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The Taxation of Defamation Recoveries: Toward Establishing Its Reputation

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RECENT DEVELOPMENT

The Taxation of Defamation Recoveries: Toward Establishing Its Reputation

I.	INTRODUCTION	621
II.	LEGAL BACKGROUND	624
	A. <i>The Personal Defamation Damage Exclusion</i>	624
	B. <i>The Distinction Between Personal and Business Reputation</i>	626
III.	RECENT DECISIONS	629
	A. <i>The Tax Court</i>	629
	1. <i>Glynn v. Commissioner</i>	629
	2. <i>Roemer v. Commissioner</i>	630
	3. <i>Church v. Commissioner</i>	634
	B. <i>The Ninth Circuit</i>	636
IV.	ANALYSIS	637
	A. <i>Problems with the Tax Court's Recent Approach</i>	637
	B. <i>The Ninth Circuit's Search for a Solution</i>	640
	C. <i>The Recommended Approach: A Uniform Standard</i>	643
V.	CONCLUSION	646

I. INTRODUCTION

Section 104(a)(2) of the Internal Revenue Code of 1954 excludes from gross income "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness."¹ By enacting this provision, Congress has recognized a

1. I.R.C. § 104(a)(2) (1976). This provision states in full:

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

distinction between personal and nonpersonal injuries and has chosen not to tax damages that a taxpayer receives as the result of personal injuries he suffers.² The dispositive issue courts address in cases concerning taxation of damages is whether the damages resulted from personal or nonpersonal injuries.³ Neither the Code nor the Treasury Regulations, however, define "personal injury."⁴ Courts have determined that section 104(a)(2) personal injuries include both physical and nonphysical injuries.⁵ Even though courts and the Internal Revenue Service generally interpret the term "personal injury" strictly,⁶ they have held that defamatory statements which injure "personal" reputation are within the scope of section 104(a)(2).⁷

year, gross income does not include—

....

(2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.

Id.

The Code states that "[e]xcept as otherwise provided . . . , gross income means all income from whatever source derived." I.R.C. § 61(a) (1976). Section 104(a)(2) is one of the provisions of the Code that "otherwise" provides.

2. Congress first established this distinction in the personal injury award exclusion of the Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1919) (current version at I.R.C. § 104(a)(2) (1976)). See *infra* text accompanying note 21 (setting out provision). The rationale that courts and commentators generally proffer for excluding personal injury damages from gross income is "that the taxation of recoveries carved from pain and suffering is offensive, and the victim is more to be pitied rather than taxed." Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614, 627 (1952). Commentators believe that courts base that rationale in emotion rather than logic. See, e.g., Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 706 (1977).

Taxing nonpersonal injury damages, however, depends on whether the recovery is for loss of capital or for lost profits or earnings. *Id.* at 702-03. Recovery of lost capital is taxable only to the extent that the amount the taxpayers receive exceeds the basis in the capital that the defendant's actions damage or destroy. See, e.g., *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944). Recovery for lost profits or earnings, however, is fully taxable if the injury is non personal. *Id.* at 113.

3. See Fouts, *Payments Received in Settlement of Litigation and Claims*, 25 INST. ON FED. TAX'N 555, 561 (1967).

4. The Treasury Regulations that the United States Treasury Department promulgated under the auspices of the Internal Revenue Code add to the statutory language only that "[t]he term 'damages received (whether by suit or agreement)' means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." Treas. Reg. § 1.104-1(c) (1956).

5. See *infra* note 22.

6. The rationale behind this strict interpretation is that compensatory personal injury awards are excluded completely from gross income. Comment, *Income Tax Effects on Personal Injury Recoveries*, 30 LA. L. REV. 672, 674 (1970).

7. See, e.g., *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1024 (1927); Sol. Op. 132, I-1 C.B. 92 (1922); see also *infra* notes 25-28 and accompanying text.

Courts have had difficulty differentiating between statements that injure business reputation and statements which injure personal reputation such that the injured party suffers economic harm like lost profits or earnings. In general, courts have held that recovery for damage to business reputation is not personal and, therefore, does not fall within the exclusion that section 104(a)(2) offers.⁸ Courts have been uncertain about the way to treat awards for economic injury resulting from personal defamation.⁹ In the recent decisions of *Glynn v. Commissioner*,¹⁰ *Roemer v. Commissioner*,¹¹ and *Church v. Commissioner*,¹² the United States Tax Court approached this issue by classifying the awards according to the effects of the injuries that the defamatory attacks caused,¹³ rather than by the personal or nonpersonal nature of the attacks themselves.¹⁴ As a result, if a statement caused economic injury to the taxpayer, the court taxed the award for that economic injury, despite any possible noneconomic aspects of the injurious statement.¹⁵ In a recent decision, however, the United States Court of Appeals for the Ninth Circuit reversed the Tax Court's decision in *Roemer*¹⁶ and held that the crucial issue in defamation damages cases is the personal or nonpersonal nature of the attack, not the effects of the injury.¹⁷

This Recent Development advocates that courts adopt the Ninth Circuit's *Roemer* approach to determine the nature of damages for injury to reputation by focusing on the attack rather than

8. See, e.g., *Agar v. Commissioner*, 19 T.C.M. (CCH) 116, 119 (1960), *aff'd*, 290 F.2d 283 (1961); see also *infra* notes 33-41 and accompanying text.

9. One commentator stated that the distinction between damages to personal as opposed to business reputation is the most ambiguous limit on the § 104(a)(2) exclusion. See Lorentzen, *Tax Aspects of Litigation Settlement*, 17 TRIAL, May 1981, at 36, 36.

10. 76 T.C. 116 (1981), *aff'd mem.*, 676 F.2d 682 (1st Cir. 1982).

11. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

12. 80 T.C. 1104 (1983).

13. To establish a cause of action for defamation, the plaintiff must prove four elements:

- (a) a false and defamatory statement concerning another;
- (b) an unprivileged publication to a third party;
- (c) fault amounting at least to negligence on the part of the publisher; and
- (d) either actionability of the statement irrespective of special harm or the existence of special harm caused by the publication.

RESTATEMENT (SECOND) OF TORTS § 558 (1977).

14. See *infra* notes 55-107 and accompanying text.

15. See *id.*

16. *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), *rev'g*, 79 T.C. 398 (1982); see *infra* notes 69-92 and 108-14 and accompanying text.

17. *Roemer v. Commissioner*, 716 F.2d at 697; see *infra* notes 108-14 and accompanying text.

the effects of the injury, but suggests that courts replace the Ninth Circuit's reliance on state law with a uniform standard. Part II of this Recent Development traces the evolution of the personal injury exemption and the confusing judicial treatment that courts have accorded economic damages which result from personal injuries. Part III of this Recent Development discusses the most recent treatment of economic damages by examining the Tax Court's decisions in *Glynn*,¹⁸ *Roemer*,¹⁹ and *Church*²⁰ and the Ninth Circuit's decision in *Roemer*. Part IV advocates using the Ninth Circuit's approach, which would allow courts to determine whether to tax awards for injury to personal or business reputation by examining the nature of the attacks rather than the effects of the injuries that those attacks cause. Part IV suggests, however, that courts replace the *Roemer* court's reliance on state law for determining the personal or business character of damaging attacks with a uniform standard.

II. LEGAL BACKGROUND

A. *The Personal Defamation Damage Exclusion*

The Revenue Act of 1918 excluded from gross income "[a]mounts received . . . as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injury or sickness."²¹ The Solicitor of Internal Revenue sought to limit the scope of this exclusion by ruling that payments the taxpayer receives in a libel action are taxable.²² The Supreme Court's intervening decision in *Eisner v.*

18. 76 T.C. 116 (1981), *aff'd mem.*, 676 F.2d 682 (1st Cir. 1982).

19. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

20. 80 T.C. 1104 (1983).

21. Ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1919) (current version at I.R.C. § 104(a)(2) (1976)). In the enactment of this provision, 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. (1918), *reprinted in* 1939-1 (Part 2) C.B. 86, 92.

