NOTES

Congress's Amendment to Section 104 of the Tax Code Will not Clarify the Tax Treatment of Damages and Will Lead to Arbitrary Distinctions

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INTRODUCTION

In August 20, 1996, Uncle Sam once again raised taxes. The vehicle for this tax increase was the Small Business Job Protection Act (Small Business Act) of 1996.\(^1\) The Small Business Act involved tax provisions for small businesses,\(^2\) provided various tax credits for parents who adopt a child,\(^3\) and increased the minimum wage.\(^4\) Although the Act appears innocuous, there are controversial changes to the tax code tucked away in the revenue provision of the act, including the amendment of the Internal Revenue Code (I.R.C.) § 104.\(^5\) In making the amendment to section 104, Congress hoped to raise an additional $662 million over a period of ten years.\(^6\)

The purpose of the amendment was to clarify the tax treatment of damages.\(^7\) In doing so, the amendment deals with three areas of

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2. See id. at §§ 1101-1501.
3. See id. at § 1807.
4. See id. at § 2104.
5. See id. at § 1605 (codified as amended at I.R.C. § 104 (West Supp. 1997)).
the law: taxation of physical injury damages, taxation of emotional distress damages, and taxation of punitive damages. Although the amendment addresses punitive damages, a recent decision by the Supreme Court has rendered the issue moot. Thus, punitive damages are not discussed in this article.

Prior to the amendment of I.R.C. § 104, the manner in which damages were treated for tax purposes depended on the nature of the claim; to avoid taxation, a claim had to be either a tort or a violation of a tort-type right. Consequently, to avoid taxation, attorneys creatively argued that their clients’ claims were torts.

In an effort to solve this problem, Congress sought to clarify the tax treatment of damages so that the taxation of damages would not depend on the nature of the claim. However, the amendment merely replaced one vague phrase with another. The ambiguous term “personal injury” has been replaced by “personal physical injury,” a term that is equally ambiguous.

Accordingly, the tax treatment of damages will still depend on the nature of the claim. In order to avoid taxation, a claim must be characterized as one involving a “personal physical injury.” This is problematic because the amendment does not define what constitutes a “personal physical injury.” Instead, the meaning of “personal physical injury” is left to the courts and attorneys to determine. Undoubtedly, this will result in much needless litigation to decide the definition of “personal physical injury.” Therefore, Congress’s goal of clarifying the tax treatment of damages will not succeed.

This Note examines the recent amendment of I.R.C. § 104 and argues that the amendment will not clarify the tax treatment of damages.

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8. See id.
9. The new amendment to I.R.C. § 104 states that punitive damages are not excludable from gross income unless the punitive damages are awarded in a wrongful death action and the state law limits the available damages in a wrongful death action to punitive damages. This amendment is prospective. I.R.C. § 104 (West Supp. 1997). However, the Supreme Court ruled in O’Giltié v. United States, 117 S. Ct. 452 (1996), that punitive damages are taxable income. This decision resolved a split in the circuits and clarified the prior tax treatment of punitive damages awarded in personal injury cases. See O’Giltié, 117 S. Ct. at 454, 458. Furthermore, punitive damages awarded in nonphysical injury cases have been taxable income since the 1989 amendment to I.R.C. § 104. See I.R.C. § 104(a) (1994); O’Giltié, 117 S. Ct. at 457.
12. See Commissioner v. Schleier, 515 U.S. 323, 333 (1995) (arguing that age discrimination was a tort or violated a tort-type right). See also Burke, 504 U.S. at 238 (arguing that sexual discrimination was a tort or violated a tort-type right).
damages, but will instead lead to inequitable results and arbitrary distinctions. Part I explores the policy justifications for the exclusion of damage awards from gross income and provides a brief overview of section 104. Next, in Part II, the Article reflects upon the tax treatment of damages prior to the recent amendment. In doing so, Part II focuses on the relevant case law and revenue rulings. Turning toward the tax treatment of damages under the new amendment, Part III examines Congress's intent in amending section 104. Finally, Part IV discusses the ramifications of the new amendment on damages for physical injuries and damages for emotional distress and illustrates that the new amendment is problematic. This article concludes that the amendment to section 104 will not clarify the tax treatment of damages as intended by Congress and ends with suggestions on how section 104 could be amended so as to achieve the clarity sought by Congress.

PART I

A. Policy Explanations for the Tax Treatment of Damages Under Section 104

Although the tax code defines income broadly, the Internal Revenue Code, for tax and public policy reasons, has many exclusions to income. One such exclusion is found in section 104 for damages received "on account of personal physical injuries or physical sickness." The most common policy explanations for this exclusion are (1) the return of capital theory; (2) the involuntary nature of the transaction theory; (3) the compassion or humanitarianism theory; (4) the imputed income theory; and (5) the bunching of income theory.

The return of capital theory is the most common explanation for the section 104 exclusion. Return of capital is a payment received that equals a taxpayer's investment or basis in an item. As such, a

18. See id. at 1465.
19. See id.
20. See id.
21. See id. at 1466.
22. See id. at 1463.
23. See Burnet v. Logan, 283 U.S. 404, 412-14 (1931) (holding that the taxpayer's recovery of basis in the item is not a taxable event).
taxpayer can have capital in his or her body, which consists of physical and mental health. Under this approach, damage awards are considered to be a return of capital. When a taxpayer's mental or physical health is injured, a damage award compensates a taxpayer for the injury and, in doing so, returns the lost capital. This mirrors a traditional principle in tort law that the purpose of compensatory damages is to put the injured party in the position that he or she would have been had the party not been injured. Thus, the damages make the injured party whole.

Nonetheless, this theory has been criticized. In order to have a return of capital, a taxpayer must first have a basis in his or her body. However, a taxpayer cannot be said to have a basis in his or her body because human bodies are not purchased. Furthermore, a person's basis in his or her body cannot be the cost to maintain that body because a taxpayer deducts those costs in the annual personal exemption. Accordingly, the return of capital theory alone cannot adequately explain the policy underlying the section 104 exclusion.

