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## Arguably Arbitrary: Taxation and the Physical Injury Requirement of I.R.C. Section 104(a)(2)

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# ARGUABLY ARBITRARY: TAXATION AND THE PHYSICAL INJURY REQUIREMENT OF I.R.C. SECTION 104(a)(2)

*There will always be death and taxes; however, death doesn't get  
worse every year.*

–Unknown

To the average taxpayer, the appropriation of his hard-earned income by the government is unpleasant enough without arbitrarily having to pay tax on something on which his neighbor does not. When dealing with section 104(a)(2) of the Internal Revenue Code, however, this is exactly what happens. This provision and the arbitrariness in taxation it causes will be the focus of this Note.

Ben Franklin once echoed the sentiment towards taxation common to many taxpayers when he observed that life comes with but two equally unpleasant guarantees: death and taxes. If this is the case, then one can blame Article I, section 8 of the U.S. Constitution for bestowing upon Congress the authority to effect the taxes.<sup>1</sup> Congress primarily exercises this power through the Internal Revenue Code, and with this power Congress possesses the ability to tax American citizens in ways it sees fit. Although many of the Code's provisions for distributing the tax burden are straightforward and well thought out, some have characteristics the purpose of which is at best ambiguous and at worst arbitrary and harmful. The latter is the case with the modern version of I.R.C. section 104(a)(2), which until 1996 allowed a taxpayer to exclude from income any amount received on account of a "personal" injury.<sup>2</sup> That year, however, Congress

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<sup>1</sup> U.S. CONST. art. I, § 8 ("Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States . . ."). Of equal importance is the Sixteenth Amendment to the Constitution, which authorizes Congress to tax incomes. *See* U.S. CONST. amend. XVI.

<sup>2</sup> I.R.C. § 104(a)(2) (1995).

amended the statute to allow exclusion from income only of recoveries for physical personal injury.<sup>3</sup> In the following pages, this Note will argue that this addition was ill-advised and that a better approach would be to return the provision to its previous form.

The bases for this proposal are numerous. Because of inherent ambiguities involving the nature and requisite degree of physical injury as well as its relation to nonphysical harm, the amended section 104(a)(2) creates the potential for arbitrary treatment of tort victims by the courts.<sup>4</sup> More fundamentally, however, the addition of a physical injury requirement to the statute causes it to deviate from its underpinnings in the concepts of human capital and traditional tort in which it has long found justification. Because of this lack of support, distinguishing between those who have suffered a physical harm and those whose injury is intangible is by definition arbitrary.

To put these contentions in the proper context, Part I of this Note serves to define the scope of the argument as well as present hypothetical cases that suggest some of the potential issues involved. Part II illustrates the underlying purpose of section 104(a)(2) by examining traditional rationales for its existence while acknowledging some of the inherent flaws of those rationales. Part III chronicles the history behind the statute's creation and evolution, while Part IV examines the legislative history behind the 1996 addition of the physical injury requirement. Part V views the modern provision in light of its traditional justifications and asks whether these reasons still work in light of a physical injury requirement. Part VI, in turn, looks to the statute's roots in traditional notions of tort and asks whether a physical injury requirement is consistent with this heritage. After concluding that such is not the case, Part VII will examine the relevance of this lack of support from either traditional justifications or basic tort law. Finally, Part VIII considers alternatives to the modern statute before reiterating that a return to its previous form is in order.

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<sup>3</sup> I.R.C. § 104(a)(2) (2004). Although it is outside of the scope of this Note, it is worth noting that a taxpayer whose recovery does not qualify for exclusion under section 104(a)(2) may have another option. In 1974, the Treasury issued Revenue Ruling 74-77, which held that a recovery for a claim of alienation of affection did not constitute income. Rev. Rul. 74-77, 1974-1 C.B. 33. Curiously, the ruling made no mention of section 104(a)(2) in reaching its conclusion, and it has never been officially revoked. *Id.*

<sup>4</sup> Or by the IRS in those cases that do not create litigation.

## I. SCOPE OF NOTE AND POTENTIAL ISSUES

### A. Scope

Since the 1996 enactment of the Small Business Protection Act,<sup>5</sup> section 104(a)(2) has excluded from income, and thus taxation, “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<sup>6</sup> personal physical injuries or physical sickness.”<sup>7</sup> The key addition provided by the Act was, of course, the requirement that any harm be physical in nature in order for a recovery on its behalf to be excludable from taxable income.<sup>8</sup>

Attempts at exclusion from taxation under section 104(a)(2) tend to fall into one of two categories. In the first instance, the recovery at issue is received as compensation for a traditional tortious injury—auto accident, wrongful death, defamation, or the like.<sup>9</sup> The second kind of situation involves amounts received for civil rights violations, such as discrimination and other statutorily-created harms. Generally, suits in this second category are filed against current or former employers; the point at issue in those cases is whether the recovery in question represents back or lost wages on one hand or compensation for a personal injury (for example, discrimination) on the other.<sup>10</sup>

Both types of situations raise unique issues.<sup>11</sup> The civil rights type cases are more straightforward as recoveries and are usually classified

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<sup>5</sup> Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755 (1996).

<sup>6</sup> For a discussion on the nature of the “on account of” requirement, see *infra* Part III.

<sup>7</sup> I.R.C. § 104(a)(2) (2004).

<sup>8</sup> See I.R.C. § 104(a)(2) (2004). The previous version of the statute likewise had been in place only since 1989 and will be discussed *infra*. See I.R.C. § 104(a)(2) (1995).

<sup>9</sup> See, e.g., *Francisco v. United States*, 267 F.3d 303 (3d Cir. 2001) (dealing with recovery from an auto accident; dispute over portion of recovery attributable to “delay damages”); *Chamberlain v. United States*, 286 F. Supp. 2d 764 (E.D. La. 2003) (involving swimming injury caused by another’s negligence; dispute over interest income); *Kovacs v. Comm’r*, 100 T.C. 124 (1993) (dealing with a wrongful death action; dispute over interest income).

<sup>10</sup> See, e.g., *Comm’r v. Schleier*, 515 U.S. 323 (1995) (examining taxability of recovery obtained under Age Discrimination in Employment Act); *United States v. Burke*, 504 U.S. 229, 233 (1992) (questioning taxability of back pay received for sex discrimination); *Young v. United States*, 332 F.3d 893 (6th Cir. 2003) (holding that a settlement from employer for lost wages, humiliation, embarrassment, and so forth was taxable; moreover, the physical injury requirement of section 104(a)(2) was not a violation of the Fifth Amendment’s equal protection requirement).

<sup>11</sup> One well-covered topic not pertinent here is the taxability of contingent attorney’s fees paid out of such recoveries. For an overview of some of the general issues, see Karl L. Marschel, Note, *It’s a Property Issue: The Proper Treatment of Contingent Fees Under the Federal Tax Code*, 11 WASH. U. J.L. & POL’Y 323 (2003).

as back wages, thus making the nature of the injury itself irrelevant.<sup>12</sup> The issues involved in the other category of cases—those that involve a traditional tortious injury—are not as clear-cut, however. As a result, this Note will focus on these cases, for it is in such instances that the true problems caused by adding a physical injury requirement to section 104(a)(2) come to light.<sup>13</sup>

Although a physical injury requirement would initially seem to provide a clear definition of, perhaps even a bright-line rule for, which kinds of awards for traditionally tortious injuries beget taxable compensation and which do not, upon closer inspection this is not the case. For instance, what degree of physical injury is required for exemption under the statute? Is mere pain enough? Or is something more required, such as a broken bone? What about a situation where what is initially a nonphysical harm (say, defamation) eventually leads to physical injury or sickness? These are important questions, and as will be illustrated in this Note, they expose a rift created between the current section 104(a)(2) and the traditional justifications for its existence. This deviation and the ensuing ambiguity in the tax code create the undesirable potential for arbitrary treatment of taxpayers and therefore require change.

Just as important as the problems raised, however, is the existence of potential alternatives: while the current version of the statute leaves something to be desired, is there a better option? As litigation in the area is sparse,<sup>14</sup> these are but a few of the questions that have yet to be answered in regards to section 104(a)(2). In proposing that Congress return the statute to its pre-1996 form, this Note will highlight and attempt to address the importance of these issues.

### B. Hypothetical Situations

Perhaps the best way to understand some of the issues raised by the physical injury requirement of section 104(a)(2) is to consider what might happen in hypothetical situations. Consider the following scenarios as the Note progresses; the discussion will return to these cases later.

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<sup>12</sup> See *Burke*, 504 U.S. at 242 (holding that award received was for back pay and not discrimination). The result in *Burke* is typical for this kind of case. Further, Congress has made it clear that such recoveries of wages are to be included in income. See *infra* Part IV.

<sup>13</sup> Note that the facts of some of the cases analyzed deal with civil rights type recoveries, but the substantive law is applicable to both categories of cases. Further, the requirement that an injury be "personal" is common to any excludable recovery under section 104(a)(2). Thus, for the purposes of this Note, nonphysical harms such as contractual and property damages are irrelevant.

<sup>14</sup> For more on the possible significance of this, see *infra* Part VII.

Charlie Rogers was a respected second-grade teacher at an elementary school where he had been employed for a number of years. He lived in a small Ohio town, and due to his tenure as an educator was well-known throughout the community. Not everyone liked Charlie, however, and a disgruntled parent made a convincing (albeit totally false) case to the local newspaper that Mr. Rogers was actually a sexual predator. Because of Charlie's position and the closeness of the community, the ensuing story caused quite an uproar. Before an investigation could clear Charlie's name, students' parents demanded that the formerly esteemed educator be removed from his position. Charlie was forced to resign soon thereafter.