22. Sol. Mem. 957, 1 C.B. 65 (1919). In 1920 the Solicitor ruled that an award the taxpayer received for alienation of his wife's affections was taxable on the ground that the statute's exclusion for "personal injuries" applied to "physical injuries only." Sol. Mem. 1384, 2 C.B. 71 (1920); *see* Yorio, *supra* note 2, at 704. Courts and commentators currently reject the distinction between physical and nonphysical injuries. *See, e.g., Roemer v. Commissioner*, 79 T.C. 398, 405 (1982), *rev'd on other grounds*, 716 F.2d 693 (9th Cir. 1983); *Seay v. Commissioner*, 58 T.C. 32, 40 (1972); *see also* Moe, *The Tax Effects of Tort Dam-*

Macomber,²³ however, limited the definition of income, thus prompting the Solicitor to reverse his earlier decision and rule that damages for defamation of personal reputation are not taxable.²⁴ Several years later, in the seminal case of *Hawkins v. Commissioner*,²⁵ the Board of Tax Appeals affirmed the Solicitor's new position.²⁶ The Board reasoned that "the income tax is primarily an application of the idea of measuring taxes by financial ability to pay, as indicated by the net accretions to one's economic wealth during the year."²⁷ The Board concluded that compensation for injury to integrity is personal and "adds nothing to the individual. . . . It is an attempt to make the plaintiff whole as before the injury."²⁸

The rule that excludes from taxation awards for injuries to personal reputation remains in force today.²⁹ The rationale for the rule, however, has changed. Courts and commentators today recognize that a defamation recovery does more than merely make the plaintiff whole: even the compensatory portion of the award commonly includes lost profits or wages, items that the government otherwise would tax.³⁰ Courts continue to exclude personal defamation damages from gross income because of the public policy

ages, *PRAC. LAW.*, Jan. 15, 1980, at 37, 39.

23. In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Court defined income as "the gain derived from capital, from labor, or from both combined." *Id.* at 207 (quoting *Stratton's Independence v. Howbert*, 231 U.S. 399, 415 (1913)).

24. Sol. Op. 132, I-1 C.B. 92, 93 (1922) (expressly modifying Sol. Mem. 957 and revoking Sol. Mem. 1384, *supra* note 22). The Solicitor reasoned that compensation for invasion of a personal right confers no gain or profit upon the taxpayer. I-1 C.B. at 93.

25. 6 B.T.A. 1023 (1927). The reason the Service assessed taxes in *Hawkins* on a defamation recovery five years after the Solicitor conceded that these recoveries are excludable from gross income probably is that the taxable year in issue in *Hawkins* was 1919—three years before the Solicitor rendered that opinion. Therefore, the earlier Solicitor's opinion, expressly including defamation recoveries in gross income, was in effect. *See supra* note 22 and accompanying text.

26. 6 B.T.A. at 1025.

27. *Id.* at 1024.

28. *Id.* at 1025.

29. *See infra* notes 55-114 and accompanying text.

30. Comment, *supra* note 6, at 674. Under the Supreme Court's most recent definition of income, which includes "all gains except those specifically exempted," the "make whole" rationale is particularly weak. *See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955). This broad definition indicates a judicial willingness to include in gross income every accretion to wealth unless the Code specifically excludes it. *But see United States v. Gotcher*, 401 F.2d 118, 120 (5th Cir. 1968) (holding that "exclusions from gross income are not limited to the enumerated exclusions"). *Glenshaw Glass*, therefore, provides no rationale for the exclusion of personal injury awards, other than that the Code specifically exempts them, because the Court's formula would require an injured plaintiff to pay the same tax whether he is indemnified or earns a profit under the recovery.

against overburdening injured plaintiffs and because of the difficulty of separating lost profits and wages from the other elements of a personal defamation award.³¹ Awards for injury to nonpersonal reputation do not receive the same tax advantage, however, because the separation difficulties and the sympathy rationale generally do not exist to the same degree as in personal injury cases.³²

B. *The Distinction Between Personal and Business Reputation*

The Tax Court historically has refused to recognize injury to business reputation as personal injury. Only taxpayers that received injuries to their personal reputations could exclude awards from gross income. In *Agar v. Commissioner*,³³ the Tax Court held that in cases of injury to reputation, the dispositive issue courts must address is whether the taxpayer suffered damage to his personal or to his business reputation.³⁴ In *Agar* the taxpayer had resigned as treasurer and director of a company because his relationship with the other members of the executive staff began to deteriorate.³⁵ He then informed the company's president that he intended to sue the company because its personnel mistreated him.³⁶ The parties reached a settlement under which the company agreed to pay the taxpayer \$45,000 to "cover all claims of any kind and character."³⁷ The issue before the Tax Court was whether it should tax the taxpayer's recovery under the settlement. The court required the taxpayer to prove that he had received the payments in settlement of his claim for damages to his personal reputation.³⁸ Even if the company had intended to make the payments in settlement of the taxpayer's proposed libel suit, the court held that it could not exclude the payments from gross income be-

31. See Comment, *supra* note 6, at 674; see also *supra* note 2.

32. See Comment, *supra* note 6, at 674.

33. 19 T.C.M. (CCH) 116 (1960), *aff'd*, 290 F.2d 283 (1961); see Lorentzen, *supra* note 9, at 36.

34. 19 T.C.M. (CCH) at 119-20.

The Service first recognized a distinction between personal and business reputation injury in 1922. See Sol. Op. 132, I-1 C.B. 92 (1922). The Tax Court first adopted that distinction in *Agar*.

35. *Agar v. Commissioner*, 19 T.C.M. (CCH) at 117.

36. *Id.*

37. *Id.* at 118.

38. *Id.* at 119. The court stated that the taxpayer "must bring himself squarely within the exemption from tax upon which he bases his case; *i.e.*, that the \$45,000 was received in settlement of his claim for damages resulting from injury to his *personal reputation*." *Id.* The court cited *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), for support. See 19 T.C.M. (CCH) at 119; see also *supra* note 30 (discussing *Glenshaw Glass*).

cause the injuries were to his business reputation.³⁹ The court stated that the evidence indicated company personnel had attacked the taxpayer's professional judgment, not his personal character.⁴⁰ The Tax Court defined personal reputation as the community's perception of the taxpayer's honesty, integrity, and trustworthiness, and business reputation as the community's perception of his professional ability and judgment.⁴¹

The Tax Court continued to distinguish between personal and business reputation⁴² until 1978, when in *Wolfson v. Commissioner*,⁴³ the court questioned this dichotomy. The taxpayer in *Wolfson* enrolled as a student at a medical school while also serving as a member of the school's faculty. When the Army called him to active duty, his patients sought to obtain his deferment.⁴⁴ One faculty member openly accused the taxpayer of exploiting the plight of his patients to escape military service, and the school administration publicly denied that he was a faculty member.⁴⁵ The taxpayer filed suit and the parties reached a settlement under which the taxpayer agreed to withdraw all claims in exchange for the correction of the school's records and payment of \$105,000.⁴⁶ The issue before the Tax Court was whether to tax this payment. The taxpayer had sued in state court for damages to his profes-

39. 19 T.C.M. (CCH) at 119-20. The *Agar* court, however, found that the record failed to support the contention that the company made the payments in settlement of the threatened libel suit. The court determined, to the contrary, that the payor viewed the payments as severance pay. *Id.* The Second Circuit affirmed the Tax Court's decision stating that:

Since we affirm upon the [severance pay] ground, we do not have to decide whether whatever tort claim *Agar* may have asserted was based upon damage to his personal as well as his business reputation, assuming that the dichotomy is realistic, and whether all payments or a portion of them would therefore be tax exempt.

Agar v. Commissioner, 290 F.2d at 284.

40. *Agar v. Commissioner*, 19 T.C.M. (CCH) at 119.

41. *Id.*; see Lane, *Tax Principles of Damages*, 31 S. CAL. TAX INST. 185, 191 (1979).

42. See, e.g., *Wallace v. Commissioner*, 35 T.C.M. (CCH) 954, 959 (1976) (holding that a recovery for injury to personal reputation is exempt from federal taxation but the damages a taxpayer receives for injury to business reputation are taxable to the extent they exceed the taxpayer's basis in that reputation); *Knuckles v. Commissioner*, 23 T.C.M. (CCH) 182, 185 (1964), *aff'd*, 349 F.2d 610 (10th Cir. 1965) (finding a total lack of evidence of personal injury while recognizing that "[i]t may be that petitioner's business reputation has suffered . . . , but that fact militates against him"); see also *Seay v. Commissioner*, 58 T.C. 32, 37 (1972) (holding that taxation of settlements "depends on the nature of the claim settled and not the validity of the claim" and that a settled claim for damage to reputation must compensate for injury to personal reputation to escape taxation).