A second policy explanation for the exclusion of damage awards is based on the involuntary nature of the transaction. In short, a plaintiff does not ask to be injured. Therefore, under this theory, section 104 is analogous to other sections of the tax code that afford special tax treatment to involuntary transactions. For example, I.R.C. section 1033 allows a taxpayer to postpone gain after an involuntary conversion of property. Under this section, if a taxpayer's property is destroyed, the taxpayer can exclude any gain received from insurance, but only if the taxpayer reinvests the money

24. See Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962) (holding that “[d]amages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights—because, in effect, they restore a loss to capital”).

25. See BLACK'S LAW DICTIONARY 390 (6th ed. 1990). "The rationale behind compensatory damages is to restore the injured party to the position he or she was in prior to the injury." Id. (citing Northwestern Nat. Cas. Co. v. McNulty, C.A. Fla., 307 F.2d 432, 434 (1962)).

26. See id.

27. See generally Horton v. Commissioner, 100 T.C. 93, 96 (1993) (stating that the Court has rejected the return on capital theory), aff'd, 33 F.2d 625 (6th Cir. 1994).

28. See Illig, supra note 17, at 1464.

29. See id.


32. See id.

33. See I.R.C. § 1033(b) (West Supp. 1997).
into a replacement property. However, sections 104 and 1033 are not analogous. Even though section 1033 allows for a postponement of gain, section 1033, unlike section 104, does not create an exclusion from income. Consequently, this policy is inadequate for explaining the exclusion under section 104.

A third theory that has been put forth to explain the exclusion for damages is based on the principles of compassion and humanitarianism. Under this rationale, section 104 excludes a taxpayer's damages because the taxpayer is considered to have suffered enough. Under this theory, the exclusion for damages under section 104 is compared to section 101 of the code, which excludes from gross income all amounts "received . . . under a life insurance contract." Thus, under the theory of compassion or humanitarianism, an analogy is drawn between Congress's compassion for a bereaving family member and Congress's compassion for an injured taxpayer. Additionally, the compassion theory might explain the tendency for courts to expand the section 104 exclusion, a tendency that runs contrary to the usual judicial practice of narrowly interpreting exclusions from income. However, this theory cannot adequately explain section 104's exclusion for the simple reason that not all damages awarded to an injured taxpayer are excluded from income.

A fourth possible explanation for the exclusion rests on the imputed income theory. There are two types of imputed income. One type is income derived from the use of "household durables." Under this type of imputed income, the owner of a house is said to have imputed income because if the taxpayer did not own the house, the taxpayer would have to pay a landlord rent. This saving of rent

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34. See I.R.C. § 1033(a). The gain is preserved because the basis of the destroyed property is carried over to the replacement property. Any gain will be postponed until the taxpayer sells the replacement property. See I.R.C. § 1033(b).
35. See I.R.C. supra note 17, at 1465; see also, Roemer v. Commissioner, 716 F.2d 693, 696 (9th Cir. 1983) (describing the humanitarian theory as "a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award").
36. See Roemer, 716 F.2d at 696.
37. See I.R.C. § 101(a) (West Supp. 1997); see also CHIRELSTEIN, supra note 31, § 2.04, at 43.
38. See I.R.C. 101(a). See also CHIRELSTEIN, supra note 31, § 2.03, at 39 (stating that under the life insurance exclusion, "there is a heavy flavor of condolence about the whole affair").
39. See CHIRELSTEIN, supra note 31, § 2.04, at 40.
40. See I.R.C. supra note 17, at 1461, 1466.
41. See id. at 1466.
42. See id. at 1465.
43. See CHIRELSTEIN, supra note 31, § 1.03, at 23.
44. See id.
payments is considered imputed income. The second type of imputed income involves the taxpayer who enjoys the fruits of his or her labor.\textsuperscript{45} For example, when a lawyer writes his or her own will rather than paying someone else to write it, this savings in payment is imputed income to the lawyer. However, in both cases the IRS does not include this amount in gross income.\textsuperscript{46}

The imputed income theory has been used to explain the exclusion of damages from gross income.\textsuperscript{47} An example of such an exclusion would be when a jury awards a husband damages for the loss of consortium for the death of his wife. Inherent in such a damage award is an amount for the loss of the wife’s services, and this amount is considered imputed income. Therefore, under existing tax policy, it would not be taxed. However, the use of the imputed income theory as a basis for excluding damages for income has been criticized because the decision by the IRS not to tax imputed income is based on valuation problems.\textsuperscript{48} But, tort-related damages are paid in cash so there is no problem of valuation.\textsuperscript{49}

A fifth policy justification for the section 104 exclusion is based on the bunching of income theory.\textsuperscript{50} The bunching of income theory is based on the idea that “it is unfair to subject such an award (or settlement) to the progressive rate structure of federal income tax, since [sic] the bunching usually forces the recipient into a higher marginal tax bracket.”\textsuperscript{51} While in the case of back pay or lost profits the taxpayer would have spread the amount over many years, taxpayers often receive damage awards as a lump sum payment.

To illustrate the bunching of income theory, assume that age discrimination damage awards are taxable income, that the taxpayer files a claim for age discrimination, and that, in a settlement, the taxpayer receives $260,000 in back pay for the previous four years.\textsuperscript{52}

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\textsuperscript{45} See id.
\textsuperscript{46} See id.
\textsuperscript{47} See Illig, supra note 17, at 1465.
\textsuperscript{49} See Cochran, supra note 48, at 49; Illig, supra note 17, at 1465.
\textsuperscript{50} See Illig, supra note 17, at 1466.
\textsuperscript{51} Cochran, supra note 48, at 49.
\textsuperscript{52} This example assumes that the taxpayer has no other source of income. In addition, this example does not allow for any deduction (standard or otherwise) or any personal exemptions. Furthermore, this example does not account for inflation. For a similar example see Edward Yorio, The Taxation of Damages: Tax and Non-Tax Policy Considerations, 62 CORNELL L. REV.
Under these circumstances, the taxpayer's tax liability for the year of receipt is $83,732.53 However, under this example, if the taxpayer had earned the $260,000 over the four years, the taxpayer would have had taxable income of $65,000 for each year. This would result in a total tax liability for the four years of $62,688.54 But, if the taxpayer receives the damage award in one year instead of four, the taxpayer pays and additional $21,044 of tax.