Although subsequent inquiry revealed Charlie's innocence of any wrongdoing, the damage had been done. He had lost both the job he loved and his only source of income. Furthermore, enough suspicion remained in parents' minds to prevent any local school from rehiring him. As bills mounted and Charlie unsuccessfully tried to find work and reconcile with the community, the stress took its toll and he succumbed to a long bout of pneumonia. In the meantime, he successfully sued both the town newspaper and complaining parent for defamation.

Charlie's friend, Abe Wilson, likewise had a tumultuous year. While walking his dog early one morning, Abe was hit by a drunk driver. The accident left Abe a paraplegic, and although this did not affect his ability to work, it greatly affected his lifestyle. Abe sued for the injury and recovered a handsome award from the driver's insurer.

Like Charlie and Abe, Jane Doe did not have the best of years. As she was an aging widow and avid pianist, most of Jane's pleasure in life came from charitably tutoring local children on how to play her favorite instrument. While walking early one evening, however, she was also hit by a drunk driver returning from the local watering hole. The accident crushed most of the bones in her right hand, and, although pins and multiple surgeries eventually allowed her to perform common tasks, she could never play the piano with the hand again. Jane sued the driver and recovered for her medical bills as well as the emotional distress caused by being deprived of her primary joy in life.

Notwithstanding the common specters of misfortune and litigation, the situations of these three people seem at first quite disparate. Section 104(a)(2), however, serves as the glue that binds them. As all three parties received recoveries for some legal harm, all of the compensation given as a result of their injuries is potentially excludable from taxable income under that section. The initial results of the hy-

pothetical cases may be similar in that the victims all recovered for their injuries; likewise, the taxability of each recovery is subject to the same statute. As will come to light throughout the course of this Note, however, the current version of section 104(a)(2)'s physical injury requirement could cause each party to find him- or herself with different, if not questionable, results.

## II. RATIONALE FOR EXCLUSION FROM INCOME UNDER SECTION 104(a)(2)

A necessary first step towards evaluating the validity and efficacy of any statute is consideration of the purpose that the provision aims to serve. In the case of section 104(a)(2), the statute has traditionally relied on the theory of human capital to justify its existence,<sup>15</sup> although an argument can also be made that the provision is simply the result of Congress's wanting to act kindly towards victims.<sup>16</sup>

### A. *Kindness to the Victim*

The simpler of the two approaches—the idea of kindness towards injury victims—is straightforward enough. Reasoning in this case suggests that, although a victim has recovered for his injuries, he has nonetheless suffered a wrong to his person. As such, the government should not add to his troubles by sending the tax collector to his door. As will be illustrated subsequently, this view roughly comports with section 104(a)(2) but falls apart when Congress begins to distinguish harms that are excludable under the statute from those that are not.

### B. *Restoration of Human Capital*

#### 1. *Background*

While the notion of kindness by Congress is helpful as a basic explanation for section 104(a)(2), throughout its existence the policy behind the provision has primarily been attributed to the theory of restoration of human capital.<sup>17</sup> Human capital is in turn a variation on

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<sup>15</sup> *O'Gilvie v. United States*, 519 U.S. 79, 85 (1996) (acknowledging that Congress likely sought to codify the theory of human capital in enacting the provision).

<sup>16</sup> Note that these are not necessarily mutually exclusive. See F. Philip Manns, Jr., *Restoring Tortiously Damaged Human Capital Tax-Free Under Internal Revenue Code Section 104(a)(2)'s New Physical Injury Requirement*, 46 BUFF. L. REV. 347, 354 (1998). Professor Manns suggests that when and even if kindness is the underlying policy behind section 104(a)(2), that kindness dissipates when the parties have a preexisting economic relationship. *Id.*

<sup>17</sup> *O'Gilvie*, 519 U.S. at 85.

the concept of return of capital, itself a common concept in tax law.<sup>18</sup> Before even considering the theory of *human* capital, as such, one must first understand the concept of return of capital and its relation to taxation.

One of the fundamental notions of taxation is that for a taxpayer to have income he must have enjoyed some sort of gain; otherwise, there would be nothing to tax.<sup>19</sup> Under the Supreme Court's holding in *Commissioner v. Glenshaw Glass Co.*,<sup>20</sup> income was defined as any "accession[] to wealth, clearly realized, and over which the taxpayer[] [has] complete dominion."<sup>21</sup> Essentially, to determine whether an amount received is income under *Glenshaw Glass*, it must be considered whether the sum is actually an addition to what the taxpayer previously possessed that has left him in a better position than that in which he started. If that is the case, the recovery would be income and taxable (in theory, at least); if not, it would not be beyond the reach of the IRS.

The return of capital theory, with which the concept of human capital is closely related, fits comfortably with the *Glenshaw Glass* holding and is actually quite simple. Under this theory, when a taxpayer loses an asset—for example, a building burns down—and subsequently gets that capital (or its equivalent) back through insurance proceeds, damages from litigation, or some other means, he has not been placed in a better position than before or received any income.<sup>22</sup> To the extent that it replaced his basis in the property, the "gain" enjoyed by the taxpayer in such a situation is only a substitute that returned him to the position in which he found himself before losing the capital. Thus, the logic goes, why tax him on it? Clearly, there is no accession to wealth.

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<sup>18</sup> See 31 Op. Att'y Gen. 304, 307–08 (1918) ("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."). *But see* Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical but Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51, 64 (1997). Professor Hobbs questions the basis for the Attorney General's opinion, suggesting that the relationship between 104(a)(2) (and its predecessors) and the theory of human capital may have gotten off to a rocky start. *Id.* Still, the theory appears to be the most prevalent and most logical basis for 104(a)(2), and this Note will so argue.

<sup>19</sup> WILLIAM D. ANDREWS, *BASIC FEDERAL INCOME TAXATION* 77 (5th ed. 1999) (noting that "[a] central defining characteristic of income is gain").

<sup>20</sup> 348 U.S. 426 (1955).

<sup>21</sup> *Id.* at 431. Note that this definition of income is not exclusive—the Supreme Court's actual holding was "[h]ere we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.*

<sup>22</sup> Note that this is applicable only to the extent that payment received replaces the taxpayer's cost basis in the capital. Any recovery received *beyond* that amount will generally be a taxable gain.



The theory of human capital is analogous to the concept of return of capital. Under the human capital theory, every person has "capital" in his own body and person. When one is injured, he is deprived of use of that capital for some period of time (if not permanently) much in the same way that a building owner whose facility burns down can no longer use the premises. As such, when an injured person receives compensation for an injury—whether through insurance payments or damages received through litigation—the amount should not be taxable as it basically functions to "restore" the person to his former state.<sup>23</sup>

## 2. *Flaws with the Theory*

Although the theory of restoration of human capital is the best available to justify section 104(a)(2), it is admittedly not perfect. Two issues exist with the theory, with each one raising unique issues. First is the question of where human capital is actually created. Second, and more fundamental, is the matter of what actually makes up "human capital."

### a. *Where is human capital created?*

Three potential explanations exist as to the origins of human capital. First, one could argue that every person is born with a fixed amount of capital of which he can subsequently be deprived through injury.<sup>24</sup> The problem with this idea, of course, is that it would result in one experiencing a *Glenshaw Glass* accession to wealth immediately upon birth.<sup>25</sup> One commentator aptly summed up the situation potentially arising from such a concept of capital: "[b]esides being ludicrous, taxing an individual at birth would resemble a capitation or head tax that would have to be apportioned under the Constitution."<sup>26</sup>

A second explanation for the origin of human capital posits that one is born with a small amount that increases as the person matures.<sup>27</sup> This view suggests that through education, physical growth and experience and other "assets" bestowed by parents and others, a person's level of human capital increases with maturity. As much of

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<sup>23</sup> This assumes, of course, that substitution for one kind of asset (cash) for another (bodily integrity) is acceptable.

<sup>24</sup> One problem with this idea: what about the handicapped? Are they simply born with less human capital than others and thus any compensation for injury would be more likely to be income? This is unclear.

<sup>25</sup> Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U. L. REV. 61, 63 (1997).

<sup>26</sup> *Id.*

<sup>27</sup> The credit for this idea goes to my advisor, Prof. Dale Nance.

what might be considered human capital (either in terms of physical strength, skills or other “assets”) accrues over time and not immediately upon birth, this seems a more plausible explanation than the first approach.

A third theory as to the origin of human capital holds that the cost of human capital is actually zero and thus any recovery for injury constitutes income.<sup>28</sup> The very existence of the physical injury exclusion under section 104(a)(2), however, suggests that this concept has not found its way into the tax code.<sup>29</sup> Regardless of which theory for human capital’s origin one accepts, as of 2005, the Internal Revenue Code contained no specific provisions requiring taxation of the human capital bestowed upon one at birth *or* accrual, so for now this point seems moot.<sup>30</sup>

*b. What is “human capital”?*

The second issue with human capital, and one that brightly illuminates a schism between post-1996 tax treatment of injury under section 104(a)(2) and the theory itself, is determining what exactly constitutes human capital. If one accepts that a taxpayer has capital in his own body, it follows that a person also has capital in his mind and the synapses and neurons that make it work. Damage to one’s mental functions—for example, emotional damage—would thus be a loss of capital.<sup>31</sup> As such, payment for emotional distress should constitute a nontaxable return of human capital. Section 104(a) specifically provides that such recoveries are not excludable under the provision, however.<sup>32</sup> Likewise, one can argue that a taxpayer has capital in his reputation. Thus, in such a scheme damages received on account of

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<sup>28</sup> Hobbs, *supra* note 19, at 64.

