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Personal Injury Exclusion: Is the Slashing of Wrists Necessary?

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PERSONAL INJURY EXCLUSION: IS THE SLASHING OF WRISTS NECESSARY?

by

DONALD J. ZAHN *

"Capital return . . . in tax accounting, payments received by taxpayer which represent the individual's cost or capital and hence not taxable as income."[1]

I. INTRODUCTION

What do damage awards really represent? Does a damage award stemming from a personal injury lawsuit or settlement compensate the individual for lost capabilities? Does a damage award confer a windfall upon that individual?

The predecessor statute of section 104(a)(2) of the Internal Revenue Code of 1986[2] and the policy behind that statute equate damage awards to the wronged individual as a return of capital.[3] As years passed, the courts, as well as Congress refined the return of capital concept, expanding the concept to include within its boundaries all forms of personal injury recoveries. With the United States Supreme Court's decision in *Commissioner v. Schleier*[4] in 1995, however, the courts suddenly ignored previous reasoning, effectively obscuring any vestiges of the return of capital concept for many types of personal injury.[5] Subsequently, this deviation has been reinforced by the Congress.

This paper will examine the history of damage award taxation beginning with the earliest income tax statute through the present law. Part II traces the 1918 and 1939 income Tax Code provisions and the court cases interpreting those provisions. Part III addresses the 1954 income Tax Code provisions and the case law which further defines tax aspects of damage awards, and Part IV outlines the 1986 tax reform legislation, the 1989 damage award changes, and recent United States

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1. BLACK'S LAW DICTIONARY 209 (6th ed. 1990).
2. Revenue Act of 1918 § 213(b)(6), Pub. L. No. 65-254, 40 Stat. 1066 (1919). (All references to the current Internal Revenue Code of 1986 will be noted as "Code").
3. 31 Op. Att'y Gen. 304, 307 (1918).
4. Commissioner v. Schleier, ___ U.S. ___, 115 S. Ct. 2159 (1995).
5. *See also* O'Gilvie v. United States, ___ U.S. ___, 117 S. Ct. 452 (1996); Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994).

Supreme Court rulings on the taxation of damage awards. Finally, Part V suggests that the courts have turned their backs on traditional reasoning behind damage award exclusion and have ignored the return of capital concept the statute was designed to protect. Moreover, Congress may have enacted tax legislation in response to court decisions, rather than basing the new legislation upon its own determinations and criteria, for later interpretation by the courts.

II. HISTORY

A. 1918 Statute

Gross income includes "all income from whatever source derived. . . ."[6] The Congress provided certain exclusions in calculating income. The 1918 income tax statute excluded from gross income:

> . . . amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.[7]

The statute clearly excluded from gross income any insurance proceeds as well as any compensation or damages awarded as a result of personal injury. The statutory language clearly treats all such proceeds as non-taxable.

Furthermore, the United States Attorney General issued an opinion that same year based upon the 1916 statute, discussing proceeds of accident policies, and concluded that:

> Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore "capital" as distinguished from "income" receipts.[8]

6. I.R.C. § 61(a) (1997).
7. Revenue Act of 1918 § 231(b)(6), Pub. L. No. 65-254, 40 Stat. 1066 (1919).
8. 31 Op. Att'y Gen. 304, 308 (1918).

While the Attorney General reinforced the concept that insurance proceeds amount to a return of capital, the courts struggled with the same concept.[9] In *Doyle v. Mitchell Bros. Co.*[10] the United States Supreme Court examined the legislative intent surrounding certain corporation tax legislation.[11] The plaintiff corporation manufactured and sold lumber cut from its own lands.[12] The corporation then sold off the stumpage land after it cut and sold the timber from the land.[13] The plaintiff claimed the proceeds from the sale of stumpage land represented a return of capital.[14] In its examination of Congressional intent, the Court found the mere conversion of a capital asset was not to be treated as income.[15] The Court further found income is the gain derived from capital or labor,[16] and that capital must be restored before gain or loss may be calculated.[17] The *Doyle* opinion reasoned that "[w]hen the act took effect, plaintiff's timber lands, with whatever value they possessed, were a part of its capital assets, and a subsequent change of form by conversion into money did not change the essence."[18] The Court therefore distinguished a return of capital from taxable income in the context of value existing prior to the effective date of the tax legislation.[19]

The United States Supreme Court continued its examination of the return of capital concept in *Southern Pacific Co. v. Lowe.*[20] In *Southern Pacific* the plaintiff owned and operated a railway line.[21] The plaintiff accumulated a surplus on its books prior to enactment of the Income Tax Act of 1913.[22] However, the plaintiff did not declare and pay dividends from the surplus until after the 1913 Act went into effect.[23] The plaintiff argued that the dividend was not includible in income, as the dividend was paid from surplus accumulated prior to the Act's effective date.[24] The Court rejected the contention that all receipts are characterized as income.[25] It further rejected the contention that proceeds from conversion

9. For a different perspective see Steven Jay Stewart, Note, *Damage Award Taxation under Section 104(a)(2) of the I.R.C. — Congress Clarifies Application of the Schleier Test*, 47 SYRACUSE L. REV. 1255 (1997).
10. Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918).
11. *Id.* at 183.
12. *Id.* at 181.
13. *Id.*
14. *Id.*
15. *Doyle*, 247 U.S. at 184.
16. *Id.* at 185.
17. *Id.*
18. *Id.* at 187.
19. *Id.* at 188.
20. Southern Pac. Co. v. Lowe, 247 U.S. 330 (1918).
21. *Id.* at 331-32.
22. *Id.* at 333.
23. *Id.*
24. *Id.*
25. *Southern Pac.*, 247 *U. S.* at 335.

of capital assets are to be considered income.[26] Again, asset value accumulated prior to the effective date, regardless of the form of the distribution, was considered a return of capital.