However, this theory has been criticized because Congress can easily alleviate the bunching of income.55 For example, Congress could average the damage award over the relevant period. In doing so, the taxpayer would not have to report the entire award as income for one year. Further, the Tax Reform Act of 1986 eliminates the code's income averaging sections,56 which would indicate that the bunching of income is not of great congressional concern. Consequently, this theory is also unable to adequately explain the section 104 exclusion.

In short, none of the aforementioned policies can adequately explain why section 104 excludes specific types of damages from income. Part of this problem lies in the nature of damages themselves. Compensatory damages are just that—compensation for an injury. They are intended to make a person whole, not to provide a windfall gain.57 However, with juries awarding larger damage awards, there is a potential for more tax revenue. Courts and Congress are thus at odds with each other, and unless we are willing to change our belief about the nature of compensatory damages, they simply cannot be classified as an "accession to wealth."58 In order to fully understand Congress's amendment to section 104 and the policies behind the amendment, a brief overview of section 104 is necessary.

701, 716 (1977).
53. See I.R.C. § 1(c) (1996). Tax liability is calculated as follows: $79,772 plus 39.6% of the excess of $250,000.
54. See id. Tax liability is calculated as follows: $12,107 plus 31% of the excess over $53,500. This amount is $15,672 for each year or $62,688 for four years.
55. See Cochran, supra note 48, at 49.
57. See BLACK'S LAW DICTIONARY, supra note 25, at 390.
58. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (defining income as any "accession to wealth").
B. Brief Overview of Section 104

Section 61(a) of the tax code liberally defines income as follows: "Except as otherwise provided . . . gross income means all income from whatever source derived."\(^{59}\) According to the Supreme Court, income is any "accession to wealth,"\(^ {60}\) over which the taxpayer has "complete control."\(^ {61}\) As a result of this all-inclusive language, a taxpayer must find an exclusion in the tax code in order to avoid paying taxes on any income received.\(^ {62}\) A problem from the taxpayer’s perspective, however, is that courts interpret exclusions from income narrowly.\(^ {63}\)

One such exclusion is section 104 of the tax code. Before the 1996 amendment, this exclusion applied to "any damages received . . . on account of personal injuries or sickness."\(^ {64}\) Because the term "personal injuries or sickness" was difficult to define, this exclusion was the source of much confusion. To exacerbate matters, neither the tax code nor the Treasury Regulations defined "personal injury or sickness." However, the Regulations defined "damages received"\(^ {65}\) as "an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights . . . ."\(^ {66}\)

This definition forced attorneys to draw analogies between their clients’ claim and a tort or tort-type right. In turn, this forced courts to determine if the claim in question was a tort as defined by the Treasury Regulations.\(^ {67}\) The Supreme Court, in an attempt to resolve the confusion, decided *United States v. Burke*,\(^ {68}\) stating that for a taxpayer to qualify for the section 104 exclusion, both the injury and the remedy available must be tort-like.\(^ {69}\) In 1995 the Supreme Court,

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60. *Glenshaw Glass Co.*, 348 U.S. at 431. See definition *supra* note 58.
61. See id.
63. See Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) (stating that exemptions are specifically stated and should be construed with restraint).
65. Id.
67. See, e.g., *Roemer*, 716 F.2d at 693 (arguing that compensatory damages received in a defamation suit are excludable from gross income).
69. Id. at 239-41. To add to the confusion in this field, courts treat "tort-like" and "tort-type right" as synonyms. Compare *Burke*, 504 U.S. at 232, 234 (tort-like), with Commissioner v. Schleier, 515 U.S. 323, 334 (1995) (describing the holding of *Burke* as analyzing a tort-type right).
once again, addressed this issue in Commissioner v. Schleier. In Schleier, the Court held that in order to qualify for the section 104 exclusion, the injury must be tort-like (both in injury and remedy) and that there must be a linear causal relationship between the personal injury and the damages received.

In August of 1996, the tax treatment of damages changed dramatically. Section 104 was amended. The amended section 104 states that damages are excludable from gross income if they are received "on account of personal physical injuries or physical sickness." In addition, the amendment provides that "[e]motional distress shall not be treated as a physical injury or physical sickness." This amendment will have sweeping effects.

First, unless a taxpayer's damage award is for a physical injury, any damages received on account of that injury will be considered taxable income. Therefore, under the new tax treatment, damages received for a violation of a taxpayer's First Amendment rights are taxable income. Also, damages received for sexual discrimination brought under Title VII of the Civil Rights Act of 1991 are taxable income. Furthermore, damages received for slander and libel will be taxable income. In short, unless the taxpayer can demonstrate a physical injury, the above claims are merely considered dignitary wrongs and, under the new treatment, will be taxable income.

The second major change includes damages received for emotional distress. Under the amended code, damages for emotional distress that do not reimburse the taxpayer for medical treatment incurred in an attempt to alleviate the emotional distress are now considered taxable

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71. See id. at 336-37.
72. The Small Business Job Protection Act of 1996 § 1605 [emphasis added].
73. Id.
income. However, if a taxpayer can demonstrate that the emotional distress flowed from a physical injury, rather than demonstrating that the emotional distress caused a physical injury, the damage award should avoid taxation.

Through this amendment, Congress hoped to clarify the tax treatment of damages and end the needless litigation. Unfortunately, the new amendment will render the same result. To illustrate, a discussion of the prior tax treatment of damages follows.