43. 37 T.C.M. (CCH) 1847-14 (1978), *aff'd*, 651 F.2d 1228 (6th Cir. 1981).

44. *Id.* at 1847-16.

45. *Id.*

46. *Id.* at 1847-18 to 1847-19.

sional rather than his personal reputation.⁴⁷ He did not argue to the Tax Court, however, that damages for injury to professional reputation are exempt from taxation.⁴⁸ The court, therefore, decided the case based on the damages that the plaintiff requested in his state court complaint and expressly refused to decide whether a valid distinction between personal and business reputation damages exists.⁴⁹

The *Wolfson* decision diverged from *Agar* in two respects. First, *Wolfson* questioned whether the distinction that *Agar* established between damage to personal and professional reputation was valid.⁵⁰ Second, assuming the validity of the distinction, *Wolfson* applied a new analysis to determine whether an injury is to personal reputation.⁵¹ The *Agar* court had focused primarily on whether the damaging statement attacked the taxpayer's honesty, integrity, and trustworthiness or insulted his business acumen and judgment.⁵² The *Wolfson* court, on the other hand, determined the type of injury the taxpayer suffered solely by interpreting the wording of the complaint the taxpayer filed in his original tort action.⁵³ Although the Tax Court probably would have reached the same result in each case under either analysis,⁵⁴ the *Wolfson* decision left the rules governing taxation of damages for injury to reputation in an unsettled state. Recent decisions, therefore, have attempted to resolve the confusion in this area of tax law.

47. *Id.* at 1847-17, 1847-21.

48. The Commissioner argued that damages for injury to professional reputation are taxable. He relied on a revenue ruling which stated that damages for defamation of one's business reputation are in lieu of future or past income and, therefore, are taxable as ordinary income. *Id.* at 1847-21 n.9, 1847-22 (citing Rev. Rul. 58-418, 1958-2 C.B. 18). The taxpayer did not challenge the ruling probably because of the relatively strong precedent against finding personal reputation damages that *Agar* and its progeny established. See *supra* notes 33-42 and accompanying text.

49. *Wolfson*, 37 T.C.M. (CCH) at 1847-21 n.9, 1847-22. The court relied solely on the taxpayer's tort complaint in ruling that the damages were taxable even though the court had "no doubt petitioner felt he was being called a liar; however, . . . no damages were sought for personal slander and libel and the entire thrust of petitioner's efforts was to regain his former position in the medical field and recognition of his proper status." *Id.* at 1847-21.

50. See *id.* at 1847-22.

51. See *supra* text accompanying note 49.

52. See *supra* note 41 and accompanying text.

53. See *supra* text accompanying note 49.

54. The taxpayers in both *Agar* and *Wolfson* came to the Tax Court with weak arguments. In *Agar* the taxpayer complained only about accusations of bad business judgment, and in *Wolfson* the taxpayer could not prove he suffered any defamatory attacks. See Lane, *supra* note 41, at 191-92.

III. RECENT DECISIONS

From 1981 to 1983, the Tax Court faced its first three opportunities since *Wolfson*⁵⁵ to decide under what circumstances it would allow taxation of damages for injuries to reputation. In *Glynn v. Commissioner*,⁵⁶ the first of these three cases, the Tax Court recognized in dictum that only recovery for injuries to personal reputation are excludable from gross income.⁵⁷ In *Roemer v. Commissioner*⁵⁸ and *Church v. Commissioner*,⁵⁹ the Tax Court purportedly applied identical analyses to similar sets of facts but reached strikingly different results. The Ninth Circuit subsequently reversed *Roemer*⁶⁰ and applied an analysis that is procedurally novel but substantively reminiscent of the Tax Court's earlier approach in *Agar v. Commissioner*.⁶¹

A. The Tax Court

1. *Glynn v. Commissioner*

In *Glynn v. Commissioner*,⁶² the Tax Court's first decision subsequent to *Wolfson* concerning taxation of damages for injury to reputation, the taxpayer alleged that he had received settlement payments from his employer to compensate for injuries to his professional reputation.⁶³ The employer was dissatisfied with the taxpayer's job performance and the taxpayer refused to resign because his employer would not pay him for his accrued sick leave.⁶⁴ The court determined that the settlement payments were severance pay and, therefore, were in settlement of a contract claim, not a reputation injury claim.⁶⁵ The court, nevertheless, stated in dictum that recoveries for injury to professional reputation are taxable, while recoveries for damage to personal reputation are exempt.⁶⁶ In do-

55. See *supra* notes 43-49 and accompanying text.

56. 76 T.C. 116 (1981), *aff'd mem.*, 676 F.2d 682 (1st Cir. 1982); see *infra* notes 62-68 and accompanying text.

57. *Id.* at 120.

58. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983); see *infra* notes 69-92 and accompanying text.

59. 80 T.C. 1104 (1983); see *infra* notes 93-107 and accompanying text.

60. *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983); see *infra* notes 108-14.

61. 19 T.C.M. (CCH) 116 (1960), *aff'd*, 290 F.2d 283 (1961); see *supra* notes 33-41 and accompanying text.

62. 76 T.C. 116 (1981), *aff'd mem.*, 676 F.2d 682 (1st Cir. 1982).

63. *Id.* at 120.

64. *Id.*

65. *Id.* at 120-21.

66. The court stated that

ing so, the court impliedly followed the reasoning that *Agar* set forth⁶⁷ and made no reference to the statement in *Wolfson* that a valid distinction between personal and professional reputation may not exist.⁶⁸

2. *Roemer v. Commissioner*

In *Roemer v. Commissioner*⁶⁹ the taxpayer, an independent insurance broker, applied for an agency license from a life insurance company.⁷⁰ As part of the application, the company requested a report from a credit reporting service. The report was "grossly defamatory,"⁷¹ falsely accusing the taxpayer of incompetence⁷² and dishonesty.⁷³ The credit reporting company, upon the taxpayer's demand, issued a retraction, but it contained further false and defamatory insinuations regarding the taxpayer's business abilities and personal character.⁷⁴ When the insurance company denied the taxpayer an agency license, he brought an action for libel⁷⁵ against

payments for injury to professional reputation are not excludable from gross income, since any damages alleged to have been paid as a result of such injury would not fall within the exclusion afforded payments for injuries to *personal* reputation. Rather, they would more properly be characterized as payments made in satisfaction of injuries to petitioner's *business* reputation as compensation for past or future income which might have been or might be lost, and thus, being compensatory by nature, would be taxable as ordinary income.

Id. at 120.

67. See *supra* text accompanying notes 38-41.

68. See *supra* note 49 and accompanying text.

Actually, the Tax Court in *Glynn* foreshadowed the Ninth Circuit's analysis in *Roemer* even though the *Glynn* court held that the taxpayer received payments because of his contractual rights. In answer to the taxpayer's contention that he became ill as a result of the dispute with his employer, and that the payments compensated him for this infirmity, the court stated that "it should be evident that the consequences of a dispute are not necessarily commensurate with its origin." *Glynn*, 76 T.C. at 121. Similarly, the Ninth Circuit held that the consequences of an injury are not necessarily commensurate with its nature. See *infra* notes 108-14 and accompanying text.

69. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

70. *Id.* at 400.