In early years, the income tax statute treated damage awards and insurance proceeds as a return of human capital. Without many controversies to decide, the courts relied on this overriding rationale and took a reasonable, not to mention humane, approach.

B. 1939 Statute

Wording of the damage exclusion remained unchanged as the result of the enactment of the 1939 Tax Code.[27] However, the United States Supreme Court refined the parameters of the definition of income in the 1940 case of *Helvering v. Clifford*.[28] The issue in *Clifford* concerned whether to represent the distribution of a temporary, self-settled trust as income.[29] During the term, the trustee had distributed the trust assets to the trust beneficiary, who then included the income in her tax return.[30] The Commissioner, however, determined that the income should have been taxed to the settlor.[31] Although the opinion did not concern itself with damage awards, the *Clifford* Court did examine the definition of gross income.[32] As such, the Court had no trouble treating the trust income as includible to the settlor, even though the statute itself failed to consider this type of income.[33]

In support of its decision, the *Clifford* majority remarked that Congress may use the full measure of its taxing power within certain definable categories.[34] However, the better-reasoned dissent argued that Congress may not tax income not within the boundaries of the Tax Act.[35] Justice Roberts pointed out that legislation is the function of Congress and it is not the role of the judiciary to supply deficiencies in the Act.[36] The dissent upholds the letter of the statute and cautions the judiciary against writing, rather than interpreting, the

26. *Id.*
27. Internal Revenue Act of 1939, Pub. L. No. 76-1, 53 Stat. 9 (1939).
28. Helvering v. Clifford, 309 U.S. 331 (1940).
29. *Id.* at 332.
30. *Id.* at 333-34.
31. *Id.* at 334.
32. *Id.*
33. *See Helvering,* 309 U. S. at 337.
34. *Id.* at 334.
35. *Id.* at 342 (Roberts, J., dissenting).
36. *Id.* at 338 (Roberts, J., dissenting).

law.[37] It is for its dissent that this case is cited, as this concept seems to have been lost on subsequent courts.

The United States Supreme Court did uphold the plain meaning of the tax statute in *Commissioner v. Glenshaw Glass Co.*[38] In *Glenshaw Glass,* the Court considered whether punitive damages received by settlement of an antitrust violation were includible as income.[39] The Court ultimately held that Congress did not intend to carve out an exemption from the tax statute,[40] as an examination of the literal wording of section 22(a) revealed no explicit exception concerning punitive damages.[41] As punitive damages were not intended to be gifts, nor to be considered return of capital, they lapsed into the category of "income from whatever source derived"[42] and were therefore includible as income.[43]

Subsequent to the *Glenshaw Glass* opinion, the courts have steadfastly adhered to the plain meaning of the law in including punitive damages as income not specifically excluded by the Act.

III. COURTS SETTLE INTO A WAY OF THINKING

A. 1954 Statute

The Internal Revenue Code of 1954 [44] modified the wording of the damage award exclusion. The new section 104(a)(2) read: "gross income does not include . . . the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness."[45] The wording change resulted from Congressional desire to distinguish employer-paid benefits.[46] All other aspects of the statute, including the essence of the damage award exclusion, were to remain unchanged.[47]

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37. *Id.* at 342.
38. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).
39. *Id.* at 427.
40. *Id.* at 432.
41. *Id.* at 429.
42. *Id.* (quoting I.R.C. § 61(a)).
43. *Glenshaw Glass Co.,* 348 U. S. at 432-33.
44. *See* Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 1 (1954).
45. *Id.* at 30.
46. *See* S. REP. No. 83-1622, at 470 (1954), *reprinted in* 1954 U.S.C.C.A.N 4621, 4817. Congress intended to include as taxable any "amounts received by an employee, to the extent that such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee." *Id.*
47. *Id.; See* H.R. REP. No. 83-1337, at 347 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4025, 4168-69.

B. Adding and Defining Nuances

Decisions from the Circuit courts and the Tax Court focused on the new statutory language. In 1963, prior to the bulk of damage award litigation, the Fourth Circuit decided *Commissioner v. Liftin.*[48] The *Liftin* court considered whether income received from discounted notes is taxable before the cost of the notes have been recouped.[49] The court noted that "it is, of course, true that there is no gain constituting income until the investment has been recovered in full."[50] Further, "where it is shown that the amount of realizable discount gain is uncertain or that there is 'doubt whether the contract (will) be completely carried out,' the payments should be considered as a return of cost until the full amount thereof has been recovered . . . ."[51] Thus the basic element of the return of capital concept previously established was reinforced — return of capital was held to be excludable from income.[52]

1. Tort or Tort-Like Nature of the Claim

Meanwhile, the Treasury Regulations had added the requirement to section 104(a)(2) that, to be excludable from income, damages received must result from causes of action based upon tort or tort-like rights.[53]

As follows, the Tax Court decision in *Seay v. Commissioner*[54] began the judicial development of taxability of tort settlements and awards. The *Seay* court considered whether a portion of the settlement received on a breach of contract claim against an employer is includible as income.[55] The plaintiff instructed his attorney to file suit for breach of contract upon termination by his employer corporation's board of directors,[56] arguing that the subsequent negative publicity humiliated and embarrassed the plaintiff, a cause of action for defamation was included.[57] The parties eventually settled the claim, with payment of damages to the plaintiff.[58] The court held that taxability of the settlement depends first upon the nature of the claim.[59] Further, if the nature of the claim is one for personal

48. Commissioner v. Liftin, 317 F.2d 234 (4th Cir. 1963).
49. *Id.* at 234.
50. *Id.* at 235.
51. *Id.* at 236 (quoting Hatch v. Commissioner, 190 F.2d 254, 252 (2nd Cir. 1951) (alteration in original)).
52. *Id.*
53. Treas. Reg. § 1.104-1(c) (1961).
54. Seay v. Commissioner, 58 T.C. 32 (1972), *acq. in result*, 1972-2 C.B.3.
55. *Id.* at 32.
56. *Id.* at 37.
57. *Id.*
58. *Id.* at 34.
59. *Seay*, 58 T.C. at 37.

injury, then that income is exempt.[60] A portion of the *Seay* settlement was received "as compensation for such personal embarrassment, mental and physical strain and injury to health and personal reputation in the community as petitioner had suffered."[61] Thus, the nature of the settlement was held to be defamatory. Since defamation is a personal injury, the *Seay* personal embarrassment claim was held exempt from income.[62] The remaining portion was simply compensation.