PART II

A. The Prior Tax Treatment of Damages Resulted in Much Litigation

The relevant portions of the pre-1996 I.R.C. § 104 read:

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

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

As previously discussed, neither the tax code nor the Treasury Regulations define “personal injuries or sickness,” although the Regulations do define “damages received” as “an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights. . . .” However, a tort is “a private or civil wrong or injury.” Thus, almost all claims “independent of contract” are considered torts. Therefore, under the pre-1996 amendment, attorneys argued that their clients’ claims were torts and were therefore

78. See H.R. REP. NO. 104-586, at 143-44 (1996). “If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party.” Id.
81. BLACK’S LAW DICTIONARY 1489 (6th ed. 1990). “A legal wrong committed upon the person or property independent of contract. It may be either (1) a direct invasion of some legal right of the individual; (2) the infraction of some public duty by which special damage accrues to the individual; (3) the violation of some private obligation by which like damage accrues to the individual.” Id. at 1489.
82. Id.
excluded, under section 104, from income.\(^8^3\) Consequently, the Supreme Court attempted to narrow the tax treatment of damages. The Court first attempted to clarify the Treasury Regulation's definition in *United States v. Burke*.\(^8^4\)

1. United States v. Burke

In *United States v. Burke*, the Supreme Court decided whether damages awarded under Title VII of the Civil Rights Act of 1964\(^8^5\) were excludable from gross income under section 104.\(^8^6\) Judy Hutcheson, an employee of The Tennessee Valley Authority (TVA), claimed that her employer had discriminated against her because of her gender.\(^8^7\) The basis of the complaint was that TVA paid male employees higher wages than similarly situated female employees.\(^8^8\) In a settlement agreement, TVA agreed to pay five million dollars to be shared by all affected employees.\(^8^9\) When the settlement was distributed, TVA withheld federal income tax from each employee's payment.\(^9^0\)

After unsuccessful attempts to obtain a tax refund, Burke and other employees initiated a lawsuit.\(^9^1\) When the case reached the Court of Appeals for the Sixth Circuit, the court determined that both the "beginning and end of the inquiry" was whether the injury and claim were "personal" and "tort-like in nature."\(^9^2\) Based on this limited inquiry, the Court of Appeals held that TVA's unlawful sexual discrimination was a personal, tort-like injury, and therefore, the damage award was excludable under section 104.\(^9^3\)

In order to resolve the split among the circuits, the Supreme Court granted certiorari to determine whether section 104 excluded Title VII damage awards.\(^9^4\) The Court began its analysis by reason-

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86. 504 U.S. at 242.
87. See Burke, 504 U.S. at 230-31.
88. See id.
89. See id. at 231.
90. See id. TVA did not withhold federal income taxes in the payment to Ms. Hutcheson.
91. See id. at 232.
93. See Burke v. United States, 929 F.2d at 1123-24.
94. See Burke, 504 U.S. at 233 & n.3.
ing that "remedial principles" are inherent in the definition of tort and, consequently, the "hallmark" of traditional tort liability was "a broad range of damages to compensate the plaintiff 'fairly for injuries caused by the violation of his legal rights.'" The Court, however, declined to only analyze the nature of the claim; it also analyzed the nature of the remedy.

In doing so, the Court looked at Title VII's remedies that are available to a successful claimant. The Court found that Title VII limited available remedies to back pay, injunctions, and other equitable relief, but did not allow for pain and suffering, emotional distress, or other compensatory damages typically associated with a tort. Therefore, the Court concluded that Title VII was not tort-like because it addressed "'legal injuries of an economic character.'" Thus, because the taxpayers did not receive traditional tort compensation, the damages were not excludable under section 104 and were taxable income.

Prior to the Court's ruling in Burke, Congress amended Title VII to allow a successful plaintiff to recover compensatory and punitive damages. In 1993, in response to the Burke decision's potential impact on the amended Title VII, the IRS issued Revenue Ruling 93-88.

2. Revenue Ruling 93-88

Revenue Ruling 93-88 addressed Title VII and whether damages received under the amended Title VII were excludable from gross income. The ruling states:

95. See id. at 234.
96. Id. at 235 (quoting Carey v. Piphus, 435 U.S. 247, 257 (1978)).
97. See id.
98. See id.
99. See Burke, 504 U.S. at 238-39.
100. Id. at 239 (citing Albemarle Paper Co. v. Moody, 422 U.S. 405, 418 (1975)).
101. See id. at 242.


Amounts received in satisfaction of claims of disparate treatment discrimination made under Title VII of the Civil Rights Act of 1964, as amended in 1991, and 42 U.S.C. section 1981 are excludable under section 104(a)(2) of the Code. Amounts received in satisfaction of claims under the Americans With Disabilities Act are also excludable.105

However, after the Supreme Court decided Commissioner v. Schleier106 the IRS suspended Revenue Ruling 93-88 and requested further guidance from Congress.107 While awaiting this guidance, the IRS did not issue a replacement ruling.108 This resulted in considerable ambiguity to the tax treatment of damages.109

3. Commissioner v. Schleier

In 1995, the Supreme Court once again addressed section 104 in Commissioner v. Schleier.110 Schleier, a sixty-year-old airplane captain working for United Airlines, was fired pursuant to the company’s age-based policy.111 Schleier brought a claim under the Age Discrimination in Employment Act (ADEA).112 The parties settled and Schleier received $145,629, fifty percent of which was considered back pay, the other fifty percent of which was deemed liquidated damages.113 Schleier’s 1986 income tax return included the back pay...

108. After Congress passed the Small Business Act, which amended I.R.C. § 104, the IRS issued a replacement ruling, Revenue Ruling 96-65. Revenue Ruling 96-65 replaced Revenue Ruling 93-88 and superseded Notice 95-45. Revenue Ruling 96-65 reiterates that under the new law, backpay received for Title VII claims are “not excludable from gross income under § 104(a)(2) because . . . [backpay is not] received on account of personal physical injuries or physical sickness . . . .” Rev. Rul. 96-65, 1996-53 I.R.B. 5. Further, this ruling states that damages for emotional distress received for a Title VII claim are “not excludable from gross income . . . except to the extent they are damages paid for medical care . . . attributable to emotional distress.” Id. However, this ruling still does not provide any guidance in that the IRS merely reiterates the obvious. Instead, the IRS should issue a ruling providing guidance to the critical question: What is a personal physical injury or physical sickness?
111. See id. at 325.
113. See Schleier, 515 U.S. at 326.
amount but did not include the amount of liquidated damages.\textsuperscript{114} As a result, the IRS issued a deficiency notice, and Schleier filed suit against the IRS Commissioner in Tax Court.\textsuperscript{115}

The Tax court held that both the back pay and liquidated damages should be excluded from gross income because the ADEA claim was a tort-like cause of action.\textsuperscript{116} The Fifth Circuit Court of Appeals affirmed the decision of the tax court.\textsuperscript{117} The Supreme Court granted certiorari to resolve a split in the circuits concerning the taxability of ADEA awards\textsuperscript{118} and, in doing so, expanded its \textit{Burke} ruling.