71. *Id.*

72. The report stated that the taxpayer was an incompetent salesman because he neglected his clients' affairs. *Id.*

73. The report implied that the taxpayer misappropriated funds for his personal benefit. *Id.*

74. *Id.*

75. The taxpayer sued in California. Under California law, "[l]ibel is a false and unprivileged publication by writing, printing, picture, effigy, or other fixed representation to the eye, which exposes any person to hatred, contempt, ridicule, or obloquy, or which causes him to be shunned or avoided, or which has a tendency to injure him in his occupation." CAL. CIV. CODE § 45 (West 1982).

the credit reporting service.⁷⁶ The jury awarded him compensatory and punitive damages, and litigation costs.⁷⁷

In the Tax Court the taxpayer argued that the damages were not taxable because the jury awarded them for personal injuries and, therefore, section 104(a)(2) applied.⁷⁸ The Commissioner responded that the compensatory damages were taxable because the award compensated the taxpayer for damage to his business or professional reputation and, therefore, section 104(a)(2) did not apply.⁷⁹ To determine whether the taxpayer suffered injury to his personal or his business reputation, the court examined the allegations the taxpayer made in his complaint in the libel suit.⁸⁰ The

76. *Roemer v. Retail Credit Co.*, 44 Cal. App. 3d 926, 119 Cal. Rptr. 82 (1975).

77. *Id.* at 930, 119 Cal. Rptr. at 84.

Although awards for injury to reputation often include compensatory, punitive, and cost elements, the determination whether to tax compensatory damages is dispositive of whether the punitive and cost reimbursements are taxable. Punitive damages generally are taxable. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). The Service in 1958 applied the *Glenshaw Glass* doctrine to include in gross income punitive damages received in a defamation suit. Rev. Rul. 58-418, 1958-2 C.B. 18. Since then, the Service has reversed its position and ruled that "any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income." Rev. Rul. 75-45, 1975-1 C.B. 47.

Cost reimbursements also are not taxable if they are part of a personal injury recovery. If the injury is nonpersonal, then the reimbursement is includable in gross income, but the taxpayer may deduct his costs as an expense of income production. See I.R.C. § 212(1) (1976). No § 212 deduction exists for a reimbursement award in a personal injury case because the award produces no income and because the Code does not allow a deduction when the compensatory and punitive elements of the award are tax-exempt. See I.R.C. § 265(1) (1976). Cost reimbursements, therefore, have a zero net tax effect regardless of whether the taxpayer's injury is personal, but the procedures for arriving at that effect vary according to the character of the injury. See *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983) (adding that the costs which produced interest income on the award were includable in gross income and deductible under I.R.C. § 212(1), even though the injury was personal).

78. *Roemer v. Commissioner*, 79 T.C. at 404; see *supra* text accompanying note 1.

79. *Id.* The Commissioner relied heavily on *Glynn*. The taxpayer made a persuasive argument that because the cause of action in *Glynn* was in contract and not in tort, the court was speaking only in dictum when it stated that the distinction between personal and business reputation was still viable. See Appellant's Reply Brief at 2-4, *Roemer v. Commissioner*, 716 F.2d 693 (1983); see also *Glynn v. Commissioner*, 76 T.C. 116, 120 (1981), *aff'd mem.*, 676 F.2d 682 (1st Cir. 1982); *supra* notes 62-66 and accompanying text.

80. Paragraph III of the taxpayer's amended complaint in the libel action stated:

That at all times prior to the publication of the matters herein complained of, plaintiff has enjoyed a good name and business reputation, both generally and in particular with respect to high standards of business, service rendered to clients, credit standing, honesty, integrity, financial responsibility; that by reason of this excellent name and reputation, plaintiff has enjoyed the continued patronage of his clients and of insurance companies he represents; that the continued patronage of plaintiff and the respect of his clients and companies depends on the good name and reputation of plaintiff for honesty, integrity, quality of service, financial responsibility, credit standing and high standards of business practice.

court concluded that the taxpayer had claimed recovery predominantly for damage to his professional reputation as an insurance broker.⁸¹ Because the effects of the injuries for which the taxpayer recovered were business-related, the court reasoned that the damage award was taxable.⁸²

The dissenting judges argued that a valid distinction did not exist between defamatory injury to personal reputation and defamatory injury to business reputation.⁸³ Judge Forrester in the lead dissent opined that business or professional reputation is only one aspect of a person's general reputation in the community. He felt that all persons have a single intangible reputation with personal and professional sides.⁸⁴ These two sides of reputation are often indistinguishable.⁸⁵ Thus, Judge Forrester believed that damage awards for injury to both personal and professional reputation should be excludable from gross income because those aspects of a person's general reputation are inseparable.⁸⁶ He suggested, therefore, that the court should distinguish between injury to reputation and injury to occupation. If the defamatory statements injured the taxpayer's personal reputation—his character, honesty, or personal habits, for example—then his recovery should be excludable from

79 T.C. at 401.

81. After reviewing the pleadings, testimony, and other evidence in the libel suit, the court declared:

[The taxpayer] told the jury that other insurance licenses were denied him as a result of the defamatory qualification report. He told the jury that he lost income as a direct result of the false report. He described in detail to the jury how the defamatory report affected his business relations, but said little, if anything, about how it affected his personal affairs. The evidence presented through many witnesses in the trial of the libel suit was primarily directed at how the petitioner's business relationships and planned business ventures were harmed by the false report of [the credit reporting company]. There was no testimony by the petitioner or others in the libel suit that the libelous report was published anywhere outside of the insurance industry.

Id. at 401-02.

82. *Id.* at 407.

83. 79 T.C. at 411 (Forrester, J., dissenting). Judge Forrester wrote the lead dissent, which Judge Körner joined. Judge Wilbur also wrote a dissenting opinion. *Id.* at 413; see *infra* note 92. The dissents are enlightening because, although the Ninth Circuit did not cite either of them in reversing the Tax Court decision, the Ninth Circuit did adopt a similar approach. See *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983); *infra* notes 108-14 and accompanying text.

84. 79 T.C. at 411. In *Roemer*, differentiating between professional reputation and personal reputation was particularly difficult. The taxpayer built a lucrative insurance practice by making friends and acquaintances through membership in social and civic organizations and then soliciting their business. As a result, most of the taxpayer's business clients were also his friends. *Id.*

85. *Id.*

86. *Id.* at 411-12.

gross income under section 104(a)(2).⁸⁷ If the defamatory statements, however, attacked the taxpayer's occupational abilities—his professional competence, for example—then the recovery would be wholly business-related and, therefore, outside the scope of section 104(a)(2).⁸⁸

The dissent stressed that the trier of fact must determine “whether . . . professional injury and lost profits are the injury sought to be compensated, or are merely . . . the collateral effects of injury to reputation in an effort to prove the extent or severity of the damages.”⁸⁹ After listing the important factors in this determination,⁹⁰ Judge Forrester found that the occupational damages in *Roemer* were merely evidence of injury to the taxpayer's reputation.⁹¹ He reasoned that the taxpayer had offered evidence of the credit report's adverse effects upon his business to convince the jury that the report injured him. According to the dissent, the showing of economic loss was only an objective substitute for subjective evidence that the credit reporting service hurt and humiliated the taxpayer.⁹²

87. *Id.* at 412.

88. *Id.* The dissent gave an example of a defamatory statement that would injure only a person's occupational opportunities: if a defamatory remark about an automobile dealer's work product tortiously injured the dealer, the recovery would be wholly business-related and outside the scope of § 104(a)(2). *Id.* If a person falsely accused the dealer of “padding” the number of working hours spent on a particular job, however, the dissent seemingly would hold the dealer's damages excludable under § 104(a)(2) because the accusation attacked an element of the dealer's personal reputation—his honesty—rather than his occupational competence.

89. *Id.* at 412 (emphasis in original).

90. The dissent stated:

The determination [of whether the injury is to reputation or occupation] will have to be made on the basis of all the facts and circumstances. While no single factor should be determinative, the following factors are among those which should be considered: (1) The statements made, i.e., whether they are directed at the person's character (honesty, personal habits, etc.) or at his occupation (incompetence, etc.); (2) the geographic area where the statement is published relative to the taxpayer's business and residence; (3) the nature of the taxpayer's occupation; (4) the definitional nature of the action under local law; (5) the relief sought in the complaint; (6) the arguments presented to the jury; (7) the classification (if any) of the damages awarded; and (8) the evidence presented to the jury.

Id.