The Internal Revenue Service ("Service") affirmed the *Seay* reasoning when, in 1972, it issued a revenue ruling holding that a settlement award for a civil rights violation is includible as income.[63] The Service concurred that the nature of the claim on which the damages were based would govern.[64] The Service based its conclusion on a somewhat imperfect ordinary income analogy to an earlier U.S. Supreme Court case where the damages received for a lease cancellation were actually a substitute for rent that would have been paid.[65] Therefore, since the nature of the claim amounted to a contractual recovery in the form of a rent substitute, the damage award was includible in income.

2. Agreement or Payor's Intent

In a case decided prior to the *Seay* case, the Tenth Circuit holding in *Knuckles v. Commissioner* considered the question of whether settlement amounts were paid due to personal injury or for another reason.[66] In *Knuckles*, a taxpayer filed suit for breach of contract against his employer.[67] The parties agreed to settle the matter with payment of damages by the employer.[68] The employer agreed to the settlement amount, but continually denied any liability in tort.[69] The court held the award includible because the settlement turned on a tort claim, with respect to which the employer vehemently denied liability.[70] The court reasoned that "[t]he most important fact in making that determination, in the absence of an express personal injury settlement agreement, is the intent of the payor as to the purpose in making the payment."[71] Here, the employer's sole purpose for settling with the petitioner was to avoid damaging publicity; no evidence existed as to

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60. *Id.* at 37.
61. *Id.* at 38.
62. *Id.* at 40.
63. Rev. Rul. 72-341, 1972-2 C.B. 32
64. *Id.*
65. *Id.*
66. Knuckles v. Commissioner, 349 F.2d 610 (10th Cir. 1965).
67. *Id.* at 611.
68. *Id.* at 612.
69. *Id.*
70. *Id.* at 613.
71. *Knuckles*, 349 F.2d at 613 (emphasis added).

actual tort liability.[72] The logic of the case dictates that, if the payor intends the award or settlement to be a personal injury payment, that award would be exempt from income.

3. Exclusion of Punitive Damages: Misplaced

In 1975 a new revenue ruling extended the Service's concept of damage award excludability. An employee had been killed when his employer's airplane crashed.[73] The wrongful death settlement agreement called for an award in return for a release of all claims by the deceased's executor.[74] The issue dealt with whether the award constituted excludable personal injury compensation or punitive damages.[75] The Service affirmed its prior position that section 104(a)(2) excludes from gross income any amount received for personal injuries.[76] The Service noted that the employee suffered a personal injury, "[t]herefore, under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income."[77] Here the Service, for whatever reason, went beyond the concept of return of capital and essentially began the confusion which led to the ultimate destruction of a true return of capital concept in this context.

4. Return of Capital and Nature of the Claim

That same year the United States Supreme Court decided *Albemarle Paper Co. v. Moody*.[78] *Albemarle Paper* involved a racial discrimination class action claim by black employees against their employer.[79] The plaintiffs requested back pay and the Court decided that back pay should be awarded.[80] Upon determination of the nature of the damages, the Court considered the origin of Title VII stating that, "[i]t is also the purpose of Title VII to make persons whole for injuries suffered on account of unlawful employment discrimination."[81] The make whole concept stemmed from the National Labor Relations Act wherein public policy demanded that employees be made whole for unfair labor practice losses, as a restoration of pre-wrong status.[82] Ideally, any damage award would

72. *Id.*
73. *See* Rev. Rul. 75-45, 1975-1 C.B. 47; *see also* Rev. Rul. 84-108, 1984-2 C.B. 32, *revoking* Rev. Rul. 75-45, 1975-1 C.B. 47.
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.* (emphasis added).
78. Albemarle Paper Co. v. Moody, 422 U.S. 405 (1975).
79. *Id.* at 408.
80. *Id.* at 413.
81. *Id.* at 418.
82. *Id.* at 419.

make the employee whole again, and would thus represent a return of the individual's capital. The *Albemarle Paper* opinion demonstrates the judicial thought process behind damages awarded pursuant to the Civil Rights Act.

In determining whether damage settlements are includible in income, the Tax Court in 1981 again considered the nature of the claim in the case styled *Glynn v. Commissioner.*[83] In *Glynn*, the plaintiff threatened suit against his employer for wrongful termination and obtained a judgment.[84] While the case ultimately settled, the nature of the settlement turned, not on damages for personal injury, but on payment for accrued sick leave.[85] The court held the payment includible, as the settlement was contractual in nature rather than personal.[86] This case is not troubling in theory, although, with respect to the settlement, plaintiff's counsel was seemingly unaware of the appropriate tax analysis.