First, the Court explained that Title VII awards are not based on tort-type rights, because there are no provisions for jury trials or punitive damages.\textsuperscript{119} And, even if Title VII did provide for those remedies, such a provision would not be sufficient to bring the damages within the section 104 exclusion. The Court concluded that the ADEA liquidated damages are not compensatory, and, therefore, ADEA actions do not provide for the "hallmark" of traditional tort liability and, consequently, are outside the scope of section 104.\textsuperscript{120}

The Court stated that \textit{Burke} did not mean that a recovery based on a tort or a tort-type right was the "beginning and end of the analysis."\textsuperscript{121} A taxpayer also had to satisfy a causation requirement.\textsuperscript{122} Thus, the Court essentially introduced a second test to exclude damages under section 104. Under this second test, not only must a recovery be based on a tort or tort-type right, but a taxpayer must have received the damages "on account of personal injuries."\textsuperscript{123} After hypothetically illustrating this need for a linear causal relation-

\textsuperscript{114} See id. at 327.
\textsuperscript{115} See id.
\textsuperscript{118} See Downey v. Commissioner, 33 F.3d 836, 840 (7th Cir. 1994) (holding that damages due to age discrimination are not excludable from gross income under section 104); but see Smitch v. Commissioner, 34 F.3d 790, 791 (9th Cir. 1994) (holding that damages due to age discrimination are excludable from gross income under section 104), vacated and remanded, 115 S. Ct. 2373 (1995) (for consideration in light of Schleier).
\textsuperscript{119} See Schleier, 515 U.S. at 334-35.
\textsuperscript{120} See id. at 336.
\textsuperscript{121} Id. at 336.
\textsuperscript{122} See id.
\textsuperscript{123} See id. at 337. The "on account of personal injuries" is pulled directly from I.R.C. § 104(a)(2) (1994).
ship between the injury and the damages, the Court further explained that the age discrimination was the cause of both the personal injury and the lost wages. However, the personal injury did not cause the lost wages. Because there was no linear causation between the injury and the lost wages, there was no basis to exclude the settlement from gross income.

The Schleier decision is problematic because it draws unnecessary and arbitrary distinctions. For example, lost wages under the ADEA are considered taxable income. However, lost wages due to emotional distress are not taxable income. The combination of this illogical distinction and the suspension of Revenue Ruling 93-88 created ambiguity and uncertainty with regard to the tax treatment of damages. Congress attempted to resolve this ambiguity by passing the Small Business and Job Protection Act of 1996.

PART III

A. The New Tax Treatment of Damages

On August 20, 1996, Congress attempted to clarify the tax treatment of damages by amending section 104 of the tax code. This move was an ill-considered attempt to fix a long-standing problem: whether damage awards should be taxable. The vehicle for this change was the Small Business Act.

124. The Court provided the following hypothetical:
Assume that a taxpayer is in an automobile accident, is injured, and as a result of that injury suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for $30,000 (and if the taxpayer has not previously deducted her medical expenses, see § 104(a)), the entire $30,000 would be excludable under § 104(a)(2). The medical expenses for injuries arising out of the accident clearly constitute damages received "on account of personal injuries." Similarly, the portion of the settlement intended to compensate for pain and suffering constitutes damages "on account of personal injury." Finally, the recovery for lost wages is also excludable as being "on account of personal injuries," as long as the lost wages resulted from [the] [sic] time in which the taxpayer was out of work as a result of her injuries.

Id. at 329.
126. See id. at 337.
127. See id. at 329.
128. Fernandez & Dwyer, supra note 109, at 811.
129. See The Small Business Job Protection Act § 1605.
130. See id.
The Small Business Act moved rapidly through Congress\textsuperscript{131} with very little public debate or vocalized thought given to the policy ramifications of the section 104 amendment.\textsuperscript{132} Moreover, the Senate's version of the bill amending section 104 did not discuss compensatory damages but dealt only with the taxability of punitive damages.\textsuperscript{133} Senators believed that taxing compensatory damages was too controversial.\textsuperscript{134} In contrast to the Senate, the House version dealt with compensatory damages.\textsuperscript{135} Therefore, the Senate requested a conference with the House to resolve the discrepancy.\textsuperscript{136} Unfortunately, however, the House version was selected primarily because of the extra revenue the bill would raise.\textsuperscript{137}

In addition to raising revenue, Congress passed the amendment to section 104 to clarify a much litigated area.\textsuperscript{138} The existing law required that a claim must be either a tort or tort-like in order to avoid taxation of damages. Congress amended section 104 to ensure that the tax treatment of a damage award did not depend on the nature of the claim.\textsuperscript{139} However, Congress failed at its attempt to clarify the tax treatment of damages.

The amendment to section 104 changes several areas of tax law.\textsuperscript{140} First, the amendment replaces the phrase "personal injuries

\textsuperscript{131} The bill was introduced on May 14, 1996. It passed in the House on May 22, 1996, and was referred to the Senate on June 6, 1996. It was amended and reported to the Senate on June 18, 1996. The Senate began consideration of the bill on July 8, 1996, and the bill passed as amended on July 9, 1996. The bill went to conference on July 26, 1996. The conference report was reported in the House and Senate on August 1, 1996. The House and Senate agreed to the conference report on August 2, 1996. The President signed the bill on August 20, 1996. See 104 Bill Tracking H.R. 3448, available in LEXIS, Legis Library, BLT104 file.

