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Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?

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I.	INTRODUCTION	329
II.	HISTORY	330
	A. <i>Generally</i>	330
	B. <i>Punitive Damages</i>	332
	C. <i>Prejudgment Interest</i>	335
	D. <i>Damages for Defamation</i>	336
	E. <i>Damages for Discrimination</i>	337
III.	TAX POLICY	340
	A. <i>Containment of Size of Award</i>	340
	B. <i>Return of Human Capital</i>	341
	C. <i>Involuntary Conversion</i>	347
	D. <i>Combination of Considerations</i>	348
	1. <i>Noncommercial Zone</i>	348
	2. <i>Vulturous Behavior</i>	349
	3. <i>Author's Conclusions</i>	352
	E. <i>Income-Connected Damages</i>	352
	1. <i>Given in Mitigation of Personal Loss Rather Than in Substitution for Lost Income</i>	353
	2. <i>Administrative Convenience</i>	353
	F. <i>Injuries to Nonphysical Personal Rights</i>	356
	G. <i>Punitive Damages</i>	358
IV.	BURKE DECISION AND SUBSEQUENT CASES	360
V.	PUNITIVE DAMAGES	366
	A. <i>1989 Statutory Amendment</i>	366
	1. <i>Post-1989 Punitive Damages in Cases In- volving Physical Injury</i>	367
	2. <i>Excludability of Punitive Damages Under Pre-1989 Law</i>	370
	3. <i>Meaning of "Physical"</i>	371

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	B. <i>Apart from 1989 Amendment</i>	371
VI.	AGE DISCRIMINATION	378
VII.	OPERATION OF <i>BURKE</i> STANDARDS	381

I. INTRODUCTION

Since the adoption in 1919 of the Revenue Act of 1918, damages received on account of personal injuries or sickness have been excluded by statute from gross income.¹ This exclusion, which does not apply to reimbursements for medical expenses for which the taxpayer was previously allowed a tax deduction,² is presently set forth in section 104(a)(2). One might expect that a provision having recently attained the ripe age of 75 years without change in its basic language would have a settled meaning. However, recent litigation under section 104(a)(2) bristles with unsettled issues. Does the exclusion apply to punitive damages? To prejudgment interest included in a personal injury recovery? To recoveries under various antidiscrimination statutes?

The Supreme Court entered the fray in 1992 with its decision in *United States v. Burke*,³ dealing with the application of section 104(a)(2) to recoveries in employment discrimination cases. The Court followed a regulation stating that the exclusion applies only to amounts received, through suit or settlement, "based upon tort or tort-type rights,"⁴ and held that a claim is tort or tort-type only if it can be redressed by a broad range of damages, such as those traditionally allowed in tort cases. Specifically, the Court found that a recovery under Title VII of the Civil Rights Act of 1964 was not within the section 104(a)(2) exclusion because Title VII, as it existed when the facts of the case arose, allowed only equitable relief and recoveries of backpay.

If the Court believed that the *Burke* decision would bring order to this corner of the law, it was sadly mistaken. Just how broad must the range of recoverable damages be to make a claim tort or tort-type under *Burke*? Is a claim under the Age Discrimination in Employment Act of 1967 (ADEA)—which allows recovery of backpay plus, in cases where the employer's violation is willful, an equal amount as "liquidated damages"—tort-type? Did the Court mean to say that the exclusion applies to all damages received on a tort or tort-type claim, including punitive damages and prejudgment interest, or only to compensation for the personal injury that gave rise to the claim? The Court has granted certiorari in a case involving the excludability of ADEA recoveries,⁵ and, depending on the scope and clarity of its opinion in

1. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

2. IRC § 104(a); Regs. § 1.104-1(a).

3. 112 S. Ct. 1867 (1992).

4. Regs. § 1.104-1(c).

5. *Schleier v. Commissioner*, 26 F.3d 1119 (5th Cir.), cert. granted, 115 S. Ct. 507 (1994).

that case, it may find it necessary to hear additional cases to settle other issues on which the lower courts have not agreed.

A principal purpose of this article is to suggest that these questions should be resolved with a close eye on the history of section 104(a)(2) and the policies supporting it. Part II is a brief discussion of the history of the tax treatment of damages received for a personal injury. Part III is a discussion of policy justifications for excluding from gross income compensatory damages for personal injuries and the absence of any policy justification for excluding punitive damages. This Part also examines the policy justification for excluding that portion of a personal injury recovery that compensates for lost wages or profits. Part IV discusses the Supreme Court's decision in *Burke* and the decision's effect in subsequent litigation. Part V discusses punitive damages and sets forth the author's reasons for concluding that all punitive damages are included in income. Part VI examines whether damages (including liquidated damages) obtained under the ADEA are within the section 104(a) exclusion. The final Part VII briefly discusses the problems inherent in extension of the exclusion to all tort-type claims arising from a personal injury and whether that extension has led to inappropriate results.

II. HISTORY

A. Generally

The Treasury initially took the position that damages received for personal injury are gross income, analogizing them to the proceeds of accident insurance, which the Treasury assumed to be taxable.⁶ However, in 1918, the Attorney General issued an opinion concluding that accident insurance proceeds are not taxable because they constitute a kind of conversion of human capital caused by the injury.⁷ As a consequence of the Attorney General's opinion, the Treasury promptly revoked the regulation that declared personal injury damages to be taxable, holding instead that "an

6. "[An a]mount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be accounted for as income." Reg. 33, art. 4, Treas. Dec. Int. Rev. 8 (1918).

The history of § 104(a)(2) is recounted in several articles. E.g., Margaret Henning, Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries, 45 Tax Law. 783, 784-95 (1992); James C. Moser, Jr., Note, *Miller v. Commissioner*: The Expanding Scope of the I.R.C. Section 104(a)(2) Exclusion "On Account of Personal Injuries," 44 Ark. L. Rev. 167, 173-82 (1991).

7. 31 Op. Att'y Gen. 304, 308 (1918). The Attorney General's opinion was apparently based on *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918), where the Court defined "income" as "the gain derived from capital, from labor, or from both combined."

amount received by an individual as the result of a suit or compromise for personal injuries sustained by him through accident" is not gross income.⁸

The Revenue Act of 1918, enacted in 1919, included a provision excluding from gross income "[a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness."⁹ The Ways and Means Committee Report on this provision stated:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.¹⁰

Thus, the first statutory antecedent of section 104(a)(2) was adopted in order to codify what Congress believed to be the state of the law at that time and to eliminate the possibility that case law would follow a different path.

The Service initially concluded that the statutory exclusion applied only to damages for physical injuries and that damages for nonphysical personal injuries were taxable.¹¹ However, the Service repudiated that view only a few years later and acknowledged that damages (or a settlement payment) for an invasion of a personal right (e.g., defamation or alienation of affection) was not taxable because such receipts are not gain to the taxpayer.¹² The Board of Tax Appeals (the predecessor of the Tax Court) similarly determined that apart from the statutory exclusion, damages for defamation are not gross income because, in the court's view, the term "income" does not encompass them.¹³ The Service acquiesced in that

8. T.D. 2747, *Treas. Dec. Int. Rev.* 457 (1918).

9. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

10. H.R. Rep. No. 767, 65th Cong., 2d Sess. 9-10 (1918), reprinted in 1939-1 (Part 2) C.B. 86, 92.

11. E.g., Sol. Mem. 1384, 2 C.B. 71 (1920) (holding that damages for alienation of affections (although a personal injury) are taxable); Sol. Mem. 957, 1 C.B. 65 (1919) (holding taxable damages for defamation).

12. Sol. Op. 132, I-1 C.B. 92 (1922), superseded by Rev. Rul. 74-77, 1974-1 C.B. 33 (holding also that damages received for alienation of affections or for custody of a child are excluded from income).

13. *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1024 (1927), acq., VII-1 C.B. 14 (1928). The *Hawkins* opinion implies that if the taxpayer had received punitive damages, they would have been taxable. Since the factual events of the case arose before the effective date

decision, thereby reaffirming its acceptance of the excludability of damages for nonphysical personal injuries.

The exclusion of damages for nonphysical injuries thus was initially grounded on a construction of the term "income" (as employed in the Revenue Acts) rather than on the statutory antecedent to section 104(a)(2). The determination that such damages are within the statutory exclusion for personal injuries came later. Indeed, it was some 45 years later that the courts and the Service held that the statutory exclusion of damages for personal injuries applied equally to physical and nonphysical injuries.¹⁴ Any lingering doubt about the issue was laid to rest by the Supreme Court in its 1992 *Burke*¹⁵ decision in which a majority of the Supreme Court held section 104(a)(2) applicable to damages for nonphysical personal injuries and rejected the contrary suggestion made by Justice Scalia in his concurring opinion.

B. Punitive Damages

The tax treatment of punitive damages has a history of its own. In the 1920 decision in *Eisner v. Macomber*, the Supreme Court adopted the circumscribing definition of "income" as "gain derived from capital, from labor, or from both combined."¹⁶ For some years thereafter, that definition was strictly applied, excluding from gross income any gain not derived from capital or labor. Windfall income (including punitive damages), not being derived from capital or labor, was generally held to be exempt from tax.¹⁷ Accordingly, punitive damages were not taxed until the Supreme Court abandoned the "capital or labor" requirement in its 1955 decision in *Glenshaw Glass*, deciding instead that gross income included, at a minimum, all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."¹⁸ The characterization of income as derived from capital or labor was useful, according to the *Glenshaw Glass* Court, but it is not a delimiting definition of that term. The Court held that

of the 1918 Revenue Act, the court did not pass upon or even discuss the application of the statutory exclusion to nonphysical personal injuries.

14. See *Seay v. Commissioner*, 58 T.C. 32 (1972), acq., 1972-2 C.B. 3. Until 1955, it made little difference whether the exclusion was the product of a statutory exclusion or a narrow construction of the term "income." However, when the meaning of that term was broadened by the Supreme Court's decision in *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), it became important whether nonphysical injuries were within the § 104(a)(2) exclusion.

15. *United States v. Burke*, 112 S. Ct. 1867, 1871 (1992).

16. 252 U.S. 189, 207 (1920) (dealing with the taxation of stock dividends).

17. E.g., *Highland Farms Corp. v. Commissioner*, 42 B.T.A. 1314, 1322 (1940), acq. in result, 1941-1 C.B. 5.

18. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

exemplary damages received for fraud and punitive damages received for anti-trust violations were gross income.

After the decision in *Glenshaw Glass*, the Service asserted that punitive damages in personal injury actions are also taxable.¹⁹ However, the Service reversed course in Revenue Ruling 75-45,²⁰ holding that all damages on account of personal injury, whether punitive or compensatory, are excluded from gross income by section 104(a)(2). The ruling dealt with an award for wrongful death in a state where wrongful death awards were punitive in nature.²¹ In two cases decided in 1983, the position taken by the Service in Revenue Ruling 75-45 was deemed by the Tax Court and by the Ninth Circuit to be a concession that punitive damages are within section 104(a)(2); relying on that concession, those courts excluded punitive damages from income in cases where the personal injury that gave rise to the taxpayer's claim qualified for section 104(a)(2) treatment.²² The opinions in the cases make clear that the Tax Court and the Ninth Circuit rested their holdings on the Service's concession, and did not make independent determinations of whether that section is applicable.

In Revenue Ruling 84-108,²³ the Service revoked Revenue Ruling 75-45, holding that punitive damages are not covered by section 104(a)(2) and are therefore gross income. Revenue Ruling 84-108 dealt with two situations involving awards for wrongful death. In one situation, state law limited a wrongful death award to the amount necessary to compensate the victim's survivors for their pecuniary loss. The Service ruled that these compensatory awards are excluded from gross income by section 104(a)(2). The second situation involved a state law under which wrongful death damages were determined by the degree of fault of the tortfeasor, rather than the amount of loss incurred. The Service classified these damages as punitive, and since punitive damages add to a taxpayer's wealth rather than compensating for loss, it held them to be taxable.

19. Rev. Rul. 58-418, 1958-2 C.B. 18, superseded by Rev. Rul. 85-98, 1985-2 C.B. 51.

20. 1975-1 C.B. 47, revoked by Rev. Rul. 84-108, 1984-2 C.B. 32.

21. While the ruling does not state why wrongful death awards in that state were classified as punitive, it is likely that the amount of the award was based on the degree of the tortfeasor's culpability, rather than the extent of the loss suffered by the victim and the victim's family. See Rev. Rul. 84-108, 1984-2 C.B. 32, 34.

22. *Church v. Commissioner*, 80 T.C. 1104, 1110 n.7 (1983); *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983).

23. 1984-2 C.B. 32. For an analysis of the positions taken by the Commissioner in the 1975 and 1984 rulings, and the courts' construction of the 1975 ruling, see Mary J. Morrison, *Getting a Rule Right and Writing a Wrong Rule: The IRS Demands a Return on All Punitive Damages*, 17 Conn. L. Rev. 39 (1984).

In 1989, in *Miller v. Commissioner*,²⁴ the Tax Court, by a vote of 16 to 2, rejected the reasoning of Revenue Ruling 84-108 and held that punitive damages obtained in connection with a personal injury claim are within the section 104(a)(2) exclusion. The court held that the reference in section 104(a)(2) to "any damages" means all damages, including punitive damages. While the statute requires that the damages be received "on account of personal injuries or sickness," the court construed that requirement as demanding no more than that there be a causal connection between the damages claim and a personal injury. The court noted that most jurisdictions allow punitive damages only to claimants who suffered actual injuries. It concluded that since an actual injury is a prerequisite to a punitive damages award, such damages are on account of that injury, and if the underlying injury is personal, section 104(a)(2) applies to the punitive damages.

The Fourth Circuit Court of Appeals reversed the Tax Court's decision in *Miller*, holding that the presence of a causal link between a personal injury and an award of punitive damages does not satisfy the statutory requirement that the damages be "on account of" a personal injury. According to the court, there must be more than a "but for" causal relationship; the presence of a personal injury must be "sufficient" in itself to qualify the taxpayer to receive the damages.²⁵ In other words, section 104(a)(2) applies only if the personal injury is "sufficient," and not merely "necessary," to obtain the damages. Even if punitive damages are awarded only when there is an actual injury, they are not given unless the tortfeasor's actions are especially reprehensible. The presence of a personal injury therefore is not sufficient, and, in the court's view, punitive damages are therefore taxable.

Section 7641 of the Omnibus Budget Reconciliation Act of 1989 amended section 104(a) to preclude the exclusion of punitive damages received in connection with a claim not involving physical injury or sickness.²⁶ The legislation was adopted after the Tax Court's decision in *Miller* but before the Fourth Circuit reversed that decision.²⁷ Subject to certain

24. 93 T.C. 330, 340 (1989) (reviewed by the court), rev'd sub nom. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

25. *Miller*, 914 F.2d at 589-90.

26. Pub. L. No. 101-239, § 7641, 103 Stat. 2379 (1989).

27. The Tax Court's decision in *Miller* was issued on September 13, 1989, and the Fourth Circuit reversed on September 21, 1990. Neither the House Bill nor the Senate Bill of the 1989 Act contained a provision dealing with punitive damages as such. H.R. 3299, 101st Cong., 1st Sess. (1989); S. 1750, 101st Cong., 1st Sess. (1989). The provision addressing punitive damages came out of the Conference Committee. See H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 622-23 (1989), reprinted in 1989 U.S.C.C.A.N. 3018, 3225-26. The House Bill was introduced on September 20, 1989, and was passed by the House on October 5, 1989. H.R. Rep. No. 147, 101st Cong., 1st Sess. (1989), reprinted in 1989 U.S.C.C.A.N. 1906. The Conference Committee's version of the Bill (which was adopted by the Congress and which

transitional rules, the amendment applies to amounts received after July 10, 1989. The amendment makes no reference to punitive damages connected with a physical injury, whether received before or after July 10, 1989, and the taxation of these damages is one of the principal topics of this article.