91. *Id.*

92. *Id.* at 413. In a second dissenting opinion, Judge Wilbur criticized the majority opinion on several grounds. He agreed with the lead dissent that whether the damages in a given case compensate the taxpayer for lost income is irrelevant because § 104(a)(2) exempts defamation damages from federal taxation. To illustrate what he considered the anomaly that the majority holding created by taxing defamation damages, Judge Wilbur pointed out that a young surgeon who loses a finger recovers damages that replace otherwise taxable future earnings, but § 104(a)(2) does not require bifurcation of that award into per-

3. *Church v. Commissioner*

In *Church v. Commissioner*⁹³ the taxpayer, Attorney General of Arizona, delivered a speech about the excessive influence of certain lobbies upon the Arizona State Legislature. In response to this speech, a Phoenix daily newspaper published an article calling him a communist.⁹⁴ The taxpayer brought an action for libel against the newspaper in an Arizona state court.⁹⁵ A jury awarded him compensatory and punitive damages, but did not indicate its method of arriving at the award.⁹⁶ The Tax Court addressed the issue of whether the compensatory damages were taxable.⁹⁷ Church asserted that the award compensated him for damage to his personal reputation and, therefore, was excludable from gross income

sonal and economic components. *Id.* at 414.

Judge Wilbur also argued that damages for injury to reputation should be excludable from gross income because state law recognizes that reputation injuries are as personal to the taxpayer as loss of limb. *Id.* Judge Wilbur recognized that "federal tax consequences often flow from, or turn on, the legal characterization of a transaction or cause of action under State law." *Id.* He expressed concern, however, that

[t]he majority has reversed the process, characterizing the cause of action under State law in accordance with the misperceived exigencies of Federal tax law. We are cited to no authority in the field of tort law or libel for the bifurcation of a defamation action into categories corresponding to components of damage.

Id. Judge Wilbur then turned to tort law authorities and found that defamation is an invasion of the personal "interest in reputation and good name." *Id.* at 414 n.1 (quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 111, at 737 (4th ed. 1971)). Rather than divide this personal interest into components, Judge Wilbur believed that all damages resulting from interference with a taxpayer's personal reputation are personal injuries within the scope of § 104(a)(2). His theory relied upon the recognition that a separate cause of action would lie for falsehoods that are not personally defamatory ("injurious falsehoods"), and that any recovery for these torts presumably would be wholly business-related and thus completely taxable. 79 T.C. at 414 n.1 (citing W. PROSSER, *supra*, § 128, at 915-16). *See supra* note 88 and accompanying text; *infra* note 137 and accompanying text.

Finally, Judge Wilbur alluded to one of the key arguments for excluding from taxation damages for economic loss that result from any injury—the income bunching problem. *See* 79 T.C. at 414. Commentators recognize that taxing economic opportunities that would have produced earnings over a period of years as a one-time lump sum at the ordinary income rate is inappropriate. *See, e.g.,* Yorio, *supra* note 2, at 714-19.

93. 80 T.C. 1104 (1983). The Tax Court filed *Roemer* on August 30, 1982, and *Church* on June 20, 1983. The Ninth Circuit filed its *Roemer* opinion on September 22, 1983.

94. 80 T.C. at 1105.

95. *See* Phoenix Newspapers, Inc. v. Church, 24 Ariz. App. 287, 537 P.2d 1345 (1975).

96. 80 T.C. at 1106.

97. The Commissioner conceded that if the court viewed the jury award as personal injury damages, then both the compensatory and punitive elements of the recovery should be exempt from taxation. *Id.* at 1106, 1110 n.7; *see supra* note 77 (discussing taxation of punitive damages). The court held that the taxpayer's costs of suit were deductible only to the extent that they produced interest on the award. 80 T.C. at 1110-11; *see supra* note 77 (discussing taxation of cost reimbursements).

as a personal injury award under section 104(a)(2).⁹⁸ The Commissioner contended that the Tax Court's recent decision in *Roemer*⁹⁹ required the court to find that the jury award was for business-related injuries.¹⁰⁰

Applying the *Roemer* court analysis, the *Church* court began by examining the allegations in the taxpayer's complaint, the evidence that he presented, and the arguments he made in the libel suit.¹⁰¹ The court concluded that the entire thrust of the taxpayer's libel case was that the defamatory article affected him personally.¹⁰² The court found that the award compensated him for the humiliation, public embarrassment, pain, suffering, and emotional distress that came from being labeled a "communist."¹⁰³ Although a substantial portion of the award compensated the taxpayer for loss of his political career, the court distinguished that part of the recovery from the compensation for loss of income in *Roemer*.¹⁰⁴ The court felt that it would be applying the *Roemer* test too broadly if it held that the defamatory article injured the taxpayer's professional reputation solely because it ended his political career.¹⁰⁵ To tax all or part of a recovery, the court would have to require that an element of the recovery compensate for loss of profits or earnings.¹⁰⁶ The court noted that not only did the taxpayer not attempt to prove such a loss, but also that he might have been unable to prove it, since he probably would earn more in private law practice than he would have earned as a public official.¹⁰⁷

98. 80 T.C. at 1106.

99. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983); *see supra* notes 69-92 and accompanying text.

100. 80 T.C. at 1106.

101. *Id.* at 1107-08.

102. *Id.* at 1108-09.

103. *Id.* at 1108.

104. *Id.* at 1108-09.

105. *Id.* at 1109. The court stated:

In our opinion, shattered dreams, ruined careers, and the mental anguish that follow [sic] are just as personal as, for instance, loss of limb. . . . The distinction [from *Roemer*] in this case is that the jury in this defamation proceeding simply did not intend to compensate petitioner for injury to his professional or business reputation to the extent it affected past or future income.

Id. at 1109-10 (citations omitted).

106. *Id.*

107. *Id.* at 1108 n.4.

B. *The Ninth Circuit*

In *Roemer v. Commissioner*¹⁰⁸ the Ninth Circuit reversed the Tax Court's decision and held that the taxpayer's damage award in state court was for a personal injury and, therefore, was not taxable. The Ninth Circuit felt that the Tax Court confused the effects of the injury a damaging statement causes with the nature of the statement itself.¹⁰⁹ The court stated that taxing recoveries for damage to reputation depends on whether the state in which the taxpayer brings his tort claim recognizes the statement as a personal attack.¹¹⁰ The court held that the state of California, in which the *Roemer* taxpayer brought his tort claim, recognizes that the cause of action for defamation protects a personal right.¹¹¹ California also allows actions for the related business torts of disparagement and trade libel, which provide a remedy for attacks on the quality of one's goods or services.¹¹² Because the taxpayer filed an action for personal defamation,¹¹³ however, the court concluded that the damages, both compensatory and punitive,¹¹⁴ were for a

108. 716 F.2d 693 (9th Cir. 1983). See *supra* text accompanying notes 69-76 for a discussion of the facts and allegations in *Roemer*.

109. The court reasoned:

Although there are different types of defamation actions (libel or slander) depending on the form of the defamatory statements, all defamatory statements attack an individual's good name. This injury to the person should not be confused with the derivative consequences of the defamatory attack, *i.e.*, the loss of reputation in the community and any resulting loss of income. The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect.

...

... [A] defamatory attack on one's character should not be confused with the damage to a person's reputation that flows from that injury. Frequently, as a result of defamatory statements attacking one's character, the individual suffers an impairment of his or her relationships with others. While some of these relationships may be personal and some may be professional, all of the harm that is done flows from the same personal attack on the defamed individual.

Id. at 699-700 (footnote omitted). The Ninth Circuit held that because the Tax Court confused the attack with its effects, it illogically distinguished between physical and nonphysical injuries. *Id.* at 697; see *supra* note 92.

110. 716 F.2d at 697.

111. *Id.* at 699. See *supra* note 75 for the text of the relevant California statute.

112. 716 F.2d at 699; see *infra* note 139 and accompanying text.

113. 716 F.2d at 700.

114. The court acknowledged that punitive damages are ordinarily includable in gross income, but it recognized that the Commissioner liberally interprets § 104(a)(2) to exempt from taxation punitive as well as compensatory damages for personal injuries. In addition, the court followed the well-settled law regarding the taxation and deduction of reimbursed costs. 716 F.2d at 700; see *supra* note 77.

personal injury under section 104(a)(2) and, therefore, were not taxable.