\textsuperscript{132} See Tax Legislation, supra note 6, at D-3 (stating that, "The House debate on the bill was dominated by the minimum wage increase, with little attention other than praise given to the tax breaks."). This also is evidenced by the lack of statements and debates in the Congressional Record.


\textsuperscript{134} See GOV'T. PRESS RELEASE 4104-234 (June 12, 1996) (Statement of Chairman Roth at Markup on Adoption and Small Business Tax Bills).


\textsuperscript{137} See Tax Legislation, \textit{supra} note 6, at D-3. "According to a Senate staff member, the conferees chose the house version because of the additional revenue it would raise." \textit{Id.}

\textsuperscript{138} See H.R. REP. NO. 104-586, at 143 (1996). "The confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation including two Supreme Court cases within the last four years." \textit{Id.}

\textsuperscript{139} See H.R. REP. NO. 104-586, at 143 (1996). "The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made." \textit{Id.}

\textsuperscript{140} The full text of the amendment is as follows:
or sickness" with "personal physical injuries or physical sickness." 141  

Second, the amendment states that emotional distress is not a physical injury or physical sickness. 142

While these changes were designed to clarify the tax treatment of damages, the statute does not define the phrase "physical injuries or physical sickness." This phrase is left for the courts and the I.R.S. to define. Furthermore, the tax treatment of a damage award will still depend on the nature of the claim. Under the amended section, a claim must be one involving a physical injury or physical sickness. Consequently, to avoid taxation of the damage award, astute attorneys will search through seemingly insignificant facts so as to find a "physical injury or physical sickness." For example, in a sexual

(a) IN GENERAL.—Paragraph (2) of section 104(a) (relating to compensation for injuries or sickness) is amended to read as follows:
(2) 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;.

(b) EMOTIONAL DISTRESS AS SUCH TREATED AS NOT PHYSICAL INJURY OR PHYSICAL SICKNESS.—Section 104(a) is amended by striking the last sentence and inserting the following new sentence: "For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress."

(c) APPLICATION OF PRIOR LAW FOR STATES IN WHICH ONLY PUNITIVE DAMAGES MAY BE AWARDED IN WRONGFUL DEATH ACTIONS.—Section 104 is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:
"(c) APPLICATION OF PRIOR LAW IN CERTAIN CASES.—The phrase 'other than punitive damages' shall not apply to punitive damages awarded in a civil action—
(1) which is a wrongful death action, and
(2) with respect to which applicable State law (as in effect of September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.

This subsection shall cease to apply to any civil action filed on or after the first date on which the applicable State law ceases to provide (or is no longer construed to provide) the treatment described in paragraph (2)."

(d) EFFECTIVE DATE.—
(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to amounts received after the date of the enactment of this Act, in taxable years ending after such date.
(2) EXCEPTION.—The amendments made by this section shall not apply to any amount received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.


141. Id. (emphasis added).
142. See id.
harassment case, an attorney might look to see if the client was bruised from a pinch to prove that the client suffered a physical injury.

However, while the terms are left undefined, the House Report does attempt to explain the meaning of the amendment. Under the new law, if a claim is based on a physical injury or physical sickness, then all damages that "flow therefrom" are treated as being received "on account of personal physical injury or physical sickness."143 Using an example of an individual who is awarded damages for loss of consortium for the physical injury or physical sickness of that individual's spouse,144 the House Report explains that the taxpayer's award would be excludable from gross income because the loss of consortium flows from a physical injury.145 However, the House Report merely reiterates the linear casual relationship stated in Schleier without providing any guidance to the crucial question: What is a physical injury or physical sickness?

Furthermore, the House Report states that juries typically award lost profits in cases involving nonphysical injuries or sickness.146 Thus, in the opinion of Congress, there is no need to give preferential tax treatment to a taxpayer who receives damages for a nonphysical injury.147 This assumption is based on the idea that had the taxpayer worked and earned the profits, those profits would be taxable income, and therefore, lost profits should still be taxable income.148 The House assumes that lost profits are typically awarded for nonphysical injuries. However, the House provides no data to support this significant assumption.

Unfortunately, this assumption will lead to inequitable results. For instance, assault and false imprisonment may not involve a physical injury, but the damages a jury awards may not be for lost wages. Accordingly, this award will be taxable income even though the damage award may be compensating a taxpayer for something other than economic loss. In addition, this assumption will lead to a victim of sexual harassment being treated differently by the IRS than a victim of sexual assault. Both taxpayers are victims. Both suffered humiliation. Yet, the taxpayer who is a victim of sexual assault will be far more likely to have a physical injury and thus receive preferential tax treatment. This is an arbitrary distinction, and the "ills of deficit

144. See id.
145. See id.
146. See id. at 143.
147. See id.
148. See id.
spending should not be carried on the backs of those who have been hurt." 149

In addition, the Small Business Act changes the tax treatment of damages received for emotional distress. Under this new treatment, emotional distress is not a physical injury or physical sickness. 150 According to the House Report, emotional distress includes "physical symptoms [such as] insomnia, headaches, and stomach disorders which may result from [the] emotional distress." 151 Therefore, taxpayers cannot use physical manifestations of emotional distress to satisfy the physical injury or physical sickness requirement. However, the amendment continues to exempt from taxation any portion of the emotional distress award actually used to pay for medical care of injuries caused by the emotional distress. 152

Congress intended to clarify the tax treatment of damages by taxing nonphysical injuries. 153 However, the tax treatment of damages should not depend on the arbitrary distinction of whether the taxpayer is fortunate (or unfortunate) enough to have sustained a physical injury. A victim of a dignitary wrong such as sexual harassment has suffered no less of an injury than a taxpayer who broke a leg in a car accident. Furthermore, a victim of sexual harassment might be tormented for years before the taxpayer files suit, while the taxpayer who broke his leg will most likely suffer pain for only a few months. Also, dignitary wrongs such as sexual harassment inflict a pain that is not easily remedied. Consequently, Congress should not treat a taxpayer who is a victim of sexual harassment differently from a taxpayer who is a victim of a car accident.