As of this writing, no court has passed on the taxability of punitive damages received in a personal injury case after July 10, 1989, but several cases decided since 1989 have involved punitive damages received before that date. Three Courts of Appeals (the Fourth, Ninth, and Federal Circuits) have held that punitive damages are taxable,²⁸ but the Sixth Circuit has held them to be excluded by section 104(a)(2).²⁹ Also, several lower court decisions have divided on this issue, and two of them are pending on appeal.³⁰

C. *Prejudgment Interest*

The exclusion of compensatory damages for personal injury encompasses any portion of the damages that compensates the victim for lost income.³¹ The exclusion applies both to replacements of lost past income and to amounts received to compensate for diminished future earning capacity resulting from the personal injury. It has not yet been resolved whether the exclusion also applies to prejudgment interest—an amount received to compensate for potential income that was lost because the taxpayer was not able to invest or use the awarded damages during the period between the time

was the first version to deal with punitive damages) was promulgated on November 21, 1989. The history of this legislation is described in greater detail later in this article. See *infra* Part V.A.1.

28. *Hawkins v. United States*, 30 F.3d 1077 (9th Cir.) (2-1 decision), cert. denied, 115 S. Ct. 648 (1994); *Reese v. Commissioner*, 24 F.3d 228 (Fed. Cir. 1994); *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

29. *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994) (2-1 decision).

30. E.g., *Estate of Wesson v. United States*, 843 F. Supp. 1119 (D. Miss. 1994) (holding that punitive damages in an action for bad faith are taxable); *O'Gilvie v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567, 71 A.F.T.R.2d (P-H) 93-547 (D. Kan. 1992) (*O'Gilvie II*) (holding that punitive damages in a wrongful death case are excluded from gross income by § 104(a)(2)). Those cases have been appealed to the Fifth and Tenth Circuits. Compare *Rice v. United States*, 834 F. Supp. 1241 (E.D. Cal. 1993) (holding punitive damages taxable), and *Kemp v. Commissioner*, 771 F. Supp. 357 (N.D. Ga. 1991) (same), with *Horton v. Commissioner*, 100 T.C. 93 (1993) (reviewed by the court) (holding that punitive damages arising from personal injury are excluded by § 104(a)(2)), *aff'd*, 33 F.3d 625 (6th Cir. 1994) (2-1 decision), and *Downey v. Commissioner*, 100 T.C. 634, 637 (1993) (*Downey II*) (suggesting that punitive damages are not taxable), *rev'd*, 33 F.3d 836 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

31. Rev. Rul. 85-97, 1985-2 C.B. 50.

of the injury (or the time that suit was filed) and the time of the judgment against the tortfeasor.³²

D. Damages for Defamation

The Service maintained for a brief period that damages for defamation of an individual's business or professional reputation (as contrasted to personal reputation) was taxable.³³ While the Service enjoyed a fleeting success on that issue in a 1982 Tax Court decision, the decision was reversed on appeal,³⁴ and the subsequent cases (including decisions of three Courts of Appeal) repudiated that view.³⁵ The Tax Court itself, in a later case reviewed by the entire court (*Threlkeld*), overruled its prior decision and accepted the view that such damages are excluded from income whether the defamed reputation is business or personal.³⁶ In *Threlkeld*, the Tax Court stated that section 104(a)(2) excludes from gross income compensatory damages "received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."³⁷ The crucial test is whether the injury is a "personal injury." The court further stated: "To determine whether the injury complained of is personal, we must look to the origin and character of the claim . . . and not to the consequences that result from the injury."³⁸ It is now settled that it is the nature of the taxpayer's claim that determines whether damages are excluded from income.

An injury to an individual's reputation damages a personal attribute of the individual, and the fact that a decline in reputation results in a loss of income or profits is merely one manifestation of that injury. If a taxpayer

32. Compare *Kovacs v. Commissioner*, 100 T.C. 124 (1993) (reviewed by the court) (holding that prejudgment interest is taxable), *aff'd* (without published opinion), 25 F.3d 1048 (6th Cir.), cert. denied, 115 S. Ct. 424 (1994), with *Brabson v. United States*, 859 F. Supp. 1360 (D. Colo. 1994) (holding that prejudgment interest is excluded from income). These cases are discussed later in this article. See also *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994) (suggesting that prejudgment interest is taxable). Cf. *Pagliarulo v. Commissioner*, 68 T.C. Memo (CCH) 9171, T.C. Memo (P-H) ¶ 94,506 (1994) (holding that interest on a workmen's compensation award is taxable).

33. See Rev. Rul. 85-143, 1985-2 C.B. 55.

34. *Roemer v. Commissioner*, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

35. *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989), *aff'g* 89 T.C. 632 (1987); *Threlkeld v. Commissioner*, 848 F.2d 81 (6th Cir. 1988); *Bent v. Commissioner*, 835 F.2d 67 (3d Cir. 1987), *aff'g* 87 T.C. 236 (1986).

36. *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986) (reviewed by the court), *aff'd*, 848 F.2d 81 (6th Cir. 1988). The case involved a recovery for injury to the taxpayer's professional reputation caused by malicious prosecution.

37. *Threlkeld*, 87 T.C. at 1308.

38. *Id.* at 1299 (citation omitted).

loses a limb in an accident, all damages received for the injury are excluded from income, even to the extent they are received in substitution of items that would have been taxable if the individual had earned and received them (such as lost wages or profits). The most obvious difference between a taxpayer losing a limb and a taxpayer whose reputation is damaged is that the former suffers a physical injury, while the latter's injury is not physical. The effect of the exclusion of compensatory damages for defamation of an individual's professional or business reputation is to accord the same treatment to damages, whether the injury is physical or nonphysical. Nevertheless, there is a question whether it is good tax policy to exclude damages for nonphysical injuries. That issue is discussed in Parts II and III of this article.

E. Damages for Discrimination

A related, widely litigated issue is whether damages received by victims of discrimination are excluded from income by section 104(a)(2). The Service initially took the position that such damages are taxable because they are merely a substitute for lost income.³⁹ Before 1986, the Service was generally successful in litigating that position,⁴⁰ but the results since then have been mixed.⁴¹ A key authority on this issue is the Supreme Court's 1992 decision in *United States v. Burke*,⁴² which involved the applicability of section 104(a)(2) to damages received under Title VII of the Civil Rights Act of 1984 because of sex discrimination. The damages at issue in *Burke* were for back wages lost by the taxpayers because of the employer's discriminatory acts.

According to the regulations under section 104(a)(2), the term "damages received" . . . means an amount received . . . through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution."⁴³ Only damages (or settlements) received pursuant to a claim that qualifies as a tort or a tort-type right can be excluded under section 104(a)(2). The exclusion does not apply to recoveries for violations of rights more accurately described

39. Rev. Rul. 72-341, 1972-2 C.B. 32.

40. E.g., *Hodge v. Commissioner*, 64 T.C. 616 (1975); *Coats v. Commissioner*, 36 T.C. Memo (CCH) 1650, T.C. Memo (P-H) ¶ 77,407 (1977), aff'd by court order, 626 F.2d 865 (9th Cir. 1980).

41. E.g., *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990); *Rickel v. Commissioner*, 900 F.2d 655 (3d Cir. 1990); *Downey v. Commissioner*, 97 T.C. 150 (1991) (*Downey I*), aff'd on reconsideration, 100 T.C. 634 (1993) (reviewed by the court) (*Downey II*), rev'd, 33 F.3d 836 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

42. 112 S. Ct. 1867 (1992).

43. Regs. § 1.104-1(c).

as contract rights.⁴⁴ For that reason, several courts, including the Supreme Court, have held that a crucial step in applying section 104(a)(2) is determining the nature of the claim underlying the taxpayer's damages or a settlement.

In *Burke*, the Supreme Court held that the characterization of a claim as tort or tort-type depends upon the breadth of the remedies for such claims. The common law (and present state laws) permit a wide range of remedies for tort victims. Recovery is allowed for lost wages or profits, medical expenses, and diminished future earning capacity. In addition to recoveries for pecuniary losses, recovery is also permitted for such nonpecuniary items as pain and suffering, emotional or mental distress, and personal humiliation. Punitive or exemplary damages are generally available if the wrongdoer's conduct was intentional or reckless. The Court held that if the remedies for a violation of an individual's rights are significantly narrower than those typically available to tort victims, damages or a settlement obtained for the violation is not based on a tort or tort-type claim, and the amounts received are taxable.

At the time of the facts of *Burke*, the remedies for Title VII violations were restricted to compensation for lost wages and equitable relief, including reinstatement or elevation to a job. The Court found that the range of damages then available to a claimant under Title VII was too restricted to qualify the claims as tort or tort-type claims, and it held the taxpayers' damages to be taxable. The Court contrasted the remedies then provided by Title VII with the broad range of remedies under other antidiscrimination statutes, including the remedies under 42 U.S.C. section 1981 for victims of race-based employment discrimination. The Court noted that Title VII was amended in 1991 to expand the available remedies, but because the facts of the *Burke* case arose before the effective date of that amendment, the Court did not pass upon the treatment of damages in cases governed by the amended statute.

Two types of discrimination are proscribed by Title VII of the Civil Rights Act of 1964.⁴⁵ One type is a "disparate treatment" violation—where an employer intentionally discriminated against an individual, with respect to compensation or other employment terms, because of the individual's race, color, religion, sex, or national origin. The second type (a "disparate impact" violation) consists of facially neutral employment practices, not necessary for business purposes, that have a disparate impact on persons within a protected class (e.g., persons within a group classified by race or gender). A violation

44. *Burke*, 112 S. Ct. at 1877-78 (Justice Souter concurring).

45. 42 U.S.C. § 2000(e) et. seq.

of the second type can occur whether or not the employer intended that the disparate impact occur.⁴⁶

The Civil Rights Act of 1991 added a new provision to Title VII (section 1981a) that expanded the range of relief available for disparate treatment violations—intentional acts of discrimination by an employer. In such cases, compensatory damages can be awarded for nonpecuniary injuries, and punitive damages are allowable in some cases. This provision does not apply to disparate impact cases, for which the available relief continues to be only backpay and equitable relief.

In summary, under the *Burke* construction of section 104(a)(2), compensatory damages received by a discrimination victim are excluded only if the damages claim is of a type that can be redressed by a wide range of remedies. It is not necessary that a range of remedies actually be awarded to the taxpayer; it is only necessary that the claim arise under a law that permits a wide range of remedies. Even if the sole remedy actually awarded to the taxpayer is back wages, the damages are excluded if the taxpayer's claim qualifies as a tort or tort-type claim.⁴⁷ The Service has acknowledged that the section 104(a)(2) exclusion covers compensatory damages for race-based discrimination under 42 U.S.C. section 1981 and compensatory damages received under the amended version of Title VII for disparate treatment type of discrimination.⁴⁸ However, damages received under Title VII for disparate impact violations are taxable because of the limited range of remedies available for those claims.

The Courts of Appeals are divided over whether compensatory damages received under the Age Discrimination in Employment Act of 1967 (ADEA) are taxable, and the Supreme Court has granted certiorari from the Fifth Circuit's unpublished decision on that issue in *Schleier v. Commissioner*.⁴⁹

46. For a discussion of the employment discrimination provisions of Title VII and of the remedies available to victims of violations of those provisions, see Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 *Tax Law.* 755, 768-70 (1993).

47. Rev. Rul. 93-88, 1993-2 C.B. 61.

48. *Id.* In that ruling, the Service acknowledged that damages under the Americans With Disabilities Act (42 U.S.C. §§ 12101-12213) are excluded from income.

49. 26 F.3d 1119 (5th Cir.), cert. granted, 115 S. Ct. 507 (1994). The circuit court split is evidenced by *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994) (holding that damages received pursuant to an ADEA claim are taxable), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999), and *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994) (holding that such damages are excluded by § 104(a)(2)), petition for cert. filed, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944). This issue is discussed below in Parts IV and VI.

III. TAX POLICY

Several rationales have been suggested for the exclusion of personal injury damages from gross income. In this Part, the author describes and critiques some of those suggestions and offers his own explanation.

A. *Containment of Size of Award*

One suggested explanation for the exclusion, which the author does not believe to be sufficiently credible to justify extensive discussion, is that the purpose of the provision is to prevent the awarding of exorbitantly large judgements that, in the absence of the exclusion, might be required to provide a victim with sufficient after-tax dollars to compensate for the injury.⁵⁰

If personal injury damages paid in a lump sum were taxed when received, there would be a bunching of income in that year. Part of the damages could possibly be viewed as a replacement of the appreciation of value in the damaged item that had occurred gradually over many years, and another part of the damages might be a substitute for the loss of income that would have been earned over many years if the victim had not been injured. If the realization of the appreciation of personal rights and the substitution for several years of income were bunched into one year, the rate of tax would likely be in the higher brackets. To provide full compensation, the amount payable to the victim would have to be increased to cover some part of the tax on the damages, that increase in the damages would itself be taxed and cause the imposition of even more taxes for which taxable compensation would be made, and so on. While that is a daunting prospect, there are several reasons to conclude that the containment of damage awards is not the object of section 104(a)(2).

In the first place, Congress had no reason to believe that state laws on tort damages would be adjusted to pass the benefit of the income tax exclusion to the tortfeasor. In fact, a significant number of states do not do so. The determination of damages is not influenced by section 104(a) unless either (1) the trier of facts (often a jury) is informed that an award to the victim will not be taxed or (2) the calculation of the victim's lost income takes account of the nontaxability of damages by reducing the loss by the amount of income tax that the victim would likely have incurred if the income had been earned rather than lost. State laws are divided on whether to so inform a jury and whether to reduce damages by the tax liability that it is estimated the victim would have incurred. A substantial number of states

50. See Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 *Cornell L. Rev.* 701, 719-22 (1977) (rejecting this suggestion).

prohibit information about nontaxability from being given to the jury, some states require it to be given, and some states leave the matter to the discretion of the trial judge.⁵¹ Similarly, the states are divided over whether income taxes should be taken into account in calculating a victim's lost income.⁵² While the Supreme Court has required that federal taxes be taken into account in FELA cases (thereby reducing the size of the awards),⁵³ that has not bound federal courts in cases involving other statutes.⁵⁴

Moreover, if there were concern that the taxation of such damages would create excessively high awards because of bunching problems, the better solution would be to adopt an income-averaging system rather than to exclude damages from income.⁵⁵ If full taxability would overburden tortfeasors, the exclusion errs more obviously in the other direction, thrusting portions of the costs of torts on the taxpaying public and compromising one of the fundamental policies of tort law—to encourage tort-free behavior by placing on tortfeasors the full costs of their wrongs.

B. *Return of Human Capital*

While there is uncertainty as to precisely what considerations led Congress to adopt the antecedent to section 104(a)(2), the background history of the provision suggests that Congress focused on a "return of human capital" theory. The first pronouncement of an exclusion for personal injury recoveries was made by the Attorney General in an opinion promulgated in 1918 concerning accident insurance proceeds.⁵⁶ The opinion indicates that the rationale for the exclusion was that accident insurance proceeds merely provide a monetary substitution for a personal attribute that was lost as a consequence of an accident. It seems likely that a similar rationale underlay the Treasury's 1918 determination that personal injury damages are excludable because the Treasury's reversal of its prior regulatory position was made

51. See John E. Theuman, Annotation, Propriety of Taking Income Tax into Consideration in Fixing Damages in Personal Injury or Death Action, 16 A.L.R.4th 589, 594-602 (1982).

52. *Id.* at 605-16.

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

54. *E.g.*, *Estate of Spinosa v. International Harvester Co.*, 621 F.2d 1154, 1158 (1st Cir. 1980). In *Purcell v. Seguin State Bank & Trust Co.*, 999 F.2d 950 (5th Cir. 1993), the court affirmed an award of compensatory damages for age discrimination in employment, which the lower court determined with a reduction for the income taxes that the plaintiff would have borne on the lost income.