<sup>29</sup> Admittedly, this argument cuts both ways: the provision’s existence could suggest either a recognition that there is simply no gain when one recovers for injury, or, on the other hand, that there is a gain but Congress felt some need to exclude the gain from taxation. This Note will assume that the former is the case.

<sup>30</sup> Although section 61 of the Code specifically declares what kinds of gains can constitute income, the list is not exclusive. See I.R.C. § 61 (2004). To the best of this author’s knowledge, however, no court has ever held that one incurs a liability to the IRS upon emerging from the womb, nor has the issue even arisen. Further, the administrative problems in trying to quantify additions to human capital for the purpose of taxation would be overwhelming and likely quite arbitrary.

<sup>31</sup> Not only would such harm be a loss of human capital, such injury generally coincides with actual physical changes in the body. For more on this point, see *infra* Part V.

<sup>32</sup> I.R.C. § 104(a) (2004) (“For purposes of [damages received on account of personal physical injuries or physical sickness], emotional distress shall not be treated as a physical injury or physical sickness.”). Keep in mind that just because a recovery does not fall under the provision does not necessarily mean that it is automatically taxable. In theory, other means of avoiding taxation may exist but they are beyond the scope of this Note.

harm to one's reputation through defamation or other dignitary torts should be a return of human capital.<sup>33</sup>

This is not the approach taken by the Internal Revenue Code, however. The questions thus present themselves: how did the statute reach its current state? Perhaps more important, *why* has it deviated from what was an apparent foundation in a pure theory of restoration of human capital?<sup>34</sup>

### III. A BRIEF HISTORY OF TAXING COMPENSATION RECEIVED FOR INJURY: HOW WE ARRIVED AT THE PRESENT-DAY SECTION 104(a)(2)

By examining how and why section 104(a)(2) reached its present state, one can begin to understand the problems with the current version of the provision. When determining what may or should be excluded from taxable income by section 104(a)(2), it is likewise important to consider what exactly constitutes income in the first place. The Supreme Court provided a useful definition of income when it stated that

[t]he definition of gross income under the Internal Revenue Code sweeps broadly. Section 61(a) provides that "gross income means all income from whatever source derived," subject only to the exclusions specifically enumerated elsewhere in the Code. As this Court has recognized, Congress intended through § 61(a) and its statutory precursors to exert "the full measure of its taxing power," and to bring within the definition of income any "accession to wealth [clearly realized, and over which the taxpayer[] ha[s] complete dominion]."<sup>35</sup>

With this in mind, in making changes to the Internal Revenue Code Congress must consider the question: what *should* constitute income? Because Congress writes the Code and can essentially exempt from taxation whatever it pleases, the answer to this question can vary—and has done so—along with the policies motivating the legislature.

Section 104(a)(2) and its predecessors fit into the scheme of defining income by attempting to clarify what should and what should not be taxable when compensation is received for some tortious injury, be it physical or otherwise. The statute's predecessors date as far back

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<sup>33</sup> Doti, *supra* note 26, at 64 (arguing that "the victim's untainted reputation in the community is no less a birthright than an uninjured body and mind").

<sup>34</sup> The implications of the theory on how section 104(a)(2) should treat taxpayers is considered *infra* Part VIII.

<sup>35</sup> *United States v. Burke*, 504 U.S. 229, 233 (1992) (citations omitted).

as 1918. Importantly, earlier in that same year the Attorney General had issued an opinion suggesting that insurance proceeds received from an accident should not be taxable. In doing so, he discussed the idea that insurance proceeds were really a return of capital:

[I]n 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.<sup>36</sup>

This philosophy was essentially codified by Congress when, later that year, it enacted the Revenue Act of 1918,<sup>37</sup> and gives credence to the notion that, from its inception, section 104(a)(2) has been based on the concept of restoration of human capital.<sup>38</sup>

A few years later, in 1920, the Supreme Court decided *Glenshaw*'s predecessor, *Eisner v. Macomber*.<sup>39</sup> In holding that a stock dividend paid by a corporation was not taxable, the Court defined income as gain received “from capital, from labor, or from both combined.”<sup>40</sup> This view of income persisted for nearly four decades, when the Court finally changed its stance in *Glenshaw Glass*.

When the Supreme Court decided *Glenshaw Glass*, not only did it provide a definition of income that stands to this day—any clearly realized accession to wealth over which the taxpayer has complete dominion—it also judicially sanctioned the idea of return of human capital as a rationale for excluding personal injury recoveries from taxation.<sup>41</sup> At the time, compensation for nonphysical personal inju-

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<sup>36</sup> 31 Op. Att’y Gen. 304, 308 (1918). *But see* Hobbs, *supra* note 19, at 64 (arguing that “[a]lthough the Attorney General’s human capital approach to accident recoveries may have had merit in the abstract, the theory was unsupported by existing tax doctrine.”); Doti, *supra* note 26, at 65 (also noting a “misunderstanding” starting with the opinion).

<sup>37</sup> Revenue Act of 1918 §213(b)(6), 40 Stat. 1057, 1066 (1918). The Act excluded “[a]mounts received, through accident or health insurance or under workman’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.” *Id.* *See also* O’Gilvie v. United States, 519 U.S. 79, 85 (1996) (suggesting that Congress sought to codify this approach).

<sup>38</sup> Hobbs, *supra* note 19, at 65 (suggesting that “[i]t is clear from the single paragraph of legislative history accompanying the provision that Congress was simply incorporating into the Code the Treasury’s treatment of such amounts [the Treasury’s behavior having been influenced by the Attorney General’s opinion]”).

<sup>39</sup> 252 U.S. 189 (1920).

<sup>40</sup> *Id.* at 207. The Court reasoned that because the stock dividend lowered the value of the shares themselves, there was no gain or loss in terms of the shareholders’ overall wealth. *Id.*

<sup>41</sup> *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

ries was exempt from taxation (albeit not statutorily).<sup>42</sup> Because this nonphysical exemption was based on *Macomber's* much narrower concept of income, *Glenshaw Glass* provided an opportunity to reconsider the validity of the exception, should the Supreme Court question it.<sup>43</sup> This did not happen, however. Shortly after the Court's decision in *Glenshaw Glass*, in fact, the Internal Revenue Service issued numerous revenue rulings on the subject. Although none of these rulings explicitly mentioned *Glenshaw Glass* by name, the Service reiterated its position that recovery for nonphysical personal injury was not taxable.<sup>44</sup>

Although the exemption of nonphysical injuries from taxation remained relegated to case law and revenue rulings for a number of years, in 1983 the Ninth Circuit effectively merged the nonstatutory exclusion with its physical injury statute-based cousin in *Roemer v. Commissioner*.<sup>45</sup> In *Roemer*, an insurance agent sued a credit company for issuing a defamatory report and was awarded damages by a jury.<sup>46</sup> In holding against the taxpayer, the Tax Court distinguished between harm to personal and harm to business reputation.<sup>47</sup> The Ninth Circuit found this distinction improper and further found that the Tax Court's decision "illogically distinguishes physical from non-physical personal injuries."<sup>48</sup> The court went on to add that

[t]he relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries. I.R.C. § 104(a)(2) states that damages received on account of *personal* injuries are excludable; it says nothing about physical injuries . . . . The ordinary meaning of a personal injury is not limited to a physical one.<sup>49</sup>

Other courts quickly adopted the Ninth Circuit's position, even though Congress had yet to expressly codify this view by making the nonphysical exception statutory.<sup>50</sup>

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<sup>42</sup> Hobbs, *supra* note 19, at 70.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* (citing numerous Revenue Rulings from 1955 through 1958). Among other things, Hobbs points out that these rulings excluded from income sums received by former World War II POWs for violations of the Geneva convention as well as for prisoners involved in the Korean War. *Id.*

<sup>45</sup> 716 F.2d 693 (9th Cir. 1983).

<sup>46</sup> *Id.*

<sup>47</sup> *Roemer v. Comm'r*, 79 T.C. 398, 405 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

<sup>48</sup> *Roemer*, 716 F.2d at 697.

<sup>49</sup> *Id.*

<sup>50</sup> Hobbs, *supra* note 19, at 74.

In 1989, however, Congress finally addressed the courts' view of physical and nonphysical injury exclusion when the House of Representatives proposed an amendment to section 104(a)(2). The change would have limited exclusion from taxation to compensation received for "personal injuries or sickness in a case involving *physical* injury or sickness."<sup>51</sup> As such, the conference committee considering the report found that the exclusion should not apply "where no physical sickness or injury is involved."<sup>52</sup>

The committee, however, eventually decided on an amendment with a result that has been described as having "achieved expansion by contraction."<sup>53</sup> Instead of an explicit limitation to physical injury, the final version of the Omnibus Budget Reconciliation Act of 1989 added that section 104(a)(2) "shall not apply to any *punitive* damages in connection with a case not involving physical injury or physical sickness."<sup>54</sup> Thus, by making only *punitive* damages for nonphysical injuries taxable, Congress implicitly allowed section 104(a)(2) to cover—and thus exempt from taxation—compensatory damages for nonphysical injuries. Further, any court examining the legislative history of the amendment would see the failed attempt to limit the exclusion to recoveries for physical injury, and could thus reasonably believe that Congress's intent was to include *all* recoveries for injury in the exclusion. The courts that interpreted the amendment did exactly this, and those that had not done so already proceeded to embrace the Ninth Circuit's approach in *Roemer*.<sup>55</sup>

Although it has never explicitly defined what constituted a physical injury, the Supreme Court weighed in on the scope of section 104(a)(2) two times between 1989 and the provision's eventual amendment in 1996. Both of these cases, and another heard following the 1996 amendment, would have an important effect on how the provision was viewed and its application.

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<sup>51</sup> H.R. 3299, 101st Cong. (1st Sess. 1989) (emphasis added). At the time, the statute allowed exclusion from taxation of recoveries received on account of "personal injuries or sickness." The proposed amendment would simply have changed this to recoveries received on account of "personal injuries or sickness in a case involving physical injury or physical sickness." *Id.*

<sup>52</sup> H.R. REP. NO. 101-247, at 1355 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2825.

<sup>53</sup> Hobbs, *supra* note 19, at 75.

<sup>54</sup> Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 7641(a), 103 Stat. 2106, 2379 (1989) (emphasis added).

<sup>55</sup> Hobbs, *supra* note 19, at 77.

### A. *United States v. Burke: Establishing the "Tort-Like" Requirement*

In *United States v. Burke*,<sup>56</sup> the Supreme Court took a key step by formally approving a link between section 104(a)(2) and traditional tort principles. *Burke* involved taxpayers who had been awarded back pay for sex discrimination under the pre-1991 version of Title VII, and the IRS had denied the taxpayers a refund for taxes paid on their recoveries.<sup>57</sup> In its analysis, the Court noted that IRS regulations formally linked identification of a "personal injury" (the "physical" requirement had not yet been added to the statute) for purposes of section 104(a)(2) to traditional tort principles, saying such an action must be based on "tort or tort type rights."<sup>58</sup> Even though the court examined the basic definition of a tort, an action based on tort should, the Court concluded, be identified through the remedies available to the plaintiff. Further, the Court noted that Title VII did not compensate for "pain and suffering, emotional distress, harm to reputation, or other consequential damages."<sup>59</sup>

In the immediate case, Title VII did not entitle the taxpayers to what the Court considered traditional tort remedies: trial by jury, compensatory or punitive damages.<sup>60</sup> Because Title VII provided none of these, the court found the plaintiffs' recovery not tort-like and thus includable in income.<sup>61</sup> Importantly, however, the Court had formally acknowledged section 104(a)(2)'s roots in traditional principles of tort, and notably required an action to be tort-like in order for its resulting proceeds to be excludable under the statute.

### B. *Commissioner v. Schleier: Adding a Causation Requirement*

A mere two years after *Burke*, the Supreme Court heard another section 104(a)(2) case in *Commissioner v. Schleier*.<sup>62</sup> In *Schleier*, the Court revisited *Burke* and attempted to clarify its earlier holding by declaring that the tort-type requirement for excludability was actually the first prong in a two-part test. Specifically, the court held that

though *Burke* relied on Title VII's failure to qualify as an action based upon tort type rights, we did not intend to eliminate the basic requirement found in both the statute and the

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<sup>56</sup> 504 U.S. 229 (1992).

<sup>57</sup> The older version of the statute allowed only for back pay damages; the later amended version provided for both compensatory and punitive damages. *Id.* at 232.

<sup>58</sup> *Id.* at 234.

<sup>59</sup> *Id.* at 239.

<sup>60</sup> *Id.* at 238.

<sup>61</sup> *Id.* at 242.

<sup>62</sup> 515 U.S. 323 (1995).

regulation that only amounts received "on account of personal injuries or sickness" come within § 104(a)(2)'s exclusion. Thus, though satisfaction of *Burke's* "tort or tort type" inquiry is a necessary condition for excludability under § 104(a)(2), it is not a sufficient condition.<sup>63</sup>

The case itself involved an airline pilot fired upon reaching the age of 60 in accordance with company policy. The taxpayer had sued under the Age Discrimination in Employment Act and the parties had settled, with half the settlement amount designated as back pay and half as liquidated damages.<sup>64</sup> In its analysis the court found that the settlement was not "on account of personal injuries or sickness" and thus not excludable from income.<sup>65</sup> According to the court, the taxpayer's recovery failed the causation element of its test because "[i]n age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury."<sup>66</sup>

To illustrate the "on account of" causation requirement, the Court used the example of an auto accident. In such a case, the accident causes injuries which in turn directly result in medical expenses, lost wages, as well as pain, suffering, and emotional distress. If the injured party recovered for all three claims, the entire amount would be excludable "as being 'on account of'" personal injury.<sup>67</sup> The Court thus found that the back pay awarded *Schleier* was not excludable from income as it was not "on account of" the discrimination suffered.<sup>68</sup> Further, the Court suggested that *each element* of the recov-

<sup>63</sup> *Id.* at 336. This was not novel—"on account of" had been in the statute itself all along.

<sup>64</sup> *Id.* at 326.

<sup>65</sup> *Id.* at 336.

<sup>66</sup> *Id.* at 330.

<sup>67</sup> *Id.* at 329. Keep in mind that the Court was considering the pre-1996 section 104(a)(2) which lacked the physical injury requirement. The exclusion of wages—whether "on account of" injury or not—is curious in light of the fact that they would have otherwise been income.

<sup>68</sup> *Id.* at 330. The Court added:

Whether one treats respondent's attaining the age of 60 or his being laid off on account of his age as the proximate cause of respondent's loss of income, neither the birthday nor the discharge can fairly be described as a "personal injury" or "sickness." Moreover, though respondent's unlawful termination may have caused some psychological or "personal" injury comparable to the intangible pain and suffering caused by an automobile accident, it is clear that no part of respondent's recovery of back wages is attributable to that injury. Thus, in our automobile hypothetical, the accident causes a personal injury which in turn causes a loss of wages. In age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury.



ery must be "on account of" the injury in order to be excludable from income.<sup>69</sup>

Put another way, *Schleier* held that to be excludable from income under section 104(a)(2), a recovery had to meet two conditions. First, the statute providing for the award had to have a tort-like remedial scheme; and second, the damages had to be for personal injury.<sup>70</sup> Thus, the case's key addition to section 104(a)(2) analysis is the causation requirement that each element of a recovery be "on account of" the injury that caused it.

As will be illustrated below, while acceptable in theory this condition can become problematic when considered in light of the physical injury requirement of the modern statute.

### C. *O'Gilvie v. United States: No Punitive Damages on Account of Personal Injury*

The case of *O'Gilvie v. United States*, decided shortly after the 1996 amendment to section 104(a)(2), considered whether punitive damages were "on account of" personal injury.<sup>71</sup> In doing so, the court essentially affirmed its view that section 104(a)(2) was based on a human capital rationale, stating that punitive damages "are not a substitute for any normally untaxed personal (or financial) quality, good or 'asset.' They do not compensate for any kind of loss."<sup>72</sup> Thus, although the court had recently stated in *Schleier* that even lost wages received on account of personal injury could be excludable from income, it took the opposite (and seemingly inconsistent) approach with punitive damages and held such an award was includable in income.<sup>73</sup>

While the Supreme Court had addressed what was required of a recovery for injury in order to make it excludable under section 104(a)(2) (award must be on account of a tort type injury), it never adequately clarified exactly what constituted a personal injury. In 1996, however, Congress itself attempted to clarify the statute's scope

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<sup>69</sup> *Id.*

<sup>70</sup> Hobbs, *supra* note 19, at 81. Because discrimination is a statutory tort and all the losses claimed must be caused by the discrimination (otherwise, they would not be recoverable), the Court appears to have read "personal injury" as narrower than "tort." It is unclear, however, if it means to say that "personal injury" is no broader than "physical injury."

<sup>71</sup> 519 U.S. 79 (1996). Note that the case was decided shortly after the 1996 amendment to section 104(a)(2) but considers the pre-1996 version of section 104(a)(2).

<sup>72</sup> *Id.* at 86-87.

<sup>73</sup> *Id.* at 92. Important to the Court was the purpose of punitive damages—to punish the defendant. The inconsistency in the holdings lies in that lost wages that were normally taxable would be excludable from income, whereas punitive damages, which likewise would normally be taxable, remained so.

and late in the summer of that year the Small Business Job Protection Act became law. Although the focus of the Act was on small business tax legislation, Congress needed to raise additional revenue to offset the tax relief the Act offered to small businesses.<sup>74</sup> In order to achieve this goal, Congress attempted to narrow the scope of exclusion from taxation under section 104(a)(2).

Replacing the older statute that allowed tax exemption of compensation received for *personal* injuries or sickness, the new version limited exclusion to “the amount of damages (other than punitive damages)<sup>75</sup> received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or *physical* sickness.”<sup>76</sup> Further, the statute explicitly proclaimed that “emotional distress shall *not* be treated as a physical injury or physical sickness.”<sup>77</sup>

With this change, Congress was partly reacting to a perceived tendency of courts to read the previous statute too broadly and noted that some jurisdictions had included such harms as employment discrimination—the remedy for which would be in the form of lost or back wages—in the definition of “personal injury.”<sup>78</sup> Moreover, *Schleier* had recently held that damages received from a claim brought under the Age Discrimination in Employment Act were not excludable from income under section 104(a)(2),<sup>79</sup> and the IRS had subsequently suspended guidance on the taxability of damages received on account of other forms of employment discrimination.<sup>80</sup>

While the revised statute makes it clear that punitive damage awards are not excludable under the provision, the rest is not as straightforward as it may initially appear. As a result, the previously mentioned ambiguities involving physical harm arising from a non-physical tort, degree of injury, and other issues arise, and inconsistency with the underlying theory of restoration of human capital begins to become apparent.

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<sup>74</sup> Hobbs, *supra* note 19, at 82.

<sup>75</sup> This essentially codified *O’Gilvie* before the case was even decided.

<sup>76</sup> I.R.C. § 104(a)(2) (2004) (emphasis added).

<sup>77</sup> I.R.C. § 104(a) (2004) (emphasis added).

<sup>78</sup> H.R. CONF. REP. NO. 104-737, at 300 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1792, 1792 (note that this is for the House version of the bill, which is the one adopted in conference). As will be discussed, however, the true underlying reason for the change is far from clear.

<sup>79</sup> *Comm’r v. Schleier*, 515 U.S. 323 (1995).

<sup>80</sup> H.R. CONF. REP. NO. 104-737, at 300 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1792, 1792.

#### IV. THE LOGIC BEHIND THE LAW: LEGISLATIVE HISTORY AND CONGRESS'S PURPOSE IN ADDING THE PHYSICAL INJURY REQUIREMENT

As has been suggested up to this point, IRC section 104(a)(2) and its predecessors have enjoyed an intriguing, though not entirely consistent, history. For decades, compensation for nonphysical personal injury was exempt from taxation under the statute before perceived judicial expansion of the doctrine caused Congress finally to declare otherwise through the Small Business Job Protection Act. The 1996 alteration can hardly be seen as sudden, however, as it is clear in hindsight that as early as 1989 Congress had aspirations of making the change.<sup>81</sup> The question thus becomes: by narrowing the provision to require a physical injury, was Congress trying to bring it in line with what it perceived to be a human capital approach? Perhaps Congress was considering the statute's tort-based roots or the suggested altruistic nature of the provision. Maybe Congress was more concerned about a perceived tendency of the judicial system to apply the statute too liberally. Or perhaps a major consideration was simply the bottom line—increasing revenue to offset the tax breaks offered by other portions of the Act. As it turns out, Congress's underlying rationale seems to have been based on a combination of factors.

The logical focus for an analysis of congressional intent would be the legislative history behind the 1996 amendment and the Small Business Job Protection Act. Although that history is not sufficiently comprehensive to be determinative, it does provide some guidance. The House Conference Report notes that

[c]ourts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness... [These damages] generally consist of back pay and other awards *intended to compensate the claimants for lost wages or lost profits*.<sup>82</sup>

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<sup>81</sup> See discussion *supra* Part III (discussing the Omnibus Budget Reconciliation Act of 1989).

<sup>82</sup> H.R. CONF. REP. NO. 104-737, at 300 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1792, 1792 (emphasis added).

One problem exists if such logic was indeed the driving force behind the addition of a physical injury requirement: if this were truly the root of Congress's concern, why did Congress not simply amend the provision to exclude from income only those recoveries that did not compensate the claimant for lost wages or profits? Drawing a distinction between physical and nonphysical injury is hardly the most efficient means by which to address such a concern.

Although the report makes reference to *Schleier* in support of its position,<sup>83</sup> another possible reason for the change that is *not* mentioned is that Congress feared a flood of frivolous claims (*i.e.*, suits alleging that a large portion of damages came from emotional distress and other difficult-to-prove, nonphysical injuries) were it to allow the exclusion to encompass all types of harms.<sup>84</sup> One problem, however, is that the provision had allowed exclusion of recovery for nonphysical injury for years, and Congress offered no evidence of such a fear (or even a suggestion that this was even an issue in the first place) in the legislative history.<sup>85</sup>

Interestingly, the history adds that although emotional damage is not a physical injury for purposes of the statute, recovery for a claim of emotional distress attributable to a physical injury or sickness *would* be excludable from income.<sup>86</sup> Similarly, damages for "loss of consortium due to the physical injury or physical sickness of [one's] spouse are excludable from gross income."<sup>87</sup> This suggests that the requisite physical harm need not always be suffered by the party receiving the recovery; under the *Schleier* "on account of" test, the damages would be received because of the spouse's injury, not because of the harm the injury causes to the taxpayer. In fact, the report explicitly states that "[i]f 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

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<sup>83</sup> *Id.* (noting that "[t]he Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income." The report goes on to point out the fact that in light of that decision, the IRS had suspended existing guidance on other forms of employment discrimination, suggesting a need to clarify the issue).

<sup>84</sup> As noted, however, the legislative history is silent as to *any* reason for the change beyond the perception that courts tended to interpret the existing statute too broadly.

<sup>85</sup> Even if this were a reason for the amendment, a logical flaw exists behind this argument that will be discussed *infra* Part VIII.

<sup>86</sup> H.R. CONF. REP. NO. 104-737, at 301 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1792, 1793. Note that it is not clear from this part of the text whether the physical harm must be suffered by the taxpayer. The treatment of loss of consortium claims, discussed *infra*, seems to suggest that it does not matter.

<sup>87</sup> *Id.*

physical injury or physical sickness *whether or not the recipient of the damages is the injured party.*"<sup>88</sup>

In the end, the legislative history behind the addition of a physical injury requirement to section 104(a)(2) sheds light in two ways. First, it suggests that Congress disapproved of the courts' tendency to apply the statute too broadly in favor of taxpayers, specifically in allowing awards that essentially constituted back wages to be exempt from income tax. This is of limited value, however, given that Congress's reaction was the legislative equivalent of using a chainsaw to do a scalpel's job. Second, it clears the air somewhat as to nonphysical injury caused by physical harm, although it remains conspicuously silent as to the opposite situation.

Otherwise, the legislative history unfortunately serves mainly to recite the provision that it supports albeit with slightly different wording. There is no mention of excluding from income compensation that substitutes for capital, nary a word on any altruistic motive of the legislature, and no mention of the provision's close connections with tort. As a result, the history's value as a gauge of *why* Congress felt the need to limit exclusion from taxation to physical injuries is of limited value other than suggesting that Congress needed to raise revenue and failed to use the most narrow means by which to allay its alleged fears. It sheds little light on why Congress made a change that risked severing section 104(a)(2) from the justifications on which the provision had long relied.

#### V. SECTION 104(a)(2) AND TRADITIONAL JUSTIFICATIONS: DO THEY STILL WORK?

Because Congress provided little insight into the fundamental purpose underlying the modern incarnation of section 104(a)(2), in considering the provision's validity it is necessary to look at the rationale for the existence of its predecessors and whether the modern statute stays true to those roots. If the provision remains consistent with its traditional justifications, then there exists a logical explanation for the results produced by the statute; if not, these same results run the risk of being completely arbitrary. Although in this case the provision's existence has traditionally (and as recently as *O'Gilvie*) been attributed to the desire not to tax what is essentially a return of human capital, some have also suggested that the provision exists merely out of an altruistic desire of Congress not to further burden those who have suffered harm.<sup>89</sup> As the so-called "kindness" rationale is the simpler

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<sup>88</sup> *Id.* (emphasis added).

<sup>89</sup> See *supra* Part II.

of the two, its legitimacy as a justification for the modern section 104(a)(2) will be examined first.

Under the kindness rationale, section 104(a)(2) exists simply because of Congress's good will towards tort victims.<sup>90</sup> This approach, however, is not supported by the post-1996 provision, or even by the 1989 amendment. A general underlying motive of compassion towards taxpayers would not be supported by a provision that picks and chooses what the injured may or may not exclude from their incomes. The 1989 requirement that punitive damages be included in income would seem to call the validity of the kindness rationale into question—if Congress simply felt that victims had “suffered enough,” why pick and choose what they can and cannot exclude from taxable income?<sup>91</sup> If any uncertainty remained as to the viability of the kindness rationale as a justification for the statute, however, the denial from exclusion of recoveries for nonphysical injury—arguably a substantial sum in many cases—removes what little support remains. Thus, while the idea of Congress's altruism was never the primary justification for section 104(a)(2), it carries little weight under the statute's modern version and its distinction between physical and nonphysical injuries.

As authorities rarely rely on the kindness rationale to justify the existence of section 104(a)(2), the lack of a meaningful relationship between the theory and the provision is not problematic. On the other hand, the concept of not taxing a return of human capital has been frequently suggested as an underlying purpose for the statute, even to the point that the idea has been sanctioned by the Supreme Court.<sup>92</sup> Under the human capital approach, the exclusion granted by section 104(a)(2) exists because awards for injuries to one's person simply compensate the victim for “capital” in their person lost or destroyed by a tortious action.<sup>93</sup> Essentially, the victim in such a case has experienced an involuntary conversion<sup>94</sup> of one asset—their body or person—for another, cash.<sup>95</sup> Further, although the recovery in such a

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<sup>90</sup> See Manns, *supra* note 17, at 354-55. Manns suggests that this rationale fails when the parties involved had some preexisting economic relationship, when contract rights come into play.

<sup>91</sup> Admittedly the argument can be made both for and against exclusion of punitive damages from income depending on just *how* altruistic Congress should be in enacting a provision such as section 104(a)(2). Picking and choosing might just be an effort to provide the optimal amount of generosity.

<sup>92</sup> See 31 Op. Att'y Gen. 304, 307 (1918); *O'Gilvie v. United States*, 519 U.S. 79 (1996).

<sup>93</sup> Recall the scope of this Note—traditional tortious injury. In the case of the other class of cases under section 104(a)(2)—discrimination and other employment-related suits—the recovery would likely replace lost income, not destroyed human capital.

<sup>94</sup> See Hobbs, *supra* note 19, at 63.

<sup>95</sup> In addition to the traditional human capital rationale, there is also the question of fair-

case is simply a substitution of one asset for another, the extreme difficulty in quantifying the value of the destroyed human capital would make any alternative approach overly cumbersome.<sup>96</sup>

Under the human capital theory, it makes sense that neither wages (either of the lost or back variety<sup>97</sup>) nor punitive damages would be excludable from taxable income. Even ignoring the *O'Gilvie* holding that punitive damages are not on account of personal injury, both wages and punitive damages constitute amounts that would have been taxed otherwise. They do not represent compensation that *substitutes* for harm to a person (even though the punitive damages would not have been received without the initial harm), and as a result they are an accession to wealth and taxable.<sup>98</sup> Thus, as far as punitive damages and substituted wages go, there is no issue with the theory's support of section 104(a)(2).

Inconsistencies arise, however, when one determines that compensation substituting for physical injury should be excludable from taxation while compensation for nonphysical injury should not. Such a distinction necessitates one of two assumptions. First, it can be assumed that one has no human capital in his person outside of his body—*i.e.*, mental health, integrity, character, and reputation are worth nothing even though the body itself can be theoretically replaced by dollars. Second, the distinction may suggest an assumption that although one has capital in the intangible parts of his person, this human capital cannot be harmed, or at least that money cannot serve as a substitute to replace such damaged capital.

Given the physical/nonphysical dichotomy introduced to the tax code in 1996, it seems likely that in amending section 104(a)(2) Congress made at least one of these assumptions. As a taxpayer's human capital includes both physical and intangible assets, making either one of these assumptions would seriously undermine the idea of the theory as a basis for the statute. The inherent conflicts between such a view and the theory of human capital are clear. For one, to argue that a person who suffers a broken arm experiences a loss of capital while

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ness in taxing one who has experienced an involuntary conversion of capital.

<sup>96</sup> The inherent problem in alternative approaches is that they would require placing a dollar value on the use of various body parts. How much money substitutes for the loss of use of one's arm? \$1? \$100? \$1000?

<sup>97</sup> "Lost" wages are income that would have been earned subsequent to the injury but, because of the injury, the victim was unable to work. "Back" wages are income for which one has already worked, but because of discrimination or some other type of action the person has not been paid the funds. The two terms sometimes seem to be used interchangeably, however.

<sup>98</sup> This does make the Supreme Court's holding in *Schleier* that lost wages received on account of personal injury were excludable seem curious, however.

one whose public reputation (and hence ability to obtain gainful employment) is tarnished does not borders on absurd. Even if one were to accept this, many nonphysical harms such as depression and emotional damage involve actual physical changes in the body, most often in the brain.<sup>99</sup> One does not become depressed or distraught without actual physiological changes in his person.<sup>100</sup> Thus, by requiring a showing of "traditional" physical injury, the statute fails to protect taxpayers who have suffered a physical harm brought about by a non-physical injury.

Further, another inconsistency exists in that even though Congress made physical injury a prerequisite to exclusion under section 104(a)(2), the provision's legislative history explicitly states that one can exclude from taxable income recovery for a loss of consortium claim for harm to a spouse.<sup>101</sup> While one could argue that the harm suffered by the taxpayer is indeed physical in such a case,<sup>102</sup> an equally good claim exists that the injury suffered is an emotional loss coupled with deprivation of emotional support. Notwithstanding the physiological changes caused by emotional harm, the destroyed human capital would be nonphysical; well-being, happiness, and other intangibles that exist as a result of one's relationship with his or her spouse would be destroyed. If this is indeed why recovery for such a harm is excludable from income, it would be consistent with the idea of human capital but in direct conflict with the treatment such damages normally received under section 104(a)(2). Why should such a recovery be excludable from income simply because another party suffered a physical injury?

Regardless of whether Congress believed that one cannot have capital in his intangible personal attributes or simply felt that money cannot substitute for such assets, the scarcity of support for either contention in the legislative history bolsters the logical conclusion that Congress ignored the consideration altogether. The result is that the theory of human capital can no longer provide justification for

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<sup>99</sup> See Narbeh Bagdasarian, *A Prescription for Mental Distress: The Principles of Psychosomatic Medicine with the Physical Manifestation Requirement in N.I.E.D. Cases*, 26 AM. J.L. & MED. 401, 427-28 (2000) (noting that mental injury and physical injury are not separate and distinct types of harm, and that "all emotional disturbances necessarily possess some physical aspects") (quoting Virginia E. Nolan & Edmund Ursin, *Negligent Infliction of Emotional Distress: Coherence Emerging from Chaos*, 33 HASTINGS L.J. 583, 618 n.169 (1982)).

<sup>100</sup> Bagdasarian, *supra* note 100, at 427-28.

<sup>101</sup> H.R. CONF. REP. NO. 104-737, at 301 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1792, 1793. The pertinent text states that "[i]f an action has its origin in a physical injury or sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury" before using a loss of consortium claim as an example.

<sup>102</sup> This author will spare the reader the details in this instance. Consider, however, an elderly woman who was forced to care for her disabled husband even before the accident.



section 104(a)(2), as distinguishing between physical and nonphysical assets is fundamentally inconsistent with the theory's underlying notion that a person has capital in all aspects of his person.

#### VI. DOES THE MODERN SECTION 104(a)(2) REMAIN TRUE TO ITS ROOTS IN TORT?

When it decided *United States v. Burke*, the Supreme Court linked identification of a personal injury, the recovery for which was excludable under section 104(a)(2), to traditional tort principles.<sup>103</sup> While the court looked to available remedies to identify a tort, Black's Law Dictionary has defined the term as "[a] private or civil wrong or injury" or "[a] wrong independent of contract." A tort can 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; [or] (3) the violation of some private obligation by which like damage accrues to the individual."<sup>104</sup> Likewise, a personal injury "is one 'which is an invasion of personal rights and . . . may include such injuries to the person as libel or slander . . . and mental suffering.'"<sup>105</sup> Notably, in *Burke* the Supreme Court acknowledged that such a nonphysical harm—there, discrimination—could in some cases constitute such a personal injury under section 104(a)(2).<sup>106</sup>

Although nowhere in either definition (or in the Treasury Regulation on which the Court relied, for that matter) is there a requirement that in order to be tortious a harm must be physical, that is precisely what Congress added in 1996. By the Supreme Court's own admission and by a regulation issued by the Treasury itself, a personal injury for purposes of section 104(a)(2) is based in tort. By adding a requirement that an injury be physical, however, Congress omitted a plethora of tortious actions from the coverage of the provision. As such, not only does the post-1996 statute fail to find justification in a human capital or kindness rationale, it is not reconcilable with the fundamental principles of tort on which it purportedly relies.<sup>107</sup>

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<sup>103</sup> *United States v. Burke*, 504 U.S. 229, 234 (1992) (citing 26 C.F.R. §1.104-1(c) (1991)).

<sup>104</sup> BLACK'S LAW DICTIONARY 1660 (4th ed. 1968).

<sup>105</sup> Donald J. Zahn, *Personal Injury Exclusion: Is the Slashing of Wrists Necessary?*, 13 AKRON TAX J. 129, 150 (1997).

<sup>106</sup> *Burke*, 504 U.S. at 239. Recall that the Court looked to Title VII's remedies in holding otherwise in that case.

<sup>107</sup> See Zahn, *supra* note 106, at 150. Zahn suggests that *Burke* and *Schleier* had added a physical injury requirement even before the 1996 amendment.

## VII. THE LACK OF A THEORETICAL JUSTIFICATION FOR THE PHYSICAL INJURY REQUIREMENT: WHY DOES IT MATTER?

While adding a requirement of physical injury for exclusion under section 104(a)(2) may not comport with ideas of kindness, human capital or even tort, such inconsistency will not likely be a harbinger of the Apocalypse. The flaws are, after all, theoretical, and the Constitution possesses no requirement that the tax code be logical. There do exist, however, two practical reasons why adding a physical injury requirement to the provision was not a wise decision. For one, because the statute has been separated from any logical justification, any results it produces will be arbitrary by definition. As far as the statute is concerned, there is no reason why a taxpayer who has suffered a physical injury should be able to enjoy the benefits of the provision while one whose injury is intangible should not.

The second and more problematic result of the physical injury requirement is that the lack of a clear definition of physical injury, the uncertainties as to the result when physical injury arises from non-physical harm, and other issues create ambiguity in the statute. Dealing with such ambiguity is the province of the judicial system, and in all likelihood the taxpayer will often get the short end of the stick as the Supreme Court has made clear that exclusionary provisions of the Internal Revenue Code must be narrowly construed.<sup>108</sup> Even if this is not the case, however, ambiguity leads to the potential for arbitrariness; because courts are left to concoct their own definition of physical injury in borderline cases, taxpayers with identical injuries may receive different treatment under section 104(a)(2) in different jurisdictions. Further, under a scheme that protects only those with tangible injuries, tax-conscious plaintiffs will have an incentive to “find” physical harm where none may have previously existed.

The problem, however, is that section 104(a)(2) is not *per se* ambiguous and thus in need of replacement, as it is capable of functioning well in basic cases.<sup>109</sup> It is not a statute that screams for attention because of the patently unjust results it produces. One instance where it functions quite well is that of Abe, the hypothetical man who became a paraplegic after being hit by a drunk driver. In a negligence suit, damages received would be on account of a physical harm, and would compensate Abe not only for his pain and suffering but also for

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<sup>108</sup> *Burke*, 504 U.S. at 248.

<sup>109</sup> Section 104(a)(2) is *per se* arbitrary because there is no clear reason for distinguishing between physical and nonphysical injury. Further complicating matters is the possibility that those with borderline cases will be faced with the inconvenience of and cost of engaging in two suits—one for the initial tort, and another over the taxability of the recovery received.

his lost human capital—the use of his legs. As Abe was able to continue working normally (ignoring time lost due to hospitalization), damages would not represent any type of substitute for wages.<sup>110</sup> Because the requirements of section 104(a)(2)—recovery received on account of a physical harm—have been satisfied, an award in this case would fall squarely under the provision and thus be excludable from income. Any punitive damages would of course be taxable.

Not all cases are as clear as Abe's, however. The physical injury requirement of section 104(a)(2) is the result of a seemingly arbitrary decision to pare back a tax exclusion to satisfy a desire to increase revenue, and it likewise can lead to arbitrary results. All other things being equal, why should one who suffers a broken arm have a recovery for the accident (even the amount that goes above and beyond medical expenses) excluded from income while another who loses his job and reputation would pay tax on proceeds from a defamation suit? The statute makes this unfortunate distinction without any real explanation from Congress as to why it does so. Because appellate-level litigation on the subject is far from common, it seems apparent that courts are taking a bright-line approach in interpreting the statute, or at the very least that appellate courts seem hesitant to disturb a lower court's determination of what is or is not a physical injury.

While distinguishing between those with physical and nonphysical harms is inherently arbitrary when no reason exists for doing so, a more problematic source of arbitrariness in section 104(a)(2) cases is the ambiguity in what exactly constitutes a physical injury. How severe must an injury be to be "physical" under the statute? Is a stubbed toe enough, or must the digit appear in the courtroom in a plastic baggie?<sup>111</sup> Other issues of ambiguity exist in terms of what kind of injury is sufficient for exclusion under the statute: for example, what if one develops an ulcer after swallowing years of discrimination at work? Or, consider Charlie's case: Although Charlie initially sustained no physical harm, defamation and its direct effects contributed heavily to an undeniably physical sickness—pneumonia. Again, taken literally, as many courts might do considering the general favoritism granted bright-line rules, modern section 104(a)(2) would seem to deny Charlie the ability to exclude his recovery from income.

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<sup>110</sup>Note that although *Schleier* used an auto accident example to illustrate when wages might not be includable in income, this appears to be the exception rather than the rule. See *Comm'r v. Schleier*, 515 U.S. 323 (1995).

<sup>111</sup>Although these are extreme examples, there exists a broad spectrum of injury in between.

This position is not without support, either. At first glance, a footnote to the 1996 amendment's legislative history seemingly adopts this view. The footnote suggests that "[i]t is intended that the term emotional distress includes symptoms (*e.g.*, insomnia, headache, stomach disorders) which may result from such emotional distress."<sup>112</sup> These are truly all *symptoms*; however, the footnote is silent as to more serious *conditions* that develop as a result of emotional distress—*e.g.*, pneumonia, heart attack, mental breakdown, and so forth. Further, what about a more contemporary concern—stress-triggered immune system disorders?<sup>113</sup> Again, the footnote says nothing.

All may not be lost in trying to clarify the result of such a situation, however. In the legislative history to the 1996 amendment to the statute, Congress specifically allowed, through recovery for a loss of consortium claim, exclusion of damages for a *nonphysical* injury resulting from *another's physical* injury.<sup>114</sup> The fact that Congress would do so seems to lend weight to the idea that physical injury resulting from one's own nonphysical injury could be treated likewise; otherwise, the statute would implicitly place more value in the physical body of another than in a taxpayer's own intangible human capital.

One final issue remains, though. Under the *Schleier* causation requirement, would Charlie's sickness be directly attributable to the harm suffered or is it too far removed for the purposes of causation? This is not clear. A court reading the modern statute literally and viewing the initial harm as the determinative injury would likely force Charlie to pay taxes on his recovery. On the other hand, a court taking a broader view of the situation could easily note that pneumonia is a physical sickness and allow Charlie exclusion under the statute. Thus, by requiring courts to distinguish between physical and nonphysical injury and examine sometimes unclear chains of causation, the ambiguity of the physical injury requirement of section 104(a)(2) creates the possibility of arbitrariness in application. As such, the taxability of an award for an injury such as Charlie's would thus be unclear and left to the discretion (and potentially arbitrary application) of the judicial system. The only clear thing about a recovery for

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<sup>112</sup>H.R. CONF. REP. NO. 104-737, at 301 n.56 (1996), reprinted in 1996 U.S.C.A.N. 1792, 1793 n.56.

<sup>113</sup>See Jennifer Warner, *Too Much Stress Hinders Immune System*, at <http://my.webmd.com/content/article/53/61245.htm> (Nov. 4, 2002) (noting the negative effects of stress on the immune system).

<sup>114</sup>H.R. CONF. REP. NO. 104-737, at 301 (1996), reprinted in 1996 U.S.C.A.N. 1792, 1793 ("Damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income.").

an injury such as Charlie's is that the taxability of the award under the modern section 104(a)(2) is anything but clear.

What of the case of Jane Doe, however, whose broken hand deprived her of the ability to teach children to play the piano, an undertaking of extreme importance to her? Ms. Doe suffered an indisputably physical injury—a broken hand—but the true harm came from the distress caused by her inability to engage in that which she loves. When she receives a recovery for the drunk driver's negligence, will the award be excluded from taxation based on the broken hand or would a court look at the fact that the hand is otherwise healed and deny that section 104(a)(2) applies? Because of the provision's physical injury requirement, a court will be forced to make a judgment of what harm the recovery was intended to remedy, and this may not be consistent with where the true harm occurs.

The legislative history to the 1996 amendment to section 104(a)(2) suggests that damages for such an intangible harm rooted in a tangible injury may be excludable, but, as with Charlie's case, the result is not clear.<sup>115</sup> Yet again, whereas pre-1996 there would have been no issue as to the taxability of the award, the addition of a physical injury requirement to the statute results in the potential both for arbitrariness by a court and needless litigation over a scant two pages of legislative history.

Finally, what of the question of the requisite degree of physical injury required for a harm to be "physical" for the purposes of section 104(a)(2)? For instance, suppose a taxpayer receives an award in a negligence suit for various injuries—for example, a bad back as well as emotional distress. Must his back be broken to meet the requirement of a physical injury under the statute, or is a severe blow that causes pain while sleeping enough? Technically, both injuries are physical, but they vary greatly in degree. By requiring a physical injury, section 104(a)(2) thus places the judicial system in the role of determining what degree of physical injury is sufficient and thus who can enjoy the statute's benefits. As has been emphasized up to this point, leaving matters to the discretion of the courts opens the door to potential arbitrariness; leaving matters to such discretion without a coherent theory from which courts can draw reason nearly guarantees such arbitrariness.

Thus, while it is possible that Congress intended to simplify section 104(a)(2) by adding the requirement that any personal injury under the provision be physical in nature, the actual result is anything but clear. By distinguishing between taxpayers with physical and

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<sup>115</sup> *Id.*

nonphysical injuries without any discernable logical basis for doing so—whether in human capital or any other theory—the statute is by definition arbitrary. Further, the physical injury requirement creates ambiguity, with the possibility of allowing recoveries for minor physical harms to be excluded from taxation while recoveries for traumatic nonphysical harms are not. Likewise, the tax treatment of a physical harm stemming from a nonphysical injury is unclear, such as with Charlie, as is a situation where a physical harm ultimately causes much more severe intangible distress, as is the case with Jane. Finally, the issue remains of how *much* physical harm is required for exemption—is a twisted ankle sufficient, or must one suffer a broken bone, for example?

By creating this ambiguity through the addition of a physical injury requirement to section 104(a)(2), Congress has saddled the judicial system with the responsibility to answer these questions for itself, and this in turn creates the potential for arbitrary application.<sup>116</sup> If our legal system truly strives for fairness and equity, this is anything but a desirable situation.

#### VIII. ALTERNATIVES TO A PHYSICAL INJURY REQUIREMENT: A BETTER WAY EXISTS

*Having the critics praise you is like having the hangman say  
you've got a pretty neck.*  
—Eli Wallach

As this Note has aimed to illustrate, in reaching its current state section 104(a)(2) of the Internal Revenue Code has devolved from a relatively straightforward statute into a narrow exclusion. As a result, the provision no longer embodies a desire not to tax returns of human capital, nor does it support the simple notion that Congress acted altruistically in enacting the section. Through its physical injury requirement, the modern statute similarly fails to stay true to its explicitly documented roots in traditional tort law. Even with these theoretical inconsistencies aside, there exist more practical, and thus arguably more important, considerations. Not only is the statute itself arbitrary by drawing without logical support a distinction between

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<sup>116</sup> As alluded to, *supra* note 108, another inherent but easily overlooked burden on the taxpayer is the requirement that he engage in two suits—one for the initial tort and another to argue over the taxability of the recovery received. Part of these litigation costs could include, for example, the need to hire two doctors as expert witnesses—one to establish the existence of the initial injury and another to establish its physical nature. Not only does the taxpayer thus incur additional costs, but a large percentage of the recovery may be unreachable for years while litigation is ongoing.

sufferers of physical and nonphysical injury, but by doing so it also creates ambiguity and opens the door to interpretation and thus potentially arbitrary application by the judicial system.

All of this is fine and well, but why chastise Congress for its decision if no better choice exists? After all, it is easier to criticize others' work than to attempt to improve upon it. There do, however, exist alternatives to the modern version of section 104(a)(2), the most viable of which is an option that has essentially been present all along: Congress could do away with the statute's physical injury requirement and return the provision to its pre-1996 form, albeit with certain conditions.

#### A. *A Return to the Post-1989 Statute with Certain Conditions*

Assuming that the theory of human capital serves as the basis for section 104(a)(2), in returning the provision to allow exclusion from income recoveries based on personal injury, Congress should retain the post-1989 view that punitive damages should not be excluded from income. Such recoveries cannot represent a return of capital and instead constitute a windfall no matter how one examines the situation.<sup>117</sup> Further, assuming that human capital is itself an accession to wealth, such "accessions" are not directly taxable for ordinary, uninjured taxpayers. For these parties, their capital is not taxed until it is used to produce earnings. Therefore, in the interest of equity (among other considerations), any award that represents lost or back wages should likewise be included in income. Such sums would be taxed anyway<sup>118</sup> and do not substitute for destroyed human capital; in some cases, an even stronger argument for taxation exists as victims did not actually work to earn them.<sup>119</sup>

The modified provision would likely require a *Schleier*-like test to determine personal injury and causation, albeit with somewhat clearer lines. This would not require any more analysis than courts already perform, however; even under the modern statute, an injury must be "personal"<sup>120</sup> and a recovery must be awarded on account of that

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<sup>117</sup> See *O'Gilvie v. United States*, 519 U.S. 79, 86-87 (1996) ("[Punitive damages] do not compensate for any kind of loss."). Further, one of the primary purposes of such damages, to punish the defendant for his "evil behavior" or to make an example of him, has no compensatory function that would be excluded from taxation. See BLACK'S LAW DICTIONARY 467-68 (4th ed. 1968). But see Thomas B. Colby, *Beyond the Multiple Punishment Problem: Punitive Damages as Punishment for Individual, Private Wrongs*, 87 MINN. L. REV. 583, 619 (2003) (noting that the early focus of punitive damages was actually on the insult to the victim).

<sup>118</sup> I.R.C. § 61 (2003).

<sup>119</sup> This is not intended to diminish the significance of a victim's suffering in any way.

<sup>120</sup> Note that use of the term "personal injury" here is not to suggest the paradigm of personal injury (physical injury) as a requirement, but rather it serves to differentiate relevant

harm.<sup>121</sup> Thus, no matter what the system, courts will have to decide at what point compensation does not substitute for injury.

Perhaps a good place at which to draw the causational line would be at all injuries sustained at the time of suit. Given the amount of time that would elapse between the initial injury, the recovery on behalf of that injury, the taxpayer's filing of taxes and IRS's rejection of their exclusion, and the subsequent suit to resolve the issue, there exists a sufficient window in which injuries stemming from the initial accident would manifest themselves. Further, after a certain point, injuries suffered would be irrelevant, as the plaintiff would have already paid taxes (or attempted to withhold them) on the recovery.<sup>122</sup>

Although the proposed system is by no means perfect, it avoids the arbitrariness of taxing those who suffer nonphysical injury while those who show some physical manifestation escape taxation. Such a provision would benefit Charlie, the most problematic of the cases discussed: assuming his pneumonia developed at an early enough point, unlike under the current statute, all of his damages (except for recovered lost income and punitive awards) received would be excluded as they are personal, tort-based injuries. The modified provision thus allows the system to take account of all of Charlie's harms—the initial injury to his character (defamation) and the subsequent pneumonia—and he would thus be treated the same under the statute as someone whose physical sickness led to a nonphysical injury.

Likewise, Jane would enjoy the benefits of the statute without being forced to engage in needless litigation over whether her recovery compensates her for an injured hand or the distress stemming from that injury. Further, by retaining the requirement that an injury be personal, the provision would not become so broad as to make it impractical and unworkable. Thus not only would the statute be simpler

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harms from property damage and breach of contract claims which have their own, simpler rules.

<sup>121</sup> Admittedly, the proposed change will not eliminate disagreements over what constitutes a "personal" injury for the purposes of section 104(a)(2). This has been, and will continue to be, a source of contention. See *United States v. Burke*, 504 U.S. 229, 234-35 (1992) (struggling with what is or is not a "personal" injury). Further, eliminating the "personal" requirement altogether would not be feasible; this would vastly broaden the provision to encompass such claims as contractual damages.

<sup>122</sup> Although this might prevent Charlie from excluding income based on his pneumonia (if it occurred after the time of suit), he would have been allowed to exclude his award for defamation—a harm to his character—anyway. Likewise, in cases where nonphysical injury develops from a physical injury (such as Jane Doe), exclusion could be difficult unless the plaintiff was beginning to suffer the injury at the time of suit. In Ms. Doe's case, with a crushed hand it is likely that she would know by that time of her inability to play the piano. If her impairment had not manifested itself by the time Ms. Doe got to court, the issue would be irrelevant as there would be no recovery for it and thus nothing to exclude from income.



in application, its benefits would still be available to a reasonably select group of taxpayers.

One potential, and unfounded, fear is that such a change would result in an increase in frivolous suits filed for hard-to-define intangible harms. While this is possible, is a plaintiff who would not have filed a lawsuit before going to do so now simply because he will have to pay fewer (if any) taxes on the recovery?<sup>123</sup> Notably, doing away with the section 104(a)(2)'s physical injury requirement would not open the door to *new* claims; rather, it would simply affect the *tax treatment of existing recoveries*.

### B. Other Alternatives to the Modern Section 104(a)(2)

Instead of removing the provision's physical injury requirement, Congress could simply do away with section 104(a)(2) altogether. Congress is not required to exclude *any* recoveries received on account of personal injury if it deems that the exclusion is not necessary. Throwing out the provision entirely, however, would result in taxpayers being taxed on what is essentially (at least under the theory of human capital) a return of capital, and this would be inconsistent with other portions of the Code.<sup>124</sup> More important, uninjured persons who have acquired human capital are not taxed on their gain, so why should one who receives compensation for human capital of which they have been deprived be treated differently?

Another option would be to tax the injured party only on the part of a recovery that exceeds his initial basis in the asset (his person). This would, after all, be consistent with the notion that a taxpayer should avoid tax liability only on that portion of an award that represents a return of capital. Both the current and proposed statutes recognize this to the extent that wages and punitive damages—undeniable accessions to wealth—are not eligible for exclusion under section 104(a)(2). The fatal flaw in such a system, however, is that it would require courts to determine a taxpayer's basis in his own person. As discussed earlier, this is much more easily said than done, and the amount of gain in a given situation would

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<sup>123</sup> It is possible, of course, that if a potential recovery were small enough and the rate of taxation high enough, that some potential plaintiffs could be deterred from filing suit under the current system. Assuming that the potential plaintiff and his lawyer make such calculations, they would necessarily consider such factors as potential value of the claim, probability of success, and costs likely to be incurred. For a more technical overview of the economic decision-making process in filing suit, see ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 334-50 (2d ed. 1997).

<sup>124</sup> See, e.g., I.R.C. § 1001(a) (2003); I.R.C. §§ 1011-12 (2003). See also ANDREWS, *supra* note 20, at 77 (giving an overview of the Code and the concept of return of capital).

necessarily depend on which theory of human capital's origin one adopted.

One final possibility is that Congress could amend the statute to allow exclusion from income recoveries based on *any* injury. As stated previously, however, this would broaden the statute to the point where it is no longer workable; it would become a haven for anyone with any kind of injury seeking to avoid taxation.

Thus, while Congress could broaden section 104(a)(2), alter it in other ways or do away with it altogether, the best choice for purposes of both fairness and application remains to simply do away with the provision's physical injury requirement while maintaining a few select conditions.

### CONCLUSION

In the end, while there is no perfect solution to the problems of ambiguity and arbitrariness caused by the physical injury requirement of section 104(a)(2), a simple reversion to the old form along with a few modifications would go a long way in addressing the provision's shortcomings. Not only would the statute return to a solid theoretical grounding in the concept of restoration of human capital, but it would neither arbitrarily distinguish between those who have suffered harms different in nature but arguably equal in magnitude nor allow courts to do the same.

Suits for tortious injury have long been a part of the legal system and will continue to be so in the future. Not only must the law deal with suits and issues that have presented themselves in the past, it must be able to face new problems that arise in the future. For example, what of a suit that recovers damages from fast-food establishments that supposedly caused their customers to become overweight? Is such an award a recovery for obesity? Even if so, is obesity even a physical injury for the purposes of section 104(a)(2)? Or, on the other hand, would such a recovery be for the clogged arteries and heart attacks caused by the condition? Perhaps an award would actually compensate for the "shame and humiliation" suffered by the overweight plaintiff? Whatever the validity of such claims, requiring a showing of a physical injury for tax exclusion can only create the potential for disputes and differing treatment of taxpayers who have suffered similar harms.

Likewise, although such cases are currently in their infancy, consider the possibility of a suit against brewers and liquor companies for allegedly advertising to minors. In considering physical and non-physical injury, how would the present-day section 104(a)(2) treat a

recovery for a taxpayer who developed sclerosis of the liver after starting to drink heavily at 15? The result seems clear enough. But what about a depressed mother whose 17-year-old son was killed after he had one beer too many before getting behind the wheel? What of the plaintiff who escaped liver damage, but whose memory was severely damaged after he began heavily drinking at a young age? Is that a physical injury for the purposes of the statute? While the treatment of recoveries for some of these injuries would be clearer than others, the fact remains that these are but a few of the plethora of injuries that could present themselves in such lawsuits. It is clear, then, that such issues of taxability will have to be resolved one way or the other and simply are not going to disappear.

These are but some of the potential issues dealing with the scope of section 104(a)(2) that will likely arise in the near future. Neither the tax code nor the legal system is perfect; nor is it at all likely that they ever will be. In the case of this single provision of the voluminous Internal Revenue Code, however, Congress has the ability to take a step in that direction with one simple change. Because while death and taxes may both be certainties, so should be the treatment one receives when he is asked to pay those taxes.

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