a lump sum.").

131. *See* 2009 ANNUAL REPORT, *supra* note 4, at 351–56; 2008 ANNUAL REPORT, *supra* note 4, at 472–74.

132. 2008 ANNUAL REPORT, *supra* note 4, at 472.

133. *See supra* Part III and the cases discussed therein.

134. The majority of the cases were in Tax Court, rather than federal district court; many of the taxpayers were pro se. *See* 2008 ANNUAL REPORT, *supra* note 4, at apps. tbl. 3, http://www.irs.gov/pub/irs-utl/08_tas_arc_apps.pdf. Although foregoing representation saves attorney fees, it creates additional stresses for taxpayers, who often spend a great deal of time and money representing themselves.

135. *See, e.g.*, Parkinson v. Commissioner, 99 T.C.M. (CCH) 1583, T.C.M. (RIA) ¶ 2010-142 (2010) (holding taxpayer not liable for accuracy-related penalty); Longoria v. Commissioner, 98 T.C.M. (CCH) 11, T.C.M. (RIA) ¶ 2009-162 (2009) (rejecting the Commissioner's request for an accuracy-related penalty); Pettit v. Commissioner, 95 T.C.M. (CCH) 1341, T.C.M. (RIA) ¶ 2008-087 (2008) (rejecting the Commissioner's request for accuracy-related penalties); Prinster v. Commissioner, T.C. Summ. Op. 2009-99 (June 30, 2009); Smith v. Commissioner, T.C. Summ. Op. 2007-106 (June 25, 2007) (rejecting the Commissioner's request for accuracy-related penalties); Medina v. Commissioner, T.C. Summ. Op. 2003-148 (Oct. 7, 2003) (rejecting the Commissioner's request for accuracy-related penalties).

rarely upheld, but they nonetheless sometimes are upheld,[136] and the threat of penalties is an added stress to taxpayers who have already been victimized or injured. Finally, even those taxpayers who avoid penalties must pay the statutory rate of interest on any income they failed to include.[137]

The frequency of litigation pointed out by the NTA is likely the tip of an iceberg. The ongoing confusion surrounding the issue no doubt influences parties' settlement negotiations. In cases in which taxpayers are wrongly advised that their damage award will not be taxable, the taxpayer demands insufficient monies to make her whole. Mistakes going the other way no doubt occur — it is almost certain that taxpayers and tortfeasors on occasion mistakenly include damages in taxable income that properly would be excluded pursuant to section 104(a)(2). Such mistakes are difficult to quantify, since it is highly unlikely that the IRS will have any way of finding an overpayment of this sort and has no incentive to do so.

A. Allocation Arbitrage

I agree with these drawbacks of the present regime, as I make clear in the above discussion, which significantly expands on the preliminary remarks offered in the NTA's reports. Another pressing concern not identified by the NTA reports is that the exclusion of damages on account of physical injury provides an incentive for taxpayers and the parties against whom they are negotiating to engage in creative structuring of settlement agreements to "share" the tax savings that results by exclusion. As it stands, section 104(a)(2) provides a significant tax incentive for plaintiffs to settle, especially in cases where there is a probability of punitive damages. This incentive exists because the parties can engage in what I have termed "allocation arbitrage" — they can agree that the damages awarded to the plaintiff are not punitive and are instead awarded on account of physical injury so that the plaintiff will not be taxed on the award. The resulting tax savings can then be shared between the parties.

It is difficult to establish the extent of such allocation arbitrage, but it no doubt exists. For example, consider a negotiation surrounding an employment discrimination dispute — assume that the plaintiff suffered a minor physical injury and that physical injury was related to the illegal discrimination. Also assume that the plaintiff and plaintiff's counsel were

136. *See, e.g.*, Sanford v. Commissioner, 95 T.C.M. (CCH) 1618, T.C.M. (RIA) ¶ 2008-158 (2008) (upholding an accuracy-related penalty).

137. I.R.C. § 6601(a) ("If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or before the last date prescribed for payment, interest on such amount at the underpayment rate established under section 6621 shall be paid for the period from such last date to the date paid.").

able to find some sort of "smoking gun" that would be damning to the company's reputation if revealed in trial. Counsel, and no doubt the parties, are keenly aware that if the case went to trial the "smoking gun" would present a huge risk that the jury would award punitive damages. In such a situation, our hypothetical plaintiff will be able to negotiate a very favorable settlement, some of which ought to be attributable to punitive damages. There is absolutely no incentive though, to allocate even one dollar of the settlement agreement to punitive damages. Rather the plaintiff has an incentive not to do so, since the damages would be taxable. The tortfeasor has no incentive to do so,[138] since they would then be admitting wrongful conduct *and* since the plaintiff is likely to demand some additional sum to make up for the tax cost.[139]

B. Gendered component

In addition, yet another significant drawback to the current treatment of the taxation of damages is its gendered component: women, more than men, recover damages attributable to "noneconomic" injury,[140] and therefore, men, more than women, benefit from this tax rule. By taxing damages for physical injury just as we tax damages for nonphysical injury, we lessen the significance of this gendered distinction.