55. The operation of a typical income-averaging provision is described *infra* note 81.

56. 31 Op. Att'y Gen. 304, 308 (1918).

in response to the Attorney General's opinion.⁵⁷ Since the 1919 legislation that enacted the antecedent to section 104(a)(2) was intended to codify the positions previously adopted by the Treasury and the Attorney General, it seems likely that Congress was motivated by the same rationale.⁵⁸ This rationale is sometimes described as a "return of capital" or as a "return of human capital" theory.

The human capital theory has recently been criticized by courts and by commentators.⁵⁹ Moreover, even if the theory was the original rationale for the statutory exclusion, it is not necessary to accept the theory as the justification for *retaining* the exclusion. A statute may be adopted for a reason that is later abandoned, but the statute may be retained for quite different reasons. Also, legislators may have a strong visceral belief that a remedy is needed, but not be able to ascertain the principles upon which that belief is founded. Thus, even when the legislative history sets forth a rationale for a provision, the rationale actually underlying the legislation may be something quite different because the legislators are then unable to articulate the true rationale.

Legal realism teaches that the principle underlying a judicial decision may be different from the one expressed in the court's opinion. The true underlying principle may be one that is not fully perceived by the judge when writing the opinion and is only discovered years later after there has been experience with a wide variety of factual circumstances to which a common principle must be applied. The flexibility of the legal system allows the cumulative wisdom of many judges, gained over time, to uncover the controlling principle for an issue when that principle may have been intuitively felt but not fully comprehended by the judges who wrote the opinions in the earlier cases. This flexibility prevents the law from being held captive to premature expressions of only dimly comprehended rationalizations, and the resulting capacity for building on the courts' initial grappling with new issues is a significant part of the genius of the common law.

The same process of rationalization can take place with legislation, and the underlying principle for a statute should be determined with the same flexibility that is applied to judicial decisions. This is especially appropriate

57. See *supra* note 8.

58. See *supra* notes 9, 10 and accompanying text. Also, shortly after the statutory exclusion was enacted, the Service characterized excludable damages as substitutes for lost personal rights that are not assignable to other persons and cannot be valued since they are not traded in the market place. Sol. Op. 132, I-1 C.B. 92 (1922), superseded by Rev. Rul. 74-77, 1977-1 C.B. 33.

59. E.g., *Downey v. Commissioner*, 97 T.C. 150, 159 (1991) (reviewed by the court) (*Downey I*), rev'd, 33 F.3d 836 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999); *Hawkins v. United States*, 30 F.3d 1077 (9th Cir.) (Trott, J., dissenting), cert. denied, 115 S. Ct. 648 (1994); Yorio, *supra* note 50, at 711-13.

in light of the fact that a statute is adopted by the combined vote of several individuals who likely have diverse reasons for their support. It is the function of the courts and of the government agencies that administer a provision to reconcile the terms of a statutory provision with the purposes that it serves and with the overall policies of the larger statutory scheme of which that individual provision is a part.

For several reasons, the human capital theory, standing alone, does not adequately justify section 104(a)(2). First, a basic premise of the theory—that personal injury recoveries should not be taxed because they merely replace the unascertainable value of what the victim lost—is inconsistent with the rules generally applied to dispositions of property. On a disposition of property, gain or loss is measured as the difference between the amount realized and the taxpayer's basis for the property.⁶⁰ The *value* of the asset when sold or destroyed is irrelevant for this purpose. For example, if *X* owns a rare vase in which she has a basis of \$1,000 when it is destroyed by the negligence of *Y*, compensation for the loss received from *Y* is gain to the extent it exceeds *X*'s \$1,000 basis, without regard to the vase's value. Assume the vase was worth, say, \$50,000 before it was destroyed, but *X* accepts \$28,000 as compensation for the loss because she believes that she could not obtain more, given *Y*'s financial resources.⁶¹ Even though the compensation is substantially less than the value of the destroyed item, *X* recognizes gain of \$27,000 (the difference between the amount received and the vase's basis). If damages for the loss of personal rights are to be treated differently, the reason does not lie exclusively in the impossibility of measuring the value of those rights.

Second, justification for the exclusion does not flow from the difficulties of determining the basis (if any) that a tort victim has in the body parts or personal rights that were damaged. A taxpayer has the burden of establishing basis,⁶² and if none can be established, basis is deemed to be zero. Since people do not anticipate having parts of their bodies (or personal rights) converted into cash, they do not keep records of any capital expenditures that may have been made in connection therewith, and it might seem appropriate to accord them relief by excluding all or part of their recoveries.⁶³ However, it is highly unlikely that a person has any basis in body parts. Most expenditures that might conceivably be attributed to body parts

60. IRC § 1001(a).

61. Also, assume *X* purchases no replacement property. If *X* reinvested all or part of the proceeds in replacement property, all or part of her gain would be deferred under § 1033.

62. E.g., *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 114 (1st Cir.), cert. denied, 323 U.S. 779 (1944).

63. See Joseph M. Dodge, *Taxes and Torts*, 77 *Cornell L. Rev.* 143, 152 (1992).

(such as purchases of food, clothing, and medical care) cannot be apportioned among them on any rational basis. Moreover, to the extent that an allocation is feasible, amounts allocated to particular parts are usually in the nature of maintenance and repairs, and such expenditures cannot be capitalized as basis. Although maintenance and repairs can be deducted only when incurred in connection with a business or profit venture,⁶⁴ they are not capital expenditures, and so are not included in basis, whether or not they were deductible.⁶⁵ It therefore is highly unlikely that anyone has a meaningful basis in body parts, and it would be overly generous to exclude damages received for a personal injury solely because of the understandable failure of persons to keep records of their investment in their bodies.

There is a remote possibility that an individual might have a basis in some personal rights. For example, a portion of the amounts expended in obtaining a college or professional education (some portion of which could conceivably be a capital expenditure) might be included in the basis of a person's reputation. Even if such an allocation were theoretically justified, no actual allocation is likely to be made because the problems in determining the amount to be allocated are mind-boggling. In the case of compensation received for an injured reputation, one possible solution to the basis problem would be to arbitrarily exclude from income some part of the compensation. However, the basis of a taxpayer's reputation would be quite small and would justify excluding no more than a small amount of compensation. Moreover, in the normal course of exploiting one's reputation in business or professional life, no deduction is allowed against the resulting income for the cost of the reputation expended in earning the income. Finally, as shown later in this Part, when everything is taken into account, the policy justification for excluding damages received for nonphysical injuries is much weaker than the case for physical injuries.

Third, some courts and commentators have suggested that the human capital theory is undercut by the fact that the section 104(a)(2) exclusion extends to damages in substitution for lost income.⁶⁶ This is a different point from the one that the author makes below in asserting that if the human capital theory were valid and were applied consistently throughout the tax law, gain from a *sale* of a personal right would not be taxed. The author does not share the view that the statutory exclusion of damages for lost income is inconsistent with the human capital justification. While the recovery of human capital theory does not support the statutory treatment of damages for lost income, that treatment is not inconsistent with the theory; rather, it rests

64. Regs. § 1.162-4.

65. See I.T. 4094, 1952-2 C.B. 134 (holding that the cost of repainting a personal residence is not a proper adjustment to its basis).

66. See, e.g., Yorio, *supra* note 50, at 712.

on a separate, independent rationale. The reason for excluding compensation for lost income is discussed below in Part III.E.

This reason does not encompass interest. Section 104(a)(2) was amended in 1983 to permit personal injury damages to be received in periodic installments without causing the recipient to be taxed on the interest element in the deferred receipts. If an interest element were to be segregated and taxed, the interest portion could be calculated only if Congress settled on a rate of interest, and the computation might be quite complex if future installments are contingent. Congress most likely decided against the imputation of interest on periodic payments of damages in order to avoid the administrative burden of making those calculations. However, in requiring the imputation of interest in many other deferred payment contexts, Congress has not been deterred by the burden of the calculations. The difficulty of making an imputed interest calculation is of a much lesser order of magnitude than the difficulty of separating income-related damages from a lump sum damage award or settlement, as discussed in Part III.E.2 of this article. Rather than raising questions as to whether there is a discernable purpose underlying section 104(a)(2), the weakness of the independent justification that underlies the 1983 amendment merely raises the question of whether the adoption of that amendment was wise.

The justification for the 1983 amendment, weak as it may be, does not support an exclusion of prejudgment interest. While the computational burden of imputing interest on sums payable in periodic installments would not be overwhelming, it is meaningful. Prejudgment interest, on the other hand, is at a specified rate for an easily determinable period of time, and the calculation of the amount of that interest presents no difficulty.

Finally, and most significantly, the human capital rationale does not jibe with the tax law's treatment of voluntary dispositions of human capital. The section 104(a)(2) exclusion applies only to damages (or to a settlement of a claim for damages) received on account of a personal injury or sickness. It has no application to an individual's voluntary sale of a body part or personal right. Federal law prohibits the sale of human organs.⁶⁷ But, if such a sale were permitted or were made in violation of the law (if, for example, a kidney were sold to a person needing a transplant), the entire amount received by the seller would be taxed as gain. It would not matter that the amount realized merely replaced a part of the seller's human capital or that the organ's basis is unascertainable. The prohibition against the sale of a human organ does not apply to the sale of blood, and it is well established that an amount realized by an individual on a sale of blood is ordinary

67. National Organ Transplant Act, § 301, 42 U.S.C. § 274e(a) (1988).

income.⁶⁸ Although damages for an invasion of privacy (e.g., the use of the taxpayer's picture for a commercial or advertising program) are likely excluded from income by section 104(a)(2), an amount received in a voluntary sale of the right to use the taxpayer's picture in a commercial program is taxable.

It is clear then that not all payments that substitute a monetary payment for a personal right or human capital are excluded from income. Thus, neither the fact of such a substitution nor the unascertainable basis of such items is sufficient by itself to justify an exclusion from income. However, the human capital consideration might be combined with other factors to justify the exclusion provided by section 104(a)(2). The author later considers that possibility.

The human capital theory might derive from the tax treatment of damages reimbursing expenditures made by the taxpayer. To the extent a damage recovery is attributable to dollars spent by the taxpayer and therefore is merely substitution for those dollars, it should not be taxable, whether or not section 104(a)(2) applies, unless a deduction was allowed for the expenditures. For example, a reimbursement for an injured person's medical expenses is excluded from income unless a deduction was allowed for the expenditures.⁶⁹ Similarly, if a taxpayer's property was destroyed by wrongful act, damages received for the loss of the property are taxable only to the extent that they exceed the taxpayer's basis for the property. Such treatment is no different than the tax treatment that would have applied if the taxpayer had sold the property before it was destroyed. Another illustration of this principle arose in a 1939 Board of Tax Appeals case, *Clark v. Commissioner*,⁷⁰ involving a taxpayer who had overpaid a federal tax liability because of poor advice received from his attorney. The court held that the attorney's reimbursement of the amount overpaid was not included in the taxpayer's income.

It is possible that the principle of allowing tax-free reimbursement of lost dollars was extended by those who conceived the human capital theory

68. In *Green v. Commissioner*, 74 T.C. 1229 (1980), the Tax Court held that payments received for the sale of blood are gross income. The taxpayer in *Green* did not dispute the taxability of such receipts, but claimed that she should be allowed deductions for expenses related to the sale. Nevertheless, the court passed on the issue of taxability. In *Lary v. United States*, 787 F.2d 1538 (11th Cir. 1986), the court denied a charitable deduction for a blood donation because, if the taxpayer had sold his blood, he would have recognized ordinary income equal to the amount received. No charitable deduction is allowed for the amount of a contribution that would have been ordinary income if the item had instead been sold by the donor for its fair market value. IRC § 170(e)(1)(A).

69. IRC § 104(a); Regs. § 1.104-1(a). A recovery of a previously deducted amount is taxed because the injured person would otherwise be left with a double tax benefit.

70. 40 B.T.A. 333 (1939), acq., 1957-1 C.B. 4.

to cover amounts received in substitution for a loss of personal rights or human capital. That extension has some superficial appeal, but as noted above, it does not withstand scrutiny. The tax treatment of the voluntary sale of such personal rights indicates that the return of human capital rationale is inadequate by itself to explain section 104(a)(2).

C. *Involuntary Conversion*

Another rationale suggested for section 104(a)(2) is that since the taxpayer did not choose to dispose of the damaged personal right or body part, it seems rapacious to tax damages received as compensation for such a personal loss. Relief is provided when damages are received to compensate for a destruction of tangible property. Gain is realized to the extent that the damages exceed the taxpayer's basis in the property. The involuntariness of the conversion of the item into cash arouses sympathy because of the forced realization of previously unrealized gain accrued to the property. Section 1033 provides relief for a taxpayer in that predicament: If, within a specified period of time, the taxpayer acquires property similar or related in service or use to the destroyed property, the gain realized on the conversion is taxed only to the extent the conversion proceeds exceed the cost of the replacement property. The taxpayer's investment in the destroyed item is rolled over and becomes part of the taxpayer's basis in the replacement property. In effect, the taxpayer's realized gain is deferred, at least in part, until the taxpayer disposes of the replacement property (or until the taxpayer is allowed depreciation deductions for that property if it is depreciable).

The question then is whether, in the case of a personal injury recovery, the involuntariness of the conversion of the taxpayer's personal rights or body parts is a sufficient justification for not taxing the damages received. In most such cases, the taxpayer has no means of reinvesting the proceeds in something similar or related in service or use to the destroyed item. If such a replacement can be located, the replacement is usually only partial, and its cost is often substantially less than the amount of damages suffered by the taxpayer, making a section 1033 deferral concept of little value. For example, a lost arm can be replaced with an artificial limb, but an artificial limb replaces only part of the function of the lost arm, and its cost is likely far less than the damages recoverable for the injury. Much of what the taxpayer lost cannot be replaced by anything similar in use.

Since a deferral of gain is not readily available, should the taxpayer be taxed on the entire amount of the gain at the time of receipt or should some relief be accorded? The taxation of damages received in a lump sum in one year may cause a bunching of income that subjects the taxpayer to a

large tax because of the operation of the graduated rates,⁷¹ and one might at least expect some relief from the bunching effect, perhaps by a form of income-averaging. Section 104(a)(2) instead excludes all such damages from income permanently, an approach not well crafted to provide relief from the bunching effect. Involuntariness alone is not a sufficient justification for this extraordinary exclusionary treatment since the involuntary conversion of tangible property is not treated so gently.

D. *Combination of Considerations.*

Given the sympathy that a personal injury engenders, the section 104(a)(2) exclusion is perhaps warranted by the combination of the fact that a personal right or body part was destroyed (the return of human capital theory) and the involuntariness of the conversion. That is, even though neither factor alone is sufficient, the cumulative effect of the combination of the factors may be sufficient. The whole may well be greater than the sum of its parts.

The author believes that there are two additional factors that color the combination of the human capital theory and the involuntariness of the conversion of a body part, and the addition of that coloration makes a compelling case for the exclusion of such damages when given for a physical injury.

1. *Noncommercial Zone.*—The tax law is aimed at market transactions. Gain on a sale of an item held for personal use, such as a residence or a piece of jewelry, is taxed, but, in such cases, the taxpayer has chosen to place the item into the commercial market by putting it up for sale. Moreover, those types of property are commonly bought and sold in the market place and are properly regarded as commercial items. In contrast, noncommercial personal attributes are not traded in the market and lie far outside the zone of properties and activities that comprise the sphere of the tax laws' operation.