5. Limitation of Pleadings: Nature of the Claim

The Sixth Circuit further refined claims for damage award excludability in *Wolfson v. Commissioner.*[87] In *Wolfson*, the plaintiff sued his university for failing to reflect the plaintiff's status as an employee rather than a student.[88] The plaintiff's claim was based on lost earnings rather than personal injury, and the recovery was held includible in income.[89] Although the plaintiff had also requested damages for injury to his reputation, the appellate court refused to address the personal injury, and awarded damages based strictly on lost earnings.[90]

6. Personal or Professional Injury: Not Physical Injury

In 1983, the Tax Court decided *Church v. Commissioner.*[91] Here, the plaintiff, the Attorney General for the State of Arizona, filed a defamation action against a newspaper which called the plaintiff a communist.[92] The plaintiff was awarded compensatory damages which the Commissioner held includible in income.[93] The Tax Court found that the plaintiff had suffered personal injury in the

83. Glynn v. Commissioner, 76 T.C. 116 (1981), *aff'd*, 676 F.2d 682 (1st. Cir. 1982).
84. *Id.* at 118.
85. *Id.* at 120.
86. *Id.* at 121.
87. Wolfson v. Commissioner, 651 F.2d 1228 (6th Cir. 1981).
88. *Id.* at 1230.
89. *Id.*
90. *Id.*
91. Church v. Commisisoner, 80 T.C. 1104 (1983).
92. *Id.* at 1105.
93. *Id.* at 1106.

form of public embarrassment and humiliation[94] and that the damage award compensated the plaintiff for his mental pain and suffering.[95] The court observed that not only had the plaintiff's professional reputation suffered, but also the stigma of being labeled a communist would personally follow him throughout his life.[96] In fact, this personal thrust was the essence of the taxpayer's case. The court held that these damages constituted a personal injury pursuant to section 104(a)(2), and the court held the award excludable.[97] Rather than reaching a conclusion based upon *Roemer v. Commissioner*,[98] the *Church* Court distinguished *Roemer* and held that damages received for personal injuries or sickness are not limited to physical trauma but do include mental pain and suffering.[99]

In *Roemer v. Commissioner*,[100] the Ninth Circuit affirmed that since 1918, tort damages received for personal injuries have been excludable on the theory that the injured party has suffered enough.[101] Therefore, damages have been held excludable if the plaintiff can show that they were received due to an injury to personal reputation.[102] The *Roemer* court makes a distinction between personal and nonpersonal injuries, but not between physical and nonphysical injuries.[103] In fact, the Code and the regulations were, at this point, silent about requiring a personal injury to be physical in order to be excludable.[104] The *Roemer* opinion reasons that the ordinary meaning of personal injury is not limited to a physical injury, as nonphysical injuries may also be personal injuries.[105] *Roemer* involved a defamation action by the plaintiff, an insurance executive, against a credit reporting firm which falsely reported the plaintiff's professional practices to other insurance companies.[106] This court distinguished between compensation for injury to personal reputation and injury to professional reputation,[107] but concluded that defamation is simply a tort-like personal injury and that "[t]he personal nature of an injury should not be defined by its effect."[108] Thus, if a tort-type injury affects

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94. *Id.* at 1108.
95. *Id.* at 1110.
96. *Church,* 80 T.C. at 1110.
97. *Id.*
98. Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983); *see also* Rev. Rul. 85-143, 1985-2 C.B. 55.
99. *Church,* 80 T.C. at 1109.
100. *Roemer,* 716 F.2d at 693.
101. *Id.* at 696.
102. *Id.*
103. *Id.* at 697.
104. *Id.*
105. *Roemer,* 716 F.2d at 697.
106. *Id.* at 695.
107. *Id.* at 699.
108. *Id.*

a plaintiff's professional career, the award would still be excludable because the injury was personal.[109]

7. The Service

The Service continued its own struggle with the issuance of a 1984 revenue ruling[110] which held that damages received under a wrongful death act are excludable from income because those damages "restore a loss of capital."[111] The Service went on, however, to conclude that damages received under a wrongful death act providing exclusively for punitive damages are not excludable, as those damages represent an accession to wealth.[112] Such conclusion with respect to punitive damages is consistent with the return of capital theory. However, this ruling does call into question the holding of the Service's earlier Revenue Ruling 75-45 which had decided that any personal injury damages, whether compensatory or punitive, are excludable from gross income. [113]

The following year the Service issued another revenue ruling denouncing the *Roemer* decision stating that "[t]o the extent damages received by the taxpayer are for an injury to the taxpayer's business, they are not attributable to a personal injury and are not excludable under section 104(a)(2)."[114] This ruling may not be destructive of the return of capital approach, as there can be a distinction between business and personal injury; however, *Roemer's* "effect"[115] argument should prevail.

8. Personal and Professional Injury: Still a Problem

Threlkeld v. Commissioner concerned the effect of damages awarded for a malicious prosecution claim.[116] The plaintiff in *Threlkeld* was awarded damages for injury to his professional and credit reputation.[117] The Tax Court noted that the law is well settled that includibility of damages depend upon the nature of the claim and not the validity of the claim.[118] The court found no difference in dam-

109. *Id.* at 700.
110. Rev. Rul. 84-108, 1984-2 C.B. 32, *revoking* Rev. Rul. 75-45, 1975-1 C.B. 47.
111. *Id.*
112. *Id.*
113. Rev. Rul. 75-45, 1975-1 C.B. 47.
114. Rev. Rul. 85-143, 1985-2 C.B. 55.
115. Roemer v. Commissioner, 716 F.2d at 693, 699 (9th Cir. 1983).
116. Threlkeld v. Commissioner, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).
117. *Id.* at 1294-95.
118. *Id.* at 1297.

ages received on account of injury to personal reputation and those received on account of injury to professional reputation.[119] The court proceeded to examine personal injuries and determined that personal injury includes more than just bodily injury.[120] Common-law tort concepts predominated,[121] and the court concluded that an action for malicious prosecution is a personal injury: "exclusion under section 104 will be appropriate if compensatory damages are received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."[122] In holding that an injury to professional reputation is equivalent to an injury to personal reputation, the Tax Court in *Threlkeld* seemingly ignored the Service's 1985 revenue ruling which had attempted to distinguish personal from professional injury.[123]

9. Cause of Action Under Civil Rights Act

Another Tax Court decision examined whether settlement proceeds from a sex discrimination suit are excludable from income. In *Metzger v. Commissioner*,[124] the plaintiff benefitted from a negotiated settlement with respect to her employer's failure to grant her tenure.[125] The Tax Court stated that "it is not necessary that the damages be on account of physical trauma" in order to be excludable from income,[126] and analogized such legal right to a tort-like right. According to the *Metzger* court, Civil Rights Act section 1983 claims are personal injury claims.[127] "We conclude that, under both the language of the statute and the interpretation of it that is provided by the regulation, gross income does not include damages received under a sec. 1983 claim based on violation of petitioner's First Amendment right to free speech."[128] Additionally, actions based on sections 1981, 1982, 1985(3) and 1986 are also personal injury actions and also excludable.[129] The court declared that it could not imagine a more fundamental injury to a person's individual rights than racial discrimination, and similarly, that proceeds from sex discrimination claims are personal injuries to be excluded from income.[130] Again, the emphasis is focused on the inherent return of capital for tort-like recoveries whether or not physical injury exists.