PART IV

A. The New Amendment Does not Provide Any Guidance in Defining What Constitutes a Personal Physical Injury

The amendment does not define physical injury, and tort victims are left to wonder what exactly constitutes a personal physical injury. Obviously, when there are severe physical signs of an injury a taxpayer will be able to avoid taxation of any damage award. After all, few

149. Anne Scott, A Tax on Sexual Harassment?, BUS. REC., Sept. 9, 1996, at 5.
151. See H.R. REP. NO. 104-586, at 144 n.24 (1996). "The committee intends that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." Id.
would argue that a person who lost a limb or is paralyzed has not suffered a physical injury. However, the harder cases will be those when a taxpayer has received only a minor physical injury, or when a taxpayer has incurred pain without signs of a visible physical injury.

Under the new law, the courts must define physical injury. Assuming the courts will not apply a "facts and circumstances test," as it would be a guaranteed invitation to litigation, courts will undoubtedly develop a legal test to define "physical injury." Because battery is an existing legal principle involving physical contact, the courts might treat physical injury as synonymous with a battery. This approach would treat similarly situated taxpayers identically.

For example, suppose two female employees are sexually assaulted. Whereas the first one struggled with her assailant and received numerous cuts and bruises, the second one did not struggle. The first employee has evidence of a physical injury, but the second employee does not have a single bruise. If physical evidence, such as a scratch or a bruise were required for the section 104 exclusion, the second employee's damage award would be taxable income and the first employee's award would not. However if courts used battery to define physical injury, both employees who suffered identical assaults would be treated identically.

The courts' decision to equate physical injury with a battery would be appropriate in some circumstances. However if courts were to require a battery, a taxpayer who has been verbally sexually harassed will receive different tax treatment than a taxpayer, who has been sexually harassed by being pinched or grabbed. Because both have suffered similar injuries, this seems an arbitrary and illogical distinction.

An additional problem may result if battery is equated with a physical injury. If battery is the standard, courts may apply the offensive battery doctrine to a taxpayer's damage award. Using the offensive battery doctrine, courts have expanded battery so that physical contact is no longer needed. All that is needed is contact with clothing or an object closely identified with the plaintiff's body.\footnote{154 See, e.g., Fisher v. Carrousel Motor Hotel, 424 S.W.2d 627 (Tex. 1967).} If battery were synonymous with physical injury, attorneys could easily bring cases when there was no physical contact and convince a court that a battery occurred. For example, in Fisher v. Carrousel Motor Hotel, the court held that the defendant's touching of the plaintiff's plate while yelling racial epithets was an offensive battery because the
plate was an extension of the plaintiff.\textsuperscript{155} If an attorney is successful in bringing an offensive battery claim, a court will find a battery and the client will avoid taxation of his or her damage award. But, this would defeat the amendment’s requirement of physical injury.

Besides using battery as the legal test, courts might turn to existing statutory definitions. Scattered throughout the United States Code there are various definitions for "physical injury or bodily injury."\textsuperscript{156} For example, title 42, section 13031 of the United States Code, states that a physical injury "includes but is not limited to lacerations, fractured bones, burns, internal injuries, severe bruising or serious bodily harm . . . ."\textsuperscript{157} Likewise title 18, section 1365 of the United States Code, defines bodily injury as "a cut, abrasion, bruise, burn or disfigurement; physical pain; illness; impairment of the function of a bodily member, organ or mental faculty; or any other injury to the body, no matter how temporary . . . ."\textsuperscript{158}

Both definitions are similar and could provide guidance to the courts. The definition found in section 13031 deals with physical injury as it relates to child abuse.\textsuperscript{159} Therefore, it is possible that the courts would be reluctant to apply this definition to the general populace. However, courts might also be reluctant to apply the definition in section 1365 because this section defines bodily injury and not physical injury.\textsuperscript{160} This definition cannot be used unless the courts are willing to equate bodily injury with physical injury. Furthermore, the section 1365 definition includes pain, while section 13031 does not. Accordingly, section 1365 is the broader definition.\textsuperscript{161}

Although a broad definition could defeat Congress’s intent to clarify the tax treatment of damages, the definition in section 1365 is more useful. Under section 1365, a taxpayer will not need to demonstrate physical signs of an injury, but instead the taxpayer could demonstrate that he or she suffered pain as a result of another’s

\textsuperscript{155} Id. at 629.


\textsuperscript{157} 42 U.S.C. § 13031(c)(2) (1994).

\textsuperscript{158} 18 U.S.C.A. § 1365(g)(4) (West Supp. 1997).

\textsuperscript{159} 42 U.S.C. § 13031. Also, 18 U.S.C. § 3509 is entitled Child Victims’ and Child Witnesses’ Rights. Because it also deals with physical injury to children and because the language defining physical injury is identical to § 13031, these sections are treated as one in the discussion.

\textsuperscript{160} 18 U.S.C. § 1365.

\textsuperscript{161} Id.; 42 U.S.C. § 13031.
tortious actions.162 For example, a taxpayer who suffered whiplash or a soft tissue injury in an automobile accident might not have evidence of a physical injury. Nonetheless, the taxpayer was injured. Under the broader definition of section 1365, the taxpayer's pain would be the result of a bodily/physical injury. Hence, the taxpayer's damages would fall under the section 104 exclusion.

Notwithstanding the broad definition in section 1365, courts will still be able to draw arbitrary distinctions. The taxpayer who is sexually assaulted will receive greater preferential tax treatment than a victim of sexual harassment. The broader definition will still exclude those taxpayers who have suffered dignitary wrongs without sustaining signs of a physical injury. Inevitably, Congress must make choices, and those choices can lead to arbitrary distinctions. However, a distinction based on the nature of the injury is a poor choice.