For example, if two persons exchange their services, each must typically include in income an amount equal to the value of the services received from the other.⁷² However, when a husband and wife exchange

71. Bunching can arise from the recognition in one year of appreciation in the value of the destroyed right that has taken place over many prior years. It can also arise from the receipt of a lump sum payment for a loss of income that would have been earned over several future years if the injury had not occurred. Later in this Part, the author questions whether damages for a physical injury truly are a substitute for lost monetary value. On the other hand, a proposal to tax such damages rests in part on the premise that the damages are a substitute. If so, that raises a bunching problem that needs to be addressed.

72. Regs. § 1.61-2(d)(1).

their services by splitting household chores between them, neither recognizes income.⁷³ Similarly, if several persons living in Manhattan, each of whom owns a small piece of land on Long Island on which vegetables are grown, agree to take turns travelling to Long Island and watering the gardens owned by all of them, they are exchanging services, but they should not be taxed on that exchange because it occurs outside the market. Another example of activities within a noncommercial zone is a baby-sitting club in which parents sit for each other's children under a kind of barter arrangement. On the other hand, bartered exchanges can become so structured and substantial that they represent more than joint activities, in which case the parties have moved into the commercial sphere and their bartered exchange should be taxable.

When a part of an individual's body is damaged or destroyed, what has been taken from the individual is predominantly of a noncommercial nature. Since humans are engaged in commercial activities, their bodies and personal attributes are inexorably entwined with those activities. However, an individual's body and personal attributes are merely *used* in commercial activities; they are not detached and sold in the market place. It is a rare person who would contemplate the sale of body parts to be removed from him while still alive. If such a transaction were to take place, the individual would have committed the sale of that body part to a commercial venture; there is no reason for the tax law to exempt from taxation the gain from such a sale, and it does not do so. However, if a body part is destroyed or injured, the compensation that the victim receives is not the product of having voluntarily committed that part to a commercial sale. Although the victim must actively seek reparations in order to be compensated, that is the consequence of the injury and is not a voluntary entrance into the commercial market.

2. *Vulturous Behavior.*—Perhaps, the most important consideration that weighs against taxing such damages is the heartlessness of the government profiting from the tort law's attempt to soften the blow that a victim has suffered. Monetary damages are not true truly substitutes for a victim's loss, but, at most, some mitigation of it. Much of the loss is not monetary, but only monetary damages can be given because no substitute is available to replace what was lost. If the government were to tax damages for the loss of a body part (or for the death of a relative), it would seem to many to have engaged in a vulturous act—analogueous to feeding off of the flesh of a dismembered arm or leg or off of the corpse of a recently departed.

73. No statute or regulation expressly exempts a spousal exchange of services from taxation. Under § 1041, which was added in 1984, no gain or loss is recognized on an interspousal transfer of *property*, but the provision does not address the tax consequences of exchanging services. The Service has never sought to tax interspousal exchanges of services, and the exclusion of such exchanges is part of the unwritten law of taxation.

The compassionate motivation for the exclusion has much greater force when the damages compensate for physical injury than when the injury is not physical. Even physical injuries are not always severe, and a minor injury (such as a sprained ankle) does not create so much sympathy that it makes the taxation of damages received for the injury unpalatable.⁷⁴ However, there are several reasons why the existence of minor physical injuries detracts little from the validity of the theory that the repression of vulturous behavior is a major justification for the exclusion. While the author has no empirical data, his intuition is that most of the dollars obtained as damages and settlements for physical injuries involve serious harm. The costs of obtaining damages for minor injuries discourage victims from prosecuting their claims, and those who do pursue them obtain only small amounts. Since damages for a minor injury are usually small, it is not worth the administrative hassle to establish and enforce criteria to distinguish between major and minor physical injuries. Consequently, the sympathy aroused for major physical injuries spills over to provide relief for the less worthy sufferers of minor injuries. It is not uncommon that the compelling concerns that cause the adoption of a relief provision also benefit a limited number of persons who are fortunate enough to fall within the scope of the remedial provision, even though their plight is not the one that triggered its adoption. Taxation is a practical enterprise, and it is not always practical to restrict a provision's application to those on whose behalf it was passed.

The compassionate justification and the human capital justification apply more readily to damages for noneconomic injuries than to damages for lost income. The justification for excluding damages for lost income is discussed below in Part III.E.

The compassionate justification rests (at least in part) on the notion that damages for noneconomic injuries are compensatory in nature. However, many commentators view the function of such damages quite differently, and some believe that damages for noneconomic losses, such as pain and suffering, mental anguish, and humiliation, should not be allowed in negligence cases.⁷⁵

There are numerous theories as to why tort law typically allows noneconomic damages. One possibility is that, while the victim has suffered a real loss for which compensation should be provided, monetary damages are the only available means of compensation. If no damages were given for noneconomic injuries, the victim might feel that the loss is lightly regarded.

74. See J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 *Mont. L. Rev.* 13, 43-44 (1989) (making that observation).

75. See, e.g., *Seffert v. Los Angeles Transit Lines*, 364 P.2d 337, 344-47 (Cal. 1961) (Traynor, J., dissenting) and the articles cited therein.

The monetary compensation for such losses assures the victim's personal integrity and is testimony that society regards the violation of that integrity as a serious matter. Monetary damages for noneconomic loss can be viewed as an effort to assuage the victim's anger at the injury and to reestablish the victim's self-confidence in his personal integrity.⁷⁶ If such damages serve only these symbolic purposes, taxation of the damages would not have a rapacious or vulturous appearance because the requirement that the tortfeasor pay is sufficient to secure those purposes.

Another view describes damages for noneconomic injuries as a punitive measure designed to deter negligent acts. The damages raise the price of negligence in order to make it economically prudent for businesses to expend the amounts needed to provide greater safety. If that view is correct, there is no justification for not taxing the damages.

However, it is far from certain that either of the two views described immediately above is correct. The victim has suffered a genuine loss, and while monetary damages are not a substitute for what was lost, they can be seen as an attempt to compensate for that loss by the only means available. Compensation is an effort to balance the scales so as to put the victim as near to the same condition that he had before the injury as is feasible. That it is not possible to substitute the same item that was lost, and that the personal loss from a serious injury to a body part cannot be measured in monetary terms, does not mean that the monetary damages given to the victim do not serve a compensatory purpose.

Each of the several theories as to why damages are provided for noneconomic losses is plausible. A dispositive case cannot be made that one of those explanations is better than another. Congress apparently adopted the explanation that the damages for noneconomic losses are designed to mitigate the victim's loss. Since that explanation is at least as good as any other, there is no basis to challenge the choice that Congress made.

In any event, whatever some commentators may believe, the commonly held view of such damages (including the view generally held by American courts) is that they are compensatory and are intended to provide relief for the victim's injury. Even if that view does not withstand an economic analysis (and even if such an analysis is considered dispositive of the issue), the prevalence of that view would make the government appear rapacious if it were to tax noneconomic damages. Our self-assessment system

76. See Louis L. Jaffe, *Damages for Personal Injury: The Impact of Insurance*, 18 *Law & Contemp. Probs.* 219 (1953). While recognizing the consolatory role of noneconomic damages, Professor White has opined that American courts conceive of such recoveries "as essentially compensatory rather than as consolatory," at least where the victim suffered physical injury. Patricia D. White, *Pain and Suffering and the Law*, 2 *Biolaw S:113, S:117* (1988).

of taxation relies on a willingness of the populace to report honestly to the government, and that willingness rests on a popular belief that the government's system of taxation is fair. The government should therefore take into account not only whether the taxation of such damages would be vulturous, but also whether it would appear to the general population to be so. While the appearance of fairness is not always a strong enough consideration to control the tax treatment of an item, it should be taken into account, especially in a case such as this where the view that such damages have a noncompensatory nature rests on an opinion that is not widely shared.

3. *Author's Conclusions.*—In the author's view, the noncommercial and nonmonetary nature of a destroyed or injured body part and the vulturous portrait that would be painted by the government's profiting from a personal tragedy explain why a suggestion that the damages for such an injury be taxed is typically met with a vigorous renunciation.⁷⁷ A body part is not perceived to be a commercial item, the taxpayer never sought to commercialize its value by selling it, and the damages mitigate the loss of a personal attribute the value of which never would have been taxed if the injury had not occurred. The damages received for the loss of a body part are widely viewed as mitigation of the victim's loss. A diversion of a portion of those damages to the government would impair that mitigation. While a strict application of such tax concepts as basis and the measurement of gain lead to the taxation of such receipts, the countervailing considerations are very strong. As with many tax provisions, the appropriateness of retaining them depends upon value judgments.

E. *Income-Connected Damages*

Personal injury damages compensating for the loss of income (backpay and compensation for the loss of potential future income) are also excluded from income by section 104(a)(2).⁷⁸ For convenience, the damages compensating for income loss are sometimes referred to here as "income-connected damages." Such damages might be viewed as a substitute for

77. The author has often raised this issue with students in his basic income tax course. Many students find it difficult even to consider seriously a proposal to tax damages for physical injuries. Some years ago, when the author was teaching as a visitor at Stanford Law School, a student expressed hostility to even examining this issue and made a thinly veiled suggestion that the author's raising the issue for discussion placed his sanity in question.

78. Rev. Rul. 85-97, 1985-2 C.B. 50. "Backpay" has been described as "the differential between the appropriate pay and actual pay for services performed." *Horton v. Commissioner*, 100 T.C. 93, 96 n.6 (1993) (reviewed by the court), *aff'd*, 33 F.3d 625 (6th Cir. 1994) (2-1 decision).

income items that would have been taxable when received. Why should damages obtained in lieu of taxable income escape taxation?

1. *Given in Mitigation of Personal Loss Rather Than in Substitution for Lost Income.*—As previously noted, damages for physical injury do not substitute for the noneconomic aspects of that loss because there is no monetary substitute for such injuries as the loss of a limb or eyesight or of the use of a limb. Damages for pain and suffering or for a reduction of the quality of the victim's life style, or amounts received as general damages, do not replace what the victim lost. The income lost because of an injury is more readily measurable than is this personal loss, but even that measurement involves considerable speculation, especially as to income that would have been earned in the future.

The exemption of income-connected damages can be justified on the ground that such damages should not be separated from general damages because the total damages merely mitigate the victim's personal loss and do not fully compensate for it. The nature of the compensation package is not changed by the fact that the courts utilize an estimate of income lost as part of the effort to arrive at a just amount of compensation. When a victim suffers a physical injury, the loss cannot be measured in dollars, and the courts can do no more than resort to some conventional devices to arrive at a reasonable amount of mitigation. One of the devices utilized for that purpose is to estimate lost income. The measurement of lost income lends respectability to the enterprise by suggesting greater precision than actually exists. Also, income loss is one of the few aspects of the victim's loss (medical expenses being another) that relate to money. Since money is all that can be granted to the victim, it is understandable that tort law seizes on a money loss as a measure of part of what must be paid to the victim. But, that should not obscure what damage awards are all about.

2. *Administrative Convenience.*—Another (and perhaps the principal) reason for not taxing income-related damages is administrative convenience. In weighing this consideration, assume (contrary to the discussion above) that income-connected damages are a substitute for lost income. In fact, they are generally so regarded.

Frequently, personal injury damages, whether received pursuant to a settlement or to a jury's award, consist of a single undifferentiated amount that is not subdivided among the victim's several losses. Whether payment is received in a lump sum or as periodic payments, the portions compensating for lost income (both past and future) typically are not identified.

If the income-connected amount of compensatory damages were to be treated differently for tax purposes than the portions attributable to other losses (e.g., pain and suffering), it would be necessary to separate an award

or settlement between its income-connected and nonincome-connected portions, and the taxpayer would likely have the burden of proof on that issue. The result would be a significant administrative burden on taxpayers and the Service.⁷⁹ While the burden would not be insurmountable, it would be substantial in most cases. In a typical case, it might not be especially difficult to ascertain the portion of undifferentiated damages attributable to back wages or other predictable income that would have been earned by the victim if the injury had not occurred. However, compensation for the victim's diminished future earning capacity is highly speculative and virtually impossible to determine with any confidence.

Moreover, the lost income for which damages are obtained would typically have been earned over a period of many years. If income-connected damages were taxed and if the damages were received during a single taxable year, income for many years would be bunched into one taxable year, often causing the tax rate to be much higher than would have been the case if the income had been earned over many years.⁸⁰ Some form of tax relief would be necessary to prevent over-taxation of the damages. An income-averaging device could provide adequate relief for the bunching of past income,⁸¹ but

79. In *Roemer v. Commissioner*, 716 F.2d 693, 696 (9th Cir. 1983), the court stated: An individual who wins a personal injury suit [is] usually given a lump-sum award that includes an amount for items that ordinarily would be taxable, such as lost income. . . . [T]he Commissioner has long excluded from income the entire monetary judgment. . . . The rationale behind the exclusion of the entire award is apparently a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award.

80. The bunching problem is mentioned above in Part III.A in the discussion of whether the Congressional purpose for adopting § 104(a)(2) was to constrain the size of tort damages for personal injuries. The author concluded that Congress had no such purpose and that an exclusionary provision cannot affect the size of tort damages unless state laws are modified as a consequence thereof, and the states generally have not done so.

The bunching problem discussed here is a different issue—whether bunching would be a hardship for the victim and, if so, whether an income-averaging device could adequately mitigate that hardship.

81. Income-averaging can be accomplished by treating the income-connected damages as if they were earned ratably over a period of years and by treating the marginal income tax rates applicable to the income in each such year as being the same as would be imposed on the portion of the income that is deemed to be earned in the current year. Assume individual *T* receives \$100,000 in Year 1 as income-connected damages, and such damages have been made taxable by Congress, subject to an income-averaging device that treats income-connected damages as having been earned ratably over a ten-year period beginning with the year of receipt. The tax on *T* would be determined by (1) adding one tenth of the \$100,000 (\$10,000) to *T*'s other income for Year 1, (2) determining the tax on the resulting amount, (3) computing the tax on *T*'s taxable income exclusive of the damage income, and (4)

that device probably would not deal adequately with damages for the loss of the capacity to earn income in the future. The estimate of a victim's lost future income could encompass a large number of years, and income-averaging over a fixed number of years would be insufficient if the fixed number were less than the number of years for which damages were received. If income-averaging were to be based on the actual number of years for which income-connected damages were obtained, that would require a determination of the number of such years, and the difficulty in making that determination would exacerbate the administrative difficulties of determining the amount of income-connected damages.

It is therefore likely that administrative feasibility plays a significant (and perhaps exclusive) role in the decision not to tax income-connected damages. Arguably, the judgment that administrative feasibility is important enough to justify the exclusion of such damages from income gives too much weight to that consideration and perhaps overestimates the degree of inconvenience that would result from taxing income-connected damages. But, it is not unreasonable to adjust the tax laws to accommodate administrative difficulties, and many tax provisions owe their existence to that purpose. The exclusion of income-connected damages is buttressed by the suggestion made earlier that these damages are not substitutes for lost income, but rather are part of an imprecise measurement of the amount of mitigation that is fair. Since the goal of administrative feasibility is a rational basis for excluding income-connected damages from taxation, there is no inconsistency between that exclusion and the rationale for excluding compensatory damages in general. Rather, the exclusion of income-connected damages rests on a separate, independent base, which must be judged on its own merits.

In some cases, the damages for lost income are identified. When identified, should they be taxed? There is no administrative burden in such cases, but if those amounts were taxed when identified but not taxed when part of an undifferentiated sum, recipients of personal injury awards would be taxed differently depending upon the happenstance of whether the lost income item is identified. Especially in settlements, the tax on separately identified amounts could easily be avoided and would operate principally as a trap for the unwary. The extension of the exclusion to such cases likely stems from an unwillingness to tax differently two sets of victims who received identical damages but with different labels. Perhaps, another reason

subtracting the latter amount from the tax computed in (2). Amount (4) is the tax on one tenth of the income-connected damages at *T*'s marginal tax bracket. The tax on the \$100,000 of income-connected damages is therefore 10 times amount (4). See IRC § 402(d) (allowing such an averaging device to be used for lump sum distributions from qualified pension and profit sharing plans).

not to tax those amounts is the suggestion made above that income-connected damages are not actually substitutes for lost income.

