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Tort Reform and the Tax Code: An Opportunity to Narrow the Personal Injuries Exemption

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NOTES

Tort Reform and the Tax Code: An Opportunity to Narrow the Personal Injuries Exemption

I. INTRODUCTION

The Internal Revenue Code (the "Code") defines income broadly to include wealth from almost every source,[1] while at the same time exempting a number of items for various tax and public policy reasons.[2] One such policy-based exemption is section 104(a)(2)—the Personal Injuries Exemption—which exempts from tax "any damages . . . received on account of personal injuries or sickness."[3] The Personal Injuries Exemption, however, exists in a state of

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1. 26 U.S.C. § 61 (1994). See *Commissioner v. Schleier*, 1995 U.S. LEXIS 4044, *9 (1995) ("We have repeatedly emphasized the 'sweeping scope' of this section and its statutory predecessors"). See also *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (giving the modern, broad definition of income: "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion"). For the pre-*Glenshaw Glass* definition of income, see *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (defining income more narrowly as "the gain derived from capital, from labor, or from both combined").

2. See, for example, 26 U.S.C. §§ 101-137 (1994) ("Items Specifically Excluded From Gross Income").

3. 26 U.S.C. § 104(a) (1994) reads:

Compensation for injuries or sickness

(a) IN GENERAL.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness;

(3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980; and

(5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a violent attack which the Secretary of State determines to be a terrorist attack and which occurred while such individual was an employee of the United States engaged in the performance of his official duties outside the United States.

For purposes of paragraph (3), in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1) (relating to self-employed individuals), contributions made on behalf of such individual while he was such an employee to a trust described in section 401(a) which is exempt from tax under section 501(a), or under a plan described in section 403(a), shall, to the extent allowed as deductions under section 404, be treated as contributions by the employer which were not includible in the gross income of the employee. Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.

The final sentence was added as an amendment in 1989 and only affects awards received after July 10, 1989. Pub. L. No. 101-239, § 7641(a) (1989).

disarray and needs amending. Since its inception, this exemption has lacked both clear definitions of its key terms and a sound theoretical foundation.[4] Moreover, although courts traditionally read exemptions narrowly,[5] they have interpreted section 104(a)(2) broadly and have applied it in a number of situations where it was not meant to be applied.[6] As a result, the exemption now serves largely as an incentive to sue and as a windfall for those taxpayers fortunate enough to fall within its scope.[7] So great is the disagreement over how to deal with these problems that between 1992 and 1994 the federal circuit courts of appeals split over at least three separate issues regarding the application of the exemption.[8] The Personal Injuries Exemption should be narrowed significantly by giving it a clear definition tied to a sound theoretical foundation.[9] These changes would alleviate many of the current problems and give courts and the Internal Revenue Service (the "Service") guidance in dealing with future problems. It would also raise revenue and eliminate a major incentive to sue.

It is a rare occurrence when the political will for change arises at the precise moment when an often-overlooked area of law most needs amending.[10] Such is the case today as a result of the confluence between America's desire for tort reform and the need for congressional action regarding the Personal Injuries Exemption. America currently needs and wants tort reform. Indeed, such reform was one of the major provisions of the Contract with America that helped

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4. See Part IV.B for a more detailed discussion of these problems.

5. See, for example, *United States v. Centennial Savings Bank*, 499 U.S. 573, 583 (1991).

6. In fact, the reach of section 104(a)(2) has been extended so far that it has recently been argued that no litigant should ever have to pay taxes on any damage award, even if the claim's origins were purely contractual. See William L. Raby, *Why Should Anyone Pay Taxes on Litigation Settlements?*, 63 Tax Notes 213, 215 (April 11, 1994) (arguing that the exclusion from income of settlement awards sounding in tort raises ethical questions for tax practitioners and judges).

7. See Part IV.A.

8. See Parts III.A, III.B, and III.C. One of the three splits was presumably resolved by the Supreme Court's decision in *United States v. Burke*, 112 S. Ct. 1867 (1992) (holding that damages received under the pre-1991 version of Title VII did not constitute tax-exempt personal injuries under section 104(a)(2)). The second was presumably resolved by *Commissioner v. Schleier*, 1995 U.S. LEXIS 4044 (holding that damages received under the Age Discrimination in Employment Act are not tax exempt). It is not clear, however, whether these two cases will truly resolve the issues.

9. See Part IV.C.

10. Indeed, the literature is full of calls for reform and outright repeal of section 104(a)(2). See, for example, Part IV.A. Notably, however, none of these proposals seems to have been implemented by Congress or the courts. For a discussion on why such calls for reform have not been answered, see Part IV.D.

catapult the Republicans to electoral victory in 1994.[11] Because section 104(a)(2) serves as a significant incentive to litigate, Congress currently has an opportunity to use the political will for tort reform to simultaneously limit one of the largest and least justified tax expenditures in the Code—the tax-exempt status of damage awards received on account of personal injuries.

Parts II and III of this Note discuss the legal background of and recent developments in the Personal Injuries Exemption. Part IV analyzes the problems arising from the exemption's current application in more detail and proposes a statutory amendment to section 104(a)(2) which narrows the exclusion by giving it a clear definition which is closely tied to a sound theoretical foundation.

II. LEGAL BACKGROUND

A. Origins and Framework of the Exemption

The predecessor of section 104(a)(2) was first enacted in the 1918 Code in order to clarify the law as Congress believed it then existed.[12] It was based on an opinion of the Commissioner of Internal Revenue that argued that, like the proceeds of life insurance policies, damages received in order to compensate the taxpayer for physical injuries were not taxable as income, but instead constituted a return on capital.[13] The exemption was re-

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11. Saundra Torry, *On the Docket: Trial Lawyers v. Tort Reformers*, Wash. Post, Washington Business 7 (November 21, 1994). Initial proposals for such reform included caps on punitive damages, changes in the rules governing products liabilities cases, and adoption of the "English Rule" whereby the losing party in a lawsuit must pay the legal expenses of the winning party. Id.

As of this writing, the House of Representatives has already begun consideration of a bill "[t]o reform the Federal civil justice system; to reform product liability law." H.R. 10, 104th Cong. 1st Sess. (January 4, 1995). The first item of the bill, entitled the "Common Sense Legal Reforms Act of 1995," awards attorney's fees to the prevailing party. Id. at § 101.

12. 18 U.S.C. § 213(b)(6) (1918) exempted "[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." H.R. Rep. 767, 56th Cong. 2d Sess., reprinted in 1939-1 Cum. Bul. 86, 92 (1918), stated that "Under the present law it is doubtful whether . . . damages received on account of such injuries or sickness . . . are required to be included in gross income. The proposed bill [Revenue Act of 1918] provides that such amounts shall not be included in gross income."

13. T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918). The Commissioner in turn based his decision on an opinion of the Attorney General holding that the proceeds of a life insurance policy were not taxable because they were a return on capital. 31 Op. Att'y Gen. 304, 308 (1918) (stating that such proceeds "merely take the place of capital in human ability which was

enacted in the 1939 and 1954 Codes and was amended in 1982 and again in 1989.[14]

Significantly, neither the Code nor the regulations have ever defined "personal injuries or sickness." Moreover, although the regulations do define "damages received," the definition does no more than link the term to traditional tort law principles.[15] This statutory ambiguity represents one of the major causes for the expansive reading courts have given the Personal Injuries Exemption.

B. Theories Underlying the Exemption

A survey of the literature on section 104(a)(2) reveals a troubling fact: no consensus exists regarding the underlying justification for its existence. Scholars, however, have suggested several possible justifications, the most common of which is the return of capital theory. According to proponents of this theory, personal injury damages represent a return of capital and thus do not constitute a taxable gain. This was the initial approach taken by both Congress and the Commissioner,[16] and is the approach which has had the most overall acceptance.[17] Most recently, Professor Kahn argued for its adoption in his article on the subject.[18]

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destroyed"). This theory is further supported by the position of the Service that the exclusion, as originally enacted, applied only to those damages which were received on account of physical injuries. See notes 39-40 and accompanying text.

14. I.R.C. § 22(b)(5) (1939); I.R.C. § 104 (1954). In 1982 it was amended to add "and whether as lump sums or as periodic payments." Pub. L. No. 97-473, § 101(a). This was intended to be a codification of existing law rather than a change. S. Rep. No. 97-646, 97th Cong., 2d Sess. at 4 (1982). In 1989 it was again amended. See note 3.

15. 26 C.F.R. § 1.104-1(c) (1995) reads:

> (c) Damages received on account of personal injuries or sickness. Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) 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.

16. See notes 12-13 and accompanying text. The Supreme Court decision of *Burnet v. Logan*, 283 U.S. 404 (1931), clarified once and for all that recovery of a taxpayer's basis in capital was not a taxable event and so was beyond the reach of the income tax. Id. at 413.

17. See *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962) (holding that "[d]amages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights because, in effect, they restore a loss to capital"). This approach also seems to have been the basis of several recent circuit court decisions regarding the taxability of punitive damages. See, for example, *Hawkins v. United States*, 30 F.3d 1077, 1084 (9th Cir. 1994) (Trott, J., dissenting) (characterizing the majority's decision as based on a "resteration of capital rule"), cert. denied, 1995 U.S. LEXIS 4093; *Reese v. United States*, 24 F.3d 228, 231 (Fed. Cir. 1994) (observing that "section 104's enumerated categories

The return of capital theory is powerful in its simplicity and intuitive logic. Its attempt to recharacterize what is essentially a policy-based exemption as a tax-based one, however, cannot survive close scrutiny and has been severely criticized.[19] For a gain to be a tax-exempt return of capital, the taxpayer must first have a basis in his or her investment, for money received over and above that basis is taxed as income. Professor Kahn's theory does not deal sufficiently with the fact that people do not have a basis in their bodies, as they invested no money to purchase them. Moreover, the argument that the cost of maintaining our bodies constitutes our basis[20] is disingenuous because it ignores the personal exemption and standard deduction received each year for just this purpose.[21] Although Congress initially assumed that the exemption was based on tax logic,[22] Congress used a pre-*Glenshaw Glass* definition of income.[23] The Supreme Court's current broad definition of income[24] suggests that the Personal Injuries Exemption can only be justified as a policy-based exception to the general rule that all gain, from whatever source, is taxable as income.

Closely related to the return of capital theory is the idea that compensation for personal injuries should not be taxed because it does

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encompass only the replacement of losses resulting from injury or sickness"); *Commissioner v. Miller*, 914 F.2d 586, 590 (4th Cir. 1990) (quoting *Starrels* with approval).

18. Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 Fl. Tax Rev. 327 (1995).

19. See, for example, *Horton v. Commissioner*, 100 Tax Ct. 93, 95 (1993) (stating that the Tax Court has long since rejected the return on capital theory); *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting) (stating that "[a]lthough I agree that the majority's restoration of the capital rule may make sense as a matter of policy, I don't think the text of § 104(a)(2), its legislative history, or the case law can be squared with the majority's interpretation").

Scholars have also criticized the return of capital theory extensively. See, for example, Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform*, 56 Tenn. L. Rev. 661, 668 (1989) (calling the theory "insufficient to fully explain section 104(a)(2)"); Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 Case W. Res. L. Rev. 43, 45-46 (1988) (calling the theory appealing if involving the "loss of a limb or organ" but insufficient as not addressing the taxpayer's lack of a basis in his or her body); Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 Tax Law. 783, 796 (1992) (criticizing the theory as not taking into account the tax-exempt status of punitive damages); Edward Yorio, *The Taxation of Damages: Tax and Non-tax Policy Considerations*, 62 Cornell L. Rev. 701, 711-13 (1977) (arguing that the theory fails to take into account the exclusion under section 104(a)(2) of lost earnings).

20. This argument suggests that as we pay for the food and medical expenses necessary to survive, our initial basis of zero should be increased. Thus, damages received on account of personal injuries merely replace these expenditures and should not be taxable as a gain.

21. 26 U.S.C. §§ 151-53. 26 U.S.C. § 63(c). See also Jennifer J. S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 Wm. Mitchell L. Rev. 759, 766-68 (1988) (arguing that self-maintenance costs do not constitute the taxpayer's paid-in basis in his or her body since such costs are already deducted in the personal exemption and standard deduction).

22. See notes 12-13 and accompanying text.

23. See notes 1, 12-13 and accompanying text.

24. See note 1.

no more than make the taxpayer whole again.[25] Although this seems to be merely a reformulation of the return of capital theory, it is not based on tax logic and so avoids much of the criticism which has been leveled at that theory.[26] Also closely related to the return of capital theory is one commentator's argument that the exemption is really based on a sort of intuitive economics.[27]

Two other theories justify the exemption on the basis of its similarity to other types of exempt income. The first is that damage awards in personal injury suits resemble imputed income.[28] Under this theory, such damages are exempt since they compensate the victim for intangibles which would not otherwise be taxed. The problem with this theory, however, is that imputed income is exempt because of the difficulties inherent in defining and administering such income, whereas no such infirmities exist regarding personal injury damages.[29] The other theory, that damage awards represent involuntary transactions analogous to ones in the Code that are exempt, also fails under close scrutiny.[30]

A third major approach that commentators have taken has been to argue that section 104(a)(2), whatever its origins, owes its continuing existence to Congress's compassion.[31] Concern for injured

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25. See, for example, Brooks, 14 Wm. Mitchell L. Rev. at 768-69 (cited in note 21) (discussing the merits of the theory); Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 Hous. L. Rev. 701, 724 (1986) (discussing the merits of the theory).

26. The criticism that the return of capital theory fails to take into account the taxpayer's lack of a quantifiable basis in his or her body, for example, does not seem to apply. It is not clear te this Author why the theory has received so little attention, however. It may be because the theory is so closely associated with the return of capital theory.

27. Brooks, 14 Wm. Mitchell L. Rev. at 804-05 (cited in note 21). Although there is nothing wrong with this theory per se, Congress's intuition would appear te be a somewhat weak foundation for such an enormous exemption.

28. See, for example, Yorio, 62 Cornell L. Rev. at 713-14 (cited in note 19) (arguing that the most convincing theory for section 104(a)(2) is that since the benefits a taxpayer receives from his or her body are not taxed—because such benefits would be non-taxable imputed income—compensation intended to repair that body should also not be taxed); Brooks, 14 Wm. Mitchell L. Rev. at 769-73 (cited in note 21) (comparing damage awards with the return of tortiously converted items and with imputed income).

Imputod income includes acts such as an accountant's preparation of his or her own tax returns. While such actions are clearly gains, Congress neither can nor desires to tax them. 501 Tax Manage. Portfolios (BNA) A-10 (1992).

29. Cochran, 38 Case W. Res. L. Rev. at 48-49 (cited in note 19).

30. Id. at 46-47 (comparing damage awards with § 1033 deductions). According to Professor Kahn, "[i]nvoluntariness alone is not a sufficient justification for this extraordinary exclusionary treatment since the involuntary conversion of tangible property is not treated so gently." Kahn, 2 Fl. Tax Rev. at 348 (cited in note 18).

31. Bertram Harnett, *Torts and Taxes*, 27 N.Y.U. L. Rev. 614, 626 (1952) (stating that "the treatment of lost earnings is rooted in emotional and traditional, rather than logical, factors").

taxpayers, especially those with physical injuries, has prompted Congress not to repeal the provision.[32] Moreover, damage awards might not cover all of the medical and legal expenses incurred by the taxpayer were they subject to tax,[33] a result which would defeat the primary goal of tort law, the compensation of victims for personal injuries.[34] Compassion for injured taxpayers as a theory also helps explain why courts have been so willing to expand the scope of the exemption to a variety of new causes of action. Aside from being more of an explanation than a justification, however, compassion as a theory fails in that it does not take into account either the increasing size of damage awards or the tax-exempt status of punitive damages, which are awarded on the basis of the defendant's degree of culpability, not the plaintiff's degree of injury.[35]

The fourth and least satisfying approach has been to base the exemption on administrative concerns. For example, because awards are often paid in lump sums, injured taxpayers would have to pay a higher rate of tax due to bunching of income.[36] Difficulties with the allocation of awards, for example between taxable and exempt income, have also been cited as potential justifications for the current system.[37] Finally, commentators have suggested that the exemption serves as a subsidy to help ease the potentially enormous burden on tortfeasors.[38] None of these administrative concerns, however, seems sufficient to justify the enormous size of the Personal Injuries Exemption.

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32. It has also been suggested that the exemption is based on the fact that taxing personal injury damages would be a "vulturous act—analogous to feeding off of the flesh of a dismembered arm or leg or off of the corpse of a recently departed." Kahn, 2 Fl. Tax Rev. at 349 (cited in note 18).

33. See *Miller v. Commissioner*, 93 Tax Ct. 330, 341 (1989) (holding that "[p]unitive damages have served as a means of compensating plaintiffs for intangible harm and for costs and attorneys' fees," presumably because compensatory damages are not always large enough to cover the costs and attorneys' fees).

34. Cecil A. Wright, *Introduction to the Law of Torts*, 8 Camb. L. J. 238, 238 (1944) (explaining that "[t]he purpose of the law of torts is . . . to afford compensation for injuries sustained by one person as the result of the conduct of another") (quoted with approval in William L. Prosser, *Handbook of the Law of Torts* 6 (West, 4th ed. 1971)).

35. Cochran, 38 Case W. Res. L. Rev. at 50-51 (cited in note 19). See also Yorio, 62 Cornell L. Rev. at 707 (cited in note 19) (arguing that if sympathy is the true basis for the exemption, it does not go far enough).

36. Yorio, 62 Cornell L. Rev. at 714-19 (cited in note 19); Cochran, 38 Case W. Res. L. Rev. at 49-51 (cited in note 19); Kahn, 2 Fla. Tax Rev. at 340 (cited in noto 18).

37. Henning, 45 Tax Law. at 797 (cited in note 19); Henry, 23 Hous. L. Rev. at 726 (cited in note 25).

38. Yorio, 62 Cornell L. Rev. at 719-22 (cited in note 19) (noting that the danger of excessively high judgments is exacerbated by the progressive tax structure).

Notably, with the exception of the administrative concerns theory, all of these approaches are based on the idea that an injured taxpayer who receives compensation for his or her injuries has not profited. To the degree that compensation merely makes the tort victim whole again, there seems to be no reason to tax the damage award. It is this overarching policy concern that this Note proposes to use as the basis for a statutory amendment to section 104(a)(2), an amendment that would tax only those portions of damage awards that represent some sort of gain to the taxpayer. The problem, as this Note will show, is that the Service and the courts have been moving further and further away from this idea in their application of section 104(a)(2). In so doing, they have brought within the ambit of the Personal Injuries Exemption a variety of claims which clearly do constitute a gain to the taxpayer.

C. Extension of the Exemption to Non-physical Injuries

Congress's original intent, and the original position taken by the Service, was that the Personal Injuries Exemption applied only to physical injuries.[39] In a crucial decision, however, the Service almost immediately reversed itself and conceded that damages received on account of certain non-physical injuries were exempt because they did not constitute a gain.[40] From this point onward, the adversarial process ceased to serve as a limit on the extension of section 104(a)(2),[41] and the Service's position was soon adopted by the Tax Court and eventually codified in the regulations.[42]

Unlike in the case of purely physical injuries, however, when the injury was to the taxpayer's reputation, the courts and the Service distinguished between the taxpayer's personal and business reputa-

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39. Sol. Mem. 1384, 2 Cum. Bul. 71 (1920) (holding that damages for alienation of affection are not excludable).

40. Sol. Op. 132, I-1 Cum. Bul. 92 (1922). See Part II.B regarding the return of capital theory. The Service later tried te reverse itself again in Rev. Rul. 74-77, 1974-1 Cum. Bul. 33 (1974), but the courts refused to acquiesce in this attompt to tighten the exclusion, see note 42.

41. See *Burke*, 112 S. Ct. at 1877 (Scalia, J., concurring) (calling section 104(a)(2) "an ever-so-rare 'taxpayer friendly' Treasury regulation").

42. *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1025 (1927). See also *McDonald v. Commissioner*, 9 B.T.A. 1340 (1928) (holding, on the basis of *Hawkins*, that damages for a breach of promise to marry were excludable).

26 C.F.R. § 1.104-1(c), enacted in 1960, linked Section 104(a)(2) te "tort or tort type rights" (quoted in full in note 15). Since tort law encompasses both physical and non-physical injuries, such a connection would seem to suggest that both types of injuries are included in the exemption.

tions.[43] Damages paid on account of a taxpayer's professional reputation were considered to be in lieu of otherwise taxable lost earnings and so were not exempt.[44] Thus, only those non-physical injuries that were strictly personal in nature were exempted under section 104(a)(2).

In 1983, however, the Ninth Circuit in *Roemer v. Commissioner*[45] reversed the position of the Tax Court and held that it was incorrect to treat physical and non-physical damages differently. Because the language of section 104(a)(2) makes no distinction between physical and non-physical injuries, the *Roemer* court looked at the nature of the underlying claim in order to discover in lieu of what were the damages awarded.[46] Thus, the entire award was exempt under section 104(a)(2) if the damages were intended to compensate the taxpayer for a "personal injury."

The Tax Court adopted the Ninth Circuit's reasoning three years later in the pivotal case of *Threlkeld v. Commissioner*.[47] Significantly, the Tax Court adopted an even more liberal approach than had the Ninth Circuit, holding that *any* invasion of the taxpayer's rights, not only those recognized by traditional tort principles, would be tax exempt under section 104(a)(2).[48] This departure from tort law principles signaled yet another major extension of the Personal Injuries Exemption, this time into the area of civil rights legislation.

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43. Rev. Rul. 58-418, 1958-2 Cum. Bul. 18 (1958). In fact, in *Roemer v. Commissioner*, 79 Tax Ct. 398, 406 (1982), the Tax Court held that the taxpayer had the burden of proving that the injuries he sustained were personal, rather than professional. Compare *Roemer* with *Church v. Commissioner*, 80 Tax Ct. 1104, 1110 (1983), wherein the Tax Court held that an award for damage to the taxpayer's personal reputation is excludable under section 104(a)(2).

44. See, for example, *Wolfson v. Commissioner*, 651 F.2d 1228, 1230 (6th Cir. 1981) (holding that damages for injury to the taxpayer's professional reputation are taxable as based on lost earnings); *Glynn v. Commissioner*, 76 Tax Ct. 116, 120 (1981) (holding that "payments for injury to professional reputation are not excludable from gross income").

For the origins of the "in lieu of what" test, see *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944) (holding that the taxation of anti-trust damages depends on the question "In lieu of what were the damages awarded?").

45. 716 F.2d 693 (9th Cir. 1983).

46. Id. at 696-97. Thus, the proper inquiry is to "look to the nature of the tort of defamation to determine whether the award should have been reported as gross income." Id.

47. 87 Tax Ct. 1294, 1299 (1986) ("whether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry"). See also *Miller*, 93 Tax Ct. at 330 (holding that all damages, both compensatory and punitive, are excludable in a defamation suit). At first, the Service refused to go along with the Ninth Circuit's decision in *Roemer*. Rev. Rul. 85-143, 1985-2 Cum. Bul. 55, 56 (1985) (stating that "[t]he Service continues to believe the decision of the Tax Court is correct. Whether a libel in a particular situation is a personal injury should depend on the nature of the libel").

48. *Threlkeld*, 87 Tax Ct. at 1308 (holding that "[e]xclusion under section 104 will be appropriate if compensatory damages are 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").

D. Extension of the Exemption to Federal Antidiscrimination Causes of Action

Consistent with its approach regarding non-physical torts such as libel and slander, the Service argued as early as 1972 that, because damages received in a Title VII suit were in lieu of backpay,[49] they were not covered by the Personal Injuries Exemption.[50] However, while still maintaining that damages received on account of non-physical injuries were only tax-exempt when they were personal, the Tax Court recognized that antidiscrimination claims such as Title VII were more complicated than simple tort actions. To determine whether the claim was personal, then, a court had to look at the complaint to determine the nature of the relief sought.[51] In *Hodge v. Commissioner*, for example, the taxpayer's original prayer for relief was for backpay only. Thus, although the case was settled immediately after the taxpayer threatened to add allegations of personal injuries,[52] the entire award was held to be taxable.[53] While the Tax Court's analysis in *Hodge* seems as first glance to have narrowed the application of section 104(a)(2), it in fact invited abuse by taxpayers who were sufficiently well-informed to add claims of personal injuries to their original complaints.[54]

Ironically, the case which did the most to expand the scope of the Personal Injuries Exemption did not involve a tax issue. In 1985, the Supreme Court decided *Wilson v. Garcia*,[55] a case addressing the appropriate statute of limitations to apply to section 1983[56] claims. Apparently unaware of the tax consequences of the decision, the Court explained at length and in great detail that section 1983 injuries were personal injuries sounding in tort.[57] This explanation had

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49. Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e et seq. (1994).

50. Rev. Rul. 72-341, 1972-2 Cum. Bul. 32 (1972). The Tax Court agreed with the Service's position. *Hodge v. Commissioner*, 64 Tax Ct. 616 (1975). See also *Seay v. Commissioner*, 58 Tax Ct. 32 (1972).

51. *Hodge*, 64 Tax Ct. at 620.

52. Id. at 620-21.

53. Id.

54. For a fuller discussion of this type of abuse, see Parts III.D. and IV.A.

55. 471 U.S. 261 (1985).

56. 42 U.S.C. § 1983 (1994).

57. *Garcia*, 471 U.S. at 276-77. The court held:

> After exhaustively reviewing the different ways that § 1983 claims have been characterized in every Federal Circuit, the Court of Appeals concluded that the tort action for the recovery of damages for personal injuries is the best alternative available. . . . We agree that this choice is supported by the nature of the § 1983 remedy . . . . The atrocities that concerned Congress . . . plainly sounded in tort.

the unintended effect of forcing the Tax Court to adopt the Supreme Court's analysis and to rule that damages under sections 1981, 1982, 1983, 1985(3) and 1986[58] were all exempt from tax under the Personal Injuries Exemption.[59] Similarly, the Tax Court felt compelled in *Thompson v. Commissioner*[60] to reverse its earlier position regarding damages from Title VII. Again borrowing language that the Supreme Court used in another context, the Tax Court held that Title VII claims were personal and hence tax-exempt.[61]

E. Extension of the Exemption to Punitive Damages

In the early days of the federal income tax, punitive damages were not considered taxable.[62] Thus, Congress never addressed the issue of whether they were meant to be included in the Personal Injuries Exemption. The Supreme Court, however, in its famous *Glenshaw Glass* decision, held that punitive damages were taxable because they constituted "undeniable accessions to wealth, clearly realized."[63] Applying the Supreme Court's new definition of income, the Service in 1958 issued a revenue ruling stating that punitive damages received on account of personal injuries were not exempt even though the compensatory damages received in the same action were exempt.[64] The logic behind this rule was that personal injury damages, to be excludable, had to be compensatory. Since punitive damages, by definition, were not compensatory, they constituted a taxable gain.[65]

Id.

58. 42 U.S.C. §§ 1981-86 (1994).

59. *Bent v. Commissioner*, 87 Tax Ct. 236, 247 (1986) (holding that "[f]irst, the Supreme Court determined that Federal rather than State law governs the characterization of a sec. 1983 claim for statute of limitations purposes. . . . Second, the Supreme Court concluded that all sec. 1983 claims should be characterized in the same way. . . . Third, the Supreme Court held that all sec. 1983 actions are best characterized as involving claims for personal injuries"); *Metzger v. Commissioner*, 88 Tax Ct. 834, 852 (1987).

60. 89 Tax Ct. 632 (1987).

61. Id. But see *Sparrow*, ¶ 89, 315 PH Memo TC (holding that a Title VII suit against the U.S. Navy, when the Navy had not waived its sovereign immunity against legal actions, could only be based on equity, and hence constituted taxable backpay).

62. *Roemer*, 79 Tax Ct. at 407; *O'Gilvie v. United States*, 1992 U.S. Dist. LEXIS 8499, *13 (1992), reconsidered, 1992-2 U.S.Tax Ct. (CCH) ¶ 50,567 (observing that "[p]unitive damages were not thought to be taxable income until [*Glenshaw Glass*]"). But see *Glenshaw Glass*, 348 U.S. at 431 (holding that "[t]he mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients").

63. *Glenshaw Glass*, 348 U.S. at 432 (holding that punitive damages received on account of fraud and antitrust violations were taxable as ordinary income).

64. Rev. Rul. 58-418, 1958-2 Cum. Bul. 18 (1958).

65. See *Starrels*, 304 F.2d at 576-77.

In 1975 the Service reversed itself, holding that "any damages" in section 104(a)(2) should be read as meaning "all damages," both compensatory and punitive.[66] This position was adopted by the Tax Court as well as by the Ninth Circuit.[67] However, in an unusual turn of events, the Service reversed itself again in 1984 and began arguing that use of the phrase "on account of" created a causation requirement.[68] Since punitive damages are based on the egregiousness of the tortfeasor's conduct rather than on the extent of the injury to the taxpayer, they are not awarded "on account of personal injuries."[69]

III. RECENT DEVELOPMENTS

A. *The Supreme Court's Decision in* Burke

United States v. Burke,[70] a suit for backpay under Title VII, was the first of two recent Supreme Court decisions dealing directly with the Personal Injuries Exemption.[71] In *Burke*, the Court sided with the D.C. Circuit, and against the Fourth and Sixth Circuits, in holding that damages under Title VII are not exempt from tax.[72] Rather than adopting the D.C. Circuit's analysis,[73] however, the Court combined the Sixth Circuit's focus on the nature of the underlying injury[74] with the regulations' focus on traditional tort law concepts.[75] Thus, the Court held that the proper analysis is to examine the

66. Rev. Rul. 75-45, 1975-1 Cum. Bul. 47 (1975).
67. *Roemer*, 79 Tax Ct. at 408; 716 F.2d at 700.
68. Rev. Rul. 84-108, 1984-2 Cum. Bul. 32 (1984).
69. Id. Interestingly, in *Burford v. U.S.*, 642 F. Supp. 635 (N.D. Ala. 1986), a taxpayer unsuccessfully challenged the revenue ruling's characterization of Alabama's rather unique wrongful death statute. See Part III.C for a discussion of the subsequent debate on this topic and the circuit court split that has arisen as a result.
70. 112 S. Ct. 1867 (1992).
71. The other was *Schleier*, 1995 U.S. LEXIS 4044. See Part III.B.
72. *Burke*, 112 S. Ct. at 1874.
73. The D.C. Circuit looked at the nature of the relief granted by Title VII and concluded that, since such relief was equitable rather than legal, the award was not excludable under section 104(a)(2). *Sparrow v. Commissioner*, 949 F.2d 434, 438 (D.C. Cir. 1991).
74. *United States v. Burke*, 929 F.2d 1119, 1123 (6th Cir. 1991) (holding that the nature of the underlying claim is the key to whether damages are exempt under section 104(a)(2)).
75. 26 C.F.R. § 1.104-1(c) defines "damages received" as damages received "through prosecution of a legal suit or action based upon tort or tort type rights" (quoted in full in note 15).

underlying claim to see whether it is tort-like in nature.[76] The Court then held that the existence of a broad range of remedies aimed at compensating the victim for intangible injuries was the hallmark of a tort-like cause of action, and that a claim which lacked such remedies was a non-tort-like, taxable claim.[77]

Having decided on the proper analysis, the Court next examined the remedies then available in Title VII suits—injunctions, reinstatement, backpay, and other equitable remedies—and concluded that they did not indicate a tort-like claim.[78] Rather, the lack of punitive and compensatory damages and the fact that Title VII made no attempt to compensate for the victim's pain and suffering or emotional distress meant that awards received in Title VII cases were not "personal injuries" within the meaning of section 104(a)(2).[79] It was on this point, and not on the appropriate test to be used, that Justices O'Connor and Thomas dissented.[80]

Justice Scalia, in an important concurrence, however, argued that the key question should be whether the taxpayer had suffered an injury to his or her physical or mental health.[81] Using rules of statutory interpretation, he concluded that an appropriately narrow reading of the exemption, in light of its overall framework and its linkage of "personal injuries" with "sickness," could only mean that section 104(a)(2) was intended to apply only to physical injuries.[82] Justice Souter, in a separate concurrence, reached much the same conclusion.[83]

B. The Supreme Court's Decision in Schleier

Although one would have expected the Supreme Court's decision in *Burke* to have settled the issue of the excludability of damages received in federal antidiscrimination claims, another circuit court

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76. *Burke*, 112 S. Ct. at 1872.

77. Id. at 1871.

78. Id. at 1873. Congress amended Title VII in 1991 by providing for a range of remedies similar to that which the *Burke* court suggested are indicative of a tort-like cause of action. Civil Rights Act of 1991, Pub. L. No. 102-166, § 102, codified at 42 U.S.C. § 1981a (1988, Supp. 1992). Rev. Rul. 93-88, 1993-2 Cum. Bul. 61 (1993) held, after *Burke*, that damages received under the amended Title VII are exempt under section 104(a)(2).

79. *Burke*, 112 S. Ct. at 1873-74.

80. Id. at 1878 (O'Connor, J., dissenting).

81. Id. at 1874-75 (Scalia, J., concurring).

82. Id. at 1875-77.

83. Id. at 1877-78 (Souter, J., concurring). Justice Souter argued that the regulations distinguish between contract law claims, which are taxable, and tort law claims, which are tax-exempt. Since Title VII seems to have elements of both, however, the rule that exemptions must be construed narrowly means that Title VII damages must be taxed. Id.

split arose only two years after *Burke*.[84] In what can only be described as the perfect split, the Ninth and Seventh Circuits disagreed about the taxability of Age Discrimination in Employment ("ADEA")[85] awards received by two United Airlines pilots. The irony of the split was that the pilots had received nearly identical sums from the same defendant as part of a single settlement.[86] The disagreement was essentially a dispute over whether the plaintiffs had realized a gain.

Prior to *Burke*, damages received in ADEA suits had generally been tax exempt.[87] On reconsideration following *Burke*, the Tax Court affirmed its pre-*Burke* decision in *Downey v. Commissioner* that both the backpay and liquidated damages portions of ADEA settlements were excludable.[88] The Seventh Circuit, however, disagreed.[89] It read *Burke* as requiring the presence of damages compensating intangible injuries, in order for the damages award to be exempt. Because neither the backpay nor the liquidated damages portion of the award offered such compensation, the court held that damages received on account of an ADEA claim were taxable.[90]

The Ninth Circuit, on the other hand, agreed with the reasoning of the Tax Court and concluded that the entire award was tax exempt.[91] It argued that the liquidated damages portion of the settlement served a compensatory as well as a punitive function. Therefore, since the claim included the possibility of tort-like remedies as required by *Burke*, the court held that the entire award was tax exempt under section 104(a)(2).[92]

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84. See *Downey v. Commissioner*, 33 F.2d 836 (7th Cir. 1994) (holding that ADEA awards are taxable); *Schmitz v. Commissioner*, 34 F.2d 790 (9th Cir. 1994) (holding that ADEA awards are tax exempt).

85. 29 U.S.C. § 621 et seq. (1988 & Supp. 1994)

86. See *Downey*, 33 F.3d at 837; *Schmitz*, 34 F.3d at 791. See also Kahn, 2 Fla. Tax Rev. at 378-81 (cited in note 18), for a critical discussion of the split.

87. *Downey v. Commissioner*, 97 Tax Ct. 150, 168-70 (1991); *Rickel v. Commissioner*, 900 F.2d 655, 662 (3d Cir. 1990); *Pistillo v. Commissioner*, 912 F.2d 145, 148 (6th Cir. 1990); *Redfield v. Insurance Co. of North America*, 940 F.2d 542, 547 (9th Cir. 1991).

88. *Downey*, 100 Tax Ct. at 637. See Parts II.E and III.C regarding the taxability of punitive damages.

89. *Downey*, 33 F.3d at 840.

90. Id. at 839.

91. *Schmitz*, 34 F.3d at 796.

92. Id. This seems to be the majority approach. See, for example, *Purcell v. United States*, 999 F.2d 950, 960-61 (5th Cir. 1993); *Downey*, 100 Tax Ct. at 637; *Bennett v. United States*, 30 Fed. Cl. 396 (1994); *Rice v. United States*, 834 F. Supp. 1241, 1243-45 (E.D. Cal. 1993). But see *Drase v. United States*, 866 F. Supp. 1077 (N.D. Ill. 1994).

The Supreme Court stepped in to resolve the split in *Commissioner v. Schleier*,[93] another of the United Airlines cases, in which the Fifth Circuit had affirmed the Tax Court without a written opinion.[94] Rather than using the analysis it had developed in *Burke*, however, the Supreme Court announced that *Burke* was only half the story.[95] Now, to be exempt, not only must the claim be tort-like in nature, as required by *Burke*,[96] but the damages must also be received "on account of personal injuries or sickness."[97] By a six to three majority, the Court then concluded that ADEA damages are not received on account of personal injuries and so are taxable as ordinary income.[98] Justice O'Connor dissented, arguing that the new test was unnecessary and that ADEA injuries are indeed personal.[99]

The most significant aspect of this decision, however, is that the Supreme Court's reasoning will likely destroy any certainty that the decision might otherwise have brought to this area of the law. In Part IV of the decision, Justice Stevens analyzed ADEA claims along the lines of *Burke* and concluded that ADEA claims are not based on personal injuries.[100] If this is so, why did the majority then add an unnecessary new test when it could have based its decision entirely on *Burke*? The only reasonable explanation is that the Court was attempting to narrow the scope of section 104(a)(2). This is an admirable objective, but, as this Note will argue, one that cannot be

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93. 1995 U.S. LEXIS 4044 (1995).

94. 26 F.3d 1119 (5th Cir. 1994).

95. 1995 U.S. LEXIS 4044 at *23-24 ("[W]e did not hold [in *Burke*] that the inquiry into 'tort or tort type rights' constituted the beginning and end of the analysis").

96. *Burke*, 112 S. Ct. at 1872 ("In order to come with the § 104(a)(2) income exclusion, respondents therefore must show that Title VII, the legal basis for their recovery of backpay, redresses a tort-like personal injury").

97. In sum, the plain language of § 104(a)(2), the text of the applicable regulation, and our decision in *Burke* establish two independent requirements that a taxpayer must meet before a recovery may be excluded under § 104(a)(2). First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is "based upon tort or tort-type rights"; and second, the taxpayer must show that the damages were received "on account of personal injuries or sickness."

1995 U.S. LEXIS 4044 at *24-25.

98. Id. In her dissent, Justice O'Connor criticized the majority for its off-hand dismissal of ADEA suits as not constituting personal injuries. Id. at *30-31 (O'Connor, J., dissenting) ("[The majority's] reasoning assumes the wrong answer to the fundamental question of this case: What is a personal injury?").

99. Id. at *25, *34-42 (O'Connor, J., dissenting) ("Age discrimination inflicts a personal injury") ("ADEA damages should be excludable from taxable income under our precedents").

100. Id. at *20-24. Justice Stevens argued that although ADEA provides for jury trials and liquidated damages, two factors that *Burke* held were indicative of a tort-like claim, 112 S. Ct. at 1873-74, the lack of compensatory damages is of such weight as to make ADEA not tort-like. Id. at *21-22.

accomplished by the courts.[101] In fact, the Supreme Court's attempt in *Schleier* to narrow the exemption has already generated further confusion. For example, what will be the new definition of "personal injuries?" From 1960 to the present, the regulations have attempted to define the term by linking it to traditional tort principles.[102] In *Schleier*, however, the Court explicitly states that such linkage is in addition to, rather than an explanation of, the requirement that the damages be received "on account of personal injuries."[103] In place of the regulations' definition, the Court merely referred to the "plain language of the statute" and suggested that a personal injury is one which is similar to an automobile accident.[104] Does this then mean that the Court intends to restrict the scope of section 104(a)(2) to physical injuries, as Justice Scalia suggested in his concurrence in *Burke*?[105] If so, what will happen to the tax-exempt status of libel and slander claims?[106] Although clearly tort-like, they are not physical injuries. Moreover, if section 104(a)(2) is limited to damages on account of physical injuries, what meaning can be given to the 1989 amendment to section 104?[107]

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101. See Part IV.D of this Note for a discussion of why Congress is in a better position than the courts to remedy the many flaws inherent in section 104(a)(2).

102. 1995 LEXIS 4044 at *37-39 ("For 35 years the IRS has consistently interpreted its regulation . . . as conclusively establishing the requirements of § 104(a)(2)").

103. Id. at *18 ("The regulatory requirement that the amount be received in a tort-type action is not a substitute for the statutory requirement that the amount be received 'on account of personal injuries or sickness'; it is an additional requirement"). But see id. at *42 (O'Connor, J., dissenting) ("It is surely more reasonable to read the regulation as defining an ambiguous statutory phrase, rather than as imposing a superfluous precondition without any statutory basis").

104. Id. at *11, *24. As Justice O'Connor pointed out, however, "the statute is anything but plain" and an example is not an adequate replacement for a clear definition. Id. at *41, *32-33 (O'Connor, J., dissenting).

105. "The [majority's] hypothetical contrast between wages lost due to a car crash and wages lost due to illegal discrimination would be significant only if . . . one reads 'personal injuries,' as Justice Scalia did in *Burke*, to include only tangible injuries." Id. at 32 (O'Connor, J., dissenting). See *Burke*, 112 S. Ct. at 1875 (Scalia, J., concurring) (arguing that the "more common connotation [of personal injuries] embraces only physical injuries to the person . . . or perhaps, in addition, injuries to a person's mental health").

106. See Part II.C of this Note for a discussion of section 104(a)(2)'s application to non-physical injuries such as libel and slander.

107. Congress amended section 104 in 1989 to add: "[p]aragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Pub. L. No. 101-239, § 7641(a) (1989). If *Schleier* holds that section 104(a)(2) does not apply to *any* damages received in connection with a case not involving a physical injury, then the statutory amendment seems meaningless. For further discussion of the meaning of this amendment, see notes 123-25 and accompanying text.

It is also uncertain whether the post-*Burke* amendments to Title VII[108] will survive the scrutiny of the *Schleier* test. The amendments were carefully drafted so as to meet *Burke*'s test of a "tort or tort type" injury.[109] However, it seems likely that sexual and racial discrimination, like age discrimination, will fail the *Schleier* test for a "personal injury." In fact, a pattern seems to be emerging wherein the Supreme Court holds a type of claim to be outside the scope of section 104(a)(2), then Congress amends the claim to meet the standard set by the Court, then the Court changes its standard again.

It is unclear whether Congress will amend ADEA to comply with *Schleier*, whether it will amend Title VII a second time, or what would occur after it took such actions. The Supreme Court's attempt in *Schleier* to narrow the scope of section 104(a)(2) is an admirable endeavor, but decisions such as *Schleier* are likely to do more harm than good. Absent a complete overhaul of section 104(a)(2) by Congress, the coming years will probably see more, rather than less, confusion over section 104(a)(2)'s applicability to federal antidiscrimination statutes.

C. Circuit Court Split over the Application of the Exemption to Punitive Damages

Notwithstanding the Service's reversal, the Tax Court has continued to maintain that all damages flowing from a claim for personal injuries, including punitive damages, are exempt under section 104(a)(2). In *Miller v. Commissioner*, the Tax Court held that punitive damages compensate for intangible injuries and serve the purpose of reimbursing the taxpayer for his or her attorney's fees.[110] Then, after avoiding the issue in *Downey*,[111] the Tax Court reaffirmed its position that "any damages" means "all damages" in its post-*Burke* decision of *Horton v. Commissioner*.[112] The court relied on *Burke*'s focus on the underlying claim to argue that once the nature of the underlying claim has been determined, all of the damages flowing from that claim should be given the same tax treatment.[113] *Burke* fur-

108. Congress amended Title VII in 1991 in response to *Burke*. See note 78 and accompanying text.

109. Id. Title VII now includes jury trials and punitive damages, two factors that *Burke* held might have made it tort-like and thus tax exempt. *Burke*, 112 S. Ct. at 1873-74.

110. 93 Tax Ct. at 341.

111. 97 Tax Ct. at 150.

112. 100 Tax Ct. at 93.

113. Id. at 96-97.

ther supports this position, according to the Tax Court, because it considers the existence of punitive damages to be a strong indication that the claim in question falls within section 104(a)(2)'s definition of "personal injuries or sickness."[114] In other words, because to be tax exempt, personal injury awards generally must involve at least the possibility of punitive damages, punitive damages must also be tax exempt.

Meanwhile, a split among the circuits has arisen as to application of the exemption to punitive damages awards. The Fourth, Ninth and Federal Circuits have taken the position that the "on account of" language in section 104(a)(2) creates a causation requirement.[115] Because punitive damages do not depend on the extent of the injury suffered by the taxpayer, they are not received "on account of personal injuries or sickness."[116] Even more importantly, taxing punitive damages is consistent with the title and purpose of the exemption and with the traditionally narrow reading which courts give to exemptions from tax.[117]

In an extremely insightful dissent in *Hawkins v. United States*, Judge Trott described the Ninth Circuit's majority opinion as constituting good policy but bad law.[118] He accused the court of ignoring the plain meaning of the phrase "any damages" as well as the Supreme Court's holding in *Burke* that the inquiry should focus on the nature of the underlying claim.[119] According to Judge Trott, the majority was making a noble attempt to bring order to section 104(a)(2) by returning it to the restoration of capital theory. While this was sound policy

114. Id. at 99. Several lower court decisions agree with the Tax Court's analysis in *Horton*. See, for example, *O'Gilvie*, 1992-2 U.S.T.C. (CCH) ¶ 50,567 (holding, on reconsideration after *Burke*, that the key factor for determining the taxability of damages is the nature of the underlying claim).

115. *Miller*, 914 F.2d at 589-90; *Hawkins*, 30 F.3d at 1080; *Reese*, 24 F.3d at 230-31. See also *Kempt v. Commissioner*, 771 F. Supp. 357, 359 (N.D. Ga. 1991); *Estate of Wesson*, 843 F. Supp. 1119, 1123 (S.D. Miss. 1994).

116. *Hawkins*, 30 F.3d at 1080. This argument was rejected by the Fourth Circuit in *Miller*, however. 914 F.2d at 589-90. Instead, the Fourth Circuit based its decision on the underlying purpose of the Personal Injuries Exemption—to make the taxpayer whole again. Since punitive damages represent a windfall to the taxpayer, it is only appropriate to make them taxable. Id. at 590-91. It was this position that prompted the Tax Court in *Horton* to argue that the Fourth Circuit might follow its decision in a case where the punitive damages served a compensatory as well as retributive function. *Horton*, 100 Tax Ct. at 591.

117. *Hawkins*, 30 F.3d at 1080.

118. Id. at 1084 (Trott, J., dissenting).

119. Id. at 1084-88.

for a number of reasons, such a drastic change in the law is the province of Congress, not the judiciary.[120]

The Sixth Circuit, on the other hand, sided with the Tax Court in holding that all damages flowing from an exempt cause of action fall within the scope of section 104(a)(2).[121] The court held that, although exemptions generally should be read narrowly, the language of section 104(a)(2) is so unmistakably broad that it must be construed to include punitive damages. The import of the *Burke* decision is that the nature of the underlying claim, rather than the nature of the damages themselves, is the key to determining whether the damages are taxable.[122]

Congress interjected itself into the debate over the taxability of punitive damages by amending section 104(a)(2) in 1989 to exclude punitive damages in cases where the underlying claim did not involve a physical injury.[123] The amendment has caused a great deal of debate over Congress's intent prior to the amendment. The Sixth Circuit, along with the dissent in *Hawkins*, argued strongly that the amendment indicates that the pre-amendment language exempted punitive damages. If this were not the case, the amendment would be meaningless.[124] The Ninth Circuit, in contrast, cautioned against using the actions of a later Congress to infer the intent of a prior one. Rather, it claimed that the text of the amendment was ambiguous and therefore did not add significantly to the debate.[125]

D. Application of the Exemption to Settlements

Until quite recently, the application of the Personal Injuries Exemption to settlements posed little reason for concern. Courts typically examined settlements to determine whether the payor intended to compensate the taxpayer for personal injuries.[126] In order to

120. Id.

121. *Horton v. Commissioner*, 33 F.3d 625, 630-31 (6th Cir. 1994).

122. Id. at 627-30.

123. Pub. L. No. 101-239, § 7641(a). Congress amended section 104 by adding after the last sentence: "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." The amendment controls any damages received after July 10, 1989. Id.

124. *Horton*, 33 F.3d at 631; *Hawkins*, 30 F.3d at 1086 (Trott, J., dissenting).

125. *Hawkins*, 30 F.3d at 1082.

126. See, for example, *Agar v. Commissioner*, 290 F.2d 283, 284 (2d Cir. 1961) (holding that money received by a taxpayer upon retirement was not intended to settle any potential claims he might have against his employer and so was taxable); *Knuckles*, 349 F.2d 610, 613 (1965) (holding that a settlement was intended to settle the taxpayer's employment dispute and so was taxable); *Fono v. Commissioner*, 79 Tax Ct. 680, 695-96 (1982) (holding that the original

determine the payor's intent, courts would look first at the settlement language[127] and, if the settlement was silent or ambiguous regarding the allocation of the award, would consider other factors such as the testimony given at trial,[128] whether the settlement embodied the initial agreement of the parties,[129] and whether any of the initial claims had been rejected by a court.[130] The nature of the underlying claim, not its validity, was and still is key.[131] In the last year, however, two Tax Court cases have suggested that well-advised taxpayers may be able to manipulate the Personal Injuries Exemption in cases which settle out of court.[132]

In *Robinson v. Commissioner*,[133] the plaintiffs, husband and wife, received almost $60 million in a suit for breach of contract. In making the award, the jury allocated approximately $1.5 million to past and future mental anguish sustained as a result of the loss of plaintiffs' business.[134] Prior to appeal, the parties settled the suit for $10 million, ninety-five percent of which was allocated to mental anguish.[135] Rather than blindly accepting the parties' allocation, however, the Tax Court ruled that the settlement's allocation could only control for tax purposes if it represented an arms-length agreement entered into in good faith by adversarial parties.[136] Since the parties admitted to having colluded in the allocation, the settlement failed this test.[137] Instead, the court reallocated the award based on the ratios inherent in the jury's decision.[138]

While at first glance *Robinson* seems to be a well-reasoned decision, it supports the proposition that a claim for emotional dis-

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settlement, not a second settlement which reallocated damages to claims for physical and emotional distress, was controlling for tax purposes).

127. *Downey*, 97 Tax Ct. at 161 (holding that the language of the settlement is the most important factor). But see *Metzger*, 88 Tax Ct. at 848-50 (holding that the settlement language did not control because it did not represent the true intent of the payor).

128. *Stocks v. Commissioner*, 98 Tax Ct. 1, 17 (1992) (holding that the testimony given at trial suggested that about eighty percent of the award was for excludable personal injuries).

129. *Fono*, 79 Tax Ct. at 695.

130. *Bent*, 87 Tax Ct. at 246 (holding that since only the taxpayer's section 1983 claim was still alive at the time of settlement, the entire settlement was tax-exempt under section 104(a)(2)).

131. *Seay*, 58 Tax Ct. at 37; *Threlkeld*, 87 Tax Ct. at 1297; *Downey*, 97 Tax Ct. at 161.

132. *Robinson v. Commissioner*, 102 Tax Ct. 116 (1994); *McKay v. Commissioner*, 102 Tax Ct. 465 (1994). See Raby, 63 Tax Notes at 213 (cited in note 6).

133. 102 Tax Ct. 116 (1994).

134. Id. at 121.

135. Id. at 123.

136. Id. at 127.

137. Id. at 129-33.

138. Id. at 134.

tress, when added to a genuine contract claim, may result in a portion of any resulting damage award being held to be tax exempt. This means that future plaintiffs may be able to avoid tax liability merely by including claims for emotional distress with their contractual claims. In fact, it has been suggested that failing to include such a claim could subject the taxpayer's attorney to malpractice liability.[139]

More disturbing in terms of taxpayer manipulation is *McKay v. Commissioner*,[140] a case decided a month after *Robinson*. In *McKay*, the prevailing party was awarded over $43 million as a result of the damages being trebled by the Racketeering Influential and Corrupt Organizations Act ("RICO").[141] Although the jury allocated the overwhelming portion of the award to taxable compensation for lost wages and future damages, the parties allocated $12 million of the $14 million settlement to the plaintiff's wrongful discharge tort claim.[142] The *McKay* court followed the court in *Robinson*, requiring that the settlement be the product of arm's-length negotiation between adversarial parties.[143] In contrast to *Robinson*, however, the *McKay* court accepted the settlement's allocation, largely because the defendant corporation, during negotiations, had refused to allocate any of the sum to RICO damages.[144]

The *McKay* court may be correct in distinguishing its case from the facts in *Robinson*.[145] Nonetheless, the court's acceptance of an allocation that differed so markedly from the jury's allocation will at the very least encourage litigants to attempt to structure their suits so as to receive a portion of any award tax-free. This potential abuse may be even more likely because both parties to a settlement may stand to gain economically by such manipulation.

139. Raby, 63 Tax Notes at 213 (cited in note 6).
140. 102 Tax Ct. 465 (1994).
141. 18 U.S.C. §§ 1961-68 (1988 & Supp. 1994).
142. *McKay*, 102 Tax Ct. at 471-72.
143. Id. at 483.
144. Id. at 483-87.
145. See id. at 483-84.

IV. ANALYSIS

The Personal Injuries Exemption is an enormous tax expenditure[146] that lacks both a clear definition and a sound theoretical foundation. This lack of clarity has engendered disputes among the courts and the Service and has resulted in a steady expansion of what was intended to be a narrow exclusion from tax. More importantly, the pace of the expansion has accelerated in the last decade, thereby creating a host of new problems regarding the application of section 104(a)(2).[147] Even a brief examination of these problems shows that the exemption, as currently applied, is in need of reform.

A. Problems with the Current Application of the Exemption

The current state of disarray regarding the application of the Personal Injuries Exemption is itself a problem. Federal law, especially that dealing with income taxes, should be applied uniformly throughout the nation.[148] The courts disagree over so many fundamental issues regarding the application of section 104(a)(2), however, that taxpayers living in different states cannot be sure of equal tax treatment.[149] Similarly, this area of the law is so volatile that it is impossible to know with any degree of certainty what part of a damage award, if any, will be taxed. More than merely indicating the presence of a problem, such confusion is itself a problem. It undermines faith in the Code and leads to strange and inconsistent outcomes.[150]

A second problem with the Personal Injuries Exemption is that its current application encourages manipulation of settlements. As

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146. The General Income Tax Problems Committee of the American Bar Association estimated that merely limiting the exemption to physical injuries would have saved $42 million over the five-year period from 1990 to 1994, with the bulk of that amount being saved in the final two years. *ABA Members Argue Against Exclusions for Punitive Damages and Lost Income Under Section 104*, 89 Tax Notes Today 227-16 (November 9, 1989).

147. See Parts II and III.

148. See, for example, David D. Willoughby, Recent Development, *The Taxation of Defamation Recoveries: Toward Establishing Its Reputation*, 37 Vand. L. Rev. 621, 643-46 (1984) (calling for courts to apply a uniform standard). Note that Willoughby was writing even before the three circuit splits arose between 1992 and 1994. His concern was that use of state definitions of tort law would result in uneven treatment of taxpayers. Id.

149. The circuit split regarding ADEA is the best example of this. There, two taxpayers, who received awards from the exact same defendant as a result of a single class action suit, received dramatically different federal tax treatment for no other reason than that they lived in different states. See Part III.B.

150. Id.

this Note has demonstrated, well-advised litigants can structure their petitions in such a way as to almost guarantee that at least a portion of any award or settlement proceeds they receive will be tax exempt.[151] This ability to manipulate exists even if the underlying claim sounds predominantly in contract law, an outcome that Congress never intended. Allowing such manipulation creates uneven treatment of taxpayers who are in the same position and gives a tax subsidy to unscrupulous taxpayers at the expense of honest ones.

The third major problem with the current state of section 104(a)(2) is that it provides windfalls for some "fortunate" taxpayers. Those who receive punitive damages as a result of a physical injury, for example, or those whose awards are trebled as a result of RICO, will receive potentially enormous sums tax-free.[152] Thus, a taxpayer who receives only a mild injury, but under egregious circumstances, or from a repeat offender, may receive a sizable tax-exempt bonus in addition to the payment needed to compensate for his or her injury. This "litigation lottery" significantly increases a taxpayer's incentive to sue.[153]

Closely related to the problem of windfalls from punitive damages is the problem of taxpayers receiving tax-free awards for claims that should be taxed as economic benefits.[154] Economic injuries should not be, and were not intended to be, exempt under section 104(a)(2).[155] This is indicated by the exemption's use of the word "personal" and the courts' original attempt to differentiate between damages to the taxpayer's personal and business reputations.[156] All injuries that

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151. See Part III.D. See also Henning, 45 Tax Law. at 783 (cited in note 19); Raby, 63 Tax Notes at 213 (cited in note 6).

152. See, for example, *McKay*, 102 Tax Ct. at 465 (awarding the plaintiff $12 million tax-free).

153. But see Cochran, 38 Case W. Res. L. Rev. at 64, n.182 (cited in note 19) (agreeing with the argument in Boris I. Bittker, *Fundamentals of Federal Income Taxation*, ¶ 5.1, 5-5 (1983), that repeal of section 104(a)(2) would result in larger awards and higher insurance premiums since juries would attempt to adjust their awards to make up for the tax).

154. In *McKay*, for example, a whistleblower was awarded $12 million largely tax free even though the award was primarily intended to compensate the plaintiff for future income. 102 Tax Ct. at 471. Likewise, in *Threlkeld* a plaintiff who suffered damage to his professional reputation received his entire award tax free. 87 Tax Ct. at 1308. In both cases, the plaintiffs received tax free sums which, if awarded outright, would have been taxed as economic gain.

155. Sol. Mem. 1384, 2 Cum. Bul. 71 (1920) (holding that "'personal injuries,' as used in [the predecessor to section 104(a)(2)] means physical injuries only").

156. See Part II.C. The mistake the *Roemer* court made in eliminating this distinction was that, rather than subjecting physical injuries to the higher standard applied to non-physical ones, it lowered the standard for non-physical injuries. See also Blackburn, 56 Tenn. L. Rev. at 690 (cited in note 19) (proposing, among other things, that a distinction should be made between injuries to the taxpayer's business and personal reputations and between personal and economic injuries); Stuart M. Schabes, Comment: Roemer v. Commissioner, 12 Hofstra L. Rev. 211 (1983)

fundamentally affect the taxpayer's business or economic interests should be taxed regardless of the nature of the underlying claim. Any other application of the exemption results in an unjustified windfall for some taxpayers.

The same analysis applies to other economic injuries to taxpayers. The various federal antidiscrimination causes of action, while being similar to traditional torts in many superficial ways, are fundamentally different and should be taxed as constituting economic gain. The Supreme Court in *Burke* recognized that the two are dissimilar but misconstrued the nature of the difference. The essence of tort law is not the remedies available to a victim, as the Court stated,[157] but rather the goal of compensating the victim for personal injuries sustained.[158] The underlying mission of the antidiscrimination statutes, in contrast, is to ensure equal treatment of all people.[159] Whereas tort law is concerned with compensating individuals for injuries to their person, the federal antidiscrimination statutes were enacted for the express purpose of protecting the economic rights of minorities.[160] Because damages received on account of causes of action such as Title VII and ADEA serve to compensate the injured taxpayer for his or her economic loss,[161] typically via awards of backpay, such awards should be taxed exactly as if they had been recovered in a contract suit.

Commentators have also identified a number of less immediate, but still significant, problems with the Personal Injuries Exemp-

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(arguing that the *Roemer* court's decision to treat all non-physical damages the same was a mistake).

157. *Burke*, 112 S. Ct. at 1870-71.

158. Wright, 8 Camb. L. J. at 238 (cited in note 34) (explaining that "[t]he purpose of the law of torts is . . . to afford compensation for injuries sustained"). See *Threlkeld*, 87 Tax Ct. at 1308 (stating that the "[e]xclusion under section 104 will be appropriate if compensatory damages are 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").

159. *Griggs v. Duke Power Company*, 401 U.S. 424, 429-30 (1971) (holding that "[t]he objective of Congress in the enactment of Title VII is plain from the language of the statute. It was to achieve equality of employment opportunities and remove barriers that have operated in the past to favor an identifiable group of white employees over other employees"). But see *Albemarle Paper Company v. Moody*, 422 U.S. 405, 418 (1975) (observing that "[i]t is also the purpose of Title VII to make persons whole for injuries suffered on account of unlawful employment discrimination").

160. *Griggs*, 401 U.S. at 429-30.

161. Id. See *Schleier*, 1995 U.S. LEXIS 4044, *31-32 (O'Connor, J., dissenting) (discussing Justice Scalia's argument in his *Burke* concurrence that "employment discrimination, without more, does not inflict a personal injury because it is only a legal injury that causes economic deprivation").

tion. For example, the exemption is difficult to enforce[162] and places an added burden on the courts to allocate settlements for tax purposes.[163] It is not applied uniformly because of its reliance on state law.[164] Furthermore, its current interpretation is inconsistent with the other subsections of section 104.[165] Finally, commentators have criticized the exemption as being bad tort policy because it interferes with the true allocation of costs to the tortfeasor and serves as a major subsidy to insurance companies.[166]

B. Fundamental Flaws Inherent in the Exemption

The current state of disagreement and confusion over the proper application of the Personal Injuries Exemption suggests, and is caused by, two deeper and more pressing flaws inherent in the exemption: it is based on neither a clear definition nor a sound theoretical basis. If either had been present from the beginning, the courts and the Service might have been able to agree on a consistent and narrow approach to the exemption's application.

The Code's failure to define "personal injuries or sickness" removed the most important check on the expansion of the scope of

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162. Henning, 45 Tax Law. at 797 (cited in note 19).

163. Henry, 23 Hous. L. Rev. at 726 (cited in note 25); *Niles v. United States*, 710 F.2d 1391, 1395 (9th Cir. 1983) (stating that judicial review of allocations would be "bewildering"); *Roemer*, 716 F.2d at 696 (noting that 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"). But see Yorio, 62 Cornell L. Rev. at 707-08 (cited in note 19) (arguing that courts are experienced at making difficult allocations).

164. Willoughby, 37 Vand. L. Rev. at 646 (cited in note 148) (criticizing the Ninth Circuit's approach in *Roemer* as creating inconsistent applications because of its reliance on state tort law).

165. Brooks, 14 Wm. Mitchell L. Rev. at 761 (cited in note 21) (suggesting that "[i]nterpretation of the tax code in light of income theory promotes internal consistency, more accurate income measurement, and horizontal equity"). See also Justice Scalia's concurrence in *Burke*, 112 S. Ct. at 1874 (arguing that the use of the term "personal injuries or sickness" in other parts of section 104—dealing with workman's compensation, for example—suggests that Congress intended the Personal Injuries Exemption to apply only to physical injuries).

166. As one author put it, "[i]n appropriate circumstances, the cost of an injury is shifted from the injured party to the party causing the injury. Presumably, the party causing the injury passes the cost on to its customers, employees, and other constituents." Cochran, 38 Case W. Res. L. Rev. at 59-64 (cited in note 19). Because the federal government does not tax damage awards, however, juries can award plaintiffs the same net damages while costing defendants less. Thus, the real beneficiaries of this tax expenditure are the tortfeasor and his or her insurance company or other constituent. By reducing the costs of engaging in reckless behavior, section 104(a)(2) distorts the cost allocation inherent in our tort system.

section 104(a)(2).[167] A strict definition gives courts something upon which to anchor their decisions and helps them deal consistently with new and old problems. In the absence of such a solid framework, taxpayers were given the freedom to argue for a broad interpretation of section 104(a)(2). This situation was exacerbated by the Service's early acquiescence to such a broad interpretation.[168] Seen in this light, the expansion of the scope of section 104(a)(2) appears to have been inevitable.

The other major flaw inherent in the Personal Injuries Exemption is that there is no consensus as to its theoretical foundation.[169] Clearly, there is no tax logic for it. Despite its appeal, the return of capital theory has been roundly criticized,[170] as have other attempts to justify its existence in tax terms.[171] Moreover, aside from several unimportant administrative justifications for its existence,[172] the only other significant theories are unsatisfying. First, that the awards should not be taxed because they do no more than make the taxpayer whole again, is simply the return of capital theory restated. Second, that Congress enacted section 104(a)(2) out of compassion, does not

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167. See Part II.A. The regulations also fail to define "personal injuries or sickness." *Schleier*, 1995 U.S. LEXIS 4044, *37 (O'Connor, J., dissenting) ("Neither the text nor the legislative history of § 104(a)(2) offers any explanation of the term 'personal injuries.' ").

168. See note 40 and accompanying text.

169. Henning, 45 Tax Law. at 795-96 (cited in note 19) (stating that the "difficulty in interpreting section 104(a)(2) and the inconsistent court holdings and Revenue Rulings of the past seven decades probably comes from the lack of any cohesive tax theory or social policy justifying the exemption. The Service, the courts, and the commentators have failed to find any entirely satisfactory explanation of section 104(a)(2)'s *raison d'être*").

170. Although Congress initially justified the exemption on this theory, it was based on a pre-*Glenshaw Glass* understanding of what constituted income. For scholarly criticism of the theory, see note 19. For recent arguments in favor of the return of capital approach, see Professor Kahn's recent article, 2 Fla. Tax Rev at 327 (cited in noto 18).

171. Cochran, 38 Case W. Res. L. Rev. at 46-47 (cited in note 19) (refuting the theory that personal injury damages should be excluded as constituting a non-taxable involuntary transaction); id. at 48-49 (arguing that personal injury damages, unlike imputed income, are not exempt due to the difficulty in defining and valuing them); Yorio, 62 Cornell L. Rev. at 713-14 (cited in note 19) (calling the imputed income theory the "most convincing argument" but rejecting it nonetheless); Brooks, 14 Wm. Mitchell at 769-73 (cited in note 21) (differentiating personal injuries damages from nonincludable items such as the return of tertiously converted posessions).

172. See, for example, Cochran, 38 Case W. Res. L. Rev. at 49-51 (cited in note 19) (noting concerns that taxing damage awards would create hunching of income and might limit the awards such that the taxpayer would have te use some of his or her own money to pay off the medical bills); Henning, 45 Tax Law. at 797 (cited in note 19) (citing the difficulty of allocating awards and settlements); Yorio, 62 Cornell L. Rev. 714-19, 707-08 (cited in note 19) (discussing potential bunching of income and the difficulty of allocating the awards); *Roemer*, 716 F.2d at 696 (discussing the difficulty of allocating awards).

seem enough of a justification for such an enormous subsidy.[173] In fact, so great and so unsuccessful has been the search for a foundation on which to base section 104(a)(2), that one commentator recently suggested that it is based on nothing more concrete than Congress's "intuitive economic sense."[174]

The lack of a theoretical foundation on which to base the Personal Injuries Exemption is troublesome because without such a foundation the courts and the Service have no common understanding on which to base their decisions. Instead, they tend to focus on different underlying concerns and to use varying approaches to novel situations. Were a foundational theory to exist, the courts and the Service would be able to reconcile their different opinions and bring order to an area of the law which is in disarray.

C. Proposed Amendment to Section 104(a)(2)

Once the two structural flaws underlying the many problems in the application of section 104(a)(2) have been diagnosed, the solution seems clear. First, the Personal Injuries Exemption should be amended to provide a clear definition of the phrase "personal injuries or sickness." Second, the definition must be extremely narrow and must be tied to a theoretical foundation.[175] Narrowing the definition would both limit many of the abuses existing today and make its linkage to a theory easier. In fact, several of the theories break down only when applied to the current, broad reading of the exemption.[176]

Although adoption of any clear, narrow definition which is tied to a sound theory would greatly improve matters, it would be best to limit the exemption to physical injuries. Such a definition would

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173. Harnett, 27 N.Y.U. L. Rev. at 626 (cited in note 31) (stating that it is "likely the treatment of lost earnings is rooted in emotional and traditional, rather than logical, factors."); Yorio, 62 Cornell L. Rev. at 707 (cited in note 19) (arguing that if sympathy is the true basis, it does not extend far enough to achieve its objective); *Huddle v. Levin*, 395 F. Supp. 64 (D. N.J. 1975). But see Susan Kim Matlow, Note, *Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?*, 44 Vand. L. Rev. 369, 393 (1991) (arguing that "[a]lthough the congressional intent in enacting the predecessor of section 104(a)(2) is unclear, legislative acquiescence to judicial expansion of the exclusion suggests that sympathy for personal injury victims may be the motive for retaining this favorable tax treatment"); Stephen Ian McIntosh, *Defining the Intersection of Tort and Tax Law: Recent Developments Regarding the Exclusion of Personal Injury Damages*, 6 Va. Tax R. 425, 425 (1986) (calling section 104(a)(2) "a sympathetic gesture from Congress").

174. Brooks, 14 Wm. Mitchell L. Rev. at 804-05 (cited in note 21).

175. See id. at 761.

176. See, for example, Henning, 45 Tax Law. at 796 (cited in note 19), who argues that the return of capital theory breaks down only when it is applied to punitive damages. Presumably, then, if punitive damages were held to be outside the scope of section 104(a)(2), the theory would not suffer this flaw.

eliminate much of the manipulative behavior which currently exists by limiting the potential for windfalls. It would also raise revenue and eliminate a major incentive to sue. With these goals in mind, this Note proposes to amend section 104(a)(2) by substituting the following sentence in the place of the 1989 amendment (which would be superseded by the new language):

> For purposes of paragraph (2), the term "damages received on account of personal injuries or sickness" shall mean any reasonable fees or expenses incurred by the taxpayer on account of physical injuries or sickness and necessary to make the taxpayer whole again.

This definition would sufficiently narrow the exemption by limiting it to reasonable medical and psychiatric expenses, court costs, and legal fees. Thus, it would ensure that the taxpayer is made whole again but would tax any sums which represent economic gain, including punitive damages and damages based on backpay or lost future earnings. Moreover, it would reduce the potential for manipulation by exempting only damages received on account of physical injuries, thereby eliminating the ability of taxpayers involved in contract disputes to recover emotional distress damages tax-free. False claims of emotional distress would also be limited by the requirement that only sums received to compensate for actual medical or psychiatric bills would be tax exempt. On a practical level, the amendment would be simple to apply because courts and the Service could require the taxpayer to document the fees and expenses he or she wishes to exempt.

Finally, the addition of the phrase "and necessary to make the taxpayer whole again" would tie the exemption to a theoretical framework and would thus offer guidance to the courts as to the underlying purpose of the exemption. The theory is that the taxpayer should be made whole again and should suffer no economic loss as a result of his or her injuries.[177] Exempting those sums necessary to repay the taxpayer's medical and legal expenses, and no more, achieves this goal. Although this policy-based variation on the return of capital theory may not be entirely satisfactory when applied to the current broad interpretation of section 104(a)(2),[178] it is sensible as applied to the proposed narrow definition which taxes punitive damages and other damages that do more than put the taxpayer in the

177. See the final paragraph of Part II.B. See also notes 25-26 and accompanying text.
178. See notes 20-22 and accompanying text.

same position he or she was in prior to the injury. It has the advantage of including elements of both compassion and economics.[179]

On the negative side, the potential for abuse might arise because the proposed amendment may create an incentive for attorneys to overcharge their clients. However, the requirement that the fees be "reasonable" may avoid this, as might the adoption by Congress of the English rule whereby the losing party in a civil suit is required to pay the prevailing party's legal fees.[180] A problem might also arise in that it treats taxpayers with psychiatric expenses differently depending upon whether the psychiatric injuries accompany physical injuries. Such inequities, however, cannot be avoided and are present in tort law as well.[181]

D. Factors Requiring Congress, Not the Courts, to Make the Necessary Changes

Given that the basic solution to section 104(a)(2)'s problems is fairly straightforward, and that commentators have been calling for the section's amendment or outright repeal for almost two decades,[182] why has so little meaningful change occurred? Part of the answer is that the courts cannot easily affect such a drastic change. Every time Congress amends the Code, while leaving section 104(a)(2) intact, one can infer that Congress intended the contemporary judicial interpretation of the section to continue. Courts, which are bound in matters of federal statutory law by congressional intent, cannot completely reformulate the exemption when Congress has failed to do so. This is even more the case today because Congress amended section 104(a)(2) itself in 1989.[183] Its failure to make more drastic amendments strongly suggests that it approves of the current interpretation.

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179. Ensuring that taxes never result in a plaintiff's award being smaller than his or her legal and medical bills is compassionate, whereas taxing monies which represent a true gain makes good economic and tax sense.

180. Adoption of this rule has already been proposed by the 104th Congress. See note 11.

181. See, for example, William Prosser, *Handbook of the Law of Torts* 49-50 (West, 1971) (holding that whereas it is difficult to win damages for mental distress "standing alone," "the courts have been quite willing to allow large sums as damages for such 'mental anguish' itself, where it accompanies a slight physical injury").

182. See, for example, Yorio, 62 Cornell L. Rev. at 736 (cited in note 19), and Matlow, 44 Vand. L. Rev. at 390-93 (cited in note 173), both calling for outright repeal of section 104(a)(2), one in 1977, the other in 1991. See also, for example, McIntosh, 6 Va. Tax R. at 454-56 (cited in note 173) (advocating taxing punitive and nonphysical business damages); Brooks, 14 Wm. Mitchell L. Rev. at 761 (cited in note 21) (advocating a change based on "the idea . . . that payments to compensate people for the loss of value they otherwise receive tax free should also be tax free.").

183. Pub. L. No. 101-239 at § 7641. See note 3.

The courts are also bound by the precedent inherent in the long and steady judicial expansion of section 104(a)(2)'s scope. Especially because the Supreme Court's decisions in *Burke* and *Schleier* failed to reinterpret the exemption to the extent suggested by this Note, the lower courts cannot do so either. Similarly, the Supreme Court itself, the only judicial body which could spearhead a consistent and logical narrowing of the exemption, cannot easily reverse itself so soon after *Schleier*.[184] Thus, because of their need to adhere to congressional intent and to judicial precedent, the courts are currently unable to redefine the Personal Injuries Exemption.

The other part of the explanation of why no real change has been forthcoming lies in the fact that Congress usually lacks the political will to affect such change. The current situation is different, however, because the 104th Congress may actually have the political will to make this change. Tort reform was promised to the voters and is being seriously debated.[185] As a result, an otherwise little-noticed tax expenditure may be able to draw attention to itself. Amendment or repeal of section 104(a)(2) would generate a huge amount of revenue at a time when Congress is counting every penny,[186] and would eliminate or severely restrict a significant incentive to litigate.[187] Thus, if Congress seriously intends to enact a comprehensive tort reform package, it should include an amendment to the Personal Injuries Exemption.[188]

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184. See, for example, *Planned Parenthood v. Casey*, 112 S. Ct. 2791, 2808 (1992) (stating that "[t]he obligation to follow precedent begins with necessity . . . we recognize that no judicial system could do society's work if it eyed each issue afresh in every case that raised it").

185. See note 11 and accompanying text.

186. See *ABA Members Argue*, 89 Tax Notes Today at 227-16 (cited in note 146) (estimating that merely limiting the exemption to physical injuries would save $42 million in five years).

187. But see Cochran, 38 Case W. Res. L. Rev. at 64, n.182 (cited in note 19) (arguing that while repeal of section 104(a)(2) "would merely relieve the tax-paying public of its share of the cost and reallocate that share to the parties involved in the accident," it would result in larger awards and higher insurance costs).

188. See McIntosh, 6 Va. Tax R. at 454 (cited in note 173) (arguing that "[m]uch of the present confusion in the area of the tax treatment of damages could be remedied through statutory amendment"); *Hawkins*, 30 F.3d at 1087 (Trott, J., dissenting) (suggesting that "Congress should straighten out this mess").

V. CONCLUSION

The Personal Injuries Exemption is in a state of complete disarray. Three circuit court splits have arisen between 1992 and 1994, and numerous other problems enable taxpayers to manipulate the Code. Section 104(a)(2) is a gigantic tax expenditure which lacks both a clear definition of its key terms and a sound theoretical foundation. As currently applied, it does little more than create a windfall for some groups of lucky or particularly well-advised taxpayers, while encouraging participation in the "litigation lottery."

The exemption needs to be amended by adding a clear and narrow definition of "personal injuries or sickness" and by tying that definition to a sound theoretical framework. This would allow courts to apply the exemption narrowly and consistently and would eliminate many of the potential windfalls and inequities which currently exist. Congress should enact the amendment because the courts cannot and because the current impetus for tort reform may have created the political will necessary for Congress to act.

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