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119. *Id.* at 1298.
120. *Id.* at 1305.
121. *See Threlkeld,* 87 T.C. at 1305.
122. *Id.* at 1308.
123. Rev. Rul. 85-143, 1985-2 C.B. 55.
124. Metzger v. Commissisoner, 88 T.C. 834 (1987), *aff'd,* 845 F.2d 1013 (3d. Cir. 1988).
125. *Id.* at 837.
126. *Id.* at 847.
127. *Id.* at 851.
128. *Id.*
129. *Metzger,* 845 F.2d at 852.
130. *Id.* at 853.

Bent v. Commissioner[131] followed the reasoning of the *Metzger* opinion in determining whether proceeds received from an award of a First Amendment freedom of speech action are excludable from income.[132] The plaintiff in *Bent* openly criticized his employer, and was then terminated as a result.[133] The resulting suit led to an award for damages.[134] The court agreed that freedom of speech claims are tort-like rights enforceable under section 1983.[135] Although the plaintiff's injuries did not involve physical trauma, they did involve mental pain and suffering which are elements of compensatory damages under section 1983.[136]

10. Civil Rights Cause of Action: Sex Discrimination

The Fourth Circuit also extended excludability to liquidated damages received in a sex discrimination action. In *Thompson v. Commissioner*,[137] the plaintiff initiated a class action suit against her employer, the United States Government, because the employer paid higher wages to male employees than to female employees for the same work performed.[138] The plaintiff was awarded both back pay and damages categorized in the opinion as liquidated damages, all of which the Commissioner claimed were includible in income.[139] In analyzing the liquidated damage claim, the court used the definition of tort to hold that "sex discrimination actions in general are tort or tort-like actions and damages awarded for violation of that right are damages for personal injuries."[140] The court agreed with the Service, however, that back pay should be includible as gross income.[141] The author suggests that the distinction between liquidated and compensatory damages in the context of the return of capital exclusion is irrelevant to this analysis.

11. Fair Labor Standards Act

Chronologically, another Third Circuit decision followed in *Byrne v. Commissioner*.[142] The plaintiff in *Byrne* sued her employer under the wrongful

131. Bent v. Commissioner, 835 F.2d 67 (3d Cir. 1987).
132. *Id.* at 68.
133. *Id.*
134. *Id.* at 68-69.
135. *Id.* at 69.
136. *Bent,* 835 F.2d at 69-70.
137. Thompson v. Commissioner, 866 F.2d 709 (4th Cir. 1988).
138. *Id.* at.710.
139. *Id.* at 710-711.
140. *Id.* at 712.
141. *Id.*
142. Byrne v. Commissioner, 883 F.2d 211 (3d Cir. 1989).

discharge provision of the Fair Labor Standards Act and under state law, and was awarded damages.[143] The court reversed the Tax Court for erroneously equating nonpersonal injury claims to contract claims and essentially determining that one-half of the award was not excludable.[144] Again, the court used the definition of tort to show that the plaintiff's wrong was more tort-like than contract-like, noting that an award for wrongful discharge is for an injury of a personal nature and not for mere economic loss: The court held the award excludable.[145] An irrelevant inquiry sidetracks the analysis, as no direct or automatic correlation between contract claims and nonpersonal injuries exists.

12. Punitive Damages: Dicta

In *Miller v. Commissioner*, the plaintiff recovered both compensatory and punitive damages in a defamation action.[146] The Commissioner claimed the entire award was includible in income because the award resulted from an injury to the plaintiff's professional reputation.[147] However, the Tax Court reasoned that, "we see no sound reason to construe the statute in such a way as to not afford the same tax treatment to recoveries for all types of 'personal' injury regardless of consequence."[148] Thus, the *Miller* court held "that section 104(a)(2) excludes the net settlement proceeds from gross income."[149] In dicta the court stated:

> Including punitive damages within the ambit of I.R.C. Section 104(a)(2) does not produce an absurd result. Punitive damages have served as a means of compensating plaintiffs for intangible harm and for cost and attorneys' fees. Although they may serve these purposes to a lesser extent now than in the past, the fact that punitive damages may possess a compensatory aspect renders it reasonable to afford them the protection of section 104(a)(2). It also might explain why Congress in 1918 did not expressly limit the statutory exclusion to compensatory damages.
>
> The legislative history provides no sound basis for disregarding the plain meaning of the statute . . . . While statutes involving exclusions from income are generally narrowly construed, without a clearer indi-

143. *Id.* at 212-213.
144. *Id.* at 215.
145. *Id.* at 215-16.
146. Miller v. Commissioner, 93 T.C. 330 (1989).
147. *Id.* at 335.
148. *Id.* at 337.
149. *Id.*

cation of Congressional intent, we will not contort the statutory language. We therefore hold than any portion of the net settlement proceeds which represents punitive damages is excluded from gross income by section 104(a)(2).[150]

The gratuitous exclusion of punitive damages with regard to the return of capital analysis may well have led to the impasse, whether tacit or explicit, which resulted in the ultimately illogical and inappropriate turns taken by the courts and the Congress. The author asserts that punitive damages should not be excluded in the context of the return of capital analysis.