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138. At present, punitive damages are deductible by business taxpayers. Polsky & Markel, *Punitive Damages*, *supra* note 8, at 1296. The deductibility of punitive damages would provide an incentive to characterize damages as punitive only if a different characterization would render the damages non-deductible. That is not a risk here — the damages would be deductible to the business tortfeasor whether characterized as compensatory or punitive.

139. In conversation with members of the employment bar, I have not been able to find even a single instance of a settlement agreement that includes punitive damages. Notes from interviews between members of the employment bar and the author, Minneappolis and St. Paul, Minn (2012) (on file with author). *See also* Robert W. Wood, *Tax Aspects of Settlements and Judgments*, 522-3d Tax Mgmt. (BNA) A-33 (2006) ("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" since "[v]irtually no defendant would agree to such a characterization") (cited in Polksy & Markel, *Punitive Damages*, *supra* note 8, at 1334 n. 98).

140. Lucinda M. Finley, *The Hidden Victims of Tort Reform: Women, Children, and the Elderly*, 53 EMORY L.J. 1263, 1265-66 (2004) [hereinafter Finley, *Hidden Victims*]; *see also* Joanna M. Shepherd, *Tort Reforms' Winners and Losers: The Competing Effects of Care and Activity Levels*, 55 UCLA L. REV. 905, 946-47 (2008) [hereinafter Shepherd, *Winners and Losers*] (finding that women suffer injuries more commonly compensated through noneconomic damages than men).

Empirical work done by scholar Lucinda Finley[141] and others in the context of tort reform[142] establishes that when women recover damages, a much higher percentage of those damage awards are for "mental-type" injury than is the case when men recover damages.[143] Finley's data establishes the strong tendency of juries to allocate a much higher portion of women's awards to noneconomic damages.[144] Finley is not the only scholar to find evidence of the gendered nature of damage awards. Joanna M. Shepherd, for

141. Finley does not address the tax consequences of the awards; instead she focuses on the impact of tort reform on women and children. *See* Finley, *Hidden Victims*, *supra* note 140. Nonetheless, her valuable work documents the gendered nature of damages, and as such is valuable to my thesis. *See id.* at 1266 (collecting data from "several states on how juries in medical malpractice and other tort suits allocate their damage awards between economic loss damages and noneconomic loss damages").

142. This section utilizes research done in the field of tort reform. As noted above, section 104(a)(2) is no longer explicitly tied to the presence of a tort; nonetheless, section 104(a)(2) applies principally in the tort context. *See supra* notes 23–26 and accompanying text. Further, it is possible that the relevant trends the tort reform studies have revealed of women recovering more for nonphysical harms (which are taxable) than physical harms (nontaxable) are not exclusive to tort actions. For example, scholars have also found evidence of gendered disparities in employment discrimination actions. *See infra* note 145.

143. In the group of California cases Finley studied, an eye-popping 76.35 percent of the damages women recovered were attributable to noneconomic damages. Finley, *Hidden Victims*, *supra* note 140, at 1285. To take another example, in the eighty-eight cases Finley collected from Maryland, the average noneconomic award to women was $714,881, while the average noneconomic award to men was $495,457. *Id.* at 1307. When further broken down into medical malpractice and automobile cases, the trend held: in medical malpractice cases, women's noneconomic damages averaged $839,341 and men's awards averaged $544,429; in auto cases, noneconomic awards to women totaled $669,474, while men's averaged $450,354. *Id.* at 1308. The work of other scholars shows similar results. *E.g.*, Thomas Koenig & Michael Rustad, *His and Her Tort Reform: Gender Injustice in Disguise*, 70 WASH. L. REV. 1 (1995) [hereinafter Koenig & Rustad, *Gender Injustice*] (noting that in the context of medical malpractice, punitive damages are more often awarded to women, and make up a higher percentage of women's awards). Recall that punitive damages are taxable even if the underlying action is for physical injury. I.R.C. § 104(a)(2); *see supra* note 27 and accompanying text.