F. *Injuries to Nonphysical Personal Rights*

It has been established for at least 22 years that section 104(a)(2) also applies to damages for injury to nonphysical personal rights (sometimes referred to as “dignitary” torts).⁸² Nevertheless, the recent expansion of the reach of that exclusionary measure to damages for injuries to rights that, at best, are only marginally personal makes it appropriate to ask whether the policy considerations supporting the exclusion of damages for physical injury apply as well when the injury is exclusively nonphysical.

As previously discussed, the policy underpinning of section 104(a)(2) apparently consists of a combination of several factors: (1) the victim’s damaged or destroyed human capital is a noncommercial item that the victim never intended to market; (2) the victim was forced into a commercial transaction because money is the only available recompense; (3) the personal nature of the damaged item makes it impossible for the victim to invest the damages in similar property in order to qualify for a rollover of the gain; and (4) the plight of a victim who suffers the loss of a body part through another’s tortious act elicits sympathy that makes it repugnant to tax the victim because there would be something vulturous in having the government require the victim to share with it a portion of the recompense received for the loss of part of the victim’s person.

The exclusion has been extended to damages for loss of reputation, emotional and mental harm, humiliation, and other injuries. Examples of actions that cause those nonphysical injuries are defamatory statements, discriminatory treatment, harassment, invasion of privacy, wrongful discharge from employment, malicious prosecution, misrepresentation in a commercial venture, and possibly even failure by an airline to honor a reservation.⁸³ To what extent do the policy considerations listed above support tax-exemption for damages for injury exclusively to a nonphysical personal right?

1. The nonphysical attributes listed above are noncommercial in the sense that while they may be utilized in commercial activities, individuals do not voluntarily separate them from

82. See *Seay v. Commissioner*, 58 T.C. 32 (1972), acq., 1972-2 C.B. 3.

83. In *Hill v. United States*, 733 F. Supp. 88 (D. Kan. 1990), the court held that a settlement of a misrepresentation claim against United Airlines was excluded from income by § 104(a)(2). While the court’s opinion does not explain the nature of the misrepresentation, the author was informed by an attorney at the Department of Justice that the taxpayer’s claim arose from being bumped from a flight.

their personae and sell them on the market. For example, an individual can exploit his reputation, but he cannot detach it from himself and dispose of it. However, claims arising exclusively from nonphysical injuries (e.g., actions for wrongful discharge or for discrimination in employment) often relate to improper interference with commercial activities. Many claims for nonphysical injuries are more closely identified with commercial ventures than is the case for torts involving physical injury. There is thus less justification to treat damages for nonphysical injuries as lying beyond the commercial sphere of the income tax system.

2. The involuntariness of the conversion of portions of the victim's persona into money damages is equally present whether the injury is physical or nonphysical.
3. As with physical injuries, the victim of a nonphysical injury cannot invest the damages in property that is similar or related in service or use.
4. In general, the plight of a victim who has suffered only nonphysical injuries does not arouse anything like the sympathy that is engendered by a physical injury.⁸⁴ An extreme case in which the victim suffered great mental and emotional harm can arouse substantial sympathy. But, even such a case does not attract the degree of compassion that is felt for a victim of serious physical injury such as the loss of a limb or a facial disfigurement. Moreover, unlike the case of physical injuries, losses associated with nonphysical injuries are principally pecuniary, although, concededly, the allocation of damages awarded in such cases does not always reflect that dominance.

The policy justification for excluding damages is thus weaker when the injury is exclusively nonphysical than when physical injury is involved. A division along a physical-nonphysical boundary is not a perfect basis for delimiting the exclusion. Ideally, damages for some types of physical injuries should be taxed, and damages for some types of nonphysical injuries should be excluded from income. In a fantastic world in which there are no transactional costs, a more valid boundary might be one that divided injuries associated primarily with commercial activities from those that have their primary association with noncommercial activities. However, the administra-

84. See Burke & Friel, *supra* note 74, at 43-44. The authors suggest, however, that the victims of discrimination might be worthy subjects of humanitarian tax relief.

tive difficulties of applying that standard are daunting. While a distinction along physical-nonphysical lines would not be perfect, it would be easy to administer and would generally be valid. A physical-nonphysical division would be a surrogate for a commercial-noncommercial distinction, and any imprecision in the reach of the exclusion would be relatively minor and justified by the administrative convenience of having a bright-line standard.

Even if Congress were to limit the statutory exclusion to cases involving physical injury, the exclusion should continue to cover damages for nonphysical losses that are byproducts of a physical injury. For example, damages for the emotional harm suffered because of the loss of a limb should be excluded. Where the victim of a physical injury also incurs nonphysical injuries from the same wrongful act, there are good reasons not to segregate the damages for nonphysical injuries and tax them. The reasons given in Part III.E for not segregating income-connected damages from damages for noneconomic injuries apply equally when damages cover both nonphysical and physical injuries. Also, a nonphysical injury that arises as a byproduct of a physical injury is likely to have a noncommercial nature, making the recovery of human capital theory applicable in those cases.

G. *Punitive Damages*

Punitive damages are awarded primarily to punish the tortfeasor and thereby deter willfully or wantonly wrongful behavior.⁸⁵ The existence and size of punitive awards depends upon the degree of the wrongdoer's culpability. While the extent of the injury is taken into account, it is used only as one means of measuring the degree of wrongdoer's culpability. Even the severity of criminal sanctions, which are clearly punitive measures, is influenced by the extent of the harm done. For example, the punishment for a drunken

85. Restatement (Second) of Torts § 908 (1977) reads as follows:

(1) Punitive damages are damages, other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct and to deter him and others like him from similar conduct in the future.

(2) Punitive damages may be awarded for conduct that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others. In assessing punitive damages, the trier of fact can properly consider the character of the defendant's act, the nature and extent of the harm to the plaintiff that the defendant caused or intended to cause and the wealth of the defendant.

See also Cal. Civ. Code § 3294 (West Supp. 1995); *Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1 (1991); Marc A. Franklin & Robert L. Rabin, *Cases and Materials on Tort Law and Alternatives* 622 (4th ed. 1987).

driver who injures a pedestrian is usually more severe if the victim dies than if he lives. The resort to the harm done by the wrongdoer as one of the factors for measuring the amount of punitive damages therefore does not detract from the punitive nature of such damages.⁸⁶ Punitive damages are paid to the injured party, rather than to the state, to encourage the victim to act as a kind of private attorney general in enforcing policies of the state,⁸⁷ and, it has been suggested, because punitive damages can have a compensatory element.⁸⁸

As discussed previously, compensatory damages can also serve a punitive purpose (at least as to damages for noneconomic injuries), but the dominant purpose for compensatory damages is to mitigate the harm that the victim incurred. Conversely, while the dominant purpose of punitive damages is to punish the wrongdoer, the suggestion has been made that the manner in which the victim was injured can cause additional harm that may be difficult or even impossible to identify.⁸⁹ On that theory, one of the roles of punitive damages is to compensate the victim for harm whose existence the victim is unable to demonstrate. However, even if punitive damages do play such a compensatory role, it is a minor feature that pales to insignificance when compared to their principal role—to punish.⁹⁰

Given the predominantly punitive nature of punitive damages, there is no policy justification for excluding them from income. They do not qualify for the return-of-human-capital justification since they are given to punish and deter, not to mitigate a loss of human capital. They do not represent a conversion of a noncommercial item into cash. Because they do not replace anything, the unavailability of a suitable substitute for reinvestment is not a factor. Finally, since the award is made to the victim (rather than to a government) in order to provide an incentive to bring the suit, the taxation of that award is not rapacious and does not put the government in

86. Restatement (Second) of Torts § 908 cmt. e (1977) states in part: In determining the amount of punitive damages, as well as in deciding whether they should be given at all, the trier of fact can properly consider not merely the act itself but all the circumstances In addition, the extent of harm to the injured person can be considered by analogy to the doctrine of the criminal law by which the seriousness of a crime may depend upon the harm done

87. See Jane Mallor & Barry Roberts, *Punitive Damages: Toward a Principled Approach*, 31 *Hastings L.J.* 639, 649-50 (1980).

88. E.g., *Horton v. Commissioner*, 33 F.3d 625, 631 (6th Cir. 1994) (2-1 decision) (quoting with approval from a Kentucky Supreme Court decision).

89. *Id.* at 632. The likelihood that punitive damages serve such a compensatory purpose was greatly reduced, and possibly eliminated, long ago when the law began to allow damage awards for noneconomic injuries.

90. See Restatement (Second) of Torts § 908 (1977), quoted above in note 85.

an unflattering light. Punitive damages are a windfall that increases the recipient's wealth.⁹¹ All accretions to wealth should be taxed unless there is a compelling policy reason not to do so, and no such reason exists as to punitive damages.

IV. *BURKE* DECISION AND SUBSEQUENT CASES

Immediately before the Supreme Court's 1992 decision in *United States v. Burke*,⁹² the status of the decisional law under section 104(a)(2) was as follows:

1. The exclusion applied to damages for nonphysical personal injuries as well as to those for physical injuries.⁹³
2. The exclusion applied to damages for defamation of an individual whether the defamed reputation was professional or personal.⁹⁴
3. There was a division of authority as to whether damages received by victims of employment discrimination were excludable.⁹⁵
4. The prevailing view was that the focus of the inquiry in a section 104(a)(2) case should be on the nature of the taxpayer's claim, rather than on the character of the damages.⁹⁶
5. To qualify for the exclusion, the taxpayer's claim had to be in tort or be tort-type.⁹⁷

91. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

92. 112 S. Ct. 1867 (1992).

93. *Bent v. Commissioner*, 835 F.2d 67 (3d Cir. 1987); *Seay v. Commissioner*, 58 T.C. 32 (1972), acq., 1972-2 C.B. 3.

94. *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983); *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986) (reviewed by the court), aff'd, 848 F.2d 81 (6th Cir. 1988).

95. Compare *Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991) (excluding such damages), *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990) (same) and *Byrne v. Commissioner*, 883 F.2d 211 (3d Cir. 1989) (same) with *Sparrow v. Commissioner*, 949 F.2d 434 (D.C. Cir. 1991), cert. denied, 112 S. Ct. 3009 (1992) (taxing such damages) and *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989) (taxing damages received as backpay under the Equal Pay Act because they were not given for a tort-type right, but excluding liquidated damages because they were given for a tort-type right).

96. E.g., *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983); *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986) (reviewed by the court), aff'd, 848 F.2d 81 (6th Cir. 1988).

97. Regs. § 1.104-1(c); *Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991); *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989).

6. The Tax Court had applied the exclusion to punitive damages, but the Fourth Circuit had reversed, including punitive damages in income.⁹⁸

The taxpayers in *Burke* had obtained a settlement on their damage claim for sex discrimination under Title VII of the Civil Rights Act of 1964. At the time of the settlement, the only remedies provided by Title VII were backpay and equitable relief (e.g., reinstatement).⁹⁹ The taxpayers paid a federal income tax on their settlement but sought a refund on the ground that the amounts received were excluded from income by section 104(a)(2). After losing in the district court, they prevailed on appeal to the Sixth Circuit, which decided the case by a divided vote. The Supreme Court reversed the Sixth Circuit's decision, holding that the settlement amounts were taxable.

The Court adopted the regulations' definition of the term "damages received" in section 104(a)(2): an "amount received . . . through prosecution of a legal suit or action based upon tort or tort-type rights or through a settlement agreement entered into in lieu of such prosecution."¹⁰⁰ Accordingly, the Court concluded that, to qualify for the statutory exclusion, damages must be based on a tort or tort-type claim. The Court looked to common law tort concepts in defining the words "tort or tort-type rights." It noted that damages are an "essential characteristic of every true tort" and held that the availability of damages was a sine qua non of a claim's qualifying as a tort. However, not just any old damage award would do. The Court said that the "hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff 'fairly for injuries caused by the violation of his legal rights.'"¹⁰¹ The range of damages that may be awarded to a tort victim includes more than an allowance for the victim's pecuniary losses (e.g., for lost wages, medical expenses, and diminished future earning capacity). Damages also are permitted for noneconomic losses such as emotional stress and pain and suffering. The victim of a dignitary or non-physical tort can receive (in addition to reimbursement for pecuniary losses) damages for impairment of reputation and standing in the community, humiliation, and mental anguish and suffering. Moreover, the Court said,

98. *Miller v. Commissioner*, 93 T.C. 330 (1989) (reviewed by the court), rev'd sub nom. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

99. In footnote 9 of the *Burke* opinion, the Supreme Court noted that some courts had allowed Title VII plaintiffs who were wrongfully discharged to recover damages for "front pay" (projected lost future earnings) when reinstatement was not feasible. 112 S. Ct. at 1873.

100. Regs. § 1.104-1(c).

101. *Burke*, 112 S. Ct. at 1871 (quoting from *Carey v. Piphus*, 435 U.S. 247, 257 (1978)).

“punitive or exemplary damages are generally available in those instances where the defendant’s misconduct was intentional or reckless.”¹⁰²

The Court did not identify particular types of damages that must be available to qualify a claim as tort-like. However, Title VII, as it existed when the taxpayers in *Burke* obtained their settlements, permitted only back-pay damages. Accordingly, the Court concluded that the taxpayer’s claims were not tort or tort-type claims, and their settlements were taxable.¹⁰³

The majority in *Burke* decided that section 104(a)(2) is not limited to damages for physical injuries. In his concurring opinion, Justice Scalia contended that the exclusion should not apply if there is no physical injury, but the majority rejected this contention. The majority opinion’s response to Justice Scalia includes a long footnote (footnote 6), one small part of which suggests that the view that section 104(a)(2) applies to nonphysical injuries is supported by a 1989 amendment stating that section 104(a)(2) “shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.” That part of the footnote has affected the view of some judges as to the excludability of punitive damages. The 1989 amendment and the Supreme Court’s characterization of it is discussed in Part V.A of this article. In Part V.B, the author discusses the excludability of punitive damages.

As could be anticipated, the decision in *Burke* has had a profound effect on subsequent litigation. No more vivid example of that effect can be found than the two decisions of the federal district court of Kansas in *O’Gilvie I*¹⁰⁴ and *O’Gilvie II*.¹⁰⁵ In *O’Gilvie I*, the court, granting the government’s motion for summary judgment, held punitive damages in a wrongful death action to be taxable because they serve no compensatory purpose and therefore are not received “on account of personal injury,” as required by section 104(a)(2). *O’Gilvie I* was decided the same day that the Supreme Court promulgated its *Burke* decision. *O’Gilvie* moved for reconsideration in light of *Burke*. In *O’Gilvie II*, the court granted the motion and changed its decision entirely. Relying on its reading of *Burke*, the court determined that it had erred in its prior ruling by focusing on the nature of the punitive damage award, rather than on the nature of the underlying claim.

102. *Id.* at 1872.

103. As noted in Part II.E, Title VII was amended in 1991 to provide a broad range of damages for disparate treatment type violations of that act (intentional discrimination). The amended version did not apply in *Burke* because the facts of the case arose before the effective date of the amendment.

104. *O’Gilvie v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,344, 70 A.F.T.R.2d (P-H) 92-5069 (D. Kan. 1992).

105. *O’Gilvie v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567, 71 A.F.T.R.2d (P-H) 93-547 (D. Kan. 1992).

Since the underlying claim was tort-type, the court decided that "its previous order is contrary to *Burke* and must be reversed."¹⁰⁶ Summary judgment was granted for the taxpayer. At this writing, an appeal is pending in the Tenth Circuit.

In *Horton v. Commissioner*,¹⁰⁷ the Tax Court, with only three judges dissenting, held that punitive damages in connection with a personal injury claim in tort are excluded from income by section 104(a)(2). The court adhered to its pre-*Burke* decision to that effect in *Miller*, even though *Miller* was reversed by the Fourth Circuit.¹⁰⁸ In *Horton*, the court placed great reliance on the Supreme Court's opinion in *Burke*, construing *Burke* to hold that once it is determined that the taxpayer's claim was based on tort or tort-type rights, any damages obtained pursuant to the claim (including punitive damages) are excluded from income. The court buttressed its reading of *Burke* by noting that the Supreme Court mentioned punitive damages as one of the remedies typically available for torts and that it was the unavailability of a range of damages that led the Supreme Court to determine that the damages at issue in *Burke* were taxable. In affirming the Tax Court's decision in *Horton*, the Sixth Circuit (in a divided decision) also gave weight to *Burke*.

As previously noted, three Courts of Appeals have recently held that punitive damages are taxable.¹⁰⁹ One of those cases, the Ninth Circuit's decision in *Hawkins v. United States*, was a divided decision. In his dissent in that case, Judge Trott gave great weight to the *Burke* decision.

The courts are also divided on whether the section 104(a)(2) exclusion applies to damages obtained under the Age Discrimination in Employment Act of 1967 (ADEA).¹¹⁰ The ADEA permits equitable relief and the award of only two types of damages: damages for pecuniary losses (backpay) and liquidated damages of an equal amount.¹¹¹ Liquidated damages are only allowed for willful violations.

Before *Burke*, the Tax Court (overruling several prior decisions of that court) held in *Downey I* that both backpay and liquidated damages received on an ADEA claim are excluded from income by section 104(a)(2).¹¹² The taxpayer in *Downey* obtained a settlement on an ADEA

106. 92-2 U.S. Tax Cas. (CCH) at 50,567, 71 A.F.T.R.2d (P-H) at 93-548.

107. 100 T.C. 93 (1993) (reviewed by the court), aff'd, 33 F.3d 625 (6th Cir. 1994) (2-1 decision).

108. *Miller v. Commissioner*, 93 T.C. 330 (1989) (reviewed by the court), rev'd sub nom. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

109. *Hawkins v. United States*, 30 F.3d 1077 (9th Cir.) (2-1 decision), cert. denied, 115 S. Ct. 648 (1994); *Reese v. Commissioner*, 24 F.3d 228 (Fed Cir. 1994); *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

110. 29 U.S.C. §§ 621-634.

111. 29 U.S.C. §§ 626(b), 216(b).

112. *Downey v. Commissioner*, 97 T.C. 150 (1991) (reviewed by the court).

claim that allocated the settlement equally between backpay and liquidated damages. Six judges in *Downey I* dissented as to the exclusion of the backpay damages, but they agreed with the majority that the liquidated damages should be excluded. After *Burke* was decided, the Service asked the Tax Court to reconsider *Downey I* in light of *Burke*. After reconsideration, the Tax Court promulgated a supplemental opinion (*Downey II*) in which it adhered to its first decision, holding that *Burke* did not alter the majority's view.¹¹³ The court found that liquidated damages under ADEA compensate the victim for nonpecuniary losses as well as serving a punitive purpose and that the range of damages available under ADEA is thus sufficient to qualify a claim thereunder as one for tort-type rights.

In *Downey III*,¹¹⁴ the Seventh Circuit reversed the Tax Court, finding that pre-*Burke* appellate decisions on the excludability of ADEA damages rested on an analytical framework that is inconsistent with *Burke*. The court therefore discarded those cases and focused on the Supreme Court's treatment of the excludability issue. The Seventh Circuit concluded that a claim is tort-type only if the available relief includes damages for nonpecuniary losses, such as pain and suffering, emotional distress, and personal humiliation. The ADEA only provides for pecuniary damages and, in the case of a willful act, liquidated damages of an equal amount. The court noted that there is a dispute as to whether liquidated damages under the ADEA are punitive or compensatory. However, it concluded that even if compensatory, the liquidated damages are designed to recompense the victim, not for nonpecuniary injuries, but instead for the income loss resulting from the unavailability of the pecuniary amounts until judgment or settlement of the claim for damages. In other words, the liquidated damages are either punitive or a substitute for prejudgment interest. In either event, in the court's opinion, the range of damages under the ADEA is not sufficient to satisfy the standard set by *Burke*, and all of the taxpayer's damages in *Downey* were taxable.

The Ninth Circuit reached quite different conclusions in *Schmitz v. Commissioner*.¹¹⁵ It found that the provision for liquidated damages in ADEA cases has both compensatory and punitive purposes. The compensatory purpose is to provide relief for damages that are too obscure and difficult to prove. The court held that the restriction of liquidated damages to cases where the employer acted willfully does not make those damages primarily punitive in nature. It concluded that the range of remedies provided by the

113. *Downey v. Commissioner*, 100 T.C. 634 (1993) (reviewed by the court).

114. *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

115. 34 F.3d 790 (9th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944).

ADEA satisfies the requirement established in *Burke*, and it held that the damages received by Schmitz in settlement of his claim were excluded from income.¹¹⁶

In *Schleier v. Commissioner*,¹¹⁷ the Fifth Circuit affirmed, without written opinion, a Tax Court decision that ADEA damages are excluded from income by section 104(a)(2). The Supreme Court has agreed to review that decision.

Even when the violation is willful, liquidated damages may not be granted in an ADEA case if the defendant is the federal government.¹¹⁸ Since federal employees can receive only backpay, the range of damages available in their ADEA suits is too narrow for their claims to be tort-type, and their damages are taxable. If the controversy concerning ADEA for non-federal employees is resolved by excluding their damages from income, there will be the anomalous result that the ADEA damages for federal employees will be taxable while all other plaintiffs' ADEA damages will be excluded.

As a consequence of *Burke*, the Service now agrees that damages for race-based discrimination under 42 U.S.C. section 1981, for disparate treatment discrimination under Title VII, and for violations of the Americans with Disabilities Act are excluded from income, but it continues to tax damages for a disparate impact type violation of Title VII.¹¹⁹

In *McKay v. Commissioner*,¹²⁰ the taxpayer, a former corporate officer whose employment was terminated, sued the employer for wrongful discharge, breach of employment contract, RICO violations, and punitive damages. A jury awarded damages for lost compensation (both past and future) and, because of the RICO violation, trebled the damages to more than \$43 million. The jury also awarded punitive damages. To avoid an appeal, taxpayer settled with the employer for \$16,744,300. In a settlement agreement negotiated at arms' length, the parties agreed that more than \$12 million of the settlement was for the wrongful discharge claim, more than \$2 million

116. The Ninth Circuit noted that several post-*Burke* decisions have held that *Burke* did not change the prevailing pre-*Burke* conclusion that ADEA damages are excludable. The one court of appeals case that the court cited is *Purcell v. Sequin State Bank & Trust Co.*, 999 F.2d 950, 960-61 (5th Cir. 1993), which addressed the excludability issue in deciding whether ADEA damages for backpay should be reduced to reflect an exemption from income taxes that the victim would otherwise have incurred. Seemingly, the Fifth Circuit merely accepted without independent examination the Tax Court's determination in *Downey II* that even after *Burke*, such damages are excluded from income. However, in a subsequent case, the Fifth Circuit affirmed a Tax Court decision holding that ADEA damages are excluded from income. *Schleier v. Commissioner*, 26 F.3d 1119 (5th Cir.), cert. granted, 115 S. Ct. 507 (1994).

117. 26 F.3d 1119 (5th Cir.), cert. granted, 115 S. Ct. 507 (1994).

118. *Smith v. Office of Personnel Management*, 778 F.2d 258 (5th Cir. 1985).

119. Rev. Rul. 93-88, 1993-2 C.B. 61.

120. 102 T.C. 465 (1994).

was for the breach of contract claim, and the balance was partial reimbursement of various legal and litigation costs incurred in prosecuting the claims. The agreement stated that no payment was made for punitive damages or for RICO violations. The Tax Court accepted the settlement agreement's allocation. Relying on *Burke*, the court held that the more than \$12 million for the wrongful discharge claim was excluded from income because wrongful discharge is a tort claim.¹²¹ An interesting and unresolved question is whether the injury resulting from wrongful discharge can properly be classified as a "personal injury or sickness" to which section 104(a)(2) can apply.

V. PUNITIVE DAMAGES

A. 1989 Statutory Amendment

In 1989, Congress amended section 104(a) by adding at the end an additional sentence stating that section 104(a)(2) "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."¹²² Subject to transition rules, the added sentence applies to amounts received after July 10, 1989. Thus, punitive damages received after that effective date in cases involving discriminatory practices, defamation, or other dignitary torts are taxable. The amendment will eliminate much of the controversy concerning punitive damages, but several important issues remain.

First, what is the tax treatment of punitive damages in a case in which there has been a physical injury? In precluding the exclusion of punitive damages when there is no physical injury, the language added in 1989 implies that punitive damages are excluded when there is a physical injury. However, care should always be taken in making negative inferences. As is shown below, an examination of the legislative history of the 1989 amendment establishes that Congress had no intention of passing on the proper treatment of punitive damages in any circumstance other than where there was no physical injury.

Second, does the adoption of the 1989 amendment demonstrate that Congress believed that pre-1989 law excluded punitive damages from income when received pursuant to a claim for a personal injury? Even if the amendment does indicate that Congress held that belief, what weight should the courts accord to it?

121. The taxpayer agreed that the balance of the settlement amount was taxable, but contended that some of the litigation and legal expenses were deductible.

122. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2379.

1. *Post-1989 Punitive Damages in Cases Involving Physical Injury.*—While no case has yet arisen in which punitive damages for a physical injury were received after July 10, 1989, several courts, including the Supreme Court, have assumed that such damages are excluded by negative inference from the 1989 amendment. For example, in footnote 6 of the opinion in *United States v. Burke*, the Court stated:

Congress' 1989 amendment to section 104(a)(2) provides further support for the notion that "personal injuries" includes physical as well as nonphysical injuries. Congress rejected a bill that would have limited the section 104(a)(2) exclusion to cases involving "physical injury or physical sickness." See H.R. Rep. No. 101-247, pp. 1354-1355 (describing proposed section 11641 of H.R. 3299, 101st Cong. 1st Sess. (1989) . . .). At the same time, *Congress amended section 104(a) to allow the exclusion of punitive damages only in cases involving "physical injury or physical sickness."* . . . The enactment of this limited amendment addressing only punitive damages shows that Congress assumed that other damages (i.e., compensatory) would be excluded in cases of both physical *and* nonphysical injury.¹²³

In the italicized portion of the foregoing extract, the Supreme Court construed the amendment as having both an inclusionary and an exclusionary effect, allowing an exclusion for punitive damages in a case involving a physical injury as well as denying an exclusion where the injury is not physical. In fact, the amendment only addresses cases where there is no physical injury and makes no express statement about the treatment of damages when a physical injury is present. The Court did not analyze the amendment; it simply assumed that the denial of an exclusion in nonphysical cases amounted to allowing one in physical cases. The italicized comment is in the middle of a lengthy footnote dealing with whether compensatory damages for nonphysical injuries are excluded by section 104(a)(2). It is dictum and does not appear to be the product of serious thought, much less a consideration of the legislative history. Moreover, the comment is unnecessary to the Court's point in the footnote—that by precluding an exclusion for punitive damages when the injury is nonphysical, Congress implied that section 104(a)(2) applies to compensatory damages for nonphysical injuries. There was no reason for the Court to focus on the applicability of the amendment to physical injury claims, and it does not appear to have done so.

123. 112 S. Ct. 1867, 1871 n.6 (1992) (emphasis added).

Nevertheless, some judges have taken the Supreme Court's statement as support for the view that the 1989 amendment authorizes the exclusion of punitive damages in cases involving physical injuries. For example, the statement was cited with approval by the Sixth Circuit in its affirmance of the Tax Court's decision that punitive damages are excluded from income by section 104(a)(2).¹²⁴ In addition, at least two commentators concluded that the amendment impliedly permits the exclusion of punitive damages received after 1989 in a case involving physical injuries.¹²⁵

The legislative history of the 1989 amendment strongly suggests that this inference is in error. The House Bill that ultimately became the Omnibus Budget Reconciliation Act of 1989 contained a provision that would have amended section 104(a)(2) to restrict the exclusion, for compensatory as well as punitive damages, to cases involving physical injury or physical sickness.¹²⁶ The bill, with that provision, was passed by the House on October 5, 1989. The Committee Report on the bill indicates that a principal purpose of the amendment was to deny the exclusion to damages in employment discrimination and defamation cases.¹²⁷

The Senate was not willing to make taxable all damages obtained for nonphysical injuries and therefore refused to adopt the House's limitation. Its bill made no mention of section 104 or of the treatment of damages. In a Conference Committee compromise, the Senate agreed to bar the application of section 104(a)(2) to punitive damages in a case involving only nonphysical injuries. This limitation became law with the adoption of the conference bill.¹²⁸

The Conference Committee reported the bill on November 21, 1989.¹²⁹ Two months earlier, on September 13, 1989, the Tax Court

124. *Horton v. Commissioner*, 33 F.3d 625, 631 (6th Cir. 1994) (2-1 decision). The Supreme Court's statement was also quoted by Judge Trott in his dissenting opinion in *Hawkins v. United States*, 30 F.3d 1077, 1086 (9th Cir.) (2-1 decision), cert. denied, 115 S. Ct. 648 (1994).

125. Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 *Tax Law.* 755, 766 (1993); David A. Jaeger, *Taxation of Punitive Damage Awards: The Continuing Controversy*, 57 *Tax Notes* 109, 114 (Oct. 5, 1992).

126. H.R. 3299, 101st Cong., 1st Sess. § 11641 (1989).

127. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1354-55 (1989), reprinted in 1989 U.S.C.C.A.N. 2824-25.

128. Omnibus Reconciliation Act of 1989, Pub. L. No. 100-239, § 7641, 103 Stat. 2379.

129. Revenue Provisions of Conference Agreement on H.R. 3299, Omnibus Budget Reconciliation Act of 1989, released by Senate Finance Committee on November 21, 1989, 224 *Daily Tax Report*, Special Supplement (Nov. 22, 1989).

promulgated its reviewed decision in *Miller v. Commissioner*,¹³⁰ in which a majority of the court held that punitive damages can be excluded under section 104(a)(2). The Fourth Circuit reversed the Tax Court's decision on September 21, 1990, ten months after the Conference compromise was adopted by Congress. Consequently, when Congress acted, the principal case on the excludability of punitive damages was a recent Tax Court decision, in which only two judges dissented, holding that they are excluded.

The Conference Committee did not necessarily believe that punitive damages would be excluded in the absence of the amendment. They could well have intended no more than to assure that punitive damages will not be excluded when there was no physical injury, regardless of how the courts might otherwise resolve the question of the excludability of punitive damages. Even if the Conference Committee believed that punitive damages would be excludable without the amendment, that belief probably derived from the very recent, reviewed Tax Court decision to that effect. The Committee could not know that the decision would be reversed on appeal.

There is no indication that the Committee, or Congress as a whole, desired that punitive damages be excluded in cases involving physical injury. To the contrary, the bill's history makes it abundantly clear that Congress deliberately chose not to pass on that issue and instead chose to leave that question to be resolved by the courts.

The Conference bill, as reported on November 21, 1989, contains inked changes in the printed copy. Four words were deleted in ink, and one word was added in ink.¹³¹ The unaltered printed copy of the relevant provision is as follows:

Sec. 7641. Limitation on Section 104 Exclusion.

(a) *General Rule.*—Section 104(a) (relating to compensation for injuries or sickness) is amended by adding at the end thereof the following new sentence: "Paragraph (2) shall not apply to any punitive damages unless such damages are in connection with a case involving physical injury or physical sickness."

130. 93 T.C. 330 (1989) (reviewed by the court), rev'd sub nom. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990). The taxpayer in *Miller* had received both compensatory and punitive damages in the settlement of a defamation claim.

131. The Conference Committee's version of the amendment is set forth in 224 Daily Tax Report, Special Supplement S-81 (November 22, 1989). The inked changes are marked on the bill as reproduced therein. The Conference Committee's bill, with those inked changes shown on the bill, also is reproduced in a bulletin of Prentice Hall that was published at that time; the bulletin is titled: *Revenue Provisions of the Omnibus Budget Reconciliation Act of 1989 (Title VII)*, and was published as Bulletin 47 Extra on November 28, 1989.

The printed copy was altered in ink by drawing a line with a deletion symbol through the words "unless such damages are" and by inserting in ink the word "not" between the words "case" and "involving." As reported by the Committee, the amendment appeared as follows:

4 SEC. 7641. LIMITATION ON SECTION 104 EXCLUSION.

5 (a) GENERAL RULE.--Section 104(a) (relating to
6 compensation for injuries or sickness) is amended by adding
7 at the end thereof the following new sentence: "Paragraph

8 (2) shall not apply to any punitive damages ~~unless such~~

~~damages~~ in connection with a case involving physical *(not)*
9 injury or physical sickness."

The original printed version of the amendment would have made both a positive and a negative statement, providing that punitive damages in connection with a physical injury are excluded from income and that punitive damages not connected with a physical injury are included in income. The handwritten alteration that was made on the printed text makes only a negative statement: that punitive damages not connected with a physical injury are not excluded from income by section 104.

Congress did not inadvertently omit to make an explicit statement that punitive damages connected with a physical injury are excluded. To the contrary, the draft containing that statement was altered to avoid taking a position on that issue. It is clear then that the 1989 amendment has no bearing on the excludability of punitive damages in cases involving physical injury.

2. *Excludability of Punitive Damages Under Pre-1989 Law.*—As the discussion above demonstrates, it is by no means clear that Congress believed that section 104(a)(2) applies to punitive damages. Congress may have merely wished to assure that the courts would not apply the exclusion when nonphysical injuries are involved. When Congress acted, the Tax Court had recently decided in *Miller* that punitive damages are excluded by section 104(a)(2). While the Tax Court's decision was later reversed, Congress must at least have recognized a possibility of the courts following the Tax Court's lead. Congress explicitly stated a position on the issue only for cases not involving physical injuries. It is highly unlikely that the Conference Committee deliberately struck from the bill any reference to punitive damages acquired in connection with a physical injury claim because it considered that issue settled and wished to avoid a redundancy. It is far more likely that Congress chose to abstain from that issue and leave the matter for the courts to resolve.

Even if Congress believed in 1989 that punitive damages are excluded by section 104(a)(2), that belief has little or no significance. In discussing this issue in *Hawkins*, the Ninth Circuit quoted the Supreme Court's statement that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one."¹³² That is especially true here since there is every reason to doubt that Congress held that opinion.

3. *Meaning of "Physical."*—The sentence added in 1989 refers to "physical injury or physical sickness." If the victim of a dignitary tort has a mental breakdown as a consequence of the humiliation suffered, could section 104(a)(2) apply to punitive damages for the tort because the victim incurred a "physical sickness"? In such a case, the injury inflicted by the wrongdoer is not physical, but one of the consequences of that injury is physical.

Given the legislative history of the 1989 amendment, it seems that Congress intended to bar the exclusion of punitive damages when the tort itself was not a physical intrusion to the person of the victim. The principal purpose of the House bill was to bar the exclusion of damages in discrimination and defamation cases, and the bill as enacted was a compromise that limited that bar to punitive damages in such cases. The purpose of the amendment would be frustrated if the exclusion were held to cover punitive damages in discrimination and defamation cases when the victim became ill as a consequence of the wrongful act. Regardless of the ultimate resolution of the issue of whether punitive damages in general are taxable, punitive damages obtained for a dignitary tort should be taxed.

B. *Apart from 1989 Amendment*

As discussed above, the 1989 amendment should be construed to mean only what it says—that the section 104(a)(2) exclusion does not apply to punitive damages received after July 10, 1989 in cases not involving physical injuries. The application of the exclusion to other punitive damages—punitive damages received before July 11, 1989 and punitive damages received on or after that date that are connected with a physical injury—should be determined without regard to the amendment.

Section 104(a)(2) applies to "any damages" received "on account of personal injuries or sickness." Under the plain meaning rule of statutory construction, the reference to "any damages" could be taken literally to apply

132. *Hawkins v. United States*, 30 F.3d 1077 (9th Cir.) (2-1 decision) (quoting from *United States v. Price*, 361 U.S. 304, 313 (1961)), cert. denied, 115 S. Ct. 648 (1994).

to any form of damages, whether or not compensatory.¹³³ However, within the four corners of the statute itself, there are signs that the reference to “any damages” is not as expansive as that term might otherwise suggest. The title to section 104 is “*Compensation for injuries or sickness.*”¹³⁴ Section 104(a) contains five subparagraphs, each of which describes a type of receipt that is excluded from income. Each of the four subparagraphs that surround section 104(a)(2) involved compensatory payments. Subparagraph (a)(1) excludes amounts received under worker’s compensation acts as “compensation” for personal injuries or sickness. Subparagraph (a)(3) excludes certain amounts received through accident or health insurance for personal injuries or sickness. Subparagraphs (a)(4) and (5) deal with pensions, annuities, and disability benefits paid to persons sustaining personal injuries or sickness while serving in the armed forces or in certain government positions.

When the antecedent to section 104(a)(2) was adopted as part of the Revenue Act of 1918, the exclusion for personal injury damages was not contained in a separate subparagraph but was instead combined in a single paragraph with the exclusion for accident and health insurance receipts and the exclusion of compensatory payments received under workmen’s compensation laws.¹³⁵ It was later that these three exclusionary provisions were separated into three subparagraphs. The original inclusion of all three provisions in one paragraph strengthens the evidence that they have a common theme—to exclude certain *compensatory* payments from income.

The Supreme Court’s decision in *United States v. Burke*¹³⁶ provides comfort to those seeking to bring punitive damages within the statutory exclusion. *Burke* establishes that the test of excludability turns on the nature of the underlying claim (whether it is tort or tort-type), not the nature of the damages obtained. On the basis of *Burke*, the Tax Court and the Sixth Circuit have concluded that since the nature of damages are not to be taken into account, all damages received under a tort or tort-type claim are excluded from income.¹³⁷ However, *Burke* deals only with the question of what kinds of claims can qualify for section 104(a)(2) treatment. The Court’s acceptance of the tort or tort-type requirement was a recognition of the need to distinguish tort claims from contract claims. The major contribution of *Burke* is to

133. This view has been adopted by the Tax Court and the Sixth Circuit. E.g., *Miller v. Commissioner*, 93 T.C. 330, 338 (1989), rev’d sub nom. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990); *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994) (2-1 decision), aff’g 100 T.C. 93 (1993) (reviewed by the court).

134. Emphasis added. A tax statute’s title can influence its construction. See *House v. Commissioner*, 453 F.2d 982 (5th Cir. 1972).

135. The original 1918 provision is quoted above in the text accompanying note 9.

136. 112 S. Ct. 1867 (1992).

137. E.g., *Horton*, 33 F.3d at 625.

establish the range of available damages as the standard for whether a claim is tort-like. *Burke* does not require the exclusion of all damages in a tort case. For example, damages compensating for the destruction of property are not excluded by section 104(a)(2) because they are not received on account of a personal injury.

Courts favoring the exclusion of punitive damages have noted that in *Burke*, the Supreme Court mentioned punitive damages as one of the types of damages typically provided for tort victims and that the availability of such damages is one of the factors to be taken into account in determining whether the range of available damages is sufficiently broad to characterize a claim as tort-like. But, as Judge Goodwin observed in writing for the majority in the Ninth Circuit's decision in *Hawkins*,¹³⁸ the fact that punitive damages are an indicator that a claim lies in tort does not mean that a punitive damage award was obtained on account of a personal injury. The Supreme Court did not address that issue in *Burke*.

A crucial hurdle for advocates of the excludability of punitive damages is whether the damages are received "on account of personal injuries or sickness," as required by section 104(a)(2). While a personal injury may be a precondition of a punitive damage award, a victim must also show that there was egregious behavior on the part of the tortfeasor. The award is not given for the personal injury, which may only be very slight, but rather is given to punish and deter the wrongdoer. The requirement that the victim have incurred a personal injury, however slight, reflects a kind of no-harm/no-foul sentiment.

In reversing the Tax Court in *Miller*, the Fourth Circuit stated that particular damages satisfy the "on account of" requirement only if the existence of a personal injury is sufficient to enable a court to award the damages.¹³⁹ It is not enough merely to be a necessary element. The court found the statutory language to be unclear on the issue, but was convinced by a consideration of the underlying purpose of section 104(a)(2) that more than a but-for causation is required. The court analogized to the induction of a baseball player into the Hall of Fame. He could not qualify if he were not a ballplayer, but he was not elected to the Hall on account of being a ballplayer.

In rejecting the Fourth Circuit's sufficiency test in *Horton*, the Sixth Circuit noted that the existence of a personal injury is not a sufficient basis for recovery of compensatory damages because the plaintiff must also establish liability by showing negligence or some wrongful act.¹⁴⁰ However,

138. *Hawkins v. United States*, 30 F.3d 1077 (9th Cir.) (2-1 decision), cert. denied, 115 S. Ct. 648 (1994).

139. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

140. *Horton*, 33 F.3d at 625.

section 104(a)(2) presupposes that liability exists. The “on account of personal injury” language is a limitation on the types of damages obtained through litigation or settlement that are excludable, denying the exclusion to, for example, damages for injuries to property. It is reasonable to construe the “on account of” language as requiring more than a fragile nexus between the damage award and the personal injury.

The language of the statute is not conclusive as to whether it applies to punitive damages. The language itself can support either proposition, although the author believes that a strong case can be made from the statutory language alone for excluding punitive damages from its protection.

The determination of the scope of the statute, especially when the language alone does not conclusively resolve the question of its applicability, should rest on an examination of the policies that justify it. In Part III, the author examines the policies served by the statutory exclusion, concluding in Part III.G that none of those policies are served by excluding punitive damages from income. Unless a valid justification for excluding such damages can be ascertained, there is no reason to strain to construe the statute to do so.

In an effort to finesse the issue of whether any policy justification for the exclusion applies to punitive damages, some courts have asserted that punitive damages have a compensatory function.¹⁴¹ The Tax Court stated in *Miller*:

Punitive damages have served as a means of compensating plaintiffs for intangible harm and for costs and attorney’s fees. . . . Although they may serve these purposes to a lesser extent now than in the past, the fact that punitive damages may possess a compensatory aspect renders it reasonable to afford them the protection of section 104(a)(2).¹⁴²

The court observes that punitive damages serve to compensate for intangible harm “to a lesser extent now than in the past” because modern tort law allows damages for many intangible harms (such as pain and suffering and emotional distress), leaving no need to provide punitive damages to compensate for such harms. This fact seriously undercuts the contention that a significant function of punitive damages is to compensate for intangible injuries.

141. *Id.*

142. *Miller v. Commissioner*, 93 T.C. 330, 341 (1989) (reviewed by the court), *rev’d sub nom. Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990). The statement in the text was quoted with approval by the Sixth Circuit in *Horton*, 33 F.3d at 629.

As noted in Part III.G, the principal function of punitive damages is to punish a wrongdoer for outrageous conduct and to deter the wrongdoer and others from engaging in similar conduct in the future.¹⁴³ Whatever minor compensatory aspect there is to punitive damages is insignificant when compared to their punitive function. The principal factor a trier of fact should consider in determining the amount of punitive damages is the degree of culpability of the wrongdoer. Let the punishment fit the crime. The wrongdoer's motives also are taken into account.¹⁴⁴ In many jurisdictions, the wealth of the wrongdoer can be considered.¹⁴⁵

The contention that a victim suffers greater harm from the knowledge that the wrongdoer's actions are egregious was rejected by Judge Kennedy in her dissent in *Horton*.¹⁴⁶ The harm that a victim suffers proceeds from the injury sustained. The evil motivation of the wrongdoer does not aggravate the victim's injury, but it can affect the amount of anger or outrage that the victim feels. As noted in Part III.D.2, an award to assuage the victim's anger or outrage is not truly compensatory. While the extent of the harm suffered by the victim may be taken into account in determining the amount of punitive damages, that is not for a compensatory purpose but rather serves as a means of measuring the culpability of the wrongdoer.¹⁴⁷ Even the criminal law looks to the extent of harm done in measuring the severity of the crime and the amount of punishment that is appropriate.

Whether damages should be characterized for tax purposes as punitive or compensatory should turn on the criteria utilized, under the law pursuant to which the damages are awarded, to determine whether to allow the damages and to set the amount thereof. Nontax laws establish rights, powers, and interests, but the tax consequence of possessing those rights, powers, and interests is an issue of tax law. Nontax law controls the nature of the items, but it cannot control their characterization for tax purposes. The label that nontax law attaches to a damage award is irrelevant to the tax consequences of receiving the award. The Supreme Court resolved any doubt concerning this issue some 54 years ago in *Morgan v. Commissioner*, where it said:

143. Restatement (Second) of Torts § 908 (1977), quoted supra note 85.

144. Restatement (Second) of Torts § 908, cmts. b and c (1977).

145. Restatement (Second) of Torts § 908, cmt. e (1977) states:

The wealth of the defendant is also relevant, since the purpose of exemplary damages are to punish for a past event and to prevent future offenses, and the degree of punishment or deterrence resulting from a judgment is to some extent in proportion to the means of the guilty person.

146. *Horton v. Commissioner*, 33 F.3d 625, 632-33 (6th Cir. 1994).

147. Restatement (Second) of Torts § 908, cmt. e (1977), quoted supra note 86.

State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.¹⁴⁸

This approach has been followed by subsequent courts. For example, in a 1985 case involving whether a decedent (named Richard H. Black) had a joint tenancy interest in property for federal estate tax purposes, the Ninth Circuit said:

When we interpret the tax code, our inquiry focuses on whether Congress intended to impose a tax on a particular property right or interest. . . . State law—in this instance the law of Arizona—defines the powers that the Blacks could exercise over the trust property. Arizona law, however, does not control our ultimate determination. If the statutory language expresses a Congressional purpose to tax the decedent's interest, that interest is includable in the decedent's gross estate regardless of whether state law would label it a "joint tenancy" interest.¹⁴⁹

The label that state law attaches to a damage provision does not control its characterization for tax purposes, whether the label is given by statute or judicial decision. The function of a damage award should be determined by examining the criteria that are used in deciding whether to grant it and for measuring the amount to be awarded.

In Part III.E, the author set forth his view that a primary reason for excluding income-connected damages is to finesse the administrative difficulty of segregating income-connected damages from other compensatory damages. Does that same consideration apply to punitive damages? Would the taxation of punitive damages cause a serious administrative burden? One response to these questions is that Congress deliberately chose to exclude income-connected damages from income. There is no evidence that Congress made that choice for punitive damages.

148. 309 U.S. 78, 80-81 (1940).

149. *Black v. Commissioner*, 765 F.2d 862, 864 (9th Cir. 1985).

Moreover, the courts and the Service have dealt for years with the need to segregate punitive and compensatory damages from each other, and the task of making that allocation has not been burdensome. Courts typically earmark punitive damages clearly. Settlement agreements often describe how the division between compensatory and punitive damages is to be made. In those situations when there has been a lump sum settlement for both punitive and compensatory damages, and in those cases where the parties' allocation has been set aside,¹⁵⁰ the courts and the Service have not encountered significant difficulty in making reasonable allocations.¹⁵¹ For example, in *Glenshaw Glass*, the landmark case that declared punitive damages to be taxable, the Tax Court¹⁵² allocated a damage settlement between punitive and compensatory elements, and the Supreme Court approved that allocation.¹⁵³ In *Commissioner v. Miller*,¹⁵⁴ where the Fourth Circuit remanded to the Tax Court for an allocation between punitive and compensatory damages, the Fourth Circuit listed several alternative means for the Tax Court to make that allocation. On remand, the Tax Court appeared to have little difficulty in making the allocation.¹⁵⁵

Also, punitive damages can be awarded in nonpersonal injury cases (e.g., anti-trust cases and fraud cases with corporate plaintiffs), where no statutory or other exclusion applies. If the burden of distinguishing punitive from compensatory damages were severe, an exclusion of punitive damages in personal injury cases would not fully resolve the problem. It is true that in many nonpersonal injury cases, all damages, whether compensatory or punitive, are taxable. However, there are many such cases in which the distinction between punitive and compensatory damages must be made. Compensatory damages may be taxable only to the extent the amount recovered exceeds the plaintiff's basis in its goodwill or other damaged property, a limitation inapplicable to punitive damages. In some cases, compensatory damages are not taxable, and, in some cases, the income from compensatory payments is capital gain, while punitive damages are ordinary income. If it were important to avoid the need to distinguish those two types of damages, one would expect a cure to be applied to nonpersonal claims.

150. See, e.g., *Robinson v. Commissioner*, 102 T.C. 116 (1994).

151. The manner in which courts have made an allocation between punitive and compensatory damages is discussed in Douglas A. Kahn, *Federal Income Tax* § 2.1341, at 103-05 (3d ed. 1994).

152. *Glenshaw Glass Co. v. Commissioner*, 18 T.C. 860 (1952).

153. *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 428 (1955).

154. *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990).

155. *Miller v. Commissioner*, 65 T.C. Memo (CCH) 1884, T.C. Memo (P-H) ¶ 93,049 (1993).

A final point on this issue is that a statutory exclusion from income of an item that would otherwise be taxable is a departure from the basic tax scheme. Such departures are not extraordinary in the Code, but their scope should not be expanded by an especially liberal construction unless the text of the statute, or policy considerations, or the legislative history of the provision indicates that a broader reading is warranted. None of those considerations applies to section 104(a)(2).

VI. AGE DISCRIMINATION

The Age Discrimination in Employment Act of 1967 (ADEA)¹⁵⁶ permits only two types of damages to be awarded for violations of that act. The victim can obtain backpay, and, if the employer's violation was willful, liquidated damages equal to the backpay are awarded. Equitable relief can also be granted. Apart from liquidated damages, the victim cannot recover damages for noneconomic harm such as emotional distress.¹⁵⁷

Because of the change that the *Burke* decision caused in the analytical framework employed under section 104(a)(2), pre-*Burke* decisions on the excludability of age discrimination damages are not helpful to the current resolution of that issue and therefore are not discussed here. Since *Burke* was decided in 1992, the focus of the courts has been on whether the range of damages available for victims of age discrimination is sufficiently broad to make the victim's claim "tort-type." The courts are divided on this issue. The Tax Court and the Ninth Circuit have held that the range of available damages provided by ADEA is sufficiently broad to warrant exclusion of both backpay awards and liquidated damages under that act.¹⁵⁸ The Seventh Circuit has held that all ADEA damages are taxable.¹⁵⁹ Without writing an opinion, the Fifth Circuit has affirmed a Tax Court decision holding that ADEA damages are excluded from income, and the Supreme Court has granted certiorari in that case.¹⁶⁰

156. 29 U.S.C. §§ 621-634 (1994).

157. See, e.g., *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999). The damage provision of the ADEA is set forth in 29 U.S.C. § 626(b) (1994), which incorporates by reference the damage provisions of the Fair Labor Standard Act (29 U.S.C. § 216 (1994) [other than subsection (a) thereof]), except that "liquidated damages shall be payable only in cases of willful violations."

158. *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944); *Downey v. Commissioner*, 100 T.C. 634 (1993) (reviewed by the court), rev'd, 33 F.3d 836 (7th Cir. 1994).

159. *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994).

160. *Schleier v. Commissioner*, 26 F.3d 1119 (5th Cir.), cert. granted, 115 S. Ct. 507 (1994).

The question of whether the range of damages provided by ADEA is broad enough has centered on the characterization of the provision for liquidated damages. That liquidated damages are available only when the employer acted willfully indicates that the damages are designed to punish wrongful behavior and deter future violations. However, neither the Tax Court nor the two courts of appeals that have promulgated written opinions since *Burke* have characterized the liquidated damage provision as exclusively punitive in nature.

The Seventh Circuit said in *Downey III*:

At the present time, there is a division in the courts of appeals over the character of the ADEA liquidated damages. Some courts have stated that the character of liquidated damages is strictly punitive [citations to decisions of the Second, Ninth and Eleventh Circuits omitted], while others have stated that ADEA liquidated damages replace prejudgment interest [citations to the First, Fourth, Fifth, and Sixth Circuits omitted]. This court [in prior nontax decisions] adheres to the position that ADEA liquidated damages replace prejudgment interest.¹⁶¹

The Seventh Circuit held that a claim qualifies as tort or tort-type under *Burke* only if nonpecuniary damages are permitted. Having characterized the liquidated damage provision in ADEA as not being a substitute for nonpecuniary losses (it is either punitive or a substitute for prejudgment interest),¹⁶² the court concluded that an ADEA claim is not a tort or tort-type claim and that all ADEA damages are taxable.

While the Tax Court and the Ninth Circuit have acknowledged that ADEA liquidated damages serve a "deterrent or punitive purpose," they hold that the damages also serve a compensatory purpose—to compensate the victim for nonpecuniary losses that are too obscure and difficult to prove.¹⁶³ The Ninth Circuit's majority opinion in *Schmitz* explained away the requirement of willfulness as follows:

In enacting ADEA, Congress was likely attempting to balance the need to compensate victims and deter discrimination with the need to protect businesses from crushing liability.

161. *Downey v. Commissioner*, 33 F.3d 836, 839 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

162. For the taxability of prejudgment interest included in damage awards for personal injuries, see Part II.C.

163. *Downey v. Commissioner*, 100 T.C. 634, 637 (1993) (reviewed by the court) (*Downey II*), rev'd, 33 F.3d 836 (7th Cir. 1994); *Schmitz v. Commissioner*, 34 F.3d 790, 794 (9th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944).

Unlike the concurrence, we see nothing “peculiar” in Congress’s decision to resolve these competing interests by compensating victims of willful discrimination at a higher rate than victims of “nonwillful” discrimination: Congress has simply decided as a public policy matter that only victims of willful discrimination should receive obscure and difficult to prove compensatory damages.¹⁶⁴

Judge Trott, concurring with the result reached by the majority in *Schmitz*, rejected the majority’s view that ADEA liquidated damages serve a compensatory purpose. Judge Trott stated that the legislative history of the ADEA and the decisions of courts of appeals in nontax ADEA cases (including two decisions by the Ninth Circuit itself) establish that the ADEA liquidated damage provision is a punitive measure. Judge Trott quoted the Supreme Court’s statement in *Trans World Airlines, Inc. v. Thurston*, that “[t]he legislative history of the ADEA indicates that Congress intended for liquidated damages to be punitive in nature.”¹⁶⁵ Despite his repudiation of the majority’s characterization, Judge Trott concurred with the result because of his belief that section 104(a)(2) encompasses punitive damages.¹⁶⁶

The requirement that a claim be tort or tort-type has its roots in the regulations.¹⁶⁷ In *Burke*, the Supreme Court merely accepted that regulatory condition. As previously noted, the apparent purpose of this requirement is to preclude the exclusion from applying to recoveries under claims grounded in contract, which are commercially oriented. Unfortunately, the distinction between tort and contract claims is blurred, and the characterization of a claim as one or the other is often arbitrary.¹⁶⁸ In *Burke*, the Supreme Court apparently adopted the range-of-available-damages test in order to provide a standard for determining excludability that separated personal, noncommercial injuries from commercial ones more effectively than does the tort/contract dichotomy. The Court may also have believed that this test is easier to administer than one that requires an inquiry into the legislative purpose for granting a right to damages.

When the Supreme Court established the range-of-available-damages test in *Burke*, it is doubtful that the Court anticipated that lower courts would

164. *Schmitz*, 34 F.3d at 795.

165. 469 U.S. 111, 125 (1985).

166. *Schmitz*, 34 F.3d at 796. Judge Trott had previously dissented in *Hawkins*, the case in which the Ninth Circuit held that punitive damages are taxable. *Hawkins v. United States*, 30 F.3d 1077, 1084 (9th Cir. 1994).

167. Regs. § 1.104-1(c).

168. For example, some breaches of contract have been deemed to be so reprehensible that they amount to a tort. See, e.g., E. Allan Farnsworth, *Contracts* § 12.17 n.19 (2d ed. 1990) and cases cited therein.

make the tax treatment of damages turn on speculation as to a legislature's underlying motive for adopting a provision under which damages were granted. The Court likely assumed that it would only be necessary to determine what remedies are available for a type of claim. The problem with liquidated damage provisions is that they may serve several functions—some of them punitive and some compensatory. In the case of the ADEA liquidated damage provision, the prevailing nontax authorities (including decisions of the Supreme Court) seem to favor either a punitive characterization or one of prejudgment interest. In either case, it seems that the range of damages is not broad enough to satisfy *Burke*. In view of the commercial nature of the injury (the claim arises from wrongful failure, because of the victim's age, to hire, promote, or retain the victim as an employee or a wrongful denial of some other employment benefit), the policy justifications for excluding personal injury damages are generally inapplicable to the ADEA. Since the compensatory nature of ADEA liquidated damages is doubtful, and since the policy justification for excluding ADEA damages is weak, ADEA damages should be taxed.

In any event, if the courts are required to speculate as to the motive for the adoption of statutory provisions for damage awards, the administrative feasibility that the range of available damages test likely was designed to provide is lost. It should not be necessary to obtain a psychological profile of the legislators who adopted a provision to determine its tax characterization.

The difficulties encountered in determining whether ADEA damages are excludable are attributable to the inadequacy of the standards of tort-type claims and "range of available damages" that were adopted by the Supreme Court in *Burke*. In Part VII, the author discusses the difficulties caused by those standards and questions whether they lead to rational distinctions. For example, as previously noted, federal employees are barred from receiving liquidated damages under the ADEA,¹⁶⁹ raising the possibility that the ADEA damages of all employees other than federal employees will be excluded from income—thereby doubly punishing the Federal employee.

VII. OPERATION OF *BURKE* STANDARDS

The *Burke* holdings—following the regulations in limiting the section 104(a)(2) exclusion to recoveries on tort or tort-type claims and defining "tort or tort-type" to require a range of available damages—have not eased the administration of the exclusion, have led to incongruous differences in tax

169. *Smith v. Office of Personnel Management*, 778 F.2d 258, 263 (5th Cir. 1985), discussed supra text accompanying note 118.

consequences, and may induce persons injured in employment or other commercial disputes arising out of contract breach to forego settlements in order to bring tort actions that might yield tax-free recoveries. Similarly, employees offered termination payments as an inducement to retire may negotiate with their employers to have the payments characterized as settlements for tortious injuries.

The differentiation between the types of claims for which damages are excluded and those for which damages are taxable appears arbitrary. Compensatory damages received for race-based discrimination under 42 U.S.C. section 1981 and for disparate treatment discrimination under Title VII are excluded from income, as are compensatory damages under the Americans with Disabilities Act.¹⁷⁰ However, compensatory damages for disparate impact discrimination under Title VII are taxable, and it is unsettled whether the damages received for ADEA claims by plaintiffs other than Federal employees are excludable, although it is clear that the *Burke* standards require the inclusion in income of ADEA damages obtained by a Federal employee. Even the possibility that all plaintiffs other than Federal employees can exclude ADEA damages from income, but Federal employees cannot, demonstrates that the *Burke* standards are seriously flawed.

Damages for wrongful discharge (a truly commercial violation) can be excluded if the jurisdiction provides a tort action for the violation, but damages obtained on a contract theory because of a wrongful discharge are taxable.¹⁷¹ In *McKay*,¹⁷² where the plaintiff brought suit for both wrongful discharge and breach of an employment contract, the Tax Court held that the damages obtained for the former were excluded from income, but the damages for breach of the contract were taxable.

Where a breach of contract is one that is likely to cause the plaintiff to incur serious emotional disturbance, courts have allowed recovery for pain and suffering.¹⁷³ In such cases, the range of damages available on the contract claim seem to be sufficient to characterize it as tort-type under *Burke*. If so, under the approach that some courts (including the Tax Court) have taken, *all* damages for breach might be excluded from income. This possibility indicates just how unworkable the *Burke* standards are. Moreover, the attempt to find a standard that distinguishes tort claims from contract claims seems to have failed.

170. Rev. Rul. 93-88, 1993-2 C.B. 61.

171. See *McKay v. Commissioner*, 102 T.C. 465 (1994).

172. *Id.* For a discussion of *McKay*, see *supra* text accompanying notes 120-21.

173. See Farnsworth, *supra* note 168, § 12.17.

Splits in authority have developed since *Burke* on the application of the exclusion to two significant items—punitive damages and prejudgment interest included in personal injury awards.¹⁷⁴

Another problem that may have arisen as a consequence of *Burke* is that employment disputes that might have been settled may instead be channelled to the courts in the hope of having settlements characterized as excludable tort damages. The author has no empirical evidence that this has occurred,¹⁷⁵ but accounts of such occurrences are circulating among some law firms. These accounts may not be accurate, but the availability of that course of action seems so tempting that it is reasonable to expect it to be pursued.

Employers often try to buy-out older employees by offering financial inducements for retirement. Employers often require employees accepting such offers to sign releases for any claims that might exist against the employers for discriminatory treatment. The requirement of such a release may only be a cautionary measure, and it usually does not cause the transaction to be treated in whole or in part as a settlement of a tort claim.¹⁷⁶ However, it seems likely that knowledgeable attorneys will counsel their clients to lodge tort claims in such cases and negotiate with the employer to structure the settlement as a payment of tort damages rather than as a termination payment. A recent commentary on this topic essentially recommends that procedure.¹⁷⁷

Most of the problems created by the *Burke* standards could be resolved by limiting section 104(a)(2) to damages arising from claims based on physical injury. No standard will preclude difficult issues from arising, but the requirement of a physical injury would go far to minimize administrative difficulties and make a more rational division of damages between those that are taxable and those that are excluded. In *Burke*, the Supreme Court rejected Justice Scalia's proposal to restrict section 104(a)(2) to cases involving physical injury,¹⁷⁸ but this issue will soon return to the Court.¹⁷⁹ Perhaps,

174. See Parts II.B, II.C.

175. However, the facts of the recent case of *Taggi v. United States*, 35 F.3d 93 (2d Cir. 1994), lend credibility to the suggestion that this is taking place. See also Loren C. Rosenzweig, Careful Planning May Establish Excludability of Damages Awarded For Age Discrimination, 81 J. Tax'n 254 (1994) (suggesting that settlements for employment terminations should be structured to maximize the amount characterized as a settlement of tort claims).

176. See *Taggi*, 35 F.3d at 93.

177. See Rosenzweig, *supra* note 175, at 258.

178. In *Downey III*, Judge Flaum expressed his admiration for Justice Scalia's cogent argument for his proposal. *Downey v. Commissioner*, 33 F.3d 836, 838 (7th Cir. 1994), petition for cert. filed, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

in light of what has transpired in the wake of *Burke*, the Court will reconsider the position it took in that case and either construe section 104(a)(2) as limited to physical injuries or adopt some other limiting rule.

179. *Schleier v. Commissioner*, 26 F.3d 1119 (5th Cir.), cert. granted, 115 S. Ct. 507 (1994).