In 1989, possibly in response to *Miller*, Congress again changed the wording of the damage award statute in perhaps the last objective and consistent utterance in the return of capital context from Washington. The new language read: "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."[151] Again, the return of capital context, there is no need for the distinction. The exclusion should not apply to any punitive damage recovery.

13. ADEA

The Third Circuit agreed with the *Threlkeld* and *Roemer* decisions and held that proceeds pursuant to an Age Discrimination in Employment Act ("ADEA") claim are tort-like and therefore excludable.[152] In *Rickel v. Commissioner,*[153] the plaintiff sued his employer for wrongful termination because of his age, and received a settlement payment.[154] The court held that age discrimination is more analogous to a personal injury tort than to contract.[155] Age discrimination invades a personal right, as the employer has a statutory duty to refrain from age discrimination, and thus, manifests itself as a tort claim.[156] The court reasoned that nonpersonal consequences do not transform discrimination into a nonpersonal injury.[157] Damages received for age discrimination, even though nonphysical, are personal and therefore excludable.[158] Notably, however,

150. *Id.* at 341 (citations omitted).
151. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 § 7641, 1989 U.S.C.C.A.N. (103 Stat.) 2106, 2379.
152. Rickel v. Commissioner, 900 F.2d 655, 656 (3d Cir. 1990).
153. *Id.*
154. *Id.* at 656-57.
155. *Id.* at 662.
156. *Id.*
157. *Rickel,* 900 F.2d at 662-63.
158. *Id.* at 664.

the court agreed with *Glenshaw Glass* in that punitive damages are not a restoration of capital, and must be includible in income.[159] It is the author's suggestion that the *Rickel* court understood the law as it had evolved preceding its determination.

The Sixth Circuit followed suit in the 1990 *Pistillo v. Commissioner* [160] decision when it held age discrimination proceeds are excludable from income. The plaintiff was awarded damages for his claim that he was wrongfully terminated because of age.[161] The *Pistillo* court analogized age discrimination to a tort-like right to redress personal injuries, noting that a loss of wages does not transform discrimination into a nonpersonal injury.[162] The court held that the plaintiff suffered a tort to his dignity and was therefore personally injured, further eliminating any distinction between types of personal injury, such as physical or nonphysical.[163] The court reasoned that the purpose of the ADEA is to make victims whole by recognizing personal indignities.[164] Therefore as recovery for a personal injury, proceeds from an age discrimination suit are excludable from income.

The Ninth Circuit examined the nature of settlement payments and damage awards in the age discrimination context in *Redfield v. Insurance Co. of North America*.[165] The federal district court had awarded the plaintiff economic damages, emotional distress damages and punitive damages for injuries suffered as a result of age discrimination.[166] The defendant employer withheld federal income tax from the payment representing economic damages, and the plaintiff complained.[167] The *Redfield* court found that age discrimination claims, as in *Rickel*[168] and *Pistillo*,[169] are tort-like recoveries for personal injuries.[170] Further, the court stated that there is no difference between settlement payments and damage awards.[171]

In analyzing causes of action subject to the personal injury award exclusion, courts have included defamation, public embarrassment, malicious prosecu-

159. *Id.* at 666.
160. Pistillo v. Commissioner, 912 F.2d 145, 146 (6th Cir. 1990).
161. *Id.* at 147.
162. *Id.* at 149-50.
163. *Id.*
164. *Id.*
165. Redfield v. Insurance Co. of N. Am., 940 F.2d 542 (9th Cir. 1991).
166. *Id.* at 544.
167. *Id.*
168. Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990).
169. Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990).
170. *Redfield*, 940 F.2d at 547.
171. *Id.*

tion, freedom of speech, wrongful discharge, sex discrimination, age discrimination and many civil rights violations as personal injuries, and awards from those actions have been excluded from income. The courts declared that the injury must be personal, not contractual, and that the intent of the payor controls in the absence of a written settlement agreement. The personal injury must be tort-like. Further, the consensus of the courts in tacitly applying the make whole or return of capital concept finds no requirement that a personal injury be physical to be excludable. Thus, the courts do not require a distinction between physical and nonphysical injuries to be excludable from income.

IV. TURNING THE TIDE

A. The 1986 Act and 1989 Changes

Congress passed major tax reform legislation in 1986.[172] Although the legislation did not change the wording of section 104(a)(2), the 1989 amendment previously mentioned did change the wording to exclude punitive damages in cases involving nonphysical injuries or sickness.[173] This change would have an impact on the tax aspects of damage award exclusion, but this change does not effect, as referenced earlier, the return of capital analysis.

The recent case of *Sparrow v. Commissioner*[174] questioned whether back pay awarded pursuant to a racial discrimination claim is includible in gross income. The plaintiff in *Sparrow* filed suit against his employer, The Department of the Navy, for wrongful discharge and for failure to reinstate.[175] The plaintiff received payments which he claimed were for personal injury and as a result of racial discrimination.[176] The Commissioner claimed that the payments represented back pay, and therefore were includible as income.[177] The court found an intent on the part of the employer to make the settlement payment a compensation payment, rather than a damage payment.[178] Thus the court held that the plaintiff must first show that he received damages, and second, that they were received as compensation for a personal injury in order to be excludable.[179] Furthermore, the court found that an award must be received from an action at law in order to be exclud-

172. Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 U.S.C.C.A.N. (100 Stat.) 2085.
173. *See supra* note 154 and accompanying text.
174. Sparrow v. Commissioner, 949 F.2d 434 (D.C. Cir. 1991).
175. *Id.* at 434-35.
176. *Id.*
177. *Id.*
178. *Id.* at 436.
179. *Sparrow*, 949 F.2d at 436.

able: back pay is not a legal remedy and, is therefore, not excludable.[180] The court investigated Title VII and concluded that Title VII did not provide for damage awards.[181] The *Sparrow* opinion determined that an award for back pay under Title VII is not, in effect, a return of capital; rather it represents back wages, characterized as includible income.[182] At best, the utilization of the law and equity distinction represents an effort by the Service to merely, by way of reaction, alleviate a perceived invasion of its fiscal integrity.