144. Because Finley examines primarily medical malpractice awards, some of these awards nonetheless qualify for the section 104(a)(2) exclusion because the underlying medical malpractice satisfies the "physical injury" requirement, and therefore the broad exclusion applies. *See also* Koenig & Rustad, *Gender Injustice*, *supra* note 143, at 1 (finding that "proposed restrictions on non-economic damages and the Food and Drug Administration defense to punitive damages will have a disparate impact on women's mass tort remedies" because of the gendered nature of damages awards).

example, has examined tort reform, and she found not only that tort reform disproportionately reduces women's overall tort judgments, but distressingly, that the reforms are associated with increases in women's death rates.[145]

The reforms envisioned by NTA and ABA seem to be driven in part by a focus on victims of employment and other forms of discrimination, and not just tort victims.[146] Just like in the more traditional tort context, however, the limited available empirical data suggest that in cases of employment discrimination, there is a gendered component to recovery.[147] One scholar who studied a large sample of California verdicts concluded that "[t]he most significant finding is that women and minorities are substantially disadvantaged in bringing certain kinds of employment discrimination claims, as compared with the success rates of all plaintiffs in all employment law jury trials."[148] This conclusion suggests that the gendered nature of recoveries ought to be considered when contemplating a reform of the tax treatment of those recoveries. Based on this data, exempting monies received by victims of employment discrimination will benefit men more than women. If that is the case, the gendered nature of the current tax treatment of damages will only be exacerbated.

In sum, reform of section 104(a)(2) is appropriate because in its current form, the preference of awards for physical injury imports into tax law the longstanding and well-documented gender bias in our tort system.[149] The exclusion of awards for physical, but not emotional damages disadvantages women in two ways: first (and ignoring "types" of awards) since "[i]n the aggregate, women's tort damage awards are lower than their

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145. Shepherd, *Winners and Losers*, *supra* note 140, at 908–09; *see also* Lisa M. Ruda, *Caps on Noneconomic Damages and the Female Plaintiff: Heeding the Warning Signs*, 44 CASE W. RES. L. REV. 197, 231 (1993) (arguing in the context of tort reform that "[t]he impact of caps on noneconomic damages will impact women disproportionately since women currently are awarded lower overall damages in comparison to their male counterparts").

146. The ABA specifically mentioned discrimination victims in its call for reform. McMillion, *Rite of Spring*, *supra* note 5, at 65 (specifically mentioning victims of discrimination in describing the ABA position).

147. Oppenheimer, *Verdicts Matter*, *supra* note 9, at 514. *See also* Charles A. Brown, *Employment Discrimination Plaintiffs in the District of Maryland*, 96 CORNELL L. REV. 1247, 1271 (2011) (noting the limitation of the empirical studies of employment discrimination litigation, which usually do not distinguish among the types of discrimination alleged or the types of plaintiffs involved).

148. Oppenheimer, *Verdicts Matter*, *supra* note 9, at 514.

149. *See generally* MARTHA CHAMALLAS & JENNIFER B. WRIGGINS, THE MEASURE OF INJURY: RACE, GENDER, AND TORT LAW 1 (2010) [hereinafter CHAMALLAS & WRIGGINS MEASURE OF INJURY] (explaining "how the shape of contemporary U.S. tort law — from the types of injuries recognized, to judgments about causation, to the valuation of injuries — has been affected by the social identity of the parties and cultural views on gender and race").

male counterparts,"[150] the total dollar amount of tax savings is higher for men than for women under the current regime. The current tax treatment of damages disadvantages women in a second way because the empirical data establishes that men, more than women, recover the types of damages, (specifically, damages on account of physical injury) that qualify for the section 104(a)(2) exclusion.[151]

By exempting from taxation only those dollars recovered for physical injury, while taxing dollars received on account of mental or emotional distress and punitive damages, we give a systematic tax advantage to men. This tax preference might be defensible if there were a legitimate or compelling reason for the preference, but the exclusion of awards for physical injury is longstanding, but not long on reason.

Neither tax policy, nor tort theory, nor the two together, supports the exclusion in its current form. Tax scholar Joseph Dodge has examined the theoretical justifications for the exclusion in his exhaustive discussion of section 104(a)(2).[152] Dodge concludes that there is no compelling policy justification for the exception, at least in its current form and in its entirety.[153] Dodge is not the only scholar to reach this conclusion.[154] The difficulty courts and tax scholars have had finding a tort theory justifying the exclusion might be in part explained by the argument that tort theory itself is muddled, as argued by leading tort theorists, such as John C.P. Goldberg and others, who suggest that tort theory itself has lost its way.[155] Though Goldberg does not appear to have addressed the intersection of torts and taxes,[156] he argues persuasively that tort theory has missed the mark by

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150. Rebecca Korzec, *Maryland Tort Damages: A Form of Sex-Based Discrimination*, 37 U. BALT. L.F. 97, 99 (2007).

151. *See* sources cited in notes 143–44, *supra*.

152. Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 144 (1992) (setting out as the "main purpose . . . to examine whether tax policy, alone or in conjunction with policies of tort law, justifies the exclusion of any component of a personal injury recovery").

153. *Id.* at 188.

154. *See, e.g.*, Manns, *Restoring Human Capital*, *supra* note 62, at 349 (complaining of a "lack of focus on the [section104(a)(2)] exclusion and a resultant failure to develop a coherent theory or policy underlying it").

155. John C.P. Goldberg & Benjamin C. Zipursky, *Torts as Wrongs*, 88 TEX. L. REV. 917, 918 (2010) [hereinafter Goldberg & Zipursky, *Torts as Wrongs*] (lamenting that "law professors have lost their grip" on the subject matter of torts and setting out their goal to "put us back on track, not just pedagogically but theoretically").

156. Goldberg is a prolific scholar, and several of his articles mention taxes to illustrate another point, but his published work does not appear to have taken up the question of the intersection of tort theory and tax policy or theory. *E.g.*, John C.P. Goldberg, *Twentieth-Century Tort Theory*, 91 GEO. L.J. 513, 544, 574 (2003) (mentioning taxes in the following rhetorical: "If mandatory insurance schemes are

disassociating "wrongs" from tort.[157] The significant scholarly focus of tort theory, which Goldberg traces with co-author Benjamin C. Zipursky from Holmes to present day scholars, has been on making torts about shifting losses regardless of fault. Goldberg and Zipursky demonstrate the pitfalls of such an approach and offer their solution — returning to torts as a law of wrongs.[158] Goldberg's critique, however, demonstrates the danger of relying on tort theory as justification for the rule set out by section 104(a)(2): If tort theory itself is disjointed, it is unlikely to suffice to justify a tax rule.

C. Additional Rationales for Eliminating the Exclusion

Another reason to eliminate the exclusion is that it is difficult to justify an exclusion for one sort of damages when other taxpayers who are equally or more sympathetic do not get the benefit of a similar exclusion for money damages. For example, in some states, individuals who have been exonerated after being wrongfully convicted and incarcerated are entitled to significant monetary awards.[159] Although academics have argued that such awards ought to be nontaxable, no Code provision provides for such.[160] As another example, victims of human trafficking are entitled to mandatory statutory restitution payments from convicted offenders.[161] In particular, courts must order convicted defendants to pay restitution including:

> [A]ny costs incurred by the victim for — (A) medical services relating to physical, psychiatric, or psychological care; (B) physical and occupational therapy or rehabilitation; (C) necessary transportation, temporary housing, and child care expenses; (D) lost income; (E) attorneys' fees, as well

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the preferred solution to the social dislocation caused by accidents, does not fairness require that they be funded by generally applicable taxes and be available not only to the victims of human-generated accidents, but to victims of all disasters?").

157. Goldberg & Zipursky, *Torts as Wrongs*, *supra* note 155, at 918–19.

158. *Id.*

159. Erin Tyler Brewster, Comment, *When Have They Paid Enough? The Taxability of Compensation Payments Made to Wrongfully Incarcerated Individuals*, 64 SMU L. REV. 1405, 1407 (2011) [hereinafter Brewster, *Compensation Payments*] (noting that in Texas, wrongly incarcerated individuals are entitled to significant damages upon exoneration, and exploring in the article "how the classification of payments made to wrongfully incarcerated individuals directly dictates their taxability," and arguing that "such payments should not be subject to federal income taxation").

160. *See generally*, Brewster, *Compensation Payments*, *supra* note 159. Although Ms. Brewster argues for exclusion, she is forthcoming in noting that there is no guidance on point. *Id.* at 1429.

161. 18 U.S.C. § 1593.

> as other costs incurred; and (F) any other losses suffered by the victim as a proximate result of the offense.[162]

Under section 104(a)(2), as well as the "in lieu of what" approach to damages, some of these damages would be excluded (unreimbursed medical services, unless previously deducted), and some would not (lost income). The IRS, however, advised recently that these restitution payments are not taxable in their entirety.[163]

I do not mean to take up the arguments surrounding the particular tax treatment of either of these examples. What I do mean to point out, though, is that these examples highlight a central problem of the current tax treatment of damages — its unpredictability. Lack of clarity in the Code, combined with the absence of a theoretical justification for the exclusion in section 104(a)(2) has forced the IRS to take a piece-meal approach, which is what we see reflected in the recent guidance to trafficking victims. Although there are no doubt good reasons why Congress might choose to exclude these mandatory restitution payments from income,[164] the fact of the matter is that they did not,[165] and left the IRS holding the bag.[166]

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162. 18 U.S.C. § 2259(b)(3); *see* § 1593 (providing that "full amount of the victim's losses" has the same definition of the term as that found in section 2259).