IV. ANALYSIS

A. *Problems with the Tax Court's Recent Approach*

The tax law governing defamation damage awards has changed greatly since the *Hawkins* court¹¹⁵ first decided to exclude such awards from gross income under the rationale that they serve only to make the plaintiff whole.¹¹⁶ The *Hawkins* analysis was too broad because it considered even damages for lost profits or earnings as attempts to make the plaintiff whole. In *Agar*¹¹⁷ the Tax Court distinguished between injury to personal reputation and injury to business reputation and held that recoveries for injury to business reputation were outside the scope of section 104(a)(2).¹¹⁸ The Tax Court and other authorities¹¹⁹ abandoned the *Hawkins* "make whole" rationale and implicitly recognized that the government does not tax defamation awards because of the public policy against overburdening injured plaintiffs, and because the pecuniary and nonpecuniary elements of these awards are difficult to separate. The *Agar* court felt that courts would not serve these policy considerations if they excluded business-related damage awards from taxation.

When the *Agar* court distinguished between personal reputation and business or professional reputation as the means of determining whether defamation damages are taxable, the court also established a method of making that distinction. Under *Agar* the court would find a personal injury whenever the damaging statement attacked the taxpayer's integrity, honesty, or trustworthiness, and would find a nonpersonal injury whenever the statement attacked his business acumen, competence, or judgment.¹²⁰ The *Wolfson*¹²¹ court, however, diverged from the *Agar* approach. It focused almost exclusively on the language of the complaint the

115. 6 B.T.A. 1023 (1927); see *supra* notes 25-28 and accompanying text.

116. See *supra* notes 25-28 and accompanying text.

117. *Agar v. Commissioner*, 19 T.C.M. (CCH) 116 (1960), *aff'd*, 290 F.2d 283 (2d Cir. 1961); see *supra* notes 33-41 and accompanying text.

118. 19 T.C.M. at 119-20; see *supra* notes 33-41 and accompanying text.

119. See *supra* note 2.

120. 19 T.C.M. at 119; see Lane, *supra* note 41, at 191; *supra* text accompanying note 41.

121. *Wolfson v. Commissioner*, 37 T.C.M. (CCH) 1847-14 (1978), *aff'd*, 651 F.2d 1228 (6th Cir. 1981); see *supra* notes 43-49 and accompanying text.

taxpayer filed in his tort action to determine the type of injuries that prompted his damages suit. The *Wolfson* analysis demonstrates the potential for heavy reliance on the taxpayer's tort complaint.

A comparison of the Tax Court's decisions in *Roemer*¹²² and *Church*¹²³ illustrates the undesirable results that can occur when the court relies upon the language of the defamation complaint to determine whether the injury was to the taxpayer's personal or professional reputation. The *Roemer* court found that the taxpayer in his complaint sought compensation for loss of prospective income.¹²⁴ The court held, therefore, that the taxpayer suffered harm to his business reputation and thus could not claim a section 104(a)(2) exclusion.¹²⁵ In *Church*, the Tax Court also focused on the defamation action complaint. The *Church* court, however, held that the taxpayer did not seek damages for lost earnings.¹²⁶ As a result, although the court recognized that "a substantial portion of the award was intended to compensate [the taxpayer] for the loss of a professional career,"¹²⁷ it concluded that the injury was to the taxpayer's personal reputation, and he, therefore, could claim a section 104(a)(2) exclusion.¹²⁸

Although the Tax Court decided *Roemer* and *Church* within one year of each other, they are obviously inconsistent. The taxpayer in each case suffered damage to both his career and his personal reputation in the community. The *Roemer* taxpayer proved his injury by showing the loss of future income.¹²⁹ The *Church* taxpayer also suffered some lost earnings¹³⁰ but chose to prove his injury with evidence of public embarrassment and humiliation. Although the nature of the injuries in both cases was defamation, the tax consequences depended upon the effects of the injuries. This approach presents two problems. First, the language that the plaintiff uses in drafting his tort action complaint determines

122. *Roemer v. Commissioner*, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983); *see supra* notes 69-92 and accompanying text.

123. *Church v. Commissioner*, 80 T.C. 1104 (1983); *see supra* notes 93-107 and accompanying text.

124. *Roemer v. Commissioner*, 79 T.C. at 406; *see supra* notes 80-81 and accompanying text.

125. 79 T.C. at 407; *see supra* text accompanying note 82.

126. *See* 80 T.C. at 1107-08.

127. *Id.* at 1108.

128. *Id.* at 1110.

129. 79 T.C. at 406.

130. 80 T.C. at 1108 n.4.

whether the defamation award is excludable from gross income. Under this reasoning, the Tax Court in *Roemer* would have reached the opposite result if the taxpayer had alleged that he suffered humiliation rather than that he lost prospective income.¹³¹ Similarly, the result in *Church* would have been different if the taxpayer had sued for lost earnings rather than pain and suffering.¹³² The court's approach, therefore, rewards provident taxpayers who draft tort complaints seeking compensation for pain and suffering rather than for economic loss.

The second problem with the Tax Court's approach is that it yields results that are inconsistent with the interpretation of section 104(a)(2) in the context of recoveries for physical personal injuries. As Judge Wilbur illustrated in his *Roemer* dissent, the law does not require a young surgeon who collects damages for a lost thumb to bifurcate his award into economic and personal components even though the award replaces otherwise taxable future earnings.¹³³ The entire award is within the scope of the section 104(a)(2) exclusion. Under *Roemer* and *Church*, however, the economic loss components of a defamation award are not exempt from taxation because they do not fall within the exclusion. The Tax Court has drawn a distinction between the tax status of awards for physical and nonphysical injuries, although section 104(a)(2) inherently recognizes a distinction only between personal and nonpersonal injuries. Even the Service has conceded that certain nonphysical injuries, including defamation, are personal.¹³⁴ The Tax Court, therefore, should not apply a standard that imposes different tax consequences on physical and nonphysical personal injury

131. See *Roemer v. Commissioner*, 79 T.C. at 413 (Forrester, J., dissenting); *supra* text accompanying note 92.

132. The taxpayers in these cases probably sued for the damages that they could prove best. The taxpayer in *Roemer* experienced definite income loss, while the taxpayer in *Church* probably could prove very little income loss because he might have earned more in private practice than he would have in public office. See *supra* text accompanying note 107. But see *Church v. Commissioner*, 80 T.C. at 1108 n.4 (indicating evidence of some lost income). In addition, allegations of humiliation and lost income are not mutually exclusive. The Tax Court's analysis alone, therefore, might not induce taxpayers to sue for nonpecuniary damages rather than economic loss. In reasonably close cases, however, the Tax Court's approach provides taxpayers with the incentive to seek damages for emotional injury rather than economic loss.

133. See *Roemer v. Commissioner*, 79 T.C. at 414 (Wilbur, J., dissenting); *supra* note 92.

134. See *Roemer v. Commissioner*, 716 F.2d 693, 697 (9th Cir. 1983); Sol. Op. 132, I-1 C.B. 92 (1922) (damages for defamation of personal character, alienation of affections, and surrender of child custody rights represent recovery for invasion of personal rights and thus do not constitute income).

awards.

B. *The Ninth Circuit's Search for a Solution*

The Ninth Circuit reversed *Roemer*,¹³⁵ discarded the Tax Court's approach, and focused instead on the nature of the tort for which the taxpayer recovered to determine whether he suffered personal injury.¹³⁶ The Ninth Circuit found that the taxpayer's injury was personal because defamation is an invasion of the personal interest in reputation and good name.¹³⁷ Although the Ninth Circuit's reliance on state tort law presents practical problems,¹³⁸ it solved the two greatest weaknesses of the Tax Court's approach.

The first problem with the Tax Court's analysis in *Church* and *Roemer* was that it encouraged plaintiffs to "draft around" the taxation of defamation damages by alleging nonpecuniary rather than economic injuries in their tort complaints. The Ninth Circuit solved that problem by focusing on the state court's judgment rather than the language of the taxpayer's tort complaint. The taxpayer's only incentive under the Ninth Circuit's approach, then, is to pursue a defamation action rather than a claim for injurious falsehood.¹³⁹ Plaintiffs, however, already have an incentive to allege defamation because it is easier to prove than injurious falsehood.¹⁴⁰

135. *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983); see *supra* notes 108-14 and accompanying text.

136. *Roemer v. Commissioner*, 716 F.2d at 699. The court relied on state law in making this determination because the federal common law of torts no longer existed, *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938), and the Code did not define personal injury. *Roemer v. Commissioner*, 716 F.2d at 697; see *United States v. Mitchell*, 403 U.S. 190, 197 (1971) (quoting *Burnet v. Harmel*, 287 U.S. 103, 110 (1932) (state law creates legal interests; federal law determines method and timing of taxation)). But see *Commissioner v. Estate of Bosch*, 387 U.S. 456, 457, 465 (1967) (even when underlying substantive federal tax rule relies on state law, lower state court rulings are not controlling).

137. See 716 F.2d at 699; W. PROSSER, *supra* note 92, § 111, at 737.

138. See *infra* notes 145-52 and accompanying text.

139. Injurious falsehood is an attack on goods or services that gives rise to an action for disparagement of title to property or disparagement of quality. RESTATEMENT (SECOND) OF TORTS § 623A (1977). A defendant is liable for injurious falsehood if he publishes a false statement harmful to the interests of another, recognized or should recognize that the publication is likely to do harm, and knows that the statement is false or acts in reckless disregard of its truth or falsity. *Id.* Although the majority of the injurious falsehood cases concern attacks upon title to or the quality of a person's property, the existence of property is not a necessary element of the tort. W. PROSSER, *supra* note 92, § 128, at 918-19. The gist of injurious falsehood is the interference with an advantageous economic relation. A person is liable, for example, if he attacks the existence, character, employees, or customers of another's business or profession, or the quality of the services the business provides. *Id.* at 919.

140. At common law, injurious falsehood is more difficult to prove than defamation for three reasons. First, the plaintiff must plead and prove that the injurious statement was false; courts presume falsity in defamation actions and truth is an affirmative defense. Sec-

The Ninth Circuit's approach, therefore, rarely should affect the plaintiff's decision to bring one reputation injury action instead of another.¹⁴¹

When the taxpayer's recovery is in the form of a settlement, the Ninth Circuit presumably would focus on the nature of the attack for which the payor intended to settle, rather than the effects of the injury the payor intended to compensate.¹⁴² In settlement cases under the Ninth Circuit's approach the parties have an incentive to agree that the allegedly harmful statements attacked the injured party's character rather than his occupation. That incentive, however, is no greater than the incentive to agree, under the Tax Court's approach, that the payments compensated for emotional distress or humiliation rather than lost earnings. In either case, the task of the court considering whether to tax the settlement is to determine the actual intent of the payor.

The second problem with the Tax Court's analysis in *Church* and *Roemer* was that it treated physical and nonphysical injuries differently.¹⁴³ A person's ability to conduct his business is no less personal than a surgeon's ability to conduct surgery. Under the Tax Court's approach, however, the surgeon's recovery for a lost thumb is exempt from taxation, while the businessman's recovery for an attack upon the ability to perform his job is taxable.¹⁴⁴ The

ond, in injurious falsehood actions the plaintiff must show that the defendant acted with reckless disregard for the truth or falsity of the statement; in defamation actions the defendant is strictly liable. Last, an injurious falsehood action requires proof of pecuniary loss; in the majority of defamation actions the plaintiff need not prove such special damages. RESTATEMENT (SECOND) OF TORTS § 623A comment g (1977). The Supreme Court, however, has held that the United States Constitution in some cases requires defamation plaintiffs to meet a higher standard of proof than strict liability. See, e.g., *Gertz v. Robert Welch, Inc.*, 418 U.S. 323 (1974); *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964). The courts have not yet determined the effect those decisions will have on the distinction between the defamation and injurious falsehood causes of action. RESTATEMENT (SECOND) OF TORTS § 623A comment g (1977).

141. If the Tax Court had followed *Agar* in later cases, it also could have discouraged plaintiffs from drafting tax-motivated tort action complaints. Like the Ninth Circuit in *Roemer*, the *Agar* court avoided focusing on the language of the plaintiff's complaint to determine whether to tax his damages. See *supra* notes 40-41 and accompanying text.

142. Courts generally look to the intent of the payor to determine whether the payment is for personal injuries. See, e.g., *Knuckles v. Commissioner*, 349 F.2d 610 (10th Cir. 1965); *Agar v. Commissioner*, 290 F.2d 283 (2d Cir. 1961).

143. Although the Tax Court's approach in *Agar* would have solved the complaint-drafting problem, *supra* note 141, it would not have treated physical and nonphysical injuries alike. The attack on the taxpayer's business acumen and judgment was as personal as a physical injury, yet the *Agar* court taxed the recovery.

144. Statements that impute conduct, condition, or character incompatible with a person's business, trade, profession, or office give rise to a cause of action in defamation. W.

Ninth Circuit's approach in *Roemer* avoids this inconsistency by recognizing that the distinction inherent in section 104(a)(2) is between personal and nonpersonal injuries, not physical and non-physical injuries.

Although the Ninth Circuit has developed the most sound approach to date, the court's reliance on state law to determine the nature of the injury for which a taxpayer recovered damages presents two problems. First, the reliance on state law could lead to inconsistent results. For example, different states might treat identical attacks on reputation differently, depending on the surrounding facts and circumstances.¹⁴⁵ Therefore, federal courts interpreting state decisions could impose inconsistent tax liability upon taxpayers from different states. For instance, most states provide that if a client falsely and publicly accuses his attorney of incompetence, the attorney can sue the client for defamation,¹⁴⁶ even though the attorney's business and personal reputation both suffer. In a minority jurisdiction, however, the attorney's cause of action might lie in disparagement of quality of services¹⁴⁷—a business tort—and the federal court, under *Roemer*, would tax the recovery. That the drafters of section 104(a)(2) intended to create a tax law which is capable of yielding such inconsistent results is doubtful.

The second problem with the Ninth Circuit's reliance on state law is that it creates inefficiency. The *Roemer* opinion shows the

PROSSER, *supra* note 92, § 112, at 758; see Comment, *Product Disparagement and False Advertising in the Common and Civil Law*, 53 TUL. L. REV. 190, 192 (1978). A defamation action, therefore, should lie for a statement wrongly accusing someone of being incompetent to perform the duties incident to his calling. W. PROSSER, *supra* note 92, § 112, at 758; see *Foley v. Hoffman*, 188 Md. 273, 52 A.2d 476 (1947) (liability for alleging plaintiff's incapacity to hold his office); *MacInnis v. National Herald Printing Co.*, 140 Minn. 171, 167 N.W. 550 (1918) (liability for alleging that plaintiff was not a citizen while he held an office which required citizenship); *Cruikshank v. Gordon*, 118 N.Y. 178, 23 N.E. 457 (1890) (liability for calling a doctor a "butcher"); *Stevens v. Morse*, 185 Wis. 500, 201 N.W. 815 (1925) (liability for stating that a farm labor organizer was ignorant of farming).

145. Courts generally find that an allegation of professional incompetence constitutes defamation. See *supra* note 144. This rule might fail, however, in an individual case. It would fail, for example, if the taxpayer alleged only injurious falsehood in his complaint. In addition, because this area of tort law is so fact-specific, different courts in the same state might render inconsistent results even though the plaintiffs made similar allegations. These potential inconsistencies demonstrate that even courts in the same state are not reliable guides for federal courts determining whether to tax damages for injury to a plaintiff's reputation.

146. See *supra* note 144 and accompanying text (allegation of incompetence in one's calling gives rise to cause of action in defamation).

147. For example, a state court expressly might equate an accusation that an attorney is incompetent with a statement that his legal services are inadequate.

substantial effort that a court must exert when relying on state law to determine the nature of the tort for which the taxpayer recovered.¹⁴⁸ The Ninth Circuit went into great detail¹⁴⁹ to determine that under California law defamation invades a personal right.¹⁵⁰ Even in a relatively simple case like *Roemer*, in which the taxpayer clearly indicated in his state complaint the tort for which he sued and a trial court directly had addressed the tort action, the court hearing the tax issue still had to analyze state law substantially to determine the nature of that tort.¹⁵¹

The inefficiencies that arise when a federal court looks to state law in an attempt to determine the federal question of taxation of damages which a plaintiff receives for a reputation injury are most noteworthy in two common situations. The first situation occurs when the taxpayer alleges both defamation and a business tort in his complaint, the jury instructions and recovery do not reveal the tort for which the jury awarded damages, and an appellate opinion is not available for the federal court's scrutiny. The second situation arises when the taxpayer receives his payment in settlement.¹⁵² In these situations, the federal courts following *Roemer* would have the difficult task of determining what tort the jury or parties to the settlement intended to remedy before ever addressing whether state law characterizes the tort as personal or nonpersonal. Federal courts have yet to devise an approach that is efficient and consistent in its application, but which follows *Roemer's* lead in discouraging plaintiffs from drafting tax-motivated tort action complaints.

C. *The Recommended Approach: A Uniform Standard*

Congress should impose a uniform standard that the courts should apply to determine whether a taxpayer who recovers for damage to his reputation received his award for personal injuries. If Congress is reluctant to provide guidance, courts should devise

148. The court devoted almost half of its analysis to California defamation law. See *Roemer*, 716 F.2d at 697-99.

149. The court traced California law back to 1850—the year the state entered the Union. *Id.* at 697.

150. See *id.*

151. Although critics might argue that the Ninth Circuit meticulously analyzed California law only because the court was applying a novel approach, and that future judges trying similar cases only will need to glance at state law to determine if an attack invaded a personal right, this argument fails to recognize that future cases might have more complex facts.

152. See *supra* note 142 and accompanying text.

an adequate approach on their own. Courts can use the following test to determine the nature of the recovery: Did the alleged statement attack the injured party's person or his business?¹⁵³ If the statement attacked the taxpayer's person, the recovery would be exempt from taxation under section 104(a)(2) because it arose "on account of" a personal injury.¹⁵⁴ If the statement attacked the taxpayer's business, however, the proposed standard would require taxing the recovery because it arose out of a business injury. For example, if a person falsely and publicly calls the taxpayer an incompetent attorney and he recovers, he does not have to pay taxes on the recovery because the statement attacks his personal ability. If the tortfeasor, however, states that the taxpayer's law firm has the worst location and the most dishonest clients of any firm in town, then the award would be taxable because the statement attacks the business entity and not the person of the taxpayer himself.¹⁵⁵ Even when the taxpayer is a sole practitioner, therefore, the

153. This standard substantively approximates the approach that the majority of state courts apply in determining whether an injured party's cause of action lies in defamation or in injurious falsehood. In a defamation case, the plaintiff must prove the existence of a "statement concerning another." RESTATEMENT (SECOND) OF TORTS § 558 (1977). In an injurious falsehood case, however, the plaintiff must offer evidence of a "statement harmful to the interests of another." *Id.* at § 623A (emphasis added). Under the Restatement, a remark attacking the method by which an individual runs his business would "concern" that person and, thus, constitute an element of defamation because it would impute "a lack of qualities which the public has a right to expect of the plaintiff in his calling." W. PROSSER, *supra* note 92, § 112, at 759; see RESTATEMENT (SECOND) OF TORTS § 573 comment c & illustration 4 (if one's calling requires a particular skill or ability, a statement that implies a lack of that skill or ability is not only actionable in defamation, but is so actionable without proof of special harm; thus, an assertion that a lawyer is "ignorant and unqualified to practice law" would subject the defendant to liability without plaintiff's proof of special harm). The proposed approach would yield the same result because the statement attacked the injured party's person. On the other hand, a statement about the plaintiff's business—its character, customers, employees, or existence, for example—would not "concern" the owner but would harm his "interest." His cause of action under the Restatement, therefore, would be for injurious falsehood. See RESTATEMENT SECOND OF TORTS § 623A comment g (1977) ("[i]f the statement reflects merely upon the quality of what the plaintiff has to sell or solely on the character of his business, then it is injurious falsehood alone"); see also W. PROSSER, *supra* note 92, § 128, at 919 nn.49-53 (citing injurious falsehood cases concerning business disparagement). Again, the suggested approach would achieve the same result because the statement attacked the owner's business, not his personal ability to conduct that business. For cases holding that defamation concerns the person and that injurious falsehood relates to the person's business or goods, see *Black & Yates v. Malogany Ass'n*, 129 F.2d 227, 232, 235 (3rd Cir. 1941); *Shores v. Chip Steak Co.*, 130 Cal. App. 2d 627, 630, 279 P.2d 595, 597 (1955); *Montgomery Ward & Co. v. United Retail, Wholesale & Dep't Store Employees*, 400 Ill. 38, 49-50, 79 N.E.2d 46, 52 (1948).

154. See *supra* text accompanying note 1.

155. The suggested standard is similar to the approach that Judge Forrester espoused in his *Roemer* dissent at the Tax Court level. See *supra* notes 83-92 and accompanying text.

suggested approach would allow a court to look to whether the harmful statement attacked his ability to run the practice—an element of his person—or the business itself.¹⁵⁶

The proposal would ensure consistency in the taxation of reputation injury recoveries among taxpayers in different states because it would replace reliance on state tort law with a uniform standard for determining the nature of injuries. The new standard also would cure the inefficiency that the Ninth Circuit created in *Roemer* because federal courts no longer would need to analyze state law to determine the federal tax consequences of an award for injury to reputation. The proposed test would be particularly efficient in cases in which the tort for which the taxpayer recovered is not readily apparent.¹⁵⁷ In these situations, the *Roemer* analysis would require two separate state law determinations: first, the federal court must determine for what tort the taxpayer recovered and, second, the court must decide whether that tort constitutes a personal injury under state law. A court applying the recommended test, however, would focus only on whether the injurious statement attacked the person himself; if it did, the recovery would not be taxable. Although the proposed approach still could require significant factfinding in settled cases and cases in which the trial court's judgment is ambiguous about the tortfeasor's remarks, the standard allows the federal courts to make that determination efficiently and without the danger of the inconsistency inherent in *Roemer's* reliance on state law.

The proposed test, however, goes one step further by distinguishing between a person and his business rather than between a person's reputation and his occupation because the test recognizes that an allegation of occupational incompetence is as "personal" as a physical injury. Under Judge Forrester's approach, recoveries for statements alleging occupational incompetence are nonpersonal and, thus, taxable. The proposal, on the other hand, recognizes that an allegation of occupational incompetence is as "personal" as an allegation of dishonesty and, therefore, is not taxable. See generally *supra* notes 88 & 90 (setting out an application of Judge Forrester's analysis and the factors he considered).

156. A meaningful distinction between the sole proprietor's ability to run his business and the business itself does exist, and the proposed mode of analysis would allow courts to resolve the federal taxation issue based upon that distinction. For example, a false allegation regarding the firm's existence or its clients clearly attacks the business itself and not the taxpayer's person, even though he is a sole practitioner. Even the solely owned business has elements in addition to and independent from its owner, like the quality and location of the building in which the businessman does his work, the sophistication of the firm's office equipment, and the competence of its support staff. If the tortfeasor referred to even a sole proprietor's business as "one of the worst in town," therefore, the suggested standard would recognize that the statement is not necessarily equivalent to an attack upon the taxpayer himself, and taxation would result accordingly.

157. See *supra* text accompanying notes 148-52.

V. CONCLUSION

Although the language of section 104(a)(2) might suggest that taxing defamation damages is a clear-cut issue, problems arise when the taxpayer suffers injury to his reputation in the form of lost earnings or foregone economic opportunity. The Ninth Circuit has adopted an approach that greatly reduces the potential for federal tax consequences to turn on tax-motivated tort complaint drafting. In determining whether an injury is personal, the court looked to the nature of the tort for which the taxpayer recovered rather than to the effects of the injury. This approach, however, is inefficient because it requires a potentially extensive analysis of state law—a laborious task for a federal court trying a federal tax issue. The Ninth Circuit's approach also is likely to result in the uneven application of federal tax laws to taxpayers in different states. Courts, therefore, should proceed beyond the Ninth Circuit's *Roemer* decision and apply a uniform standard to determine whether an injury was personal and, therefore, exempt from taxation. Adopting this standard would discourage plaintiffs from drafting tax-motivated tort complaints and would avoid *Roemer's* inconsistency and inefficiency. Thus, the recommended approach would enable courts to fulfill the objective of section 104(a)(2): to exempt all personal injury awards from federal income taxation.

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