Seizing upon the reasoning of the *Sparrow* court, the United States Supreme Court foreshadowed its change in focus on damage award exclusions in *United States v. Burke*.[183] In *Burke*, the plaintiff received a settlement award as a result of a sex discrimination claim under Title VII.[184] The Court reasoned that the award represented back pay and was therefore includible in income.[185] As observed, a calculation of loss based upon back pay if the loss is a tort-like personal injury does not invalidate the exclusion. However, the Court noted that even though discrimination causes harm to individuals, it does not imply a personal tort-like injury.[186] Title VII limits remedies to back pay, injunctions and equitable relief.[187] Because Title VII awards are equitable in nature, and do not exist by operation of law, they are not excludable from income.[188] The *Burke* court ignored the previous courts' rationale of personal injury, rights, and tort, instead focusing on the distinction between law and equity to reach a conclusion inconsistent with the underlying statutory premise. Indeed, Congress subsequently amended Title VII to provide a statutory tort-like cause of action.[189]

One year after *Burke*, the Tax Court decided *Downey v. Commissioner*.[190] Again, the issue was whether a back pay award to a United Airlines pilot under the ADEA is includible in income.[191] The *Downey* court found that the ADEA offers a wide range of remedies, including claims for back wages and liquidated damages.[192] Thus, the ADEA compensation scheme evidenced a tort-like concept of injury and remedy.[193] The court found that discrimination under the ADEA is

180. *Id.* at 438.
181. *Id.* at 439.
182. *Id.* at 440.
183. United States v. Burke, 504 U.S. 229 (1992).
184. *Id.* at 230-31.
185. *Id.* at 242.
186. *Id.* at 238.
187. *Id.*
188. *Burke,* 504 U.S. at 242.
189. *See* Civil Rights Act of 1991 § 102, 42 U.S.C. § 1981a (1994).
190. Downey v. Commissioner, 100 T.C. at 634 (1993), *rev'd,* 33 F.3d 836 (7th Cir. 1994).
191. *Id.* at 635.
192. *Id.* at 637.
193. *Id.*

a tort-like personal injury and excludable from income.[194] Following the Service's lead, the United States Court of Appeals reversed *Downey* and determined that the plaintiff had received income without benefit of the exclusion.[195]

In a similar decision involving another United Airlines pilot, the Ninth Circuit Court of Appeals in *Schmitz v. Commissioner*[196] found that ADEA recoveries were excludable. In dicta the *Schmitz* court stated that "unlike the unamended version of Title VII, ADEA does not simply recompense plaintiffs for the wages properly due them."[197] The court further noted that most courts find that civil rights violations are torts, and in the context of *Burke* the ADEA "establishes a tort-like cause of action."[198] The *Schmitz* court distinguished liquidated damages from punitive damages, holding that liquidated damages are compensatory in nature, and as such, are received on account of personal injury, and thus excludable from income.[199]

B. Supreme Court Showdown

The *Downey* and *Schmitz* inconsistency provided the opportunity for the United States Supreme Court to render its most disturbing decision in *Commissioner v. Schleier*.[200] The *Schleier* opinion analyzed another age discrimination suit under the ADEA, and the Court found a back pay award includible in income.[201] In a sweeping opinion, the Court stated that exclusions to gross income must be narrowly construed.[202] This, in and of itself, is a proper general statement of law. Although the court acknowledged that personal injuries include nonphysical injuries, it suggested that each element in a damage recovery must be for personal injury in order to be excludable from income.[203] Back wages are not equivalent to lost wages and are not considered personal injury damage awards.[204] The Court would not link personal injury to lost wages.[205] The Court further stated that ADEA injuries are economic, not personal, in nature and that Congress intended

194. *Id.*
195. *Downey*, 100 T.C. at 634.
196. Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994), *vacated*, 515 U.S. 1139 (1995).
197. *Id.* at 793.
198. *Id.* at 793-94.
199. *Id.* at 796.
200. Commissioner v. Schleier, ___ U.S.___, 115 S. Ct. 2159 (1995).
201. *Id.* at 2161.
202. *Id.* at 2163.
203. *Id.* at 2164 n.4.
204. *Id.* at 2164.
205. *Schleier*, ___ U.S.___, 115 S. Ct. 2164.

liquidated damages to be punitive.[206] The conclusion that liquidated damages are, in effect, punitive is a reach at best.

Even after accepting that certain recoveries might be tort-like, the Court relied, perhaps erroneously, on *Burke*[207] and construed vague, statutory requirements as overriding the Service's regulatory pronouncements in effect for many years.[208] It held legal injuries of an economic character cannot be characterized as tort-like.[209] The Court, in effect, broke from traditional notions of personal injuries and many years of precedent. The Court indicated that even though tort litigation allows for liquidated damages, personal injuries of a legal character are not sufficient to bring the claim within the regulation.[210] The ADEA gives no compensation for traditional harms associated with personal injury.[211] Back wages are economic and liquidated damages are not compensatory and therefore not based on tort.[212] A simple tort-like injury is not sufficient to exclude income.[213] In an interesting note, the court recognized a recent revenue ruling calling for exclusion from income, but ignored the implications of that ruling in its opinion.[214] The Court adds a requirement to section 104(a)(2), ruling that to be excludable from income, both a tort-like violation as well as a physical injury must be established.[215]

Justice O'Connor, in her dissent, found that age discrimination is a personal injury and that the majority equated personal injury to tangible injury, a theory which was rejected by eight justices in *Burke*.[216] The Court's analysis, according to Justice O'Connor, contradicts its recognition that personal injuries can be both tangible and intangible.[217] Harm to an individual's reputation and loss of business from tort may not be physical, but still can be personal.[218] Justice O'Connor cannot reconcile the majority's failure to perceive age discrimination as a personal injury when it recognizes that intangible harms are personal injuries.[219] If harms caused by discrimination are equivalent to personal injury,