163. Notice 2012–12, 2012-6 I.R.B. 365 ("This notice advises taxpayers that mandatory restitution payments awarded to victims of human trafficking under 18 U.S.C. section 1593 are excluded from gross income under section 61 of the Code for federal income tax purposes.").

164. Without purporting to be exhaustive, Congress might be persuaded that the exception is justified because the criminal court's involvement mitigates any concern about allocation arbitrage or other tax gamesmanship. Furthermore, this statute addresses a defined, specific, and limited group of potential recipients of the exclusion. Given that specificity, and the remoteness that any large number of victims will recover significant damages, Congress could reasonably decide to forego the revenue so that the IRS could go after higher dollar disputes. Yet another possibility is that because some of the award appears taxable, and some not, Congress could opt for ease in administration, so as not to burden the U.S. Attorneys prosecuting the cases.

165. The exclusion could very readily have gone into section 1593 of Title 18 itself by simply adding the phrase, "restitution awarded under this section shall be excluded from income under 26 U.S.C. 61."

166. This question likely is largely academic. Despite the criminal law beginning to "assume the same compensatory role as the large private lawsuit," few crime victims ever recover damages from perpetrators. Adam S. Zimmerman & David M. Jaros, *The Criminal Class Action*, 159 U. PA. L. REV. 1385, 1390, 1455 n.41 (2011) (internal citations omitted). Though there is little available data on sex trafficking victims in the United States, it is unlikely that trafficking victims will recover significant amounts through criminal prosecution. Donna M. Hughes, *Combating Sex Trafficking: A Perpetrator-Focused Approach*, 6 U. ST. THOMAS L.J.

V. THE BETTER SOLUTION: FULL INCLUSION WITH JURY AWARENESS

I agree with the call for reform of section 104(a)(2): many reasons support reform, not the least of which is that there is simply no persuasive reason to tax the awards of those victims whose injuries are mental or emotional, but at the same time, exempt awards of those victims whose injuries are physical.[167] Furthermore, I agree with the litany of defects in the current tax treatment of damages as identified by the NTA/ABA in their respective reports.[168] In addition to amplifying those defects noted by the NTA/ABA, I have identified and discussed additional problems plaguing the tax treatment of damages.

I differ with the NTA/ABA, however, regarding the proposed solution. The NTA/ABA proposed changes are unlikely to eliminate the problems plaguing section 104(a). Neither the NTA nor the ABA proposes a sufficiently bright-line rule; the ABA proposal simply shifts the pressure from one line that can be gamed (physical versus non-physical) to another that can similarly be gamed (economic versus non-economic). Simply put, when the problem is line drawing, changing the lines rarely solves the problem. In some respects, the NTA proposal provides a bright line, but the NTA proposal gives away the store, and it creates a tantalizing opportunity for tax gamesmanship, or what I have termed, allocation arbitrage, as well as encouraging specious claims of mental injury. The NTA proposal fails to acknowledge the floodgates that will open if damages on account of nonphysical injury become non-taxable. In this section, I discuss why the full inclusion with jury awareness proposal is the better solution.

28, 40 (2008) (lamenting that as of 2008 "[t]here are no studies of the legal or illegal sex industry in the United States" and noting that one such study was funded in 2005, but never carried out). There has been at least one high profile conviction under the anti-trafficking law that seems to have resulted in victim restitution. United States v. Sabhnani, 599 F.3d 215, 224 (2d Cir. 2010) (millionaire international perfume maker and his wife were convicted of trafficking and ordered to pay nearly one-million dollars in restitution to two victims; the restitution award was remanded for recalculation to exclude overtime pay, but generally upheld on appeal).

167. *See generally* G. Christopher Wright, *Taxation of Personal Injury Awards: Addressing the Mind/Body Dualism That Plagues § 104(a)(2) of the Tax Code*, 60 CATH. U. L. REV. 211, 242 (2010) [hereinafter Wright, *Mind/Body Dualism*] (discussing the inequity and unsoundness of the distinction).

168. *See supra* notes 128–34 and accompanying text (discussing the NTA and ABA reports).

A. The Full Inclusion with Jury Awareness Proposal Is More Likely to Lead to Tax Certainty and Uniformity

As the cases discussed above demonstrate, the level of litigation surrounding the tax treatment of damages suggests that taxpayers and their advisors are not certain about when to include damages and when to properly exclude them. This uncertainly creates unnecessary expense. The expense of litigation is a burden to individual taxpayers and a strain on the IRS. Litigation is unlikely to be stemmed by the NTA proposal because the NTA solution is not sufficiently tax-neutral, and it will lead to aggressive allocations that are likely to be challenged by the IRS.