Congress's amendment will not clarify the tax treatment of damages. Although Congress has narrowed the section 104 exclusion to require a physical injury, courts are left to define physical injury. Consequently, there will be more litigation on this issue. Furthermore, avoidance of taxation creates a huge incentive for taxpayers and attorneys to fit their claim under the section 104 exclusion. Therefore, as long as the tax treatment of damages depends on arbitrary distinctions, this tax issue will be heavily litigated.

B. The Tax Treatment of Emotional Distress Damages Should not Depend on Whether the Taxpayer Suffered a Physical Injury

The Small Business Act also amends the tax treatment of damages received for emotional distress,163 by including those damages as taxable income.164 A mental injury is treated as something less than a physical injury. Thus, even if the taxpayer suffers severe physical injury as a result of the emotional distress, the taxpayer's damages will still be taxable income. The tax code should not treat the taxpayer who suffers a broken leg any differently than the taxpayer who, as a result of sexual harassment, suffers from an ulcer and migraine headaches. Both victims have suffered physical injuries and pain as a result of tortious or illegal conduct.

The new law specifically addresses emotional distress that causes a physical injury. However, the new law does not address the situation when the taxpayer has both a physical injury and emotional distress.

162. 18 U.S.C. § 1365(g)(4).
164. See id.
The House Report states that any damages that flow from a physical injury are excluded from gross income. Accordingly, if the taxpayer can demonstrate that the emotional distress flowed from the physical injury, section 104 should exclude the damage award from income.

Consider, for example, a taxpayer who is seriously injured in a car accident. He has a broken neck, broken arms and legs, and cannot move. His child is in the passenger seat, also seriously injured. Because of his injuries, he cannot go to the aid of his child and must sit there and watch his child die. The taxpayer has suffered emotional distress because he has been unable to assist his child and has had to watch his child die. The emotional distress flowed from the physical injury because if he had not been injured, he might have been able to help his child. Consequently, section 104 should exclude his damages from taxable income.

C. The Tax Treatment of Damages Should Depend on the Type of Award, not the Type of Claim

Instead of focusing on the taxpayer’s injury or lack thereof, one possible solution would be for Congress to focus on the type of damage award received. Section 104 should draw a distinction between damages reimbursing the taxpayer for an economic loss and damages reimbursing the taxpayer for a personal loss. Furthermore, section 104 should identify those damage awards that will be taxable income. For instance, lost profits and back pay would be legitimate sources of revenue. In addition, section 104 should list those damages that will not be taxable income, such as compensatory damages like emotional distress and pain and suffering.

Section 104 should exclude from taxable income all compensatory damages. By their nature, compensatory damages are compensation to make the taxpayer whole. Compensatory damages are not an "accession to wealth." Thus, they do not meet this definition of income and should not be taxed. Furthermore, an exclusion for

166. See H.R. Conf. Rep. No. 104-737, at 301 (1996), reprinted in 1996 U.S.C.C.A.N. 1677, 1793 (stating that "the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness"). Id.
compensatory damages could be explained by the policy considerations discussed in Part I.\textsuperscript{169}

First, under the return of capital theory, compensatory damages would compensate taxpayers for loss of their human capital of mental and physical well-being. Thus, a damage award is a return of capital and should be excluded from income. Second, the compassion or humanitarianism policy that a taxpayer has suffered enough would justify excluding all compensatory damages from income. Third, because compensatory damages may compensate a taxpayer for an intangible, the imputed income theory is justified. Fourth, because the taxpayer is a victim of an involuntary transaction the taxpayer's damage award will not be taxed. Fifth, bunching of income would not be a concern because a taxpayer would not have taxable income from the damage award. In sum, the several policy considerations together support an exclusion for compensatory damages.

Moreover, taxing economic loss and excluding all compensatory damages would better promote tax policy considerations. As discussed, income is often defined as an "accession to wealth."\textsuperscript{170} Compensatory damages are not an "accession to wealth" because an award for damages reimburses the taxpayer for a personal loss and does not increase the value of the taxpayer's mental or physical health. However, while economic damages, such as back pay and profits, also reimburse a taxpayer, these damages are indeed an "accession to wealth." Had a taxpayer not been injured, the taxpayer would have earned the same amount as the taxpayer was awarded in back pay. If economic loss were not taxable, a taxpayer would pay less in taxes than a taxpayer who received the same amount from working. A taxpayer should not be put in a better tax position because the taxpayer was injured.

The tax treatment of damages should depend on the type of damage award received and not on the type of claim. Under this system, attorneys might seek compensatory damages instead of economic damages because compensatory damages would not be taxable. However, even if attorneys were to seek higher compensatory damages, this might lead to positive results. Different tax treatment for different damages will give attorneys an incentive to allocate the damage awards in order to avoid taxation.

In settlements, attorneys can distinguish between compensatory and economic damages. If settlement agreements were to result in
lower taxes, plaintiffs would have a strong incentive to settle. This would result in less litigation, emptier dockets, and lower court expenses. The savings in court costs might offset any revenue the government would lose in taxes. And, if there were obvious abuses in the settlement process, the IRS could look to the substance of the transaction rather than the form of the transaction.\textsuperscript{171}

**CONCLUSION**

The new law does not prevent that which Congress sought to fix. Under the new law, the tax treatment of damages will still depend on the nature of the claim. The taxpayer will have to establish a physical injury or physical sickness. This will lead to arbitrary distinctions and inequitable results. Furthermore, if it is possible to legally avoid taxation of damage awards, this avoidance will provide a significant incentive for astute attorneys to creatively argue that their clients suffered physical injuries.

Instead of focusing on what types of injuries will lead to taxable income, Congress should focus on the true problem: the inherent contradiction in taxing compensatory damages. Accordingly, only damages for economic loss should be taxable income.

\textsuperscript{171} See Diedrich v. Commissioner, 457 U.S. 191, 195-96 (1982) (holding that the substance, not the form of the transaction controls in determining whether taxable income was realized); see also Crane v. Commissioner, 331 U.S. 1, 14 (1947) (recognized as holding that the substance, not the form of the transaction governs the tax consequences).