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206. *Id.* at 2165.
207. United States v. Burke, 504 U.S.229 (1992).
208. *Schleier*, ___ U.S.___, 115 S. Ct. at 2166.
209. *Id.* at 2167.
210. *Id.*
211. *Id.*
212. *Id.*
213. *Schleier*, ___ U.S.___, 115 S. Ct. at 2167 n.8.
214. *Id.*
215. *Id.* at 2167.
216. *Id.* at 2167-68 (O'Connor, J., dissenting).
217. *Id.* at 2169.
218. *Schleier*, ___ U.S.___, 115 S. Ct. at 2169-70.
219. *Id.*

then damages from discrimination are received on account of personal injuries and are therefore excludable.[220] Thirty-five years of administrative rulings hold that a tort equates to personal injury and recoveries are therefore excludable.[221] The Court has always deferred to the Service's long standing interpretive regulations and rulings.[222] "[W]e give an agency's interpretations and practices considerable weight where they involve the contemporaneous construction of a statute and where they have been in long use."[223] However, this Court ignored its own practice of deference and refused to recognize the recent Service revenue rulings when deciding *Schleier.* Justice O'Connor stated the regulation defined the entire scope of section 104(a)(2) — damages received unambiguously refers to all damages.[224] Adding the extra requirement of proving a physical tort-like injury to the existing requirement of proving a personal injury requires a new condition without any basis in prior law.[225]

In the recent case of *O'Gilvie v. United States*, the court traces the history of the restoration of capital concept.[226] It held the compensated taxpayer is better off after a damage award than if the wrong had not taken place.[227] The statute fails to separate compensatory elements of damages so the Court must balance the make whole concept with a tax equality objective.[228] Punitive damages do not compensate for any kind of loss and the Court finds no reason why Congress would have wanted to exclude them from income.[229] Tax generosity has its limits.[230] "Congress' primary focus, in other words, was upon what to do about nonphysical personal injuries, not upon the provision's coverage of punitive damages under pre-existing law."[231] Thus, punitive damages, even from personal injury suits, are no longer excludable from income. This case is consistent with the return of capital approach.

As courts diverted their focus from legal precedent to flights of fancy, the state of the personal injury award exclusion deteriorated. Although the Service's

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220. *Id.* at 2170.
221. *Id.* at 2171.
222. *Id.*
223. *Schleier,* ___ U.S.___, 115 S. Ct. at 2171 (quoting Davis v. United States, 495 U. S. 472, 484 (1990)).
224. *Id.*
225. *Id.* at 2172.
226. O'Gilvie V United States, ___ U.S ___, 117 S. Ct. 452 (1996).
227. *Id.* at 456.
228. *Id.*
229. *Id.*
230. *Id.* at 457.
231. *O'Gilvie,* ___ U.S.___, 117 S. Ct. at 458.

regulations required only a tort or tort-type action,[232] the courts judicially added a physical injury requirement for a personal injury damage award to be excludable from income.

C. 1996 Legislation

In August of 1996, Congress again changed the damage award wording of section 104(a)(2) to read that: "gross income does not include . . . the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."[233] The House Conference Report explains the language change, by stating that the statute has been interpreted too broadly by some courts.[234] The report justifies that the change in statutory wording came about as a result of the United States Supreme Court's recent holdings.[235]

V. CONCLUSION

A tort is a "legal wrong committed upon the person or property independent of contract."[236] It may be either: "(1) a direct invasion of some legal right of the individual; [or] (2) the infraction of some public duty by which special damage accrues to the individual."[237] A legal wrong does not specify a physical wrong. A tort may be a nonphysical or intangible wrong as well. The United States Supreme Court's requirement of finding a physical, tort-type personal injury in *Burke* and *Schleier* contradicts the customary and accepted meaning of tort as defined by the legal community.

A personal injury is one "which is an invasion of personal rights, and . . . may include such injuries to the person as libel or slander, criminal conversation, malicious prosecution, false imprisonment, and mental suffering."[238] Nowhere in this definition does personal injury require a physical injury. However, the Court in *Burke* and *Schleier* requires a personal injury to be physical in order to be excludable from income. The original language of the damage exclusion and the original rationale behind the statute indicate that damage awards represent a return of personal capital, and do not represent income. This approach is still worthwhile.

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232. Treas. Reg. 1.104-1(c) (1990).
233. I.R.C. § 104(a)(2)(1997)(emphasis added).
234. H.R. CONF. REP. NO. 104-737, at 677 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1792.
235. *Id.*
236. BLACK'S LAW DICTIONARY 1489 (6th ed. 1990).
237. *Id.*
238. BLACK'S LAW DICTIONARY 786 (6th ed. 1990).

With the return of capital concept permeating for over sixty-five years, the United States Supreme Court suddenly and inexplicably changed the rules. Congress ordinarily implements laws in response to public or governmental pressure. As to this statute, however, Congress may have enacted laws in response to a court decision and its own perceived floodgate mentality. Courts ordinarily interpret laws passed by Congress. With respect to this statute, however, the Court wrote the law by adding extra requirements, and Congress passed the statute accordingly.

Has the law run amok from the return of capital concept? Has the Service overreacted to some perceived raid on our fiscal integrity? Has Congress overreacted utilizing an erroneous Supreme Court decision as its rationale? Have the courts vacated a fundamentally reasonable and sympathetic approach recognized for many years by the Service, to exclude damage awards from income? The *Burke* and *Schleier* decisions evaporate the last vestiges of the return of capital concept by relegating to gross income all but the narrowest damage awards. Damage awards no longer represent restoration of an individual's capital, they no longer make a person whole, they now only represent a perceived, though nonexistent, windfall to be shared with the government. Slash those wrists! The remedy is legislative!