In contrast, with full inclusion and jury awareness, there should be no derivative litigation between the IRS and taxpayers following a damages recovery. In the usual course, individual taxpayers will be taxed on all damages they receive. Furthermore, the taxability of awards will not depend on the state's tort regime, which is a result that respects state tort policy and provides no tax incentive for parties to forum shop. The NTA proposal contains a possible hidden distinction based on geography. In particular, depending on how courts treat the change in the regulations regarding "tort or tort-type damages,"[169] it is possible that victims of employment discrimination in states that permit "tag-along" claims sounding in tort will benefit but discrimination victims in other states will not.[170] For example, in some states, plaintiffs claiming employment discrimination can also bring a claim for intentional infliction of severe emotional distress. Those plaintiffs, under the NTA proposal, would presumably recover tax-free because they would satisfy the requirement of "tort or tort-like," and they would have a claim for emotional injury. These plaintiffs would thus satisfy the section 104(a)(2) requirements, as modified by the NTA proposal. On the other hand, victims of employment discrimination in states that do not permit such "tag-along" torts would presumably be taxed on their awards in their entirety.

B. The Full Inclusion with Jury Awareness Proposal Reduces Incentives for Specious Claims of Mental Anguish, and Reduces Incentives for Allocation Arbitrage

I agree with the NTA/ABA and other critics of the current system: treating victims of physical injury differently than victims of non-physical

169. *See supra* notes 23–26.

170. CHAMALLAS & WRIGGINS, MEASURE OF INJURY, *supra* note 149, at 78 (2010) (noting the geographic distinctions in permitting tag-along claims).

injury is unsound.[171] I suggest that by excluding non-physical damages, however, we throw open the door to significant tax avoidance and perhaps more damning, to specious claims of mental anguish. Specifically, if we make the NTA/ABA change, every settlement of every wrongful discharge claim will have a provision remarking that the dismissed employee has a nonphysical injury, so that the parties can, by a bit of tax thaumaturgy, render all such awards non-taxable. There is no tax or public policy reason to permit the exclusion of all such settlements. There is no compelling argument that victims of wrongful discharge ought to be taxed at a lower effective rate than other taxpayers (of course they should not be taxed at a higher effective rate, either). Not only would such a proposition give away tax revenue, but by inviting specious claims of mental anguish (or inviting an exaggeration of the value of such claims), we risk undermining the legitimacy of taxpayers who truly do suffer from mental illness. Skepticism of mental illness is already all too common.[172] The NTA/ABA proposal inadvertently risks increasing this skepticism by providing an economic incentive to invent or exaggerate claims of mental injury.

The possibility of specious or exaggerated claims of emotional injury is especially pernicious given the number of Americans who suffer from mental disorder. In the United States, "mental disorders are the leading cause of disability"[173] and a quarter of Americans "suffer from a diagnosable mental disorder in a given year."[174] In many disputes, therefore, the plaintiff will have a mental or emotional injury; that does not necessarily mean,

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171. *E.g.*, Wright, *Mind/Body* Dualism, *supra* note 167, at 242 (discussing the inequity and unsoundness of the distinction).

172. *See, e.g.*, Scott A. Moss & Peter H. Huang, *How the New Economics Can Improve Employment Discrimination Law, and How Economics Can Survive the Demise of the "Rational Actor,"* 51 WM. & MARY L. REV. 183, 221 (2009) (noting the difficulty in sustaining damages for emotional distress absent a professional psychiatric diagnosis); DePianto, The *Hedonic Impact*, *supra* 71, at 117 (2012) (noting the "enduring suspicion" of the importance of emotional tranquility); CAMILLAS & WRIGGINS, MEASURE OF INJURY, *supra* note 149, at 2 (noting the "privileged status of physical harm over emotional and relational injury" which is "sustained by dubious assumptions about the greater seriousness and importance of this type of injury in the lives of ordinary people").

173. *The Numbers Count: Mental Disorders in America*, NAT'L INST. OF MENTAL HEALTH, (citing WORLD HEALTH ORGANIZATION, THE GLOBAL BURDEN OF DISEASE: 2004 UPDATE, Annex A, tbl. A2: *Burden of Disease in DALYs by Cause, Sex and Income Group in WHO Regions, Estimates for 2004* (2008), http://www.who.int/healthinfo/global_burden_disease/GBD_report_2004update_AnnexA.pdf.), http://www.nimh.nih.gov/health/publications/the-numbers-count-mental-disorders-in-america/index.shtml (last visited Jan. 27, 2013).

174. *Id.* (citing Ronald C. Kessler, et. al., *Prevalence, Severity, and Comorbidity of 12-Month DSM-IV Disorders in the National Comorbidity Survey Replication*, 62 ARCHIVES GEN. PSYCHIATRY, 617 (2005)).

however, that the mental or emotional injury was caused or exacerbated by the defendant's acts. Given the potential for shared tax savings and lower out-of-pocket costs, few defendants will have an incentive to challenge the causation or the claim of mental or emotional injury. Even if the defendant wanted to do so, it is difficult to determine causation in the context of mental illness or injury. Furthermore, strong privacy concerns are implicated. We do not want individuals with mental illness or emotional injury to have to offer up their psychiatrist's notes to satisfy a tax requirement, especially where that tax requirement is not based in sound theory.[175]

Just as the parties do not have incentive to police each other's claims of emotional distress, they are rarely adversarial with respect to the issue of allocation (though they almost always are adversarial until that point).[176] Most settlements have no reason to allocate, and to the extent that they do so, the allocation is likely tax-motivated and subject to IRS scrutiny. Indeed, the IRS successfully challenges allocations in many instances.[177] It is unclear, though, that the allocation improves when courts reallocate. As respected commentators have quipped, "[t]he precise dollar amounts allocated to each claim, as is often true in cases such as this, were an arbitrary guess by the court."[178] Despite some re-allocations, it is almost certain that in other instances, parties have succeeded in their allocation arbitrage, and successfully worked the tax system to their mutual advantage. If we implement the NTA/ABA proposal, there will be almost no way for the IRS to catch instances of allocation arbitrage. There would simply be too great of an incentive to engage in such gamesmanship, and it would be increasingly expensive for the IRS to police it. The full inclusion proposal, in contrast, reduces the incentive to engage in allocation arbitrage.

Allocation arbitrage creates a tax-incentive to settle, and to the extent opportunities for allocation arbitrage increase, so too does the incentive to settle. The NTA and ABA proposals exacerbate the tax-incentive to settle by

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175. *See, e.g.*, Kenneth S. Broun, *The Medical Privilege in the Federal Courts — Should It Matter Whether Your Ego or Your Elbow Hurts?*, 38 LOY. L.A. L. REV. 657, 659 (2004) (discussing the important policy animating the physician-patient, and psychologist-patient privilege, and specifically discussing the "protection of basic privacy rights" afforded by recognizing the privilege). A significant scholarship discusses privacy interests in the context of mental health. *See, e.g.*, Jennifer L. Hebert, *Mental Health Records in Sexual Assault Cases: Striking a Balance to Ensure a Fair Trial for Victims and Defendants*, 83 TEX. L. REV. 1453 (2005).

176. Preston R. Burch & James H. Fowles III, *Traversing the Swamp: Understanding the Tax Implications of Settlements and Awards in Employment-Related Litigation*, 17 JAN. S.C. LAW. 28 (2006).

177. *See supra* notes 118–27.

178. BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 7.03 (3d ed. 2012).

increasing significantly the group of disputes with the possibility for allocation arbitrage. Absent the NTA/ABA proposal, only plaintiffs with colorable claims of physical injury face the allocation incentive. With the NTA/ABA proposal, added to that group will be any plaintiff with a colorable claim of mental injury. The full inclusion proposal does not have an artificial settlement incentive.

C. Additional Benefits of the Full Inclusion with Jury Awareness Proposal

The full inclusion with jury awareness proposal takes a small step toward more equal tax treatment of men and women. Admittedly, so would the NTA/ABA proposals. But the full inclusion proposal comes without the problems of the NTA/ABA proposals.

An additional benefit of the full inclusion proposal is that it mitigates a potential conflict between attorneys and clients that exists under the current regime and would be exacerbated under either alternative proposal. In most personal injury disputes, attorneys have a significant incentive to maximize the pre-tax dollars. In contrast, clients care less about pre-tax dollars and simply desire to maximize after-tax dollars. The fee structures of most personal injury retention agreements create these incentives. My proposal avoids this attorney-client tension, by more closely aligning the interests of lawyers with those of their clients. Since under the full inclusion proposal the entire award is taxable regardless of whether the parties settle or try the case, the distinction between pre-tax and after-tax dollars is eliminated. In contrast, the NTA proposal will result in attorneys having incentives to try cases, while their clients, all else being equal, would prefer to settle so they can take aggressive valuations on the tax-free versus taxable component issue.

D. Responding to Objections

The task of grossing up plaintiffs' awards adds an administrative burden.[179] Specifically, in those cases that go to trial, there likely will be expert costs associated with educating the court or jury about the mechanics of a gross up.[180] This added burden and complexity is a potential weakness of the full inclusion proposal. In other words, it might simply be too hard for the jury to deal with the tax issue. I offer two responses to this objection. The first is to attack the underlying proposition: gross-ups might be a bit

179. *See* Polsky & Markel, *Punitive Damages*, *supra* note 8, at 1345–46 (discussing the administrative burden of gross ups in the context of punitive damages).

180. *Id.*

complicated, but juries face difficult questions every day.[181] Some of those difficult questions even involve math.[182] Properly instructed, juries ought to be trusted to calculate a gross-up. As the Supreme Court remarked decades ago, "the practical wisdom of the trial bar and the trial bench has developed effective methods of presenting the essential elements of an expert calculation in a form that is understandable by juries that are increasingly familiar with the complexities of modern life."[183] In that case, the Court "reject[ed] the notion that the introduction of evidence describing a decedent's estimated after-tax earnings is too speculative or complex for a jury."[184] And I suggest the argument that a gross-up is too complex for a jury should be rejected as well.

Should the reader remain skeptical, I offer an alternative approach. If we are not convinced the task of gross-ups should be left to juries, this alternative approach would be to instruct the jury to disregard taxes, and instead permit or require the trial judge to calculate the gross-up following the jury's verdict. This is not a novel concept: many courts currently are tasked with calculating interest in certain instances.[185] No doubt some costs still will be incurred under this alternative approach, such as additional briefing to the court on the proper gross-up calculations. These minimal costs are unlikely to outweigh the significant benefits of the full inclusion with jury awareness rule discussed above.

In those disputes that do not go to trial, it is likely that some minimal additional costs also will be incurred, as the parties will have one more detail (the gross-up) to negotiate. But at the same time, the parties will not have to negotiate, or even discuss, the appropriate tax treatment; there will be no need or potential for allocation arbitrage. The more serious potential drawback is that the additional monetary demand necessitated by the tax due on the damage award will put the parties further apart, dollar-wise, and make the settlement negotiations more difficult. Absent jury awareness, this critique would have even more force. However, with jury awareness, plaintiffs need not absorb the entirety of the tax cost of the settlement. Jury

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181. After all, we trust juries to decide certain aspects of patent disputes, antitrust cases, and complex white-collar crime prosecutions. *See generally* Joe S. Cecil, Valarie P. Hans & Elizabeth C. Wiggins, *Citizen Comprehension of Difficult Issues: Lessons from Civil Jury Trials*, 40 AM. U. L. REV. 727, 729 (1991) (reviewing the literature on jury competence to, among other things, "establish that, although the civil jury has some areas of vulnerability, its ability to render a reasoned and principled decision is far greater than typically acknowledged").

182. *Id.*

183. Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490, 494 (1980).

184. *Id*.

185. *E.g.*, City of Milwaukee v. Cement Div., Nat'l Gypsum Co., 515 U.S. 189, 190 (1995) (discussing calculation of prejudgment interest in admiralty case in which the plaintiff's loss was primarily attributable to its own negligence).

awareness provides the requisite incentives to defendants to settle for appropriate amounts to make plaintiffs whole (or as close to it as the tort regime contemplates) "since settlements are reached in the shadow of what a jury would be expected to award."[186] For this reason, jury awareness is a critical component of my proposal because absent jury awareness, defendants would not have the necessary incentive to gross-up a damages award to an injured plaintiff.

Related to the previous objection, another is that under my proposal, plaintiffs will not be made whole. In a typical personal injury or employment contingency case, about one-third of any award will go to the taxpayer's attorney. If we tax the remaining amount, the plaintiff could end up with too few dollars to be made whole. But even under the current regime, there is no certainty that plaintiffs ever are being made whole. In addition, employment discrimination plaintiffs already face this predicament. Finally, the certainty is really useful. My proposal need not result in harm to tort-victim taxpayers assuming jury awareness, and the gross-up component. Injured taxpayers will know prior to making their settlement demand that any damages received will be taxable; injured taxpayers can simply demand sufficient damages to be made whole, while taking the tax payment into account.

VI. CONCLUSION

In this piece, I have called for including in gross income damages received on account of physical injury. There is no tax reason for the continued exclusion. The exclusion breeds uncertainty, encourages tax arbitrage, and perpetuates disparate treatment of taxpayers that has a gendered result. Given these bad outcomes, two solutions are obvious: do not tax any damages awards, or tax all of them. For the reasons set out above, the better solution is to tax all of them. Anne should not have to ask for a punch in the nose to achieve tax parity.

186. Polsky & Markel, *Punitive Damages*, *supra* note 8, at 1307. *See also*, Oppenheimer, *Verdicts Matter*, *supra* note 9, at 513 ("Verdicts matter . . . not only to the parties and their counsel in those few cases where verdicts are rendered, but also to public policy makers and lawyers evaluating that vast majority of cases that never go to trial. . . . Stories about jury verdicts can have a profound effect on public opinion and public policy.").