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# FEDERAL INCOME TAXATION OF PUNITIVE DAMAGES AWARDED IN PERSONAL INJURY ACTIONS

*Paul C. Feinberg\**

*The status of punitive damages for purposes of federal income taxation is unclear, particularly in light of a recent amendment to the Internal Revenue Code distinguishing punitive damages for physical injuries from those for non-physical injuries. The author considers whether or not punitive damages for personal injuries are excluded from income under section 104(a)(2). Employing an historical analysis of section 104(a)(2) and reviewing the nature of various types of damages, the author concludes that Congress did not intend to exclude punitive damages from income.*

## I. INTRODUCTION

In recent years federal income taxation of punitive damages awarded in personal injury cases has become the subject of much controversy in administrative practice, in the courts, in Congress and in academia. In fact, this area of income tax law is filled with

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such a variety of differing and contrasting viewpoints that any attempt at harmonizing them is daunting. The large number of opinions alone so obscures the debate that any effort to provide a clear interpretation of the treatment of punitive damages makes the task arduous and complicated. Despite these difficulties, this article seeks to provide a coherent understanding of how punitive damages should be treated for federal income tax purposes.

This article begins by first examining the current debate surrounding punitive damages.<sup>1</sup> After presenting the various viewpoints on the subject, Section III of the article analyzes the nature of the different types of tort damages awards.<sup>2</sup> This close examination of the various types of damages provides a solid foundation upon which to examine how federal tax law has dealt with punitive damages since 1916.

Section IV reviews the origins of the treatment of damages under federal tax law.<sup>3</sup> It considers carefully the earliest administrative interpretations of damage awards. Those decisions disclose that prior to the enactment of section 104,<sup>4</sup> the tax treatment of personal injury awards was not entirely clear. The article proceeds to analyze the first statutory exemption for personal injury damages in an effort to resolve many of the current issues. Next, section V<sup>5</sup> examines the exclusion in the context of the Supreme Court's redefinition of income in *Commissioner v. Glenshaw Glass*.<sup>6</sup> Section VI reviews cases and Service rulings interpreting personal injury for tax purposes.<sup>7</sup> This section provides further context for understanding the manner in which the exclusion for punitive damages fits with other areas of tax. Section VII discusses more recent judicial decisions regarding the status of punitive damages.<sup>8</sup>

This article concludes that the most plausible analysis of section 104(a)(2) is that Congress intended to exclude from gross income only those amounts received as *compensation* for personal injury, i.e., receipts which restore the taxpayer to his or her prior condition. Congress did not intend to exclude from gross income, and the Internal Revenue Code's exemption of damage awards does

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1. See *infra* text accompanying notes 13-41 (Section II).

2. See *infra* text accompanying notes 42-84.

3. See *infra* text accompanying notes 85-161.

4. I.R.C. § 104 (West Supp. 1992).

5. See *infra* text accompanying notes 162-72.

6. 348 U.S. 426 (1955).

7. See *infra* text accompanying notes 173-265.

8. See *infra* text accompanying notes 266-366.

not reach, punitive damages payments which serve some function other than compensating persons for injury. To reach these conclusions, this article employs historical analysis. A view of the exclusion which accounts for the traditional goals and purposes of various types of tort damages provides useful guidance for determining the taxable status of punitive damages. Accordingly, this article uses the prior enactments of section 104(a)(2) and interpretations of those earlier acts to construe the present statute.

This method of historical analysis presupposes the continuing vitality of objectives and intentions embodied in earlier versions of the statute. Prior enactments of a statute help explain the purposes behind a current statute.<sup>9</sup> Where phrases or blocks of language are adapted from earlier statutes, Congress is presumed to intend the same meaning.<sup>10</sup> Furthermore, if a section is merely renumbered, no intent to change the meaning of the statute is to be inferred.<sup>11</sup>

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9. See 1 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION, §§ 104, 108 (1991). "Legislative history includes the process by which a statutory section evolved. Thus, the language of previous statutes can be useful in interpreting current law." *Id.* § 108.

10. See, e.g., *Lorillard v. Pons*, 434 U.S. 575, 581 (1978) ("[W]here, as here, Congress adopts a new law which incorporates sections of a prior law, Congress normally can be presumed to have knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute."); *Eli Lilly v. EPA*, 615 F. Supp. 811 (S.D. Ind. 1985) ("Congress is presumed to be aware of a judicial interpretation of a statutory provision, and it can be inferred that it adopts that interpretation when it re-enacts a statute without changing the wording of that provisions."); *Massachusetts Mut. Life Ins. Co. v. United States*, 5 Cl. Ct. 581, 589 (1984) (stating that unaffected portions of changed tax law concerning taxation of life insurance companies is to be given same meaning as before amendment); see also 82 C.J.S. *Statutes* § 316 (1955) ("Although it may be presumed that by enacting a statute the legislature intended some change in the existing law, it is also presumed that the legislature did not intend to overthrow or depart from established principles of law, or, beyond what it explicitly declares either expressly or by necessary implication, to make any alteration in the existing law." (footnotes omitted)).

Where an agency interprets a statute and promulgates regulations reflecting that construction, and the Congress subsequently re-enacts the statute, the Congress implicitly approves the agency's interpretation. This rule has been referred to by courts as the "canon" of "acquiescence-by-reenactment." *Ohio v. Department of the Interior*, 880 F.2d 432, 458 (D.C. Cir. 1989) (examining CERCLA regulations).

11. See *Pacor, Inc. v. Higgins (In re Pacor)*, 743 F.2d 984, 987 n.4 (3d Cir. 1984) (observing in dictum that recent amendment, including renumbering of sections, did not change the substance of the law at issue); NORMAN J. SINGER, SUTHERLAND ON STATUTES & STATUTORY CONSTRUCTION § 22.33 (1985) ("Provisions of the original act or section which are repeated in the body of the amendment, either in the same or equivalent words, are considered a continuation of the original law."); cf. *United States v. Eller*, 208 F.2d 716, 719 (4th Cir. 1953) (noting that no change in substance should be presumed where regulations were republished "for the sole purpose of rearranging and renumbering their sections").

Based on these rules of statutory construction, this article draws inferences from earlier versions of section 104(a)(2) to derive its present meaning. Because the language concerning the treatment of exclusions has not changed from the original enactment in 1918,<sup>12</sup> examining earlier versions and interpretations of the act provides a vital link to the current version of section 104(a)(2).

## II. THE CONTROVERSY

The starting point for understanding the controversy surrounding personal injury awards is section 61(a) of the Internal Revenue Code, which contains the basic definition of income. It provides: "gross income means all income from whatever source derived . . . ."<sup>13</sup> The Supreme Court interprets this phrase broadly to effectuate Congress' intent to tax all gains except those specifically exempted.<sup>14</sup> Under the *Glenshaw Glass* definition, punitive

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12. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919) (providing that damages received "as compensation for personal injuries or sickness . . . whether by suit or agreement on account of such injuries or sickness" should be excluded for gross income). While the damages allowed as an exclusion has changed over the years, the statute's "on account of" language has remained constant. For a discussion of the evolution of § 104, see MERTENS, *supra* note 9, § 7.02.

13. I.R.C. § 61(a) (1988). References to sections, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended.

14. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955). In *Glenshaw Glass*, the Supreme Court held that a taxpayer realizes income when there are "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 431. See *infra* notes 162-72 and accompanying text.

A theoretical debate continues about whether or not amounts received as compensatory damages for personal injuries would be income in the absence of a statutory exclusion. The argument for including compensatory damages in income rests upon the premise that taxpayers lack a basis in "human capital" to offset payments received. See, e.g., *Roemer v. Commissioner*, 716 F.2d 693, 696 n.2 (9th Cir. 1983) ("Since there is no tax basis in a person's health and other personal interests, money received as compensation for an injury to those interests might be considered a realized accession to wealth. Nevertheless, Congress has retained the exclusion (now codified at I.R.C. § 104(a)(2))."), *rev'g* 79 T.C. 398 (1982); BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS*, ¶ 5.6, at 5-41 (2d ed. 1989) (comparing "human capital" theory to "human depreciation" claimed by some wage earners for loss of physical and mental capacity, but soundly rejected by courts); Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43 (1987) (criticizing return of capital argument).

The argument for excluding such receipts from income is that the damages merely restore injured parties to the status ante. See, e.g., *Glenshaw Glass*, 348 U.S. at 432 n.8 (noting the return for personal injury "roughly correspond[s] to a return of human capital" and is therefore not taxed); *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)

damages must be included in gross income absent a specific exclusion.<sup>15</sup> Section 104(a)(2) provides an exclusion for damages, but does not address punitive damages specifically. It excludes from gross income "any damages received . . . on account of personal injuries or sickness."<sup>16</sup> However, determining the extent to which

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(finding damages for invasion of privacy taxable where taxpayer's father, not taxpayer, suffered harm); see also BITTKER & LOKKEN, *supra*, ¶ 13.1.4 (discussing exclusion of damages from gross income under § 104(a)(2)); Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 766 (1988) (analogizing personal damage awards to return of capital); Bruce J. Squillante & Jeffrey L. Patterson, *Planning Strategies that Will Keep Personal Injury Damages Excluded from Income*, TAX'N FOR ACCT., June 1987, at 38 (reviewing meaning of payments received "on account of" personal injury and when excludable under § 104(a)(2)).

15. See, e.g., *Glenshaw Glass*, 348 U.S. at 431 (concluding that "mere fact" payment was to punish wrongdoing does not alter payment's character as income to recipient); *Thompson v. Comm'r*, 406 F.2d 1006, 1008 (9th Cir. 1969) (punitive damages are taxed as ordinary income); Treas. Reg. § 1.61-14(a) (as amended in 1965) ("[P]unitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income."). Compare *Rickel v. Commissioner*, 900 F.2d 655, 657 (3d Cir. 1990) (finding award for age discrimination analogous to personal injury award and excludable from personal income), *aff'g in part and rev'g in part* 92 T.C. 510 (1989) with *United States v. Burke*, 60 U.S.L.W. 4404 (U.S. May 26, 1992). See *infra* text accompanying notes 349-57.

16. I.R.C. § 104(a)(2). Section 104 provides:

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

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

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

(3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980; and

(5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a violent attack which the Secretary of State determines to be a terrorist attack and which occurred while such individual was an employee of the United States engaged in the performance of his official duties outside the United States.

For purposes of paragraph (3), in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1) (relating to

this section encompasses punitive damages is central to the controversy and the thesis of this article.

The Internal Revenue Service (the "Service") currently takes the position that punitive damages are not excluded from gross income under section 104(a)(2).<sup>17</sup> The Service limits application

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self-employed individuals), contributions made on behalf of such individual while he was such an employee to a trust described in section 401(a) which is exempt from the tax under section 501(a), or under a plan described in section 403(a), shall, to the extent allowed as deductions under section 404, be treated as contributions by the employer which were not includible in the gross income of the employee. Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.

Treas. Reg. § 1.104-1(c) (as amended in 1970) provides:

Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

The Service's initial articulation of the requirement of tort or tort-type rights appeared in Sol. Mem. 2042, IV-1 C.B. 26 (1925), *rev'd*, I.T. 2170, IV-2 C.B. 28 (1925), in which it distinguished the taxation of damages received for breach of a promise to marry from damages received for alienation of affections and personal defamation and from money received for release of child custody rights. The basis for the distinction was that the former "resulted solely from the surrender of a right to enforce a promise which the law confers upon either party to a bilateral contract . . . while in the latter, "[t]he payment involved was attributable to a tort." *Id.* at 26-27. In *United States v. Burke*, Justice Scalia questioned the Service's tort rights formulation as not within the range of reasonable interpretation of statutory text. 60 U.S.L.W. 4404, 4407 (U.S. May 26, 1992) (Scalia, J., concurring).

Income requires an accession to wealth. *Glenshaw Glass*, 348 U.S. at 431. Whether or not damages constitute an accession to wealth depends upon the reason for which they are awarded. Therefore, determining whether damages have been recovered for a tort or breach of contract is one step in determining whether the award will be included in gross income.

The law of the jurisdiction applied in the underlying suit determines whether a particular cause of action is based in tort or in contract. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Once the nature of the claim or interest is determined, federal law applies to determine the tax consequences. *Threlkeld v. Commissioner*, 87 T.C. 1294, 1297 (1987) (affirming that tax consequences of an award depends on type of claim being litigated), *aff'd*, 848 F.2d 81 (6th Cir. 1988); *Bent v. Commissioner*, 87 T.C. 236, 244 (1986) (reviewing exclusions under § 104(a)(2)), *aff'd*, 835 F.2d 67 (3d Cir. 1987); *Roemer*, 79 T.C. at 405 (1982) (tax consequences depend on "character of claims"), *rev'd*, 716 F.2d 693 (9th Cir. 1983). The issue of whether or not a particular cause of action is based upon "tort or tort type rights" has spawned a substantial volume of litigation. See *infra* note 44. The law of the applicable jurisdiction also determines whether awards are compensatory or punitive. Rev. Rul. 84-108, 1984-2 C.B. 32, 33 (comparing hypothetical states where one state does not allow punitive damages and another state provides exclusively for punitive damages).

17. Rev. Rul. 84-108, 1984-2 C.B. 32, 34 (concluding punitive damages "do not com-

of this exemption to payments which are analogous to a restoration of capital.<sup>18</sup> Capital, in the Service's view, includes human capital. Because the Service's position is that "punitive damages are awarded not 'on account of personal injury,' as required by section 104(a)(2), but are determined with reference to the defendant's degree of fault,"<sup>19</sup> punitive damages restore no capital and the amount of such an award constitutes gross income. This view recently received judicial endorsement with the Fourth Circuit's decision in *Commissioner v. Miller*,<sup>20</sup> and two district courts<sup>21</sup> which held that punitive damages did more than make the plaintiff whole and were, therefore, not excludable from income.<sup>22</sup>

A contrary position has been advanced by the Tax Court,<sup>23</sup>

pensate a taxpayer for a loss but add to the taxpayer's wealth"), *rev'g* Rev. Rul. 75-45, 1975-1 C.B. 47; *see also* Priv. Ltr. Rul. 91-06-013 (Nov. 7, 1990) (denying taxpayer's request to exclude punitive damages awarded in asbestos litigation from taxpayer's income because punitive damages "represent an addition to the wealth of the recipient"). *See infra* notes 223-65 and accompanying text.

18. Rev. Rul. 84-108, 1984-2 C.B. at 34.

19. *Id.*; *see also* Gen. Couns. Mem. 37,398 (Jan. 31, 1978).

20. 914 F.2d 586 (4th Cir. 1990), *rev'g* 93 T.C. 330 (1989).

In *Roemer v. Commissioner*, 79 T.C. 398, 408 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983), *nonacq.* Rev. Rul. 85-143, 1985-2 C.B. 55, the Tax Court held that punitive damages awarded predominantly for injury due to business and professional reputation were not awarded "on account of personal injuries" and were thus includible in gross income. In dicta, however, the Tax Court questioned the Service's interpretation of § 104(a)(2) as excluding punitive damages altogether: "Since his interpretation [in Revenue Ruling 75-45] arguably comes within the language of section 104(a)(4)[2], . . . the Commissioner has chosen to allow punitive damages to be excluded from gross income in the same manner as compensatory damages *provided they arise out of a personal injury*." *Id.* at 408. On appeal, the Ninth Circuit referred to the Service's interpretation of § 104(a)(2) as "liberal" and excluded the punitive damages Roemer received from income. *Roemer*, 716 F.2d at 700. *See infra* notes 268-83 and accompanying text.

21. *O'Gilvie v. United States*, Civ. A. No. 90-1075-B, 1992 WL 123,806 (D.Kan. May 26, 1992) (punitive damages received in wrongful death action not excludable from income); *Kemp v. Comm'r*, 771 F. Supp. 357 (N.D.Ga. 1991), *appeal dismissed*, No. 91-8610 (11th Cir. Dec. 3, 1991) (punitive damages received in settlement of action to vindicate violation of First Amendment rights are not excludable from income).

22. *Miller*, 914 F.2d at 590. In particular, the court held that, like punitive damages, the settlement was a "windfall," *id.* at 591 (quoting *Cheek v. J.B.G. Properties*, 344 A.2d 180, 184 (Md. Ct. Spec. App. 1975)), and that it was "over and above any award of compensatory damages" and thus beyond the § 104(a)(2) exclusion. *Id.* (quoting *Exxon Corp. v. Yarama*, 516 A.2d 990, 997 (Md. Ct. Spec. App. 1986)). *See also O'Gilvie*, 1992 WL 123,806 at \*4; *Kemp*, 771 F. Supp. at 359 (citing *Miller*).

23. *Miller*, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990). Although the Fourth Circuit reversed the Tax Court, holding that punitive damages are *not* excluded under § 104(a)(2), its decision is binding on the Tax Court only with respect to cases appealable to the Fourth Circuit. *Golsen v. Commissioner*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *and cert. denied*, 404 U.S. 940 (1971). The Tax



the Ninth Circuit<sup>24</sup> and one district court.<sup>25</sup> These authorities assert that punitive damages are encompassed by section 104(a)(2) and, therefore, should be excluded from gross income. Collectively, these courts reason that the phrase "any damages" in the language of the exemption includes both compensatory and punitive damages,<sup>26</sup> and that the phrase "on account of" in the statute is equivalent to "[f]or the sake of," "by reason of," or "because of."<sup>27</sup> This construction of the statute broadens section 104(a)(2) to include punitive damages. According to the Tax Court's reasoning, because most jurisdictions require that some amount of actual damages be proven before punitive damages may be awarded, "punitive damages are received 'on account of' personal injury, although personal injury alone may not justify an award of punitive damages."<sup>28</sup>

In 1989, Congress added a new dimension to this controversy when it enacted the Omnibus Budget Reconciliation Act of 1989.<sup>29</sup> This act amended section 104(a) to provide "[p]aragraph (2) [of section 104(a)] shall not apply to any punitive damages [received] in connection with a case not involving physical injury or physical sickness."<sup>30</sup> As a result, punitive damages awarded in

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Court's opinion in *Miller* retains its vitality with respect to cases from other circuits, and its analysis of § 104(a)(2) is typical of arguments excluding punitive damages from gross income. See *infra* notes 309-31 and accompanying text.

24. *Roemer*, 716 F.2d at 700. In *Roemer*, the Ninth Circuit held punitive damages excludable on the basis of the Service's "liberal interpretation" of § 104(a)(2). *Id.* The court cited Revenue Ruling 75-45, 1975-1 C.B. 47, which held that punitive damages were within the scope of § 104(a)(2). Because Revenue Ruling 75-45 has been revoked by Revenue Ruling 84-108, the continuing vitality of the Ninth Circuit's holding is questionable. See *infra* notes 282-83 and accompanying text.

25. *Burford v. United States*, 642 F. Supp. 635 (N.D. Ala. 1986). However, *Burford* may be analyzed more properly as holding that the damages awarded in an Alabama wrongful death action were compensatory in nature, not punitive. Thus analyzed, *Burford* does not address the issue of whether punitive damages are excluded under § 104(a)(2). See *Miller*, 914 F.2d at 591 ("[T]he *Burford* court[] . . . 'reject[ed] the precise argument . . . that such damages are obtained for punitive rather than compensatory purposes.'" (quoting *Burford*, 642 F. Supp. at 637)). For further discussion of *Burford*, see *infra* text accompanying notes 284-96. For discussion of various types of damages, see *infra* text accompanying notes 42-84.

26. *Roemer*, 716 F.2d at 697, 700; *Burford*, 642 F. Supp. at 636; *Miller*, 93 T.C. at 338.

27. *Miller*, 93 T.C. at 339 (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (1981)).

28. *Id.* at 340.

29. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a) (West Supp. 1992)).

30. *Id.* § 7641(a). The provision is effective for punitive damages received after July

cases which do not involve a physical injury or sickness must be included in income. Although the 1989 amendment settled the debate regarding the status of punitive damages awarded in instances not involving a physical illness or sickness, it has engendered considerable discussion and confusion about the extent to which section 104(a)(2) applies to punitive damages awarded in cases involving physical sickness or injury.<sup>31</sup> Based on the language of the amendment, a number of commentators conclude by negative implication that section 104(a)(2) now excludes punitive damages awarded in cases involving physical injury.<sup>32</sup> The Service also adopts, at least unofficially, this interpretation. In two publications, it advises taxpayers that punitive damages awarded in cases not involving physical injury or sickness are taxable.<sup>33</sup> However, others would contend that a conclusion that § 104, as amended in 1989, excludes punitive damages from gross income in a case involving physical sickness or injury cannot be reached by negative implication. Exemptions are never granted on inference alone; they "are not to be implied but must be unambiguously proved."<sup>34</sup>

The amended exclusion is also susceptible to a plausible alternate interpretation which would make punitive damages awarded in

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10, 1989, or in tax years ending after that date, other than amounts received under a written, binding agreement, court decree or mediation award in effect on or issued before July 10, 1989, or amounts received pursuant to suits filed on or before July 10, 1989. Omnibus Reconciliation Act of 1989, § 7641(b)(2), 103 Stat. at 2379. See also H.R. CONF. REP. No. 386, 101st Cong., 1st Sess. 622-23 (1989), reprinted in 1989 U.S.C.C.A.N. 3225-26 (highlighting the distinction between physical and personal injury and eliminating the exclusion for damages for the latter). See *infra* notes 367-95 and accompanying text.

31. See, e.g., Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143 (1992) (discussing whether tax policies should be used to exclude any component of recovery in a personal injury suit); David G. Jaeger, *The Dispute over Taxation of Employment Discrimination Awards*, 69 TAXES 608 (1991) (analyzing tax consequences of employment discrimination awards).

32. See JAMES D. GHOUDI & JOHN J. KIRCHER, PUNITIVE DAMAGES LAW AND PRACTICE § 14.01 at 1 (Aug. 1990 Cum. Supp.) ("[The 1989 amendment] means that punitive damages awarded where physical injury or physical sickness are involved are exempt from taxation, but that all other awards are taxable."); Robert R. Wood & Simon Noel, *Tax Aspects of Settlements, Judgments, Antitrust Payments and Recoveries*, 121-5th Tax Mgmt. (BNA), Portfolio, A-6 (1990) ("Congress settled this issue for punitive damages received after July 10, 1989.").

33. I.R.S., U.S. DEP'T OF TREASURY, PUB. NO. 525, TAXABLE AND NONTAXABLE INCOME 15 (1991); I.R.S., U.S. DEP'T OF TREASURY, PUB. NO. 17, YOUR FEDERAL INCOME TAX 77 (1990). The official position of the Service is stated in regulations, revenue rulings and revenue procedures. Taxpayers may not rely on publications. See, e.g., Adler v. Comm'r, 330 F.2d 91 (9th Cir. 1964).

34. MERTENS, *supra* note 9, § 5.06; see also Dodge, *supra* note 31.

physical injury cases includible in gross income. This alternate view simply requires that any exemptions from income be explicit rather than inferred.<sup>35</sup> Accordingly, the negative inference that the exclusion applies to awards where the taxpayer did suffer a physical injury or sickness would be impermissible. Consistent with this view, a proper explanation of the amendment limits section 104(a)(2) to its terms so that the section does not speak with respect to punitive damages where physical harm is involved. Any attempt to expand the exclusion further is inappropriate. In *Commissioner v. Miller*,<sup>36</sup> the Fourth Circuit followed this approach, noting specifically that a fundamental principle of statutory construction demands that exclusions from income be construed narrowly.<sup>37</sup> Consequently, the 1989 amendment raises difficult interpretational issues which render the effect of the provision unclear.<sup>38</sup>

The 1989 amendment is also ambiguous with respect to the particular situation it purported to address explicitly, the taxation of punitive damages awarded in "a case not involving physical sickness or injury."<sup>39</sup> This ambiguity is best illustrated by example. Assume that a taxpayer is libeled by the defendant, and the taxpayer receives a court judgment representing \$1,000,000 for actual damages and \$2,000,000 for punitive damages. Since the 1989 amendment, the punitive damages are not excludable from gross income because the tort did not involve any physical injury or sickness. Now, assume that as a result of the libel, the taxpayer suffers an ulcer and damages for this physical manifestation are alleged in the libel action. The introduction of this illness appears to bring the taxpayer's punitive damage award within the section 104(a)(2) exclusion. Determining whether or not Congress intended section 104(a)(2) to encompass this type of fact pattern as an allowed exclusion is difficult and the conclusion reached will no doubt be subject to considerable dispute.

The legislative history surrounding the passage of the 1989

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35. See *supra* note 16. See *O'Gilvie v. United States*, Civ. A. No. 90-1075-B, 1992 WL 123,806 (D.Kan. May 26, 1992) (specifically rejecting taxpayer's argument that the 1989 amendment, by implication, meant that prior to the amendment, punitive damages were excludable).

36. 914 F.2d 586 (4th Cir. 1990), *rev'g* 93 T.C. 330 (1989).

37. *Id.* at 590. See also *O'Gilvie v. United States*, Civ. A. No. 90-1075-B, 1992 WL 123,806 (D.Kan. May 26, 1992).

38. See *infra* text accompanying notes 367-95.

39. I.R.C. § 104(a).

amendment provides little guidance for clarifying the law's effect in situations like the libel hypothetical. The House report regarding the 1989 amendment indicates only a desire to tax punitive damages received in connection with a non-physical personal injury.<sup>40</sup> It does not yield any further direction for interpreting the provision generally or applying the rule to cases where the underlying tort is not physical in nature, but physical manifestations support a claim for punitive damages.

In summary, the current state of the law regarding the taxability of punitive damages is confused. Although the 1989 amendment did resolve one narrow aspect of this debate as noted above, it unfortunately continues to obscure the subject by raising new, difficult interpretational issues.<sup>41</sup> The chaos and turmoil resulting from the various views expressed above warrants resolution.

### III. TYPES OF LEGAL DAMAGES

In order to properly construe section 104(a)(2), it is important to review the three basic types of legal damages, compensatory, nominal and punitive. The tax consequences of an award or settlement depend upon determining the rationale for the award and specifically what, if anything, it replaced.<sup>42</sup> Thus, "the question to be asked is 'in lieu of what were the damages awarded?'"<sup>43</sup> To answer this question, it is necessary to determine the nature of the claim giving rise to the award of damages.<sup>44</sup> If the damages are

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40. H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 622-23 (1989), *reprinted in* 1989 U.S.C.A.N. 3018, 3225-26.

41. *See infra* text accompanying notes 367-95.

42. *See supra* note 16.

43. *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944) (citation omitted) (determining whether amounts received in settlement were lost income or a non-taxable return of capital), *aff'g* 1 T.C. 952 (1943), and *cert. denied*, 323 U.S. 779 (1944); *see also* *Roemer v. Commissioner* 79 T.C. 398, 405 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983); *Wolfson v. Commissioner*, 651 F.2d 1228, 1230 (6th Cir. 1981) (determining whether damages were for lost earnings or injury to personal reputation), *aff'g and remanding* T.C. Memo 1978-445.

44. *See, e.g.,* *Burke v. United States*, 60 U.S.L.W. 4404 (U.S. May 26, 1992) (holding damages received for Title VII violation were to restore wages and employment position and not for traditional tort-like personal injury excludable under § 104(a)(2), *rev'g* 929 F.2d 1119 (6th Cir. 1991); *United States v. Gilmore*, 372 U.S. 39, 49 (1963) (holding that legal expenses incurred to defend title to business assets in a divorce proceeding were personal in nature and therefore not deductible); *Sparrow v. Commissioner*, 949 F.2d 434 (D.C. Cir. 1991) (settlement of racial discrimination claim not excluded from gross income by § 104(a)(2)); *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990) (ADEA claim is personal in nature); *Miller v. Commissioner*, 93 T.C. 330, 334-35 (1989) (defa-

received as compensation for the personal injury, they are clearly excluded from gross income by section 104(a)(2). In contrast, when the damages are awarded for another purpose, such as to punish or to deter the wrongdoer, application of section 104(a)(2) becomes questionable.<sup>45</sup> It is thus appropriate to examine the nature of each type of damage, its purpose and the policies which support it when determining whether or not an award should be excluded from income.

### A. The Compensatory Nature of Tort Damages

The primary function of the law of torts is to compensate an injured party for harm suffered on account of a legal wrong.<sup>46</sup> In particular, tort law aims to place the injured party in the same position he would have been in if the wrong never occurred, i.e., to make the plaintiff whole.<sup>47</sup> The idea of punishment or deterrence is the objective of the criminal law.<sup>48</sup>

An injured party is restored to the state *ex ante* through an award of damages. "[T]he damages awarded should be an amount sufficient to indemnify the plaintiff for the loss which he has suffered at the hands of the defendant."<sup>49</sup> "[T]he stress [in a tort case] is on restoration to the economic position which presumably would have been occupied if no loss had occurred."<sup>50</sup> Consequent-

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mation is a personal injury action), *rev'd*, 914 F.2d 886 (4th Cir. 1990); *Rickel v. Commissioner*, 92 T.C. 510, 516 (1989) (claim for violation of Age Discrimination in Employment Act is an action in nature of personal injury), *aff'd in part and rev'd in part*, 900 F.2d 655 (3d Cir. 1990); *Bent v. Commissioner*, 87 T.C. 236, 244 (1986) (action under 42 U.S.C. § 1983 is a claim for violation of personal rights and damages are excluded by section 104(a)(2)), *aff'd*, 835 F.2d 67 (3d Cir. 1987); *Threlkeld v. Commissioner*, 87 T.C. 1294, 1307 (1986) (claim for malicious prosecution is an action for personal injury), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

45. See *infra* text accompanying notes 118-34.

46. RESTATEMENT (SECOND) OF TORTS §§ 901 cmt. a, 902 (1979); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS §§ 1, 5-6 (5th ed. 1984) (stating that the purpose of tort law is to adjust losses and compensate for injuries caused by the conduct of another); 1 THEODORE SEDGWICK, A TREATISE ON THE MEASURE OF DAMAGES § 30 (9th ed. 1912) (stating that the object of both contract and tort law is to compensate for pecuniary loss).

Tort law awards damages to serve other purposes as well. Among these other purposes are the recognition and affirmation of individual rights, punishment and deterrence. RESTATEMENT (SECOND) TORTS, § 901; KEETON et al., *supra*, §§ 2-4. These purposes are discussed *infra* text accompanying notes 62-84.

47. RESTATEMENT (SECOND) OF TORTS § 901; SEDGWICK, *supra* note 46, § 30.

48. KEETON et al., *supra* note 46, § 2, at 9.

49. SEDGWICK, *supra* note 46, § 30, at 25.

50. Bertram Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614, 617 (1952). The ob-

ly "[u]nless punitive damages are contemplated, the damages in tort are to be considered *compensatory* . . . ."<sup>51</sup> Tort law requires that the plaintiff prove the value of the sustained injuries. By requiring the damages to be proved with exactness, or at least a high degree of certainty, the law insures that the damages remain compensatory,<sup>52</sup> and do not become a windfall to the plaintiff. The amount of the award thus corresponds to the pecuniary value of the loss proven by the plaintiff.<sup>53</sup>

The compensatory nature of damages is further evidenced by an examination of the proof required to support their award. In order to receive compensatory damages, the plaintiff must prove, in monetary terms, the value of the sustained injuries.<sup>54</sup> The use of such evidence serves a dual purpose. It first insures full compensation of injuries sustained by the plaintiff. Secondly, it simultaneously avoids over-compensating the plaintiff and punishing the defendant.<sup>55</sup>

The compensatory function of tort damages is also apparent from an analysis of the personal interests infringed by a defendant. An examination of these personal interests reveals two broad types: pecuniary interests, such as lost wages or damages to property, and non-pecuniary interests, such as bodily or emotional harm.<sup>56</sup> Inju-

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jective of damages in contract is conceptually identical, but contract damages give the injured party the benefit of the bargain. RESTATEMENT (SECOND) OF CONTRACTS § 344 (1979).

51. Harnett, *supra* note 50, at 617 (emphasis added).

52. See generally SEDGWICK, *supra* note 46, § 170 (discussing plaintiff's burden of proof).

53. See *id.*; RESTATEMENT (SECOND) OF TORTS §§ 905-06.

54. Certain compensatory damages are recoverable only if the actual or a reasonably certain value can be ascertained. See DAN B. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 3.3 (1973). For example, in pecuniary loss cases involving property damage or loss of earning capacity, the tortfeasor is liable only for those losses which the injured person can substantiate within definite standards of certainty. See RESTATEMENT (SECOND) OF TORTS § 906.

55. "The universal and cardinal principle is that the person injured shall receive a compensation commensurate with his loss or injury, and no more . . . ." J. G. SUTHERLAND, A TREATISE ON THE LAW OF DAMAGES § 12 (4th ed. 1916); see also SEDGWICK, *supra* note 46, §§ 29, 38 (damages are to compensate for loss sustained to degree possible).

56. See RESTATEMENT (SECOND) OF TORTS §§ 903, 905-906 (stating that damages may be awarded for nonpecuniary harm such as bodily harm and emotional distress and for pecuniary loss including harm to property, earning capacity and creation of liabilities); SEDGWICK, *supra* note 46, §§ 39-51 (suggesting that non-pecuniary losses typically include such things as pain and suffering, loss of consortium, damage to reputation, mental suffering or emotional distress, loss of freedom, impairment of one's faculties, fear and anger and even the mental anguish of witnessing a tort being committed upon a third person or

ry to a pecuniary interest simply requires a determination of the amount of such damages. For example, if the defendant destroys property belonging to the plaintiff, the plaintiff is entitled to damages in the amount of the value of that property.<sup>57</sup> By contrast, an injury to a non-pecuniary interest is often less apparent, and as a result, more difficult, if not impossible, to measure.<sup>58</sup> Nonetheless, authorities generally are clear that awards for these non-pecuniary harms are intended to be viewed as compensation.<sup>59</sup>

Another characteristic of compensatory damages is that they are assessed according to the losses suffered by the plaintiff without regard for the defendant's motive in causing the loss.<sup>60</sup> As stated earlier, tort damages focus only on compensating the plaintiff by placing the plaintiff in the pre-loss position. Any amount awarded above the value of the loss suffered based on the defendant's motive or desire for harming the plaintiff is inconsistent with the nature of compensatory damages. A separate category of damages, punitive damages, developed later to address concerns

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a corpse); SUTHERLAND, *supra* note 55, § 75 (recognizing that compensatory damages include both pecuniary and non-pecuniary losses).

57. Section 104(a)(2) does not exclude from income gain realized on account of injury to property.

58. See RESTATEMENT (SECOND) OF TORTS §903 cmt. a.

Compensation for an injury should not be denied simply because damages are not measurable with precision. See SEDGWICK, *supra* note 46, § 46 ("[T]he law does not refuse to take notice of such injury on account of the difficulty of ascertaining its degree." (quoting *Ballou v. Farnum*, 93 Mass. (11 Allen) 73, 77 (1865)). The task of measuring nonpecuniary losses "is necessarily left to the discretion of the jury." SUTHERLAND, *supra* note 55, § 75.

59. See, e.g., SEDGWICK, *supra* note 46, § 38 ("The law does not attempt the impossibility of replacing the plaintiff in exactly the position he was in before the injury, yet within the bound of possibility its aim is compensation."); RESTATEMENT (SECOND) OF TORTS § 903. While complete certainty is not required when proving the amount of such non-pecuniary compensatory damages, the amount claimed must bear some relation to the injury suffered. See generally DOBBS, *supra* note 54, § 3.3 ("[C]ourts seem to have striven for a balance that permits the plaintiff to recover even if his proof is incomplete, but at the same time imposes upon him the requirement that he prove as much as he reasonably can and in any event that he prove something relevant to computation of damages."). If the loss is not proven with the requisite amount of certainty, the court will refuse to grant compensatory damages and may instead award nominal damages. See *id.* § 3.8, at 191 ("[Nominal] damages are awarded when the plaintiff has asserted substantial damages, but has been unable to prove those damages with the required certainty."). For discussion of nominal damages, see *infra* text accompanying notes 62-71.

60. SUTHERLAND, *supra* note 55, § 98 ("So far as pecuniary elements of damage and full compensation for injury are concerned, either in actions of tort or for breach of contract, the right to recover is wholly independent of the motives . . .").

about the egregiousness of the defendant's conduct.<sup>61</sup> Compensatory damages, however, only address the harm caused to the plaintiff.

### B. Nominal Tort Damages

At common law, damages were awarded only for a loss actually sustained.<sup>62</sup> As a corollary to that rule, in the absence of loss or harm determinable with some degree of accuracy, compensatory damages cannot be awarded.<sup>63</sup> Later, a category of damages developed to address the situation where no actual loss occurred, but a right was infringed upon by the defendant. For example, a landowner has a legal right to be protected against trespasses to land whether or not such an invasion causes an injury. Recognizing the need to affirm these kinds of individual rights as another aspect of tort law, courts developed the concept of "nominal" damages.<sup>64</sup> Nominal damages result from interference with a legal right where no loss or specific harm has occurred.<sup>65</sup> Consequently, their award is made irrespective of whether the plaintiff suffered any harm.<sup>66</sup> Moreover, since they are not predicated on the harm caused, but simply upon the violation of a right, they are trivial in amount.<sup>67</sup>

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61. See *infra* text accompanying notes 72-84.

62. SEDGWICK, *supra* note 46, § 96a ("[T]he common law, as a general rule, only gives actual compensation in cases of actual injury.").

63. See, e.g., *Gottesman & Co. v. Portland Terminal Co.*, 27 A.2d 394 (Me. 1942) (re-mandering for a new trial on the issue of damages because no evidence had been introduced to furnish a basis for estimating the damages plaintiff incurred); see also RESTATEMENT (SECOND) OF TORTS § 912 (The burden is on the one who seeks recovery of damages to establish "by proof the extent of the harm and the amount of money representing adequate compensation with as much certainty as the nature of the tort and the circumstances permit."); SEDGWICK, *supra* note 46, § 96a ("If it appears that though the defendant is in fault, still that the plaintiff is not injured, he can have no relief.").

64. See SEDGWICK, *supra* note 46, §§ 96-109 ("Wherever the breach of an agreement or the invasion of a right is established, the English law infers some damage to the plaintiff . . . ." *Id.* § 97.).

65. See *id.* §§ 97-98, 101 (stating that damages may be warranted for the infringement of a right or for wrongdoing even if there is no injury); DOBBS, *supra* note 54, §§ 3.1, 3.8 (suggesting that nominal damages may be awarded to "vindicate a legal right" or when plaintiff is unable to prove substantial damages with the "required certainty").

66. See SUTHERLAND, *supra* note 55, § 9 (noting that although no actual injury is sustained, the violation of a legal right is in itself injurious and worthy of a damage award); see also RESTATEMENT (SECOND) OF TORTS § 907 cmt. b (noting that "nominal damages can be awarded when the defendant has invaded an interest of the plaintiff protected against nonharmful conduct of the sort committed by the defendant and no harm has been proved").

67. RESTATEMENT (SECOND) OF TORTS § 907; SEDGWICK, *supra* note 46, §§ 96a, 101-106. Nominal damages may be awarded whenever a legal right is violated regardless of whether the action is in tort or contract, or whether it involves a personal or property



The differences in the nature of nominal damages, as contrasted with compensatory and punitive damages, are also reflected in the proof required to obtain their award.<sup>68</sup> At trial, the plaintiff is not required to offer any evidence of the value of the loss suffered if only nominal damages are sought for an invasion of a right.<sup>69</sup> In contrast, the proof for an award of compensatory damages focuses solely on the monetary value of the harm the defendant causes the plaintiff without consideration of the defendant's motive or deliberateness of conduct.<sup>70</sup> As such, where the plaintiff can prove actual harm with certainty, the court will award compensatory damages, and where plaintiff cannot offer such proof, but a legal right is infringed upon, the court will award nominal damages.<sup>71</sup>

### C. Punitive Damage Awards

A separate category of damages developed to address the egregiousness of defendants' conduct. "Punitive damages are damages other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct."<sup>72</sup> Punitive damages are awarded in an effort to reduce the likelihood that the defendant or others will repeat the conduct in the future.<sup>73</sup> They are provided "to promote the peace and quiet of society, and to protect every one in the full enjoyment of his rights . . . ."<sup>74</sup> Ac-

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right. Generally, the amount of nominal damages is insignificant, such as \$1.00. DOBBS, *supra* note 54, § 3.8. *But see id.* § 3.9 (noting that for certain dignitary harms, courts permit substantial damage awards despite the absence of a pecuniary injury).

68. RESTATEMENT (SECOND) OF TORTS § 907 cmt. a; DOBBS, *supra* note 54, § 3.8 ("nominal damages . . . [are] not compensable even in a limited sense . . . ."). Cf. SEDGWICK, *supra* note 46, § 352 (discussing the circumstances in which courts permit an award of exemplary damages).

69. Compare the plaintiff's burden here with the burden of proof necessary for an award of compensatory damages, discussed *supra* text accompanying notes 42-61.

70. *See* sources cited *supra* note 58.

71. DOBBS, *supra* note 54, § 3.8.

72. RESTATEMENT (SECOND) OF TORTS § 908(a). *But see* DOBBS, *supra* note 54, § 3.9 ("Some courts have viewed punitive damages as compensatory, in the limited sense that they may provide damages for the wounded feelings of the plaintiff.") KEETON et al., *supra* note 46, § 2, at 9 (noting cases awarding punitive damages to reimburse plaintiffs' costs not otherwise recoverable); Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 520-21 (1957) (noting "certain elements of compensation can be identified in awards of exemplary damages").

73. RESTATEMENT (SECOND) OF TORTS § 908.

74. SEDGWICK, *supra* note 46, § 351. Punitive damages are also referred to as "exemplary damages" or "smart money." *Id.* § 352; KEETON et al., *supra* note 46, § 2, at 9.

cordingly, an award of punitive damages requires more than the mere commission of a tort; for such damages to be imposed, courts generally require that the wrongdoer's conduct be outrageous and despicable.<sup>75</sup>

Some authorities note that punitive damages and criminal fines are essentially the same, except that a private person receives a punitive damage award whereas the state or local government receives a criminal fine.<sup>76</sup> This similarity extends further because both a criminal fine and a punitive damage award involve some element of outrageous conduct by the defendant which is unacceptable to society.<sup>77</sup> No other type of civil damage award serves this objective.<sup>78</sup>

The nature of the evidence necessary to support a claim for punitive damages and to calculate their amount further distinguishes them from compensatory and nominal damages. While compensatory damages require actual or relatively certain proof of the amount of the plaintiff's loss and nominal damages serve mainly as a token for the violation of a right, punitive damages are determined by evaluating such factors as the "character of the defendant's act, the nature and extent of the harm . . . and the wealth of the defendant."<sup>79</sup> By focusing on these factors, the court insures that the amount of the punitive damages will, in fact, serve as a punishment, and hence, a deterrent.

The unique nature of punitive damages is also exhibited by another characteristic element. Punitive damages are generally permitted only where expressly authorized by statute or case law in the controlling jurisdiction.<sup>80</sup> Moreover, they are generally award-

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75. See, e.g., KEETON et al., *supra* note 46, § 2, at 8-11 (stating that punitive damages serve to punish the defendant and vindicate his conduct); SEDGWICK, *supra* note 46, § 352 (In cases where the defendant "acted recklessly, or wilfully and maliciously, with a design to oppress and injure the plaintiff, the jury, in fixing the damages, may disregard the rule of compensation, and beyond that may, as a punishment to the defendant . . . award such additional damages as . . . they may deem proper." (quoting *Voltz v. Blackmun*, 64 N.Y. 440, 444 (1876))).

76. RESTATEMENT (SECOND) TORTS § 908 cmt. a.

77. *Id.*

78. *Id.*

79. *Id.* § 908(2). See also KEETON et al., *supra* note 46, § 2, at 15 (noting that a consideration of the defendant's wealth permits a determination as to what amount will adequately punish); cf. *Pacific Mut. Life Ins. Co. v. Haslip*, 111 S. Ct. 1032 (1991) (holding that punitive damages in excess of four times the compensatory damages awarded did not violate the Due Process Clause of the Fourteenth Amendment).

80. See KEETON et al., *supra* note 46, § 9 (listing actions which reject punitive damages in certain situations and noting representative statutes which authorize their award for

ed only after compensatory or nominal damages.<sup>81</sup> Consequently, punitive damages are available only under limited circumstances.<sup>82</sup>

Notwithstanding the labels and generally clear distinctions among the three types of legal damages, some overlap exists among the policies and objectives of the various types of damages, particularly with respect to statutory violations.<sup>83</sup> A review of the nuances of any particular cause of action and the associated damages award is beyond the scope of this article. However, characterization of damages received in any legal action is a critical step for federal income tax purposes, because the nature of the award will determine its taxability.<sup>84</sup> The Service and courts considering tax consequence that may follow these awards examine the underlying litigation to determine the nature of an award for tax purposes. This article proceeds to analyze the proper tax treatment assuming the *nature* of a damage award has been determined.

#### IV. HISTORICAL ANALYSIS PRIOR TO *GLENSHAW GLASS*

Since the first tax act, the Revenue Act of 1913,<sup>85</sup> the appropriate tax treatment of damages received on account of personal injury has been a subject of debate. Under this law, a tax was imposed upon an individual's "entire net income,"<sup>86</sup> which was broadly defined to include "gains or profits and income from any source whatever . . . ."<sup>87</sup>

##### A. Administrative Practice Prior to the Statutory Exclusion

Interpreting the 1913 Act's definition of income, Treasury Decision 2135<sup>88</sup> addressed the tax consequences of accident insur-

particular torts).

81. *Id.* § 2, at 9, 14; RESTATEMENT (SECOND) OF TORTS § 908 cmt. c.

82. RESTATEMENT (SECOND) TORTS § 908.

83. *See, e.g.,* Thompson v. Commissioner, 866 F.2d 709, 712 (4th Cir. 1989) (holding liquidated damages awarded pursuant to Equal Pay Act served both a deterrent and compensatory purpose).

84. *See supra* note 16 and accompanying text.

85. Revenue Act of 1913, Pub. L. No. 16, ch. 16, 38 Stat. 114 (1913) (codified as amended in scattered sections of 26 U.S.C.), *reprinted in* 93 UNITED STATES REVENUE ACTS 1909-1950, pt. 4 (Bernard D. Reams, Jr. ed. 1979) [hereinafter U.S. REVENUE ACTS].

86. *Id.* § 2(A)(1), 38 Stat. at 166.

87. *Id.* § 2(B), 38 Stat. at 167.

88. T.D. 2135, 17 Treas. Dec. Int. Rev. 39 (1915), *repealed in part by* T.D. 2442, Treas. Dec. Int. Rev. 25, 26 (1917). One early commentator stated that life insurance proceeds "would probably have to be reckoned as part of the 'income' of the beneficiary

ance policies and tort damages. Using the above definition, the Treasury held that proceeds of "an accident insurance policy [received] on account of accidents sustained is returnable as gross income by the insured person."<sup>89</sup> By analogizing tort damages to the receipt of accident insurance proceeds, the Treasury concluded that such damages would be includible in income.

An amount received as the result of a suit or compromise for "pain and suffering" is held to be such income as would be taxable under the provision of law that includes "gains or profits and income derived from any source whatever." An amount thus received would be, in its nature, similar to an amount paid to a person insured by an accident insurance policy on account of an accident sustained.<sup>90</sup>

A 1917 Treasury Decision extended this rationale to payments received under various accident compensation laws.<sup>91</sup> Treasury Decision 2570 states, "[p]ayments made to an insured employee by a corporation under the accident compensation laws of the several States constitute taxable income of the employee."<sup>92</sup> Similarly, the first Treasury regulations regarding the tax treatment of damage awards provided that amounts received as the result of a suit or compromise for personal injury were income.<sup>93</sup> The regulations,

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or recipient, if not specifically exempted. But in pursuance of a humane and wise policy, the income tax laws have generally provided for the exemption of such funds." HENRY C. BLACK, A TREATISE ON THE LAW OF INCOME TAXATION UNDER FEDERAL AND STATE LAWS § 87 (2d ed. Supp. 1916).

89. T.D. 2135, 17 Treas. Dec. Int. Rev. at 39. This Decision further held "[t]he proceeds of accident insurance policies paid upon the death of the person insured to the beneficiaries is to be treated like the proceeds of life insurance policies." *Id.* Because life insurance proceeds were specifically excluded from income, Revenue Act of 1913 § 2(B), 38 Stat. at 167, accident insurance payments would or would not have been includible in gross income depending upon the condition of the insured after the accident. BLACK, *supra* note 88, § 74.

90. T.D. 2135, 17 Treas. Dec. Int. Rev. at 42. *See also* BLACK, *supra* note 88, § 87 ("It may also be remarked that, under [the Revenue Act of 1913,] money received by the assured himself, as in the case of accident insurance, will not be exempt, since in theory it merely takes the place of what he would have earned during the period of his disability.").

91. T.D. 2570, 19 Treas. Dec. Int. Rev. 321, 323 (1917).

92. *Id.*; *see also* BLACK, *supra* note at 88, at 874 (3rd ed. 1917) ("An amount received as the result of a suit or compromise for 'pain and suffering' is held to be such income as would be taxable under . . . then existing state and federal tax laws.).

93. Treas. Reg. § 33, art. 4 (1918) (the regulations were promulgated pursuant to the Revenue Act of 1916, as amended).

however, recognized that damages which constitute a return of capital are not included in income.<sup>94</sup> Consequently, several early Treasury Decisions, coupled with the regulations, reflect a basic belief that money received in compensation for injury to the human body or person is not analogous, for tax purposes, to a return of capital.<sup>95</sup>

In 1918, the Solicitor of the Internal Revenue Service ("Solicitor") reexamined the taxation of accident insurance proceeds received on account of personal injury.<sup>96</sup> This reconsideration was apparently engendered, in part, by several amendments to the Revenue Act of 1916, which excluded the proceeds of life insurance policies from gross income,<sup>97</sup> as well as the fact that several cases pending before the Supreme Court advocated a reinterpretation of "income."

Despite those cases and the 1916 amendments, the Service did not change its view of the tax status of life insurance proceeds. Instead, it opined "that income included 'anything which is of easy valuation in money which is derived from the use of capital, . . . and that capital includes personal qualities as well as material things.'"<sup>98</sup> The Solicitor further stated:

the proceeds of an accident insurance policy received by an individual on account of personal injuries sustained by him through accident are clearly income. They are derived from physical injury to the body of the insured, that is, they are derived from the use of his capital. Instead of selling his labor, that is, the services of his body or mind, and receiving compensation therefor, the insured suffers injury to his

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94. *Id.* § 33, art. 94 (stating that the amount of a payment received as damages "in excess of amount necessary to make good the damage . . . " is income); *see also* Treas. Reg. § 45, art. 49 (1919) (noting that income does not include the amount of involuntary conversion damages because that amount represents a return of capital when proper replacement property is not required).

95. *See also* BLACK, *supra* note 88, § 289 (remarking that under the Revenue Act of 1913, accident insurance proceeds "received by the assured himself, as in the case of accident insurance, will not be exempt, since in theory it merely takes the place of what he would have earned during the period of his disability.").

96. Letter from the Solicitor of the Internal Revenue to the Secretary of the Treasury (April 11, 1918), *available in* National Archives Record Group No. 60, Straight No. File 191500-1 [hereinafter Solicitor's Letter] (rendering an opinion on the includability of accident insurance policy proceeds).

97. Revenue Act of 1916, § 4. *Compare* Solicitor's Letter, *supra* note 96 (noting that a deduction was not permitted for these proceeds).

98. Solicitor's Letter, *supra* note 96, at 3.

body for which he receives compensation. In both cases money has 'come in.'<sup>99</sup>

In adopting this view, the Solicitor emphasized his conclusion by noting that the section which exempted life insurance proceeds from tax "describes such proceeds as 'income.'"<sup>100</sup> The Solicitor reasoned that if life insurance proceeds are income unless specifically excluded, accident insurance proceeds should be treated likewise, i.e., as income.<sup>101</sup>

The Secretary of the Treasury, apparently concerned with the logic of the Solicitor's conclusion, requested the Attorney General's opinion on the matter.<sup>102</sup> The Attorney General deferred responding to the Secretary's request until the Supreme Court decided the above mentioned income tax cases.<sup>103</sup> After the Court issued opinions in those cases holding that a return of capital is not income,<sup>104</sup> the Service reversed its position. This reversal was also influenced by the Attorney General's response to the Treasury Secretary's earlier request for an opinion regarding the tax treatment of accident insurance proceeds.<sup>105</sup> Considering the statutory exclusion for life insurance proceeds and concluding it was inapplicable, the Attorney General opined that accident insurance proceeds were not income within the meaning of "gains or profits and income derived from any source whatever."<sup>106</sup> The opinion further concluded that such proceeds were merely a return of capital.<sup>107</sup>

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99. *Id.*

100. *Id.* But see 31 Op. Att'y. Gen. 304, 307 (1918) (commenting that the section describing exempt items as income was not significant to the Service's analysis).

101. Solicitor's Letter, *supra* note 96, at 4.

102. Letter from the Acting Secretary of the Treasury to the Attorney General (April 11, 1918), available in the National Archives, Record Group No. 60, Straight No. File 191500-1.

103. Letter from the Attorney General to the Secretary of the Treasury (April 18, 1918), available in the National Archives, Record Group No. 60, Straight No. File 191500-1.

104. *Doyle v. Mitchell Bros.*, 247 U.S. 179, 185 (1918) (distinguishing between "mere conversion" of capital and gain derived from capital); *Lynch v. Hornby*, 247 U.S. 339, 343 (1918) (describing Congress' intent in the Income Tax Act of 1913 to distinguish a shareholder's undivided capital interest prior to dividend payment from his share of dividend which is income); *Lynch v. Turrish*, 247 U.S. 221, 230 (1918) (holding that "[m]ere advance in value in no sense constitutes the gains, profits, or income specified by the statute"); *Southern Pac. Co. v. Lowe*, 247 U.S. 330, 338 (1918) (finding dividends from surplus accumulated prior to tax effective date not subject to income tax under peculiar facts of the case).

105. 31 Op. Att'y. Gen. at 304.

106. See Revenue Act of 1916, as amended by the Revenue Act of 1917, Pub. L. No. 50, § 2, 40 Stat. 300, 301.

107. See 31 Op. Att'y Gen. at 304-308. The first statutory embodiment of this proposi-

The fact that a policy insured against an accident rather than against a death was irrelevant.

In [the Attorney General's] opinion the act does not make such a distinction [between life insurance and accident insurance proceeds], because the proceeds of an accident insurance policy are not 'gains or profits and income' as these terms are defined by the Supreme Court. Without affirming that the human body is in a technical sense the 'capital' invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of *future* periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore 'capital' as distinguished from 'income' receipts.<sup>108</sup>

In Treasury Decision 2747, the Service agreed with and expanded the Attorney General's opinion by excluding from income "an amount received by an individual as the result of a suit or compromise for personal injuries sustained by him through accident . . . ."<sup>109</sup> This re-interpretation was designed to comport with section 4 of the Revenue Act of 1917 which specifically exempted from income the "proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured . . . ."<sup>110</sup> Thus, the prevailing administrative position prior to the enactment of a specific statutory exclusion was that damages received as compensation for physical injuries were not "income," based upon the theory that such proceeds are a return of capital.

#### B. The First Statutory Exemption for Damages Received on Account of Personal Injuries

The Revenue Act of 1918 contained the earliest predecessor to section 104(a)(2).<sup>111</sup> Section 213 stated:

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tion that accident insurance proceeds are not income is found in § 202(a) of the Revenue Act of 1924, Pub. L. No. 176, ch. 234, 43 Stat. 253, 255, *reprinted in* 96 U.S. REVENUE ACTS, *supra* note 85. This section provided that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis." *Id.* Compare I.R.C. §1001(a) (continuing to reflect an implicit assumption that the amounts received as compensatory damages are equal to the taxpayer's basis).

108. 31 Op. Att'y Gen. at 308.

109. T.D. 2747, 20 Treas. Dec. Int. Rev. 457, 457 (1918).

110. Revenue Act of 1917, § 4, 40 Stat. at 302.

111. Revenue Act of 1918, Pub. L. No. 254, § 213(b)(6), 40 Stat. 1057, 1066, *re-*

[E]xcept as otherwise provided . . . the term 'gross income'—

(a) Includes . . . gains or profits and income derived from any source whatever . . . but

(b) Does not include the following items, which shall be exempt from taxation under this title:

. . .

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.<sup>112</sup>

Unfortunately, the legislative history of the 1918 Act includes only a cursory treatment of section 213. One House report, however, acknowledged the controversy surrounding accident and health insurance and indicated Congress' intent to clarify the tax status of damages for personal injury. It stated:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.<sup>113</sup>

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printed in 94 U.S. REVENUE ACTS, *supra* note 85. The provision was incorporated unchanged in the Revenue Act of 1921, Pub. L. No. 98, § 213(b)(6), 42 Stat. 227, 238, reprinted in 95 U.S. REVENUE ACTS, *supra* note 85, and in the Revenue Act of 1924, Pub. L. No. 176, § 213(b)(6), 43 Stat. 253, 268, reprinted in 96 U.S. REVENUE ACTS, *supra* note 85, and in the Revenue Act of 1926, Pub. L. No. 20, § 213(b)(6), 44 Stat. 9, 24-25, reprinted in 97 U.S. REVENUE ACTS, *supra* note 85. Except for the addition of a heading and the renumbering of § 213(b)(6) as § 22(b)(5), the provision was re-enacted without revision in the Revenue Act of 1928, Pub. L. No. 562, § 22(b)(5), 45 Stat. 791, 798, reprinted in 98 U.S. REVENUE ACTS, *supra* note 85; the Revenue Act of 1932, Pub. L. No. 154, § 22(b)(5), 47 Stat. 169, 179, reprinted in 99 U.S. REVENUE ACTS, *supra* note 85, the Revenue Act of 1934, Pub. L. No. 216, § 22(b)(5), 48 Stat. 680, 687, reprinted in 100 U.S. REVENUE ACTS, *supra* note 85, the Revenue Act of 1936, Pub. L. No. 740, § 22(b)(5), 49 Stat. 1648, 1658, reprinted in 102 U.S. REVENUE ACTS, *supra* note 85, and the Revenue Act of 1938, Pub. L. No. 554, § 22(b)(5), 52 Stat. 447, 458, reprinted in 103 U.S. REVENUE ACTS, *supra* note 85. The provision was codified at 26 U.S.C. § 22(b)(5), without revision, in 1939.

112. Revenue Act of 1918, §§ 213 (a), (b)(6), 40 Stat. at 1066.

113. H. Rep. No. 767, 65th Cong., 2d Sess. 86, 92, reprinted in 1939-1 (Part 2) C.B. 92.



Although section 213(b)(6) resolved some aspects of the controversy, two ambiguities in its language presented new difficulties. First, the meaning of the word "damages" in the phrase "any damages" was unclear, and second, the phrase "on account of" is susceptible to a number of interpretations. Both of these ambiguities remain in the existing version of section 104(a)(2). Such loose statutory language is the root of much of the current controversy about whether section 104(a)(2) excludes punitive damages from gross income. Consequently, a careful construction of section 213(b)(6) may resolve much of the controversy surrounding section 104(a)(2).

The most likely, as well as most useful, construction of section 213(b)(6) requires a close analysis of its various clauses. Properly construed, the "as compensation for" clause is intended to modify only the "amounts received" clause, not the "any damages" clause. This interpretation is plausible because the "as compensation" clause follows the "amount received" clause, but not the "any damages" clause. Consistent with this formulation, the clause "plus the amount of any damages received . . . on account of [personal] injuries or sickness" stands alone and should be read accordingly. Before concluding that this latter clause encompasses punitive damages, "damages" and the phrase "on account of" must be defined.

Various authorities repeat a common error in their attempts to define the word "damages." The Service and a number of courts and commentators read the two words "any" and "damages" together, as a single phrase "any damages," without recognizing the distinct meaning definition of each word separately would yield.<sup>114</sup> Construed as a single phrase, section 104(a)(2) extends to both compensatory *and* punitive damages.<sup>115</sup> However, such a reading does not appear to comport with the earlier Congressional intent as discussed previously.<sup>116</sup> Moreover, such an expansive reading of the statutory exclusion conflicts with the general rule that exclusions from income are to be construed narrowly.<sup>117</sup> A

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114. See, e.g., *Burford v. United States*, 642 F. Supp. 635 (N.D. Ala. 1986) (excluding damages received in a wrongful death action); *Miller v. Commissioner*, 93 T.C. 330 (1989) (holding that the plain meaning of § 104(a)(2) allows for exclusion of punitive damage in a defamation action), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

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

116. See *supra* note 111.

117. See *supra* note 34 and accompanying text.

sounder rule of statutory interpretation requires the words "any" and "damages" to be read independently of each other so that "any" modifies "damages" as the law defined that term at the exclusion's inception. This alternate rule, though it appears to be an exercise in splitting hairs, produces a different result.

One principle of statutory construction is that Congress uses words in their ordinary or popular meaning.<sup>118</sup> The ordinary meaning of the word "damages" means "actual damages" or "compensatory damages."<sup>119</sup> It does not include "punitive damages."<sup>120</sup> Adhering to this narrower definition, the word becomes consistent with the principal purpose of tort law — *compensation*.<sup>121</sup> Furthermore, this construction has two significant advantages: it is consistent with Congressional intent to exclude damages to restore the taxpayer to his pre-accident condition,<sup>122</sup> and it is consonant with the rule requiring narrow statutory interpretation.<sup>123</sup> Consequently, "any damages" has an entirely different meaning under the second proposed construction than that ascribed to it when considered as a whole.

The phrase "on account of" is also ambiguous. While several recent court decisions<sup>124</sup> and the Service<sup>125</sup> have agreed that the phrase connotes causation, disagreement remains over the type of causation intended, "sufficient causation" or "but for" causation.<sup>126</sup> The interpretation that best effectuates Congressional intent and results in the most narrow construction of the exclusion is the "but for" option. In other words, punitive damages are not

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118. See *infra* notes 313-14 and accompanying text.

119. See *supra* note 46. But see *infra* text accompanying note 336.

120. See *supra* text accompanying note 51.

121. See *supra* text accompanying notes 49-53; see also *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1025 (1927) ("Such compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury."). But see *infra* text accompanying notes 309-21.

122. See *supra* notes 112-13 and accompanying text.

123. See *Commissioner v. Jacobsen*, 336 U.S. 28, 49 (1949).

124. See *infra* notes 284-96, 318-24 and accompanying text.

125. See *infra* text accompanying notes 242-65.

126. Compare *Burford v. Commissioner*, 642 F. Supp. 635 (N.D. Ala. 1986) ("sufficient causation") and *Miller v. Commissioner*, 93 T.C. 330 (1989) ("sufficient causation"), *rev'd*, 914 F.2d 886 (4th Cir. 1990); with *Commissioner v. Miller*, 914 F.2d 586, 590 (4th Cir. 1990) ("but for" causation), *rev'g* *Miller v. Commissioner* 93 T.C. 330. For a discussion of *Burford*, see *infra* text accompanying notes 284-96. The Tax Court's opinion in *Miller* is discussed *infra* text accompanying notes 309-31, and the Fourth Circuit's opinion in that case is considered *infra* text accompanying notes 332-48.

awarded "on account of" the plaintiff's injuries. Rather, punitive damages are awarded "on account of" the defendant's egregious conduct. "But for" the defendant's outrageous behavior, the plaintiff could not receive such damages. Resolution of the ambiguity in this manner also harmonizes the phrase "on account of" with the construction of "damages" as meaning compensatory damages.

An alternate construction of section 213(b)(6) which reaches the same conclusion about the exclusion's effect requires dividing the section into its components to aid in resolving inherent ambiguities.<sup>127</sup> As a whole, section 213(b)(6) contained two clauses that described the *source* of the excluded receipt. The first clause was "[a]mounts received through accident or health insurance or under workmen's compensation acts," and the second clause was "plus the amounts of any damages received whether by suit or agreement on account of [personal] injuries or sickness."<sup>128</sup> However, a third clause, "as compensation for personal injuries or sickness," identified the *type* of receipt to be excluded. When the clause that identified the *type* of receipt is read to modify each clause identifying a *source* of receipt, both the amounts received from insurance or pursuant to compensation acts and any damages from suits or agreements must be received "as compensation" for injuries to be excluded from gross income. Accordingly, the phrase "on account of" should be interpreted to mean "as compensation for."

This construction of section 213(b)(6) is consistent with the Service's position prior to the statute's enactment<sup>129</sup> and with the then-emerging (as well as the current) judicial view that amounts

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127. The author undertakes this exercise cognizant of Justice Frankfurter's admonition in *Reed v. Pennsylvania R.R.*:

I part company with the Court not in its reading of English but in its assumption that . . . [statutory] construction . . . is merely a matter of reading English . . . . [A statute] is an organism, projected into the future out of its past. It is not merely a collection of words for abstract annotation out of the dictionary. The process of judicial construction must be mindful of the history of the legislation, of the purpose which infused it, of the difficulties which were encountered in effectuating this purpose, of the aims of those most active in relieving these difficulties.

351 U.S. 502, 510 (1956) (Frankfurter, J., dissenting).

128. Revenue Act of 1918, § 213(b)(6), 40 Stat. at 1066.

129. One commentator has stated that the provision "indicates an unqualified congressional acceptance of the prevailing administrative view." Jacques T. Schlenger, *Disability Benefits Under Section 22(b)(5)*, 40 VA. L. REV. 549, 551 (1954). Schlenger cites the House report quoted *supra* text accompanying note 113.

received as compensation for personal injuries are not "income."<sup>130</sup> It also is in harmony with the apparent Congressional desire to exclude from income amounts that restore or compensate the taxpayer for injury.<sup>131</sup> In addition, this construction serves to define the phrase "any damages" as compensatory damages only. Finally, it comports with the well-known and long established rule that exclusions are to be narrowly construed.<sup>132</sup>

Subsequently in 1954, the single statutory exclusion contained in section 213(b)(6) was transformed into two subsections.<sup>133</sup> The first part of section 213 relating to amounts received under workman's compensation acts was incorporated into section

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130. See, e.g., *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955) ("The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property. Damages for personal injury are by definition compensatory only." (citations omitted))

131. Further evidence of Congressional intent can be gleaned from subsequent amendments to the Code. The Revenue Act of 1928 re-enacted § 213(b)(6) verbatim, renumbered it as section 22(b)(5), and added the following heading: "(5) Compensation for Injuries or Sickness." Revenue Act of 1928, § 22(b)(5), 45 Stat. at 798. "Titles . . . are sometimes considered in construing a statute." MERTENS, *supra* note 9, at 3-54 (citations omitted). See also *Commissioner v. Miller*, 914 F.2d 586, 590 (4th Cir. 1990) ("It also is worth noting that § 104 is entitled 'Compensation for injuries or sickness.'"). But see I.R.C. § 7806(b) (titles are for reference only).

In 1942, Congress amended I.R.C. § 22(b)(5) to disallow exclusion from gross income of amounts received in compensation for medical expenses previously deducted. Revenue Act of 1942, Pub. L. No. 753, § 127(d), 22(b)(5), 56 Stat. 798 (1942), reprinted in 108 U.S. REVENUE ACTS, *supra* note 85. The Senate Finance Committee Report stated that: "[S]ection 22(b)(5) is amended to include in gross income amounts received for compensation for personal injuries or sickness which are attributable to and not in excess of deductions [for medical expenses allowed] . . . in any prior taxable year." (emphasis added). S. Rep. No. 1631, 77th Cong., 2d Sess. 96 (1942). A Senate Finance Committee Report accompanying a 1982 amendment to § 104(a) stated that § 104, as presently enacted, "excludes from gross income the following types of compensation payments for personal injuries . . . (2) damages received under a suit or settlement of a claim." S. Rep. No. 646, 97th Cong., 2d Sess. 3 (1982), reprinted in 1982 U.S.C.C.A.N. 4580, 4582 (emphasis added). See also Mary J. Morrison, *Getting a Rule Right and Writing a Wrong Rule: The IRS Demands a Return on All Punitive Damages*, 17 CONN. L. REV. 39, 59 (1984) (asserting that, in contrast to punitive damages which have always been taxable, there is a "clear congressional intent to exempt compensatory awards for personal injury").

132. See, e.g., *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949) ("The exemptions . . . should be construed with restraint in the light of the same policy [as that supporting comprehensive taxation]."); *Commissioner v. Miller*, 914 F.2d 586, 590 (1990) ("[I]t is a well-recognized, even venerable principle that exclusions to income are to be construed narrowly."), *rev'g* 93 T.C. 330 (1989); cases cited in MERTENS, *supra* note 9, at 3-59.

133. In the 1954 recodification of the Internal Revenue Code, § 104(a) took its present form. I.R.C. of 1954, ch. 736, § 104(a), 68A Stat. 30 (1954) (current version codified at I.R.C. § 104(a)).

104(a)(1). The second part, dealing with the receipt of damages on account of personal injuries, was recodified as section 104(a)(2). This re-enactment of the exemption appears to be the source of confusion among various courts and the relevant administrative agencies about the effect of the provision.

Courts construing section 104(a)(2) generally fail to examine its predecessor, section 213(b)(6). The division of section 213(b)(6) into sections 104(a)(1) and (2) effectively eliminated the preceding analysis as an explanation of the exclusion's applicability to compensatory payments only. Instead of preserving the earlier treatment, the recodification, in effect, severed prior understandings of the exclusion from identical language albeit in a different format. This may explain, at least in part, the incorrect conclusions reached by a few courts.<sup>134</sup>

### C. Early Service Interpretations of the Section 213(b)(6) Exclusion

The Service struggled for a time with whether or not the concept of human capital<sup>135</sup> is implicated by the exclusion of personal injury damages.<sup>136</sup> The Service was also unclear about whether damages for personal injuries were "gross income" within the meaning of the then-evolving definition.<sup>137</sup> However, the Service

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134. "No provision of a statute stands alone, but each must be read with the others bearing upon it . . . . When a provision of a statute is ambiguous or doubtful' . . . other sections of the same act which are somewhat analogous in principle' are 'entitled to great weight.'" MERTENS, *supra* note 9, § 3.13.

135. See 31 Op. Atty Gen. 304 (1918); see also *supra* notes 88-90 and accompanying text.

136. The Service has, since the first Revenue Act, distinguished between physical and nonphysical injuries. Compare, e.g., T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) (damages for personal injury from accident not income) with S. 957, 1 C.B. 65 (1919) (libel damages are income), modified, Sol. Op. 132, I-1 C.B. 92 (1922), *decl'd obs.*, Rev. Rul. 69-31, 1969-1 C.B. 307.

As recently as 1978, the Service considered whether section 104(a)(2) was limited to physical injuries. Although it found some support for such a limitation, the Service rejected its adoption. Gen. Couns. Mem. 37,398 (Jan. 31, 1978); see also U.S. v. Kaiser, 363 U.S. 299, 317-25 (1960) (listing in an appendix IRS rulings on nontaxable recoveries). For an article considering the definition of the term "personal injury," see Jennifer S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759 (1988). See also J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13 (1989). Congress revived the physical/nonphysical injury distinction in the 1989 Amendment. See *infra* notes 360-382 and accompanying text.

137. See *supra* text accompanying notes 96-110.

was certain in its interpretation of the statutory exclusion as extending only to compensatory damages, i.e., to those awards restoring the taxpayer to the pre-injury position.

In two rulings issued shortly after the enactment of section 213(b)(6), the Service expressed its opinion that the 1918 legislation was merely declarative of the Service's prior position.<sup>138</sup> In Solicitor's Memorandum 1384, the Service considered whether alienation of affections, a nonphysical injury, fell within the new statutory exclusion.<sup>139</sup> It held that recoveries for nonphysical personal injuries were not within the exclusion. After recounting decisions analogizing physical injury to lost capital, the Memorandum concluded:

Probably the provision of the Revenue Act of 1918 in question, so far as personal injuries are concerned, is merely declarative of the conclusions thus stated and intended to go no further. These conclusions rest, as stated, upon the theory of conversion of capital assets. It would follow that personal injury not resulting in the destruction or diminution in the value of a capital asset would not be within the exemption.<sup>140</sup>

The Memorandum's importance stems from its indication that the Service adopted the view that the statute was simply a codification of the human capital conversion theory, and as such, excluded only damages received for "destruction or diminution . . . of a capital

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138. Sol. Mem. 1384, 1 C.B. 71, 71-72 (1920), *repealed* by Sol. Op. 132, I-1 C.B. 92, 93 (1922), *supra*d, Rev. Rule. 74-77, 1974-1 C.B. 33.

"Considerable weight is given to the Treasury Department's administrative construction of tax provisions and to Regulations. One reason is that '[t]he first administrative interpretation of a provision as it appears in a new act often expresses the general understanding of those who played an important part when the statute was drafted.'" MERTENS, *supra* note 9, § 3.46, at 76 & n.18 (quoting *Augustus v. Commissioner*, 118 F.2d 38, 43 (6th Cir.), *cert. denied*, 313 U.S. 545 (1941)). See also *id.* § 3.50, at 81 (regarding the importance of administrative interpretations contemporaneous with a statute); Harnett, *supra* note 50.

139. Sol. Mem. 1384, 1 C.B. 71 (1920), *repealed*, Sol. Op. 132, I-1 C.B. 92, 93 (1922).

140. *Id.*, 1 C.B. at 72. The Solicitor's Memorandum held that "affections" did not constitute capital and, thus, the damages received were income. Although the Service's rationale was affirmed, its finding that an individual's nonphysical attributes are not human capital was rejected in *Hawkins v. Commissioner*, 6 B.T.A. 1024, 1023 (1927). See *infra* text accompanying notes 159-61; see also Gen. Couns. Mem. 37,398 (Jan. 31, 1978) ("The [1918] House report . . . seems to suggest that the provision was merely declarative of existing law."); Harnett, *supra* note 50, at 624 ("The interpretative authority has been relatively sparse, since the statute is generally accepted as clear.").

asset."<sup>141</sup>

Two years later, Solicitor's Memorandum 1384 was revoked by Solicitor's Opinion 132.<sup>142</sup> This Opinion held that damages received for alienation of affections, slander and money received for surrender of child custody rights were not income.<sup>143</sup> Although the Opinion specifically approved Memorandum 1384's interpretation of section 213(b)(6) as inapplicable to damages for nonphysical injuries, the Opinion found a more "fundamental" principle controlling. "[T]he question is really more fundamental, namely, whether such damages [for alienation of affection] are within the legal definition of income."<sup>144</sup>

After noting the Supreme Court's definition of income as "the gain derived from capital, from labor, or from both combined,"<sup>145</sup> the Opinion continued:

In the light of these decisions of the Supreme Court it must be held that there is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character. In either case the right invaded is a personal right and is in no way transferable . . . . If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is clear, therefore, that the Government can not tax him on any portion of the sum received. This also applies to money received in consideration of the surrender of the custody of a minor child. Holding otherwise would be equivalent to treating as chattels the wife whose affections were alienated and the child whose custody was surrendered.

. . . Before the enactment of the Revenue Act of 1918, which specifically exempted from gross income damages for personal injuries, it was held that damages for personal injuries due to accident do not constitute income.

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141. Sol. Mem. 1384, 1 C.B. at 72.

142. Sol. Op. 132, I-1 C.B. 92, 94 (1922).

143. *Id.*

144. *Id.* at 93.

145. *Id.* (quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) and *Stratton's Independence v. Howbert*, 231 U.S. 399, 415 (1913)).

T.D. 2747 . . . . Much less should damages for alienation of affections or defamation of personal character be held to constitute income.<sup>146</sup>

Thus, the Opinion's underlying rationale was that damages received for an invasion of a personal nature are compensatory.<sup>147</sup> The Service continued to express this view that damages received for violations of personal rights did not constitute income. However, no reference was made to the statutory exclusion.<sup>148</sup>

#### D. Early Judicial Opinions Addressing the Taxation of Personal Injury Damages

Early judicial opinions, such as *Hawkins v. Commissioner*,<sup>149</sup> consistently held that compensatory damages for a personal, non-physical injury are a return of capital and thus do not constitute income. In *Hawkins*, the court held that damages received for libel and slander were not income.<sup>150</sup> The court reasoned:

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146. *Id.* at 93-94. Solicitor's Opinion 132 modified Solicitor's Opinion 957, 1 C.B. 65 (1919), which held, without elaboration, that damages for libel were includible in income. Solicitor's Opinion 957 did not distinguish between libel of a personal nature and libel to a business. *Ehrlich v. Higgins*, 52 F. Supp. 805 (S.D.N.Y. 1943), criticized Solicitor's Opinion 132 insofar as it held that money received for release of custody rights is not income. The taxpayers in *Ehrlich* argued that a movie contract constituted payment for their impending loss of privacy. *Id.* at 808. According to the *Ehrlich* court, Solicitor's Opinion 132 offered the only authority that a payment for giving up a legal right would be excludable from income. *Id.* The problem with Solicitor's Opinion 132, however, was that it "permits no distinction between damages for wrongs committed and payments for giving up any legal right." *Id.* The court concluded that alienation of affection constitutes injury to a personal right which can be compensated, but the release of custody rights for a future period is a "simple contract." *Id.* Furthermore, the court found that even if the taxpayers had received payment for giving up their right of privacy and such payment were not income, allocation of the contract price between this and other taxable elements was impossible. *Id.* at 809.

147. The Solicitor's Opinion clearly adopted the rationale of the RESTATEMENT (SECOND) OF TORTS § 903. Comment a explains that "damages for pain and humiliation are compensatory in that they give to the injured person some pecuniary return for what he has suffered or is likely to suffer."

148. See I.T. 2422, VII-2 C.B. 186 (1928) (revoking prior rulings which held damages for breach of a promise to marry are taxable income), *rev'g* O.D. 501, 2 C.B. 70 (1920) and I.T. 2170, IV-1 C.B. 28 (1925); I.T. 2420, VII-2 C.B. 123 (1928) (excluding a wrongful death award from income); I.T. 1852, II-2 C.B. 66 (1923) (concluding damages received for the annulment of a marriage on account of fraud and deceit are not income); I.T. 1804, II-2 C.B. 61, 62 (1923) (citing *Eisner v. Macomber*, 252 U.S. 189 (1920) and holding that damages for breach of a promise to marry are not taxable income because such a right is personal and not susceptible of any appraisal).

149. 6 B.T.A. 1023 (1927).

150. *Id.* at 1024. Following *Hawkins*, *McDonald v. Commissioner* held that damages



[T]he amount which petitioner received was wholly by way of general damages for the personal injury suffered by reason of the defamatory statements made. It was compensation for injury to his personal reputation for integrity and fair dealing, including, as the record indicates, the injury to his health. This is the ordinary basis for *compensatory damages*. *No suggestion is made that there was special damage paid or that any was asserted or that punitive or exemplary damages were claimed or paid*, and we need not consider the law as to them . . . . Such *compensation as general damages* adds nothing to the individual, for the very concept which sanctions it *prohibits that it shall include a profit*. It is an attempt to make the plaintiff whole as before the injury.<sup>151</sup>

*Hawkins* is important in at least two other respects. First, the court rejected the taxpayer's attempt to restrict the definition of income so that the definition would prevent damages for personal injury from being included and thus render use of the exclusion unnecessary.<sup>152</sup> Recognizing that the statutory definition of income was intended to be the fullest exercise of constitutional power, the Board of Tax Appeals dismissed this argument.<sup>153</sup> Thus, the rationale and result of the *Hawkins* decision, i.e., that an award which restores capital is not income, is entirely consistent with the Supreme Court's subsequent decision in *Glenshaw Glass*.<sup>154</sup> In

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received for breach of promise to marry were not income. 9 B.T.A. 1340 (1928), *acq.* VII-2 C.B. 26 (1928).

151. *Hawkins*, 6 B.T.A. at 1024-25 (citation omitted) (emphasis added). *Accord* Commissioner v. *Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955) (concluding "damages for personal injury are by definition compensatory only"); *see also supra* note 46 and accompanying text.

152. *Hawkins*, 6 B.T.A. at 1024. This restrictive definition of income is generally attributed to *Eisner v. Macomber*, 252 U.S. 189, 206-07 (1920), despite similar language in earlier cases. *See, e.g., Doyle v. Mitchell Bros.*, 247 U.S. 179, 184-85 (1918) (reasoning that increases in assets arising from corporate activity, such as sales, constitutes income); *Stratton's Indep. Ltd. v. Howbert*, 231 U.S. 399, 415 (1913) (gains derived from mining operation constitute income as mining requires a combination of capital and labor). This definition was later repudiated by *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 430 (1955).

153. *Id.* (citing *Eisner*, 252 U.S. at 203).

154. *See infra* note 169 and accompanying text. *Hawkins* also cites *United States v. Supplee-Biddle Hardware Co.*, 265 U.S. 189 (1924), *mandate granted* 44 S.Ct. 634 (1924), for support. *Hawkins*, 6 B.T.A. at 1025. *Supplee-Biddle Hardware* held that life insurance proceeds received by a corporation on the death of an officer were not income

this respect, the decision provided, in part, a foundation for consistent treatment of the exemption in nonphysical injury cases.

Second, the *Hawkins* court emphasized that the plaintiff did not claim, and the trial court did not award, special, punitive, or exemplary damages.<sup>155</sup> Although the court declined to consider the taxation of these damages, its distinction of such awards from compensatory damages strongly implies that they are fundamentally different from compensatory damages, and thus constitute income.<sup>156</sup>

*Riddle v. Commissioner*<sup>157</sup> was the first and only case to address specifically section 22(a)(5)<sup>158</sup> as it applied to damages received in a personal injury suit. However, it did so only in dictum. The *Riddle* court held that interest received on an award of \$15,000 for personal injuries resulting from the sinking of the *Lusitania* was income.<sup>159</sup> The court subsequently stated "[t]here is no controversy as to the award of \$15,000, in view of Section 22(a)(5) of the Revenue Act of 1928, which excludes from gross income damages received on account of sickness or injuries."<sup>160</sup>

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because the payment was not periodic. 265 U.S. at 195 (Taft, C.J., dictum). An early concept of income required that its receipt be recurring. *Glenshaw Glass* rejected this concept. Nevertheless, the first portion of the *Hawkins* opinion makes clear that the damages were not income even under a broad interpretation of that term. *Hawkins*, 6 B.T.A. at 1024. Given this conclusion, the reference to *Supplee-Biddle Hardware* is inapposite and logically inconsistent with the court's preceding analysis. *Hawkins* does not rest on the rationale that the damages are not income because they are not recurring, but rather on the basis that there is simply no accession to wealth. *But see* Sol. Op. 132, I-1 C.B. 92 (1922); Rev. Rul. 58-418, 1958-2 C.B. 18.

155. *Hawkins*, 6 B.T.A. at 1024 ("No suggestion is made that there was special damages paid or that any was asserted or that punitive or exemplary damages were claimed or paid, and we need not consider the law as to them.").

156. *See, e.g.*, SUTHERLAND, *supra* note 55, § 12, at 46; KEETON et al., *supra* note 46, § 2, at 14 (citation omitted).

157. 27 B.T.A. 1339 (1933) (holding that interest received as a result of an award of damages for personal injuries was improperly included in income). For further discussion of *Riddle* in connection with the distinction between taxation of the damages awarded on account of personal injury and interest on such awards, see *infra* text accompanying notes 191-98.

158. The Income Tax Act of 1928, § 22(b)(5) was originally enacted as § 213(b)(6) of the Income Tax Act of 1918. Section 22(b)(5) provided that "amounts received, through accident or health insurance or under workman's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damage received whether by suit or agreement on amount of said injuries [are excluded from gross income]."

159. *Riddle*, 27 B.T.A. at 1340.

160. *Id.* at 1339. The *Riddle* case "has been construed as holding that any compensation for personal injury would be excludable under § 22(b)(5)." Schlenger, *supra* note 129, at 551 n.9.

Thus, the *Riddle* holding illustrates that only those amounts awarded as compensation for the injury are excluded from income. The amounts received for other purposes, such as for the use or forbearance of money<sup>161</sup> or for punishment or deterrence, are includible in income.

#### V. COMMISSIONER V. GLENSHAW GLASS CO.

In *Commissioner v. Glenshaw Glass Co.*,<sup>162</sup> the Supreme Court held that the punitive damages received as a portion of an antitrust damages award were gross income. In this case, the taxpayer contended that "punitive damages, characterized as 'windfalls' flowing from the culpable conduct of third parties, are not within the scope . . . [of the definition of gross income]."<sup>163</sup> The Court, however, rejected the taxpayer's argument, noting that "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted."<sup>164</sup> Accordingly, *Glenshaw Glass* overruled the *Eisner v. Macomber*<sup>165</sup> definition of income. In fact, the Court specifically stated that the definition in *Eisner* "was not meant to provide a touchstone to all future gross income questions."<sup>166</sup> The Court concluded:

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were

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161. See *infra* text accompanying notes 180-222 and accompanying text (discussing, in detail, the tax consequences of interest awarded in personal injury actions).

162. 348 U.S. 426 (1955). *Glenshaw Glass* reversed a line of cases holding that punitive damages were not income.

163. *Id.* at 429. Although not specifically set forth in the opinion, the taxpayer apparently argued that the definition of gross income was limited to recurrent receipts, such as those derived from capital or labor, and as such, a windfall was not income. See, e.g., *Central Ry. Co. v. Commissioner*, 79 F.2d 697 (3d Cir. 1935) (holding that where recovery is derived from neither labor nor capital, it is not income); Carl C. Plehn, *The Concept of Income as Recurrent, Consumable Receipts*, 14 AM. ECON. REV. 1 (1924); William J. Schultz & C. Lowell Hurtis, *American Public Finance*, in TAXATION OF INCOME 236-38 (8th ed. 1965) (discussing a number of definitions of income including the recurrent receipt concept).

164. *Glenshaw Glass*, 348 U.S. at 429-430 (citations omitted).

165. 252 U.S. 189 (1920) (defining income as the gain from capital or labor).

166. *Glenshaw Glass*, 348 U.S. at 431.

extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients.<sup>167</sup>

Later in the opinion, the Court specifically distinguished punitive damages from personal injury recoveries. In a footnote, the Court wrote:

The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property. Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.<sup>168</sup>

This case demarcates the Supreme Court's unequivocal adoption of the view that gross income does not encompass compensatory damages. Given this, receipts which cannot be analogized to a return of human capital are net income.<sup>169</sup> It also illustrates that punitive damages are not a restoration of capital, but rather a windfall to the taxpayer.<sup>170</sup> As such, punitive damages are not encompassed by the statutory exclusion. Moreover, footnote eight in *Glenshaw Glass* reinforces the conclusion that the "ordinary everyday sense" of the word "damages" means *compensatory* damages;<sup>171</sup> the term does not include punitive damages.<sup>172</sup>

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167. *Id.*

168. *Id.* at 432 n.8 (citations omitted). Professors Bittker and Lokken express ambivalence about the importance of the Supreme Court's reference to the Service's rulings. BITTKER & LOKKEN, *supra* note 14, ¶ 5.6, at 5-41. At one point, they state "[t]his observation was probably intended only to distinguish the rulings, not to endorse them." *Id.* Later, however, they write, "[e]ven if the Supreme Court's reference in *Glenshaw Glass* to 'the long history of departmental rulings holding personal injury recoveries nontaxable' was not intended to endorse their validity ab initio, it suggests the possibility that they were subsequently sanctified by congressional acquiescence." *Id.* at ¶ 5.6, at 5-42.

169. *Hawkins v. Commissioner*, 6 B.T.A. 1023 (1928); see *supra* text accompanying notes 149-61. Notwithstanding *Glenshaw Glass*'s expansive definition of income, certain receipts are not gross income. For example, payments in release of marital obligations or in fulfillment of child support obligations do not constitute income. *Gould v. Gould*, 245 U.S. 151 (1917). Congress, however, reversed this decision in 1942 when it enacted the predecessor of § 71(a). Revenue Act of 1942, Pub. L. No. 753, § 120(a), 56 Stat. 798 (1942), reprinted in 108 U.S. REVENUE ACTS, *supra* note 85.

170. *Glenshaw Glass*, 348 U.S. at 432 n.8.

171. See *supra* text accompanying notes 46-61.

172. See *supra* text accompanying notes 72-84.

VI. CASES AND SERVICE RULINGS INTERPRETING PERSONAL  
INJURY DAMAGES IN THE TWO DECADES SUBSEQUENT TO  
*GLENSHAW GLASS*

Cases and Service rulings in the two decades following *Glenshaw Glass* continued to espouse the view that payments received on account of personal injury are compensatory in nature, and so, are not income.<sup>173</sup> Payments for other purposes remained includible in income.<sup>174</sup>

A. Payments for Consensual Violations of Personal Rights

A series of cases involving consensual violations of personal rights supports the view that section 104(a)(2) encompasses only payments which compensate for actual personal injury and, thus, restore a loss of capital.<sup>175</sup> These cases consider the taxation of

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173. See, e.g., *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990) (remanding to determine what portion of the award was compensatory and what portion was punitive).

Without citing § 104(a)(2), the following rulings hold that the amounts received by taxpayers were not income: Rev. Rul. 69-212, 1969-1 C.B. 34 (widow's pension under Austrian social insurance law); Rev. Rul. 58-370, 1958-2 C.B. 14 (payments made by Austria as war reparations); Rev. Rul. 56-518, 1956-2 C.B. 25, *clarified*, Rev. Rul. 57-505, 1957-2 C.B. 50, *amplified*, Rev. Rul. 58-500, 1958-2 C.B. 21 (concluding that compensation paid by Germany to United States citizens on account of persecution which resulted in damage to life, body, health, liberty or professional or economic advancement are essentially reimbursement for the deprivation of civil or personal rights and so do not constitute taxable income); Rev. Rul. 56-462, 1956-2 C.B. 20 (payments to former Korean War prisoners); Rev. Rul. 55-132, 1955-1 C.B. 213 (holding payments to a prisoner of war pursuant to the War Claims Act of 1948, 50 U.S.C. § 2004 (1948), are "in the nature of reimbursement for the loss of personal rights and are not includible in gross income of such individual . . ."). See also Revenue Act of 1962, Pub. L. No. 87-834, § 27(a), 76 Stat. 960, 1067 (1962) (providing that awards by Attorney General to persons of Japanese ancestry removed from their homes during World War II excludable from income); cf. *Arnold v. United States*, 289 F. Supp. 206, 208 (E.D.N.Y. 1968) ("Where a governmental body makes a payment to a taxpayer, the Commissioner tends to exclude it from income, even though similar payments from a private source would be taxable.")

174. See *infra* text accompanying notes 223-65.

175. See *Starrels v. Commissioner*, 304 F.2d 574, 577 (9th Cir. 1962) (concluding that payments for future invasion of right of privacy are not exempt from income), *aff'd* 35 T.C. 646 (1961); *Ehrlich v. Higgins*, 52 F. Supp. 805 (S.D.N.Y. 1943) (holding that money received for the release of movie rights was ordinary income comprised of compensation for rights to privacy, personal service rendered and release of future claims); *Meyer v. United States*, 173 F. Supp. 920 (E.D. Tenn. 1959) (citing *Ehrlich* as applicable law); *Roosevelt v. Commissioner*, 43 T.C. 77, 88 (1964) (holding payment for anticipated future invasion of privacy which did not occur not excludable from income); *Miller v. Commissioner*, 35 T.C. 631, 645-46 (1961) (stating in dicta that monies obtained in exchange for the release of motion picture rights amount to a surrender of a contractual right and are

amounts received for the right to portray the taxpayer, or an ancestor or spouse of the taxpayer, on the stage or in film. In each case, the taxpayers contended that the amounts received were for the invasion of a personal right of privacy, and as such, were in the nature of advance waivers of possible future damages for personal injuries. Accordingly, the taxpayers reasoned that the amounts would be excludable from income by virtue of section 104(a)(2) or its predecessor. In each decision, however, the court held that section 104(a)(2) did not exclude from gross income payments made "for an *advance waiver of possible future damages* for personal injury . . . ."<sup>176</sup>

The importance of this line of cases is two-fold. Because the first of these decisions was issued prior to *Glenshaw Glass* and the last one some nine years after that Supreme Court opinion, the consensual violation cases provided a consistent series of interpretations of section 104(a)(2) throughout this period. This consistency is particularly noteworthy given the redefinition of income between *Eisner v. Macomber* and *Glenshaw Glass*.

In addition, the reasoning of the opinions lends support to the conclusion that section 104(a)(2) extends only to compensatory damages. Collectively, these cases illustrate that a taxpayer must sustain an actual injury for a payment to be excluded from income.<sup>177</sup> The premise underlying this outcome appears to be the reimbursement of capital loss concept.<sup>178</sup> The rationale of these cases supports the view that section 104(a)(2) does not encompass punitive damages.<sup>179</sup>

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ordinary income), *aff'd on other grounds*, 299 F.2d 706 (2d Cir.), and *cert. denied* 370 U.S. 923 (1962).

176. *Roosevelt*, 43 T.C. at 87. *Accord Starrels*, 304 F.2d at 576; *Meyer*, 173 F. Supp. at 924-25; *Ehrlich*, 52 F. Supp. at 808-09; *Miller*, 35 T.C. at 641.

177. *See, e.g., Meyer*, 173 F. Supp. at 924-25 (noting that § 22 (now § 104(a)(2)) applies only where physical injuries are actually suffered).

178. *See, e.g., Starrels*, 304 F.2d at 576 (concluding that "receipts which do not compensate [a] taxpayer for a loss but instead add to his wealth" are income); *Ehrlich*, 52 F. Supp. at 808 (noting that a covenant not to sue held no value for tax purposes because it was not a return of capital).

179. *See Starrels*, 304 F.2d at 577. According to the *Starrels* court,

"[p]unitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes." By a parity of reasoning, the exemption in favor of damages for personal injuries codified in section 104(a)(2) cannot support the exemption of payments made for injuries which have never occurred because such payments are not compensatory and hence cannot be considered a restoration of capital.

*Id.*

## B. Taxation of Interest Awarded in Personal Injury Actions

A line of cases involving the taxation of interest<sup>180</sup> awarded in personal injury actions, whether prejudgment interest<sup>181</sup> or post-judgment interest<sup>182</sup> further supports the conclusion that punitive damages are not excluded from gross income by section 104(a)(2).<sup>183</sup> The support offered by these cases for including punitive damages in income stems from the nature of an award of interest. Punitive damages are analogous to interest payments because a wrongdoer is obligated to pay neither interest nor punitive damages in the absence of a personal injury. To the extent interest is taxed as a separate component of a judgment, punitive damages should be treated similarly.

The Service treats the payment of interest as includible in income to the recipient.<sup>184</sup> As a general rule, amounts received in satisfaction of a judgment are taxed in the same manner as if those

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180. Interest is generally defined as "the sum paid or payable for the use or detention of money." DOBBS, *supra* note 54, § 3.5, at 164. See also *Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 558 (1932); Rev. Rul. 69-188, 1969-1 C.B. 54.

181. Prejudgment interest is interest awarded on a claim from the time that the injury occurs until the date of judgment. See, e.g., *Monessen S.W. Ry. v. Morgan*, 468 U.S. 330, 335 (1988) ("Prejudgment interest is normally designed to make the plaintiff whole and is part of the actual damages sought to be recovered."). However, prejudgment interest is not allowed on all claims. It is generally provided for by statute and is awarded to plaintiffs in the judges' discretion. 22 AM. JUR. 2D *Damages* § 665 (1988).

Typically, prejudgment interest is awarded only for a liquidated claim. The theory supporting this rule is that the defendant must know what he owes and that amount must be due before he can be charged interest for not paying the plaintiff before trial. *Id.* §§ 651-654, 659. Accordingly, in personal injury actions, prejudgment interest will not be awarded for items such as pain and suffering because those components remain unliquidated until the trier of fact determines the amount due. In contrast, where the amount due is determined with reasonable certainty, such as medical expenses and property damage, prejudgment interest will be awarded. *Id.* §§ 664, 667.

182. Post-judgment interest is the interest that accrues upon the judgment itself from the date of judgment until the award is paid. Like prejudgment interest, post-judgment interest is regulated by statute and is not available on all awards. 45 AM. JUR. 2D *Interest and Usury* § 54 (1969). In order to receive such interest, the plaintiff must be "deprived of the use of the money during the time for which interest has been awarded." *Id.* State statutes authorizing post-judgment interest vary as to the type of awards on which post-judgment interest will be permitted. *Id.* § 62. See also *Morrison*, *supra* note 131, at 46 n.23.

183. I.R.C. § 61(a)(4) provides that gross income includes interest. See Treas. Reg. § 1.61-7(a) (as amended 1966) ("[I]nterest received by or credited to the taxpayer constitutes gross income and is fully taxable.").

184. I.R.S. PUB. 17, *supra* note 33, at 77.

amounts were paid voluntarily.<sup>185</sup> More simply, an amount received is includible in gross income if it is substitute for an amount that would be includible if paid in accordance with a contract.<sup>186</sup> Accordingly, interest received in connection with a judgment is taxable even where the award itself would be excluded from income under section 104(a)(2).

Several early authorities considering the tax consequences of damages and post-judgment interest awards arising from the sinking of the *Lusitania* in 1915 illustrate this rule.<sup>187</sup> In I.T. 2420,<sup>188</sup> the taxpayer was awarded \$40x as compensation for the death of her husband and five percent interest on the \$40x from November 1923.<sup>189</sup> After concluding that the award compensating for the loss of life was not taxable income, I.T. 2420 held, without elaboration, that the interest was nonetheless taxable.<sup>190</sup> Similarly, in *Riddle v. Commissioner* the taxpayer received compensatory damages of \$15,000 for personal injuries, plus interest of \$3,422.<sup>191</sup> The court found that the measure of damages for the personal injury was \$15,000 and that the \$3,422 was "separately computed and specifically designated as interest."<sup>192</sup> As a result, the interest was includible in income.<sup>193</sup>

A number of more recent rulings follow the reasoning of I.T.

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185. *Wheeler v. Commissioner*, 58 T.C. 459, 461 (1972); *Sager Glove Corp. v. Commissioner*, 36 T.C. 1173, 1180 (1961) ("The taxability of the proceeds of a lawsuit, or of a sum received in settlement thereof, depends upon the nature of the claim and the actual basis of recovery."), *aff'd*, 311 F.2d 210 (7th Cir. 1962), and *cert. denied*, 373 U.S. 910 (1963); see also *Hort v. Commissioner*, 313 U.S. 28, 31 (1941) (holding that negotiated settlement for cancellation of a lease should be included in income).

186. See BITTKER, *supra* note 14, ¶¶ 5-43 to 5-44 (noting that tort recoveries are excludable if they compensate for rights which would be enjoyed tax free); I.R.S. PUB. 17, *supra* note 33, at 77 ("To determine if settlement amounts you receive by compromise or judgment must be included in income, you must consider the item that the settlement replaces.").

187. *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933); I.T. 2420, VII-2 C.B. 123 (1928).

188. I.T. 2420, VII-2 C.B. at 123.

189. *Id.*

190. *Id.* at 124 (applying the Revenue Act of 1926). See also Rev. Rul. 54-19, 1954-1 C.B. 179 (citing I.T. 2420 as support for excluding proceeds obtained under New Jersey wrongful death statute from income for tax purposes).

191. 27 B.T.A. 1339, 1339 (1933). Although the Revenue Act of 1928 controlled, the applicable provision was identical to that in the 1926 Act construed in I.T. 2420. The taxpayer conceded that interest attributable to that part of the judgment constituting damages for property loss was taxable. *Id.* For additional discussion of *Riddle's* analysis of the predecessor to § 104(a)(2), see *supra* notes 157-61 and accompanying text.

192. *Id.* at 1341.

193. *Id.* .



2420 and *Riddle* and conclude that while section 104(a)(2) excludes a lump sum payment received as compensation for personal injuries from gross income, interest earned from the investment of that payment is not excluded.<sup>194</sup> In Revenue Ruling 65-29, the court awarded the taxpayer a lump sum payment equal to the present value of the damages caused to his wife by the defendant's tortious conduct.<sup>195</sup> The Service held that only the lump sum payment is excludable under section 104(a)(2). The interest accrued on the lump sum payment was taxable because the taxpayer had "unfettered control over the lump sum payment and over the income from the investment of such payment."<sup>196</sup> Revenue Ruling 76-133<sup>197</sup> follows similar reasoning. In this ruling, a lump sum settlement was invested in a five-year certificate of deposit. Neither the principal nor the accrued interest could be withdrawn prior to maturity. The Service held that although the lump-sum settlement

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194. Rev. Rul. 76-133, 1976-1 C.B. 34 (holding that interest earned on certificates of deposit purchased with an award for personal injury is includible in gross income under the regulations applicable to "original issue discount"); Rev. Rul. 65-29, 1965-1 C.B. 59 (finding that interest income gained from investment of a lump-sum personal injury award constitutes gross income).

Notwithstanding the authority just cited, the interest may be excluded under § 104(a)(2) if it is made an implicit part of the damage award. In three revenue rulings, the Service has specifically held that installment payments of settlements for personal injury damages will be entirely tax free despite the fact that such future payments contain implicit interest. Rev. Rul. 79-220, 1979-2 C.B. 74 (finding full amount of monthly payments excludable because payee has a right to receive only the monthly payments and not the economic benefit of the accrued lump-sum amount); Rev. Rul. 79-313, 1979-2 C.B. 75 (holding all proceeds excludable even though annual settlement payments increased by five percent each year); Rev. Rul. 77-230, 1977-2 C.B. 214 (finding distributions of income from trust created by settlement agreement excludable from gross income).

In Revenue Ruling 79-313, 1979-2 C.B. 75, the taxpayer was to receive 50 annual payments as compensation for injuries suffered in an automobile accident. Each payment was to be increased by five percent over the amount of the preceding payment. *Id.* The Service concluded that all of the payments were excludable because the taxpayer had neither actual or constructive receipt of the economic benefit. It contrasted this conclusion with Rev. Rul. 65-29, 1965-1 C.B. 59, in which the taxpayer actually received the present value of the award in a lump sum settlement of a personal injury suit. *Accord* Gen. Couns. Mem. 37,687 (Sept. 25, 1978); Gen. Couns. Mem. 36,093 (Nov. 29, 1974); Priv. Ltr. Rul. 90-15-046 (Jan. 16, 1990); Priv. Ltr. Rul. 83-33-035 (May 16, 1983) (acknowledging that periodic payments from an annuity purchased by tortfeasor for injured party are excludable from income); Priv. Ltr. Rul. 83-25-054 (Mar. 21, 1983).

Section 104(a)(2) was amended in 1983 to provide explicitly that neither lump sum nor periodic payments may be excluded from income. Act of Jan. 14, 1983, P.L. 97-473, § 101, 96 Stat. 2605.

195. Rev. Rul. 65-29, 1965-1 C.B. 59.

196. *Id.* at 60.

197. Rev. Rul. 76-133, 1976-1 C.B. 34.

was excludable under section 104(a)(2), the interest was includible in income as original issue discount.<sup>198</sup>

The more recent case law regarding pre- and post-judgment interest is also consistent with the Service's rulings. In *Wheeler v. Commissioner*<sup>199</sup> and *Aames v. Commissioner*,<sup>200</sup> the Tax Court held that post-judgment interest on a damage award was income.<sup>201</sup>

Although less clear than the treatment of post-judgment interest, the tax consequences of pre-judgment interest also strengthens the conclusion that punitive damages are not encompassed within section 104(a)(2). Under state law, pre-judgment interest arises in two forms, interest *eo nomine*, or interest as interest, and interest as damages.<sup>202</sup> Whatever the theory underlying the award, the amount received is unquestionably interest for federal tax law because it always represents an amount received for the use or forbearance of money.<sup>203</sup> Several illustrative cases are useful to demonstrate how such interest is relevant to the taxation of punitive damages.

198. *Id.* A 1982 Senate report noted Rev. Ruling 76-133 approvingly. S. REP. NO. 646, 97 Cong., 2d Sess. 4 (1982). See also Gen. Couns. Mem. 36,093 (Nov. 29, 1974) (holding "taxpayer must . . . include original issue discount in his gross income").

199. 58 T.C. 459 (1972).

200. 94 T.C. 189 (1990).

201. *Aames*, 94 T.C. at 193; *Wheeler*, 58 T.C. at 462. See also *In re Air Crash Disaster Near Chicago, Ill.* on May 25, 1979, 526 F. Supp. 226, 227 n.1 (N.D. Ill. 1981) ("Interest earned on the invested principle . . . is, however, subject to federal income taxation."); *Wilson v. Secretary of the Dep't of Health and Human Services*, No. 89-65-V, 1990 U.S. Cl. Ct. LEXIS 186, at \*30-31 (April 26, 1990) ("While compensation for injuries is not taxable, once it is deemed received by the petitioner, any interest or income earned thereon is taxable."); *McShane v. Commissioner*, 53 T.C.M. 409, 411 (1987) ("It is also undisputed that . . . any statutory interest on the final judgment would have been taxable income under section 61.").

202. See *Cavnar v. Quality Control Parking Inc.*, 696 S.W.2d 549, 552 (Tex. 1985). The *Cavnar* