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Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?

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Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?

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I. Introduction

The Internal Revenue Code (Code) sweeps into gross income "all income from whatever source derived," including, but not limited to, compensation for services, interest, dividends, rents, and alimony payments.[1] Specific statutory exclusions may exempt from gross income certain items that Congress has determined deserve favorable tax treatment.[2] One such exclusion, section 104(a)(2), provides that gross income

1. I.R.C. § 61 (1990).
2. *See id.* §§ 101-135.

shall not include "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] Congress enacted section 104(a)(2)'s predecessor in 1918,[4] and in spite of subsequent revolutionary tax reform,[5] this traditional exclusion remains in the present tax code. This exclusion relieves a taxpayer who has had the misfortune to be injured from including any subsequent damage award in gross

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3. *Id.* § 104(a)(2).

4. *See* Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919) (current version at I.R.C. § 104(a)(2) (1990)). After the inception of the federal income tax in 1913, the Internal Revenue Service (Service) took the position that damages recovered for personal injury were taxable income. *See* Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114 (1913); *see also* Cutler, *Taxation of the Proceeds of Litigation*, 57 COLUM. L. REV. 470, 471 n.5 (1957). This decision prompted Congress to enact § 213(b)(6) of the Internal Revenue Act of 1918, which excluded from gross income damages received on account of personal injury or sickness. Although the legislative history of the Act of 1918 is silent regarding the congressional intent behind this precursor to § 104(a)(2), the enactment clarified that Congress did not consider these damages to be taxable income.

The House Report stated:

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

H.R. REP. No. 767, 65th Cong., 2d Sess. 9-10 (1918), *reprinted in* 94 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, & ADMINISTRATIVE DOCUMENTS 9-10 (B. Reams, Jr. ed. 1979).

Commentators have offered alternative theories for this omission. One leading commentator has suggested that Congress did not intend to benefit tort victims, but merely wanted to clarify whether tort damages were income under the sixteenth amendment. *See* Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 222 (1958). Another suggested rationale is that Congress decided that an injured person had suffered enough and did not need to suffer further through taxation of any damage award. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform*, 56 TENN. L. REV. 661, 669 (1989).

The Solicitor of Internal Revenue construed § 213(b)(6) narrowly, ruling that the exclusion for personal injuries applied only to physical injuries. The Solicitor revoked his position that only physical injuries were exempt from tax following the Supreme Court's decision in Eisner v. Macomber, 252 U.S. 189 (1920). In *Eisner* the Supreme Court defined income as "the gain derived from capital, from labor, or from both combined." *Id.* at 207. The Solicitor of Internal Revenue reasoned that compensation for invasion of a personal right was not gain derived from labor or capital and, thus, did not meet the *Eisner* definition of income. Sol. Op. 132, 1-1 C.B. 92 (1922). The Supreme Court expanded its definition of income in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), indicating that all "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" would be considered as income to the taxpayer. *Id.* at 431. Under this definition of income, all damage awards potentially are includable in gross income unless specifically exempted by the Code. *See* I.R.C. § 61. For a discussion of the income tax treatment of business injury damage receipts, see Blackburn, *supra*, at 670-72. The concept of human capital has been used to explain taxation as a whole. *See* Stephan, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357 (1984).

5. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); Internal Revenue Act of 1954, Pub. L. No. 83-591, 68 Stat. 730 (1954); Revenue Act of 1939, Pub. L. No. 76-155, 53 Stat. 862 (1939).

income.[6]

Presently, neither the Code nor the related Income Tax Regulations define what constitutes a personal injury for the purposes of exclusion of damages under section 104(a)(2). Because the regulations do define "damages received" as amounts received through prosecution of a legal action hased on "tort or tort-type rights" or through a settlement agreement,[7] the essential requirement for exclusion is that the damages must derive from a tort or tort-type claim against the payor.[8] Damages received on account of physical injuries clearly are personal and excludable from gross income even if lost earnings compose part of the award,[9] and physical trauma is not a prerequisite for the exemption under section 104(a)(2).[10]

While the statutory exclusion for personal injury damages has remained static, courts have expanded the definition of what constitutes a personal injury and have brought within the scope of section 104(a)(2) certain types of damages whose exclusion from gross income is not justified by sympathy for personal injury victims. The courts have held that nonphysical torts such as injury to personal or professional reputation,[11] employment discrimination,[12] abridgment of constitutional rights,[13] and tort-type remedies in contract actions[14] are within the scope of section 104(a)(2).

Part II of this Note examines the scope and legal background of section 104(a)(2), discusses its historical application in the punitive damages, defamation, and civil rights areas, and evaluates the tax consequences of alternative methods of calculating damages awards. Part III examines the present judicial expansion of section 104(a)(2) with particular emphasis on the conflict between the courts and the Internal Revenue Service (Service) concerning what constitutes excludable personal injury damages. Part III also considers the legislative amendment

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6. The court in Huddell v. Levin, 395 F. Supp. 64, 87 (D.N.J. 1975), *vacated*, 537 F.2d 726 (3d Cir. 1976), offered this rationale for the § 104(a)(2) exclusion.

7. Treas. Reg. § 1.104-1(c) (1956). The terms "damages," "personal injury," and "tort or tort-type rights" imply that Congress intended exclusion under § 104(a)(2) to depend on classifications under state law. Although federal law determines how rights created under state law will he taxed, Congress may indicate that a tax will depend on the characterization under state law. Threlkeld v. Commissioner, 87 T.C. 1294, 1306 n.6 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

8. Glynn v. Commissioner, 76 T.C. 116, 119 (1981), *aff'd*, 676 F.2d 682 (1st Cir. 1982).

9. *See* Roemer v. Commissioner, 79 T.C. 398, 414 (1982) (Wilber, J., dissenting), *rev'd*, 716 F.2d 693 (9th Cir. 1983); Rev. Rul. 85-97, 1985-2 C.B. 50, 51 (holding that settlement proceeds, including amounts representing lost wages, were excludable in physical injury cases).

10. Church v. Commissioner, 80 T.C. 1104, 1106 (1983).

11. *See infra* notes 35-59 and accompanying text.

12. *See infra* notes 109-47 and accompanying text.

13. *See infra* notes 60-87, 148-59 and accompanying text.

14. *See infra* notes 109-47 and accompanying text.

to section 104(a)(2) limiting the exclusion of punitive damages. Finally, Part IV explores a recommendation for future legislative action.

II. Legal Background

A. *Scope of the Exclusion for Personal Injury Damage Awards*

1. Punitive Damages

The Service's position on the taxability of punitive damages in personal injury cases has fluctuated over time as a series of conflicting revenue rulings reflects. In Revenue Ruling 58-418[15] the taxpayer received compensatory and punitive damages in the settlement of a suit for injury to the taxpayer's personal reputation. In accordance with the Supreme Court's holding in *Commissioner v. Glenshaw Glass Co.*[16] that punitive damages are includable in gross income because they represent punishment for culpable conduct and are not a substitute for any loss sustained by the taxpayer, the Service held that the punitive damages received by the taxpayer were includable in gross income.[17] Because the taxpayer's settlement agreement did not allocate portions of the settlement to compensatory and punitive damages, the Service used the taxpayer's complaint as the best evidence available to determine an allocation.[18] The Service excluded from gross income the part of the settlement allocated to compensatory damages and included in gross income the portion allocated to punitive damages.[19]

The Service subsequently altered its position in Revenue Ruling 75-45.[20] This ruling concerned a decedent who died in the crash of an airplane owned by his corporate employer. The decedent's estate received a payment under the employer's aircraft liability insurance policy in exchange for the release of all claims against the employer. The policy included release of all claims under the state's wrongful death statute, which provided for the payment of punitive damages.[21] The Service examined the plain language of section 104(a)(2) and held that any damages, whether compensatory or punitive, received on account of personal injury or sickness are excludable from gross income.[22] There-

15. 1958-2 C.B. 18.
16. 348 U.S. 426 (1955).
17. Rev. Rul. 58-418, 1958-2 C.B. 18.
18. *Id.* at 19. The Service determined the percentages of compensatory and punitive damages that composed the total amount of damages sought in the taxpayer's complaint and applied these ratios to the amount of the settlement payment to determine the amounts allocable to compensatory and punitive damages.
19. *Id.*
20. 1975-1 C.B. 47.
21. *Id.*
22. *Id.*

fore, the decedent's estate could exclude from gross income all sums that it received.[23] This ruling was inconsistent with Revenue Ruling 54-418, which had held that punitive damages were taxable income.

On facts essentially the same as in Revenue Ruling 75-45, the Service reversed its position in Revenue Ruling 84-108 and adopted its current position that all punitive damages are includable in gross income.[24] The Service analyzed the facts under the wrongful death statutes of Virginia and Alabama.[25] Under the Virginia wrongful death statute, recovery is limited to the amount necessary to compensate the survivors for their actual loss sustained by reason of the wrongful death. No punitive damages are recoverable.[26] The Service held that payments made for the release of claims under the Virginia wrongful death statute are in lieu of compensatory damages and are excludable from gross income under section 104(a)(2).[27]

The Alabama wrongful death statute provides exclusively for punitive damages, which are determined based on the liable party's degree of fault for the wrongful death and not on the basis of actual loss to the survivors.[28] The Service also determined that payments made for the release of claims under the Alabama wrongful death statute were in lieu of punitive damages and relied on *Glenshaw Glass* in holding that these payments were includable in gross income.[29] Both the Virginia and Alabama taxpayers suffer the same loss of a family member, yet receive disparate tax treatment based on the label given to damages recovered under the relevant wrongful death statute.

The courts,[30] however, have not followed the Service's position and have excluded punitive damages from gross income. For example, a federal district court rejected Revenue Ruling 84-108 in *Burford v. United States*,[31] holding that amounts received by Burford under the Alabama

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23. *Id.*

24. 1984-2 C.B. 32. In this ruling a decedent was killed when an airplane owned by his corporate employer crashed, and his survivors were paid under an aircraft liability insurance policy for the release of any claim for wrongful death.

25. *Id.* at 33.

26. *See* VA. CODE ANN. § 8.01-50 (1984).

27. Rev. Rul. 84-108, 1984-2 C.B. 32, 34.

28. *See* ALA. CODE §§ 6-5-391, 6-5-410 (1975).

29. Rev. Rul. 84-108, 1984-2 C.B. 32, 34. Some courts have argued that *Glenshaw Glass* does not support the Service's position. In *Glenshaw Glass* the taxpayers had received treble damages for violations of antitrust laws and punitive damages for fraud. 348 U.S. 426, 427 (1955). The predecessor of § 104(a)(2) was not at issue because the taxpayers had not received damages on account of personal injuries. Miller v. Commissioner, 93 T.C. 330, 339 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

30. *See, e.g.*, Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983); Burford v. United States, 642 F. Supp. 635 (N.D. Ala. 1986); *Miller*, 93 T.C. at 330.

31. 642 F. Supp. at 635. Courts may disregard a revenue ruling if it conflicts with the statute it supposedly interprets or if it is otherwise unreasonable. Threlkeld v. Commissioner, 848 F.2d 81,

wrongful death statute were excludable from gross income. The court stated that it was "neither logical nor realistic" to conclude that wrongful death proceeds are not received on account of personal injury.[32] Alabama cases provide evidence that actions for wrongful death are equivalent to actions for personal injury.[33] The court held that because damages received under the Alabama wrongful death statute are received on account of personal injury, the plain language of section 104(a)(2) mandates their exclusion from gross income.[34]

2. Defamation to Personal and Professional Reputation

Another conflict between the courts and the Service exists in the context of injury to a taxpayer's reputation. A particularly vexing question has been whether damages received in a suit arising from defamatory statements affecting professional pursuits are excludable from gross income under section 104(a)(2). Initially, the Tax Court distinguished injury to personal reputation from injury to professional reputation. In *Roemer v. Commissioner*[35] a credit report defamed an insurance agent raising questions about his honesty and falsely stating that he was ignorant in insurance matters. As a result, Roemer was denied certain licenses to sell insurance, which damaged his then existing business relationships and his ability to attract new clients. In a suit against the preparer of the credit report, Roemer was awarded damages that were not allocated expressly between injury to Roemer's personal reputation and injury to his business reputation.[36] The Tax Court held that although damages for defamation are received in an action based on tort or tort-type rights, damages for defamation of a taxpayer's professional reputation are beyond the scope of section 104(a)(2).[37] Because Roemer failed to show that the award was to compensate for injury to his personal reputation, the court included the entire award in Roemer's gross income.[38]

On appeal, the Ninth Circuit reversed the Tax Court, holding that damage awards should not be differentiated on the basis of whether the

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84 (6th Cir. 1988).

32. *Burford*, 642 F. Supp. at 637.

33. *See, e.g.*, American Fidelity & Casualty Co. v. Werfel, 230 Ala. 552, 162 So. 103 (1935). Courts have interpreted the Alabama wrongful death statute to prohibit simultaneous recovery for personal injuries and wrongful death when both injury and death result from the same wrongful conduct. *See, e.g.*, Simmons v. Pulmosan Safety Equip. Corp., 471 F. Supp. 999 (S.D. Ala. 1979); *see also* ALA. CODE §§ 6-5-410, 6-5-440 (1975).

34. *Burford*, 642 F. Supp. at 638.

35. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

36. 79 T.C. at 403.

37. *Id.* at 406-07.

38. *Id.*

defamation affected personal or professional reputation.[39] Because defamation was a personal injury under the applicable state law,[40] the court excluded the entire award from gross income.[41] The court stressed that the nature of an injury, which is the determinative factor for exclusion under section 104(a)(2), should not be confused with the consequences of the injury.[42] These consequences, such as a loss of future income, may be considered in the calculation of damages because they may prove the extent of the injury most persuasively.[43]

While the appeal of *Roemer* was pending, the Tax Court softened its position on the distinction between personal and professional injury. In *Church v. Commissioner*[44] the Attorney General of Arizona, Wade E. Church, brought a libel suit against a newspaper that had published an article calling him a communist. The jury awarded damages, but did not specify the nature of the award.[45] The Tax Court found that the thrust of Church's libel suit was to show that he had suffered public embarrassment, humiliation, and emotional pain and suffering as a result of the article.[46] Despite the fact that a substantial portion of the award was intended to compensate Church for the loss of his political career, the Tax Court held that the entire award was received on account of personal injuries and, therefore, was excludable from gross income.[47] The court found that the jury intended to compensate Church for the stigma of being labelled a communist and did not intend to compensate him for injury to his professional reputation.[48] The court rejected the Service's argument that because the article ended Church's political career, the damages were awarded for injury to his professional reputation and, thus, taxable under the Tax Court's decision in *Roemer*.[49] The court found it significant that, at trial, Church had focused on evidence of his personal injuries and did not present evidence concerning his loss of income.[50] The court distinguished *Roemer* on the ba-

39. 716 F.2d 693 (9th Cir. 1983).

40. *See* CAL. CIV. CODE § 45 (West 1985). The court looked to state law to determine the nature of the injury because no federal common law of torts exists, and the Code does not define personal injury. *Roemer*, 716 F.2d at 697 (citing Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938)).

41. The court held that any punitive damages awarded for the personal injury of defamation also would be excluded under the Service's then current position that all personal injury damages, whether compensatory or punitive, were excludable from gross income. *Roemer*, 716 F.2d at 700.

42. *Id.* at 699.

43. *Id.*

44. 80 T.C. 1104 (1983).

45. *Id.* at 1106.

46. *Id.* at 1108.

47. *Id.*

48. *Id.* at 1110.

49. *Id.* at 1108-09.

50. *Id.* at 1108.

sis that the taxpayer in *Roemer* had not presented much evidence about how the defamatory credit report affected him personally.[51]

In *Threlkeld v. Commissioner*[52] the Tax Court adopted the Ninth Circuit's rationale in *Roemer* and stated that it would no longer distinguish between personal and professional reputation in determining the tax consequences of a damage award.[53] Although Threlkeld's settlement had allocated a portion of the damages for injury to his professional reputation, the court excluded the entire settlement from gross income because the action had been for malicious prosecution, a personal injury under state law.[54] According to the court, the appropriate question for determining exclusion under section 104(a)(2) was whether the injury complained of constituted a "personal injury."[55] The court maintained that all facts and circumstances should be considered to determine whether an injury is personal, including the state law characterization of the claim, allegations in the state court pleadings, the evidence brought forth at trial, the presence of a written settlement agreement, and the intent of the payor in making a settlement payment.[56]

The Service has decided to follow the decision of the Tax Court in *Roemer* and will continue to distinguish between injury to personal and professional reputation to determine exclusion of damages under section 104(a)(2).[57] The Service will consider the nature of the defamation to determine whether it is a personal injury, but the characterization of the claim under state law will not determine the treatment of the damages under federal income tax law.[58] If a defamatory statement is di-

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51. *Id.* at 1108-09.

52. 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

53. 87 T.C. at 1304-05. Threlkeld had suffered mental distress and injury to his professional and credit reputation when falsely prosecuted for real estate fraud. He filed a suit for malicious prosecution and subsequently settled all claims. *Id.* at 1296. In the context of a settlement, exclusion of the settlement from gross income depends on the nature of the claim that was the actual basis for the settlement, not the validity of the claim. *Id.* at 1297. "The proper inquiry is in lieu of what are the damages awarded." *Church*, 80 T.C. at 1107.

54. *Threlkeld*, 87 T.C. at 1308. A dissenting judge stated that the majority had "eliminated the word 'personal' from the description of the injuries for which damages are excludable under section 104(a)(2)." *Id.* at 1309 (Simpson, J., dissenting). He reasoned that damages allocated to injury to the taxpayer's professional reputation were not received on account of personal injury and, therefore, the clear language of § 104(a)(2) did not permit exclusion of these damages. *Id.* (Simpson, J., dissenting).

55. *Id.* at 1305.

56. *Id.* at 1305-06.

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

58. The Service has adopted an inconsistent position regarding when it will defer to the characterization of a claim under state law. In Revenue Ruling 84-108 the Service deferred to the state characterization of punitive damages and included the damages in gross income. In Revenue Ruling 85-143, however, the Service stated that the state characterization of a claim as personal would not determine the treatment of the damages under federal income tax law. Note, *Defining the Intersection of Tort and Tax Law: Recent Developments Regarding the Exclusion of Personal*

rected primarily at a business and causes the taxpayer loss of business income, the Service will hold that the defamation is not a personal injury, but an injury to business, and will challenge the exclusion of damages.[59]

3. Civil Rights Claims

a. Section 1983

Plaintiffs often append a constitutional claim for a violation of personal rights to an action in hope of excluding from gross income all or part of an award. The courts have brought within the scope of section 104(a)(2) damages received under section 1983[60] for the violation of an individual's constitutional or statutory rights. In *Bent v. Commissioner*[61] a public high school teacher brought suit against the school board for firing him in violation of his first amendment rights. Bent did not report the settlement payment he received in his gross income. The Service argued to the Tax Court that the settlement payment was includable in gross income because it represented compensation for wages.[62] Bent maintained that the abridgement of his first amendment rights constituted a tort, and the payment, therefore, was excludable under section 104(a)(2) and the applicable regulations.[63]

The Tax Court found that the settlement payment was made on the basis of the trial court's determination that Bent's right to freedom of speech had been violated and not to compensate Bent for lost

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Injury Damages, 6 VA. TAX. REV. 425, 442-43 (1986).

59. Rev. Rul. 85-143, 1985-2 C.B. 55, 56. Failure to report the receipt of damages that the Service would include in gross income may have severe consequences to the taxpayer. If a taxpayer substantially understates the taxpayer's income tax for any taxable year, the Service may impose a penalty of 25% of the underpayment. *See* I.R.C. § 6661 (1990).

60. Section 1983 provides:

> Every person who . . . subjects, or causes to be subjected, any citizen of the United States . . . to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. § 1983 (1988).

61. 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987). A public high school teacher, terminated from employment for his criticism of the school administrator, sued the school board for monetary damages and reinstatement in his position. Bent alleged both breach of a collective bargaining agreement and infringement of his first amendment right to freedom of speech in violation of § 1983. 87 T.C. at 240. Bent also alleged that the school board's refusal to grant him a hearing violated his right to procedural due process, but the trial court found that he had not acquired a property interest sufficient to require the school board to give him a hearing. *Id.* at 240-41. The trial court found that Bent's first amendment rights had been violated and rejected all other claims. Prior to the determination of damages, the school board settled with Bent in return for the release of his claims. *Id.* at 240-42.

62. *Id.* at 243.

63. *Id.*

wages.[64] The court then analyzed the nature of a section 1983 claim to determine the tax consequences of the payment.[65] Relying on the Supreme Court's decisions in *Carey v. Piphus*[66] that Congress intended section 1983 to create tort liability and in *Wilson v. Garcia*[67] that the best characterization of a section 1983 claim is as a personal injury claim, the court concluded that damages received under a section 1983 claim for violation of first amendment rights are awarded on the basis of personal injury suffered and are excludable from gross income.[68] Rejecting the Service's argument, the court stated that lost earnings are an element of the compensatory damages available under section 1983, and that in the present case lost earnings were an evidentiary factor in determining the extent of Bent's damages.[69]

b. Title VII

The Tax Court addressed the exclusion of damages received under Title VII of the Civil Rights Act of 1964 (Title VII)[70] in *Metzger v. Commissioner*.[71] In *Metzger* an associate professor who was denied tenure sued her private college employer, alleging that she was denied tenure on the basis of her sex and national origin.[72] As compensation for alleged violations of Title VII and sections 1981 and 1983, Metzger sought back pay, punitive damages, and reinstatement as a tenured

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64. *Id.*
65. *Id.* at 246-51.
66. 435 U.S. 247, 253 (1978).
67. 471 U.S. 261, 280 (1985).
68. *Bent*, 87 T.C. at 249.
69. *Id.* at 250-51. The Third Circuit affirmed the decision of the Tax Court, characterizing the mental pain and suffering caused by the denial of a civil right as a personal injury. 835 F.2d 67, 70 (3d Cir. 1987). Rejecting the Service's claim that the amount of the settlement representing lost wages was not excludable, the court stated, "The amount of his lost wages may he used in computing the amount of damages awarded for the constitutional violation even though an award hased directly on the claim of lost wages has been rejected by the court." *Id.* This result is consistent with the Ninth Circuit's conclusion in Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983), that the nonpersonal consequences of a personal injury are excludable from gross income under § 104(a)(2).
70. Title VII provides in relevant part:

(a) It shall be an unlawful employment practice for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or

(2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.

42 U.S.C. § 2000e-2(a) (1988).

71. 88 T.C. 834 (1987), *aff'd*, 845 F.2d 1013 (3d Cir. 1988).
72. 88 T.C. at 840-41.

professor.[73] In return for the release of all pending claims, the college made a settlement payment of $75,000. For tax purposes the settlement agreement allocated the settlement payment one half to wage claims and one half to all other claims.[74] After Metzger reported $37,500 as income the Service assessed a deficiency, contending that the entire settlement payment should have been included in Metzger's gross income because no amount was paid on account of personal injuries.[75]

Based on its opinion in *Bent v. Commissioner*,[76] the Tax Court concluded that damages received under Metzger's section 1983 claim were paid on account of personal injury and excludable from gross income.[77] The court held that because claims brought under section 1981 are tort claims brought to redress personal injuries, any damages awarded under this claim would be excludable from gross income.[78] The court next compared Metzger's Title VII claim to a claim for a section 1981 violation and concluded that the conduct prohibited by and the injuries resulting from violations of both statutes are fundamentally the same.[79] The court found that the injuries for which Metzger sought relief under Title VII were as much personal injuries as those for which she sought relief under section 1981.[80] Although in *Hodge v. Commissioner*[81] the court had held that back pay awarded under Title VII was includable in gross income, the *Metzger* court concluded that *Hodge* does not stand for the proposition that all damages received under Title

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73. Section 1981 provides:

> All persons within the jurisdiction of the Unites States shall have the same right . . . to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens. . . .

42 U.S.C. § 1981 (1988). Metzger also claimed violations of 42 U.S.C. §§ 1983, 1985(3), 1986, 2000e; 29 U.S.C. § 206(d); and Exec. Order No. 11,246, as amended by Exec. Order No. 11,375. *Metzger*, 88 T.C. at 841.

74. *Metzger*, 88 T.C. at 842.

75. *Id.* at 846.

76. 87 T.C. at 236; *see also supra* notes 61-69 and accompanying text.

77. *Metzger*, 88 T.C. at 851.

78. *Id.* at 852-53.

79. *Id.* at 856.

80. *Id.*

81. 64 T.C. 616 (1975). In *Hodge* truck drivers sued their employer claiming they were denied job promotions because of their race. The drivers sought back pay based on the difference between their present salaries and the higher salaries they would have received had they been promoted. The drivers did not claim damages for personal injury. *Id.* at 617. Under the parties' settlement agreement, the amount of the settlement proceeds was based solely on the salary differential set forth in the drivers' complaint. *Id.* at 618. In the Tax Court proceedings, Hodge contended that the purpose of Title VII is to assure recovery for the personal injuries associated with job discrimination and that his settlement payment was excludable regardless of the designation as back pay in the settlement agreement. The Tax Court found no support for the argument that Title VII is in reality a recovery for a personal injury and held that back pay recoverable under Title VII is taxable in the year in which the wages were due. *Id.* at 618-19.

VII are taxable.[82] The court stated that any possible exclusion of Title VII damages under section 104(a)(2) would depend on the nature of the injury complained of and whether back pay actually is awarded or simply is "the best measure of loss" in determining damages for a violation of Title VII.[83] The court held that at least one-half of the damages received by Metzger were for personal injuries and, therefore, excludahle from gross income under section 104(a)(2).[84] Because Metzger sought to exclude from gross income only one-half of her settlement payment, the court did not reach the issue of whether any portion of the settlement allocated to wage-related claims was excludable from gross income.[85]

Because damages awarded under section 1981 are excludable from gross income, whereas the excludability of damages awarded under Title VII is uncertain, *Metzger* suggests that a tax conscious plaintiff should seek redress under section 1981 rather than bring a claim under Title VII. This strategy violates the general rule of taxation that it is the substance of the claim—the underlying injury—and not its form that will determine the claim's tax treatment.[86] In addition, the possible exclusion of damages received in lieu of wages and the exclusion of damages calculated on the basis of lost future earnings conflict with the general principle that earnings are subject to income tax.[87] The formula used in calculating damages may overcome this tension.

B. Jury Calculation of Damage Awards Based on Lost Earnings

At the section 104(a)(2) intersection of tax and tort law, alternative methods are available to calculate damages based on lost earnings depending on whether the policies behind tax or tort law prevail. The formula for computing damages can be based on future pretax gross earnings or on net earnings, which are gross earnings minus the income taxes paid on these earnings. The proponents of a net earnings approach suggest that using net earnings in the calculation of a tax-exempt award effectuates the goals of the tort system.[88] Because the purpose of compensatory damages is to place the tort victim in the position in which the tort victim would have been absent injury, compensatory damages should reflect what the injured party actually has lost.[89] Had the tort victim not been injured, it would have heen net earnings,

82. *Metzger*, 88 T.C. at 858.
83. *Id.*
84. *Id.*
85. *Id.*
86. *See* Gregory v. Helvering, 293 U.S. 465 (1935).
87. *See* I.R.C. § 61 (1990).
88. *See* Nordstrom, *supra* note 4, at 219.
89. *See* RESTATEMENT (SECOND) OF TORTS § 901 comment a (1977).

not gross earnings, that would contribute to the tort victim's support.[90] The use of a gross earnings approach would provide a windfall to the tort victim by replacing both net earnings and the taxes that the tort victim no longer needs to pay because the award is tax-exempt.[91] The Supreme Court adopted a net earnings approach in *Norfolk & Western Railway v. Liepelt.*[92]

Despite the Supreme Court's holding in *Liepelt*, the majority of states compute damages for lost earning capacity on a gross earnings basis.[93] In support of the gross earnings approach, it has been argued that future income tax liability is too speculative and a net earnings calculation too confusing for the average juror.[94] Many variables may affect future income tax liability, including changes in the tax law, the taxpayer's family status, and the availability of deductions under the Code.[95] Even though the calculation of net earnings is complex, a jury already must speculate on an injured party's future employment, work-life expectancy, future interest rates, and inflation to calculate a damage award, and courts have developed methods of presenting this evidence in a form that a jury can understand.[96] Moreover, expert testimony on the calculation of personal injury damages using net earnings could reduce jury confusion.[97] Introduction of this evidence, however, may result in greater litigation costs and longer trials.[98]

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90. *See* Nordstrom, *supra* note 4, at 219.

91. *Id.*

92. 444 U.S. 490 (1980). The Supreme Court suggested that a net earnings calculation may be inappropriate when the impact of future income taxes would be de minimus and may be more confusing than probative. *Id.* at 494-95 n.7.

93. *See* Annotation, *Propriety of Taking Income Tax into Consideration in Fixing Damages in Personal Injury or Death Action*, 16 A.L.R. 4th 589 (1982).

Because the Supreme Court decided *Liepelt* under the Federal Employer's Liability Act, the Court's holding on calculation of damage awards is not binding on state courts when federal law is not a basis for the decision. Comment, *Income Taxation and the Calculation of Tort Damage Awards: The Ramifications of* Norfolk & Western Railway v. Liepelt, 38 WASH. & LEE L. REV. 289 (1981). *Liepelt* will control the calculation of damages under the Death on the High Seas Act, the Jones Act, and claims under 42 U.S.C. § 1983 (1988). Comment, *supra*, at 300-01.

94. *See* McWeeney v. New York, N.H. & H.R.R., 282 F.2d 34, 36-38 (2d Cir.), *cert. denied*, 364 U.S. 870 (1960). For a numerical example showing a net earnings calculation of a damage award, see Mayor & Hepburn, *The Treatment of Income Taxes in Determining Personal Injury Awards*, 18 JURIMETRICS J. 186, 204-05 (1977).

95. Determination of a taxpayer's future income tax liability became less speculative with the flattening of the tax rate schedule by the Tax Reform Act of 1986. Prior to 1986, it was more difficult to determine the rate at which a taxpayer's earnings would be taxed, especially when the amount of income from outside sources was uncertain. *Compare* Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096 (1986) *with* Internal Revenue Act of 1954, Pub. L. No. 83-591, § 1, 68 Stat. 730 (1954).

96. *Liepelt*, 444 U.S. at 494. For example, juries presently use annuity and life expectancy tables in making these evaluations. Nordstrom, *supra* note 4, at 228.

97. *Liepelt*, 444 U.S. at 494.

98. Comment, *supra* note 93, at 294-95.

In addition, proponents of calculating personal injury awards on a gross earnings approach reason that by not taxing these awards, Congress has bestowed a humanitarian benefit on tort victims.[99] Advocates of the gross earnings basis argue that by decreasing an award under the net earnings approach, a jury appropriates for the tortfeasor some of the benefit intended for the tort victim, thus frustrating congressional intent.[100] One commentator has suggested that an after-tax calculation benefits employer defendants in suits for back pay because the employers will pay a smaller amount in damages than they would have paid in wages.[101] Thus, the net earnings approach may give employer defendants an incentive to undervalue the consequences of committing torts.[102]

A second issue concerning the calculation of personal injury damages is whether a court may refuse to give a requested jury instruction informing the jury that a personal injury award is exempt from tax. Defendants request these instructions to prevent juries from inflating awards under the erroneous belief that such awards are taxable.[103] The average juror may be unaware of the section 104(a)(2) exclusion and may increase a personal injury award to ensure that the injured party is fully compensated.[104] The Supreme Court in *Liepelt* found that a judge should give the requested jury instruction when the instruction is not complicated or prejudicial to either party and would eliminate an area of speculation that might have an improper effect on the calculation of damages.[105]

The majority of states, however, have held that income tax consequences should not be presented to the jury either during the trial or in a jury instruction.[106] In not giving an instruction, a court assumes that a jury will not go beyond its specific instructions and will not consider taxes.[107] Some judges may instruct the jury that because no evidence is before them relating to taxes, they should not consider taxes in their calculation of a damage award.[108] This type of instruction, however, actually may remind the jury about taxes and lead the jury to adjust the

99. *Liepelt*, 444 U.S. at 501 (Blackmun, J., dissenting).
100. *Id.* at 498-99 (Blackmun, J., dissenting).
101. J. DODGE, THE LOGIC OF TAX: FEDERAL INCOME TAX THEORY AND POLICY 113 (1989).
102. *Id.*
103. Nordstrom, *supra* note 4, at 213-14.
104. *Liepelt*, 444 U.S. at 497.
105. *Id.* at 498.
106. *See generally* Annotation, *supra* note 93.
107. Comment, *supra* note 93, at 293 n.37.
108. *See, e.g.*, Griffin v. General Motors Corp., 380 Mass. 362, 370, 403 N.E.2d 402, 408 (1980) (stating that it was sufficient to tell the jury that because no evidence has been presented on taxes, "taxes are therefore none of their business").

award mistakenly.

III. Recent Developments

A. *Judicial Expansion of the Personal Injury Exclusion*

1. Employment Discrimination

In *Byrne v. Commissioner*[109] the Equal Employment Opportunity Commission (EEOC) filed an action alleging that Grammer, Dempsey & Hudson, Inc. (Grammer) had violated the Fair Labor Standards Act (FLSA)[110] by discriminating against employees who participated in an EEOC investigation. The EEOC sought to enjoin Grammer from intimidating and discouraging other employees from participating in the investigation and asked the court to order Grammer to reinstate Byrne.[111] In settlement negotiations between the EEOC and Grammer, Grammer refused to reinstate Byrne and suggested a lump-sum payment in lieu of reinstatement.[112] Byrne received a $20,000 settlement payment in return for a release of all claims against Grammer, including all claims that might arise out of the EEOC proceeding against Grammer.[113] After Byrne did not include the settlement payment as income on her income tax return, the Service assessed a deficiency. The Service argued that because Byrne never had asserted a claim against Grammer, the settlement did not fall within the scope of section 104(a)(2).[114]

The Tax Court rejected the Service's argument, noting that the settlement payment included consideration for the release of all Byrne's potential claims against Grammer.[115] To determine whether the settlement qualified for exclusion under section 104(a)(2), the court focused on the nature of Byrne's potential FLSA claim against Grammer.[116]

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109. 90 T.C. 1000 (1988), *rev'd*, 883 F.2d 211 (3d Cir. 1989). The petitioner worked as a billing clerk for Grammer, Dempsey & Hudson, Inc. (Grammer). After 12 years of service with Grammer, Byrne's employment was terminated when Grammer suspected her of informing the Equal Employment Opportunity Commission (EEOC) of a disparity in wages paid to males and females. The EEOC concluded that Byrne's discharge was intended to discourage other employees from participating in the EEOC's investigation. 90 T.C. at 1001-02.

110. Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (1988).

111. *Byrne*, 90 T.C. at 1002.

112. *Id.* at 1004.

113. *Id.* at 1004-05.

114. *Id.* at 1005.

115. *Id.* at 1006.

116. The EEOC charged that Grammer willfully violated § 215(a)(3) of the FLSA, which provides in relevant part: "[I]t shall be unlawful for any person—to discharge or in any other manner discriminate against any employee because such employee has . . . testified or is about to testify in any such proceeding [under or related to the Fair Labor Standards Act]." 29 U.S.C. § 215(a)(3) (1988). An employer in violation of § 215(a)(3) "shall be liable for such legal or equitable relief as may he appropriate to effectuate the purposes of section 215(a)(3) of this Title, including without limitation employment, reinstatement, promotion, and the payment of wages lost and an

The court analogized the FLSA claim to the New Jersey state law cause of action for wrongful discharge, which may be pursued as either a contract or tort claim,[117] and characterized the FLSA claim as containing elements of both contract and tort claims.[118] The court found that Byrne's release was sufficiently broad to encompass both tort and contract claims and allocated the settlement payment between them.[119] The court estimated that fifty percent of the claims were tort-like and held, therefore, that one-half of the settlement payment was excludable from gross income as damages received on account of personal injuries.[120]

On appeal, the Third Circuit determined that under the FLSA, an employer owes a duty to an employee not to discriminate, which is independent of any contractual agreement.[121] The court further found that Byrne's state law claim for wrongful discharge was comparable to a claim for a FLSA violation; therefore, it constituted recovery for personal injury rather than for economic loss.[122] Recognizing that economic losses may be the best measure of personal injury damages, the court followed its *Bent* rationale and rejected the Service's argument that because Byrne's settlement was intended to compensate her for economic losses, it was intended only as compensation for nonpersonal injuries.[123] The court excluded Byrne's entire settlement payment from gross income.[124] This decision provides authority for extending the section 104(a)(2) exclusion to damages awarded in state contract actions that provide tort-like remedies.[125]

The Tax Court maintained its more conservative position on contract-like claims in considering damages awarded under the Age Discrimination in Employment Act (ADEA).[126] In *Rickel v. Commissioner*[127] Rickel filed suit against Marlsbary Manufacturing Co.

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additional equal amount as liquidated damages." *Id.* § 216(b).

117. Under New Jersey law, an employee has a cause of action for wrongful discharge when the discharge is contrary to a clear mandate of public policy. Pierce v. Ortho Pharmaceutical Corp., 84 N.J. 58, 72, 417 A.2d 505, 512 (1980).

118. *Byrne*, 90 T.C. at 1009.

119. *Id.* at 1011.

120. *Id.* Damages for breach of contract are not within the scope of I.R.C. § 104(a)(2). *See* I.R.C. § 104(a)(2) (1990).

121. 883 F.2d 211, 215 (3d Cir. 1989).

122. *Id.* at 216.

123. *Id.* at 214.

124. *Id.* at 216.

125. ABA, Comments Concerniug § 11641 of the Revenue Reconciliation Act of 1989, Amending § 104(a)(2) of the Internal Revenue Code (Oct. 18, 1989), *reprinted in Members Argue Against Exclusions for Punitive Damages and Lost Income Under Section* 104, in TAX NOTES TODAY (Nov. 9, 1989) [hereinafter *ABA Comments*].

126. Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (1988).

127. 92 T.C. 510 (1989), *aff'd in part and rev'd in part*, 900 F.2d 655 (3d Cir. 1990). The

(Marlsbary) alleging age discrimination in violation of the ADEA,[128] and requesting back wages, an equal sum as liquidated damages, and any further relief that was proper under the circumstances.[129] At trial the jury found that age was a determinative factor in Marlsbary's decisions not to promote Rickel and to terminate his employment.[130] Prior to a determination of damages, the parties entered into a settlement agreement that did not allocate the proceeds among the damage claims that Rickel had asserted.[131] Rickel did not include the settlement proceeds in his gross income. The Service contended that these amounts were includable because the payments were in the nature of damages for breach of an employment contract and because the ADEA does not create a tort action.[132] Rickel maintained that the payments were received in settlement of an age discrimination claim for wrongful discharge, a tort-type injury, and thus, were excludable from his gross income.[133]

The Tax Court determined that the ADEA, like the FLSA,[134] contains elements of both tort and contract claims.[135] The ADEA provides for damages in lieu of wages in the nature of a breach of contract action, and an equal amount of liquidated damages, which resembles a tort recovery.[136] The court reasoned that by specifying an amount of liquidated damages, Congress, through the ADEA, is attempting to compensate individuals for tort or tort-like injuries caused by their employers' willfully discriminatory conduct.[137] The court held that the liquidated damages which Rickel received under the ADEA were received on account of personal injuries and exempt from tax under section

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petitioner was hired as general sales manager of Marlsbary Manufacturing Co. (Marlsbary) and was told he would be considered for the presidency of Marlsbary when the position became available. When Rickel was 59 years old the company presidency became available, but Marlsbary selected a younger individual to fill the position. Rickel was told that he was not given the presidency because Marlsbary wanted a younger person in the position, and Rickel's employment subsequently was terminated. 92 T.C. at 512.

128. *Id.* The ADEA applies to individuals who are at least 40 years old. 29 U.S.C. § 631(a). The ADEA provides, "It shall be unlawful for an employer—(1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compeusation, terms, conditions, or privileges of employment, because of such individual's age." *Id.* § 623(a)(1).

129. *Rickel*, 92 T.C. at 512-13. Courts are to enforce rights created by the ADEA with FLSA remedies. Liquidated damages are available only if the defendant willfully violated the ADEA. 29 U.S.C. § 626(b).

130. *Rickel*, 92 T.C. at 513.

131. *Id.*

132. *Id.* at 520.

133. *Id.* at 515.

134. 29 U.S.C. §§ 201-219 (1988); *see supra* notes 116-18 and accompanying text.

135. *Rickel*, 92 T.C. at 521.

136. *See* 29 U.S.C. § 626.

137. *Rickel*, 92 T.C. at 522.

104(a)(2).[138] Since the settlement agreement did not specify the amount of liquidated damages that Rickel had received, the court allocated the settlement.[139] Because the ADEA equates the amounts recoverable for wage-related and liquidated damage claims, the court inferred that fifty percent of the amount paid to Rickel was liquidated damages and excludable from gross income.[140]

The Third Circuit reversed, holding that the entire settlement was excludable from gross income.[141] The court applied its analysis of the FLSA in *Byrne* to Rickel's age discrimination claim under the ADEA.[142] The court found that the duty of an employer to refrain from discriminating on the basis of age arises by operation of the ADEA and exists even in the absence of a written employment contract.[143] The court found that the Tax Court failed to consider properly that the nature of the claim, not the consequences resulting from the injury, determines whether damages paid were received on account of personal injuries.[144] The court stressed, as it did in *Byrne*, that the economic effects of an employer's discrimination do not transform the tort-like injury into a nonpersonal injury.[145] Because Marlsbary's discriminatory actions invaded Rickel's personal rights, the court found that all damages Rickel received were paid for a personal injury and were excludable under section 104(a)(2).[146]

The Tax Court has yet to decide further cases addressing the issue of exclusion of damages awarded for a contract-like claim, and it is unclear whether the Tax Court will adopt the Third Circuit's expansive application of section 104(a)(2) or will continue to differentiate wage-related and tort-like damages. Under present law, the analysis of the Tax Court is proper. Damages for economic injuries received in lieu of earnings should be included in gross income and taxed as if they had been earned. No public policy justification exists for exempting tort victims from income tax. Damages have replaced their earnings, and they should pay income taxes on those earnings as do all other taxpayers. In cases awarding damages for lost wages, a plaintiff recovering for employment discrimination is in a better position, in terms of federal income tax liability, than if the discrimination never had occurred. Plaintiffs who have received just compensation for their injuries argua-

138. *Id.*
139. *Id.*
140. *Id.*
141. 900 F.2d 655, 664 (3d Cir. 1990).
142. *Id.* at 662.
143. *Id.*
144. *Id.* at 661-62.
145. *Id.* at 662.
146. *Id.* at 663-64.

bly do not merit more humanitarian benefit through exclusion from income tax than any other taxpayers who must pay taxes on their earnings.[147]

2. Civil Rights Claims

In *Johnston v. Harris County Flood Control District*[148] the Fifth Circuit examined the difference in tax treatment between wage-related damages awarded under Title VII and tort-like damages awarded under section 1983. Johnston had filed an action against the Harris County Flood Control District (HFCD), alleging violations of Title VII and abridgement of his first amendment rights in violation of section 1983.[149] The district court held HFCD liable under both statutes.[150] The court fixed Johnston's actual damages for lost wages and employment and pension benefits under section 1983 at $142,071.[151] The court also fixed recovery under Title VII at the same amount.[152] Because Johnston was entitled to only one recovery, the court entered a judgment against HFCD for $142,071 for all claims.[153]

The Fifth Circuit affirmed the district court's finding that a remedy could be granted under both Title VII and section 1983, but remanded to the district court to clarify whether the damage award constituted a personal injury award under section 1983 or a back pay award under Title VII.[154] According to the court, clarification was necessary because damages received under section 1983 are paid on account of personal injury and are excludable from gross income under section 104(a)(2) even if lost earnings were considered in the calculation of the award, but back pay awarded under Title VII is clearly taxable income.[155] The

147. *See* Chapman, *No Pain—No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407, 428 (1986-1987).

148. 869 F.2d 1565 (5th Cir. 1989), *cert. denied*, 110 S. Ct. 718 (1990). Johnston had testified against his employer, the Harris County Flood Control District (HFCD), at an Equal Employment Opportunity hearing. HFCD reacted with a series of retaliatory actions against Johnston, culminating in the termination of his employment. *Id.* at 1568.

149. *Id.*

150. *Id.*

151. *Id.* at 1579.

152. *Id.*

153. *Id.*

154. *Id.* The court explored the relationship between Title VII and § 1983. Section 1983 provides a remedy for statutory and constitutional violations and does not create any substantive rights. While Title VII does creato statutory rights that are secured by § 1983, § 1983 is not an available remedy for a violation of Title VII. When a statute itself provides the exclusive remedy for a violation of its terms as does Title VII, § 1983 is not an available remedy. A litigant must have an independent basis other than a violation of Title VII to bring claims both under Title VII and § 1983. Because Johnston alleged a violation of his first amendment rights, he was entitled to seek redress under both Title VII and § 1983. *Id.* at 1574-76.

155. *Id.* at 1580.

Fifth Circuit instructed the district court that the calculation of damages should reflect whether the amount awarded could be subject to tax.[156]

For damages awarded under section 1983, the Fifth Circuit advocated a net earnings calculation.[157] This approach would account for tax liability on the earnings replaced by the damage award and would reflect Johnston's actual loss.[158] Thus, if the district court's award was for back pay under Title VII the district court should calculate it without reduction for tax liability because the award is subject to tax.[159] By recommending a net earnings calculation for excludable damages and a gross earnings calculation for damages that must be included in gross income, the Fifth Circuit accomplished the concurrent goals of taxpayer equity and compensation for tort victims. A tax-exempt award of net earnings compensates the tort victim for actual losses. Back pay recovered under Title VII will be subject to tax, leaving net earnings once taxes have been paid. Courts that award damages based solely on gross earnings do not afford this equitable tax treatment; thus, all courts should adopt the Fifth Circuit's method of damage computation.

3. Punitive Damages

The Tax Court recently held that the plain language of section 104(a)(2) does not permit a distinction between punitive and compensatory damages. In *Miller v. Commissioner*[160] Miller alleged that her employer had accused her of embezzlement in order to conceal a bribery scheme and had attempted to defame her so that her testimony at trial would be less credible.[161] Miller released all claims in return for a settlement payment that did not allocate the settlement proceeds between compensatory and punitive damages.[162] Because the settlement satisfied claims for defamation, a personal injury under state law, the Tax Court excluded the entire settlement from gross income.[163] In determining that punitive damages are excludable, the court stated that punitive damages result from both personal injury and the defendant's culpable

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156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).
161. 93 T.C. at 331, 333.
162. *Id.* at 334.
163. *Id.* at 335. Compensatory damages awarded for injury to personal reputation clearly were excludable from gross income under prior precedent. *See supra* notes 44-51 and accompanying text. The court declined to revert to its position in Roemer v. Commissioner, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983), that injury to personal reputation should be distinguished from injury to professional reputation. *Miller*, 93 T.C. at 337.

conduct.[164] Without the invasion of personal rights, punitive damages would be unavailable regardless of a defendant's egregious conduct.[165] Because the award of punitive damages is predicated on the existence of a personal injury, the court maintained that punitive damages are received on account of personal injury and are excludable from gross income.[166] By recognizing that all damages arising from a personal injury, whether compensatory or punitive, are excludable under section 104(a)(2), the court attempted to avoid the disparity that may result if an identical injury is characterized differently under various state laws.[167]

In reversing the decision of the Tax Court, the Fourth Circuit considered the nature of punitive damages under the applicable state law.[168] Under Maryland law, punitive damages awarded in a defamation action are a punishment and a deterrent to wrongdoing rather than a means to compensate the victim.[169] The court recognized that although personal injury is a prerequisite for an award of punitive damages, a plaintiff seeking punitive damages also must show that the defendant acted egregiously.[170] Therefore, the court found that facially it is not clear whether punitive damages are awarded on account of a personal injury.[171] Construing the underlying purpose of section 104(a)(2) as solely to make the personal injury victim whole, the court concluded that punitive damages, which are awarded in addition to any award of compensatory damages, are beyond the section 104(a)(2) exclusion.[172]

B. Legislative Amendment Limiting the Scope of the Personal Injury Exclusion

In its search for additional revenue, Congress has amended section 104(a)(2) to limit strictly the exclusion of punitive damages from gross income. Section 104 as amended by the Omnibus Budget Reconciliation

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164. *Miller*, 93 T.C. at 339.

165. *Id.*

166. *Id.* at 339-40. Another argument for the exclusion of punitive damages is that they are compensatory because they compensate the plaintiff for intangible harms, attorney's fees, and costs. *Id.* at 341.

167. *See* Rev. Rul. 84-108, 1984-2 C.B. 32.

168. 914 F.2d 586, 589 (4th Cir. 1990).

169. *See, e.g.*, Nast v. Lockett, 312 Md. 343, 349, 539 A.2d 1113, 1116 (1988) (stating that punitive damages are awarded "not as the measure of actual loss suffered but 'as punishment for outrageous conduct and to deter future transgressions'" (quoting BLACK'S LAW DICTIONARY 352 (5th ed. 1979)). The Supreme Court adopted a similar position in Gertz v. Robert Welch, Inc., 418 U.S. 323, 350 (1974) (noting that punitive damages in a defamation action "are private fines . . . to punish reprehensible conduct and to deter its future occurrence," not compensation for injury).

170. *Miller*, 914 F.2d at 590.

171. *Id.*

172. *Id.*

Act of 1989 provides that the section 104(a)(2) exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."[173] Although the Conference Committee Report does not offer an explanation for the change,[174] Congress may have wished to resolve the conflict between the courts and the Service on this issue.

The amended section represents a compromise between the respective positions of the Service and the courts. The Service's position has been codified for punitive damages awarded for nonphysical personal injuries.[175] Thus, in nonphysical injury actions, such as *Miller v. Commissioner*, the punitive damages awarded will be includable in gross income. Taxation of punitive damages in nonphysical injury cases may raise revenues significantly in light of the trend of large punitive damage awards.[176] Section 104 as amended does not state that punitive damages awarded in physical injury actions no longer will be excluded; therefore, by implication punitive damages awarded in physical injury actions will continue to qualify for exclusion under section 104(a)(2). The courts previously had adopted this position, and this legislative amendment to the Code allows for the result in *Burford v. United States*.[177]

IV. Recommendation for Future Modification

Although the amendment of section 104(a)(2) has resolved the prior disparate treatment of punitive damages, other areas of conflict and uncertainty remain. Recommendations for congressional action with respect to section 104(a)(2) have been suggested. The House Ways and Means Committee proposed an amendment to section 104(a)(2) that would have excluded damages received on account of personal injuries or sickness in cases involving physical injury or physical sick-

173. Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989). The provision is effective for punitive damages received after July 10, 1989, other than amounts received under a written agreement or court decree issued before July 10, 1989, or amounts received pursuant to suits filed on or before July 10, 1989.

174. H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 622-23, *reprinted in* 1989 U.S. Code Cong. & Admin. News 1906, 3225-26.

175. *See supra* notes 24-29 and accompanying text (discussing the Service's position that punitive damages are includable in gross income).

176. For the years 1976 to 1985, the average yearly increase in jury verdict awards was 15.23%. Chapman, *supra* note 147, at 424 n.154. For the period 1990 to 1994, tax revenues are estimated to increase by $27 million as a result of the change. Joint Committee on Taxation Rep. No. JCX-74-89 (Nov. 21, 1989), *reprinted in Joint Committee Estimates Revenue Effects of Conference Agreement on Revenue Provisions of Budget Reconciliation Acts*, in Tax Notes Today (Nov. 22, 1989).

177. For a discussion of *Burford*, see *supra* notes 31-34 and accompanying text.

ness.[178] The House Committee believed that exclusion of damages was inappropriate in cases not involving physical injury or physical sickness and wished to stop the trend toward expansive judicial interpretation of the types of damages that may be recovered on account of personal injuries.[179] The House amendment would have eliminated, in nonphysical injury cases, the tax incentive to allocate settlement or judgment proceeds to tort-type remedies and also would have eliminated the windfall to personal injury plaintiffs through the exclusion of lost earnings, except in cases in which the plaintiff had been physically injured.[180] All damages flowing from a physical injury or physical sickness would have been excludable under section 104(a)(2).[181]

The House proposal would have magnified the inconsistent tax consequences currently present in the personal injury area. For example, a plaintiff suffering mostly from mental distress arising out of an automobile accident in which the physical injury was slight could exclude from gross income all damages received. Another plaintiff suffering mental distress resulting from racial slander would have to include all damages received in gross income because there was no physical injury. Although these plaintiffs essentially suffered the same injury, the House proposal would create drastically different tax consequences.[182]

One commentator has suggested that section 104(a)(2) should exclude damages only to the extent that they are a reimbursement for actual expenses, pain and suffering, mental anguish, and loss of services.[183] Under this proposal a court would consider the consequences of the injury and limit exclusion to damages received on account of injuries that are clearly personal and within the probable congressional intent in retaining section 104(a)(2).[184] Because this proposal does not distinguish between physical and nonphysical injuries, the dichotomous tax treatment in the above example would not occur. This definition of the exclusion, however, will not remove the potential for abuse, especially when a plaintiff easily could argue a claim for emotional distress.

To remove all inequities and to prevent taxpayers from determin-

178. H.R. 3299, 101st Cong., 1st Sess. § 11641 (1989). Enactment of the House bill would increase revenues by an estimated $42 million for the period 1990 to 1994. Joint Committee on Taxation Rep. No. JCX-70-89 (Oct. 26, 1989), *reprinted in JCT Releases Revenue Estimates for House and Senate Revenue-Raising Provisions in Budget Reconciliation Bills*, in TAX NOTES TODAY (Oct. 27, 1989).

179. OMNIBUS BUDGET RECONCILIATION ACT OF 1989, H.R. REP. No. 247, 101st Cong., 1st Sess. 1354-55, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS 1906, 2824-25.

180. *Id.*

181. *Id.*

182. *See ABA Comments*, *supra* note 125.

183. *See* Chapman, *supra* note 147, at 428.

184. *Id.*

ing their own tax status, Congress should repeal this exclusion. Repeal of section 104(a)(2) would have the effect of including in gross income all damages received on account of personal injury, unless the Code otherwise excludes these damages. Damages received for noneconomic injuries as well as economic injuries would be taxable and would ease the burdens of a revenue-needy Congress. Taxing damages received in lieu of lost earnings and profits would not be unfair to the taxpayer because these earnings would have been taxed if the personal injury never had occurred.[185] While the repeal of section 104(a)(2) would remove the present windfall that exclusion of earnings has bestowed on personal injury victims, steps can be taken to ensure that these taxpayers continue to receive full compensation.

Courts should instruct juries that damage awards will be subject to federal income tax. This instruction would permit a jury to adjust an award both to compensate the plaintiff for injuries and to account for the tax liability that will occur. Taxing an award not based on lost earnings will shift the tax liability to defendants, but current tort law policy justifies an award that will return the plaintiff to the position the plaintiff would have been in absent the injury. Because damages received in a personal injury suit would be taxed, an award for lost earnings should be made on a gross earnings basis. The plaintiff will receive gross earnings and pay tax on them and, thus, will be treated equitably with all other taxpayers. A gross earnings award also will avoid the state courts' concern that performing a calculation based on net earnings is beyond the capacity of a jury.[186]

Repeal of section 104(a)(2) would remove the tax-driven abuses of this exclusion. Litigants no longer would have the incentive to color both their claims and the presentation of evidence in hope of persuading the court that they had been personally injured. Repeal also would remove the burden on courts to allocate jury awards or settlement agreements between personal and nonpersonal injuries.[187] At present plaintiffs have an incentive to allocate settlements to tort-type injuries in hope of excluding at least part of a settlement from gross income.[188]

Apart from removing taxpayer abuse, repeal of section 104(a)(2) would assist in accomplishing the goals of the tort and tax systems. Juries, informed of the tax consequences of their awards, would fulfill the

185. *See* I.R.C. § 61 (1990).

186. *See* text accompanying note 94.

187. *See* Niles v. United States, 710 F.2d 1391, 1395 (9th Cir. 1983) (stating that review of IRS allocation of jury awards would be "bewildering" to courts).

188. *See supra* notes 141-46 and accompanying text. For advice to the practitioner on how to achieve excludability, see Barton, *How to Make Your Damages in Employment Cases Excludable*, 4 PRAC. TAX LAW. 57 (1989).

tort system's goal of compensation. Equitable treatment of similarly situated taxpayers also would be achieved because all personal injury damages would be taxed and the courts would not be compelled to draw arbitrary lines to determine what types of injuries fall within the scope of the personal injury award exclusion.[189] Should Congress repeal section 104(a)(2), it could provide special treatment to tort victims in a manner more closely related to the underlying tax principles of the Code. For example, Congress could grant increased personal exemptions to persons with objectively measurable disabilities.[190] This approach would be consistent with the present exemptions available to the blind or elderly and would be available regardless of the cause of the disability, thereby treating disabled persons equitably for tax purposes.[191]

V. Conclusion

Section 104(a)(2) provides an exclusion from gross income of compensatory damages received on account of personal injury or sickness and punitive damages in cases of physical injury or physical sickness. The courts have interpreted expansively what constitutes a personal injury and have brought within the scope of this section damages received for economic injury. The Service has taken a position that treats taxpayers inequitably and disputes the exclusion of economic damages only in cases not involving a physical injury.

Although 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. This rationale might justify exclusion of damages paid to compensate the taxpayer for personal injuries such as pain and suffering and emotional distress, but mere sympathy should not be allowed to legitimize inequitable treatment of taxpayers. Any future legislative action at a mini-

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189. A loophole that would be closed by the repeal of § 104(a)(2) is the exclusion of the interest component of a structured settlement or judgment. In a structured settlement, any deferred payments are excludable from gross income, and no interest income is imputed to the taxpayer. Conversely, when the taxpayer receives a lump-sum award and invests the proceeds, the interest received clearly is includable in gross income. For a discussion of structured settlements, see Blackburn, *supra* note 4, at 686.

190. *See* Burke & Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 Mont. L. Rev. 13, 46 (1989).

191. *Id.* Burke and Friel have suggested another alternative that would not involve repeal of § 104(a)(2): narrowing the scope of § 104(a)(2) to make it consistent with § 104(a)(3) and § 105. Analogizing a tort victim's damages to employer-provided insurance, damages received would he includable in gross income except to the extent that they are attributable to amounts expended for medical care, which would be similar to § 105(b), or to the extent that they are attributable to a permanent disability or disfigurement, which is similar to § 105(c). This approach would retain the § 104(a)(2) exclusion only for serious physical injuries. *Id.*

mum should remove economic recovery from the scope of this exemption because all taxpayers should be required to pay taxes on their wages. Because Congress has clung to this exclusion notwithstanding past opportunities for amendment and superficially would not wish to appear unsympathetic to tort victims, repeal of section 104(a)(2) may be unlikely. The courts, however, will view lack of legislative action as approval of their expansive interpretation of the scope of section 104(a)(2).[192]

Taxpayer abuses of this exemption through careful presentation of a claim remain unchecked under present law, and the potential for future abuse increases as the courts continue to expand the scope of the exclusion. To prevent further abuses, to achieve equitable treatment of similarly situated taxpayers, and to raise revenues, Congress should seize the initiative to repeal section 104(a)(2). The humanitarian benefit presently extended to personal injury victims may be accomplished without this exemption by ensuring through other means that they are fully compensated for their injuries.

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192. *See* Rickel v. Commissioner, 900 F.2d 655, 664 (3d Cir. 1990). In its interpretation of the OBRA amendment the Court stated, "Congress chose to implicitly endorse the courts' expansive interpretation of § 104(a)(2) to encompass nonphysical injuries and merely circumscribe the scope of the exemption as to only one type of remedy, i.e., punitive damages, and not other types of remedies typically available in employment discrimination cases, such as back pay." *Id.* The court also stated, " 'Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change.' " *Id.* (quoting Lorillard v. Pons, 434 U.S. 575, 580 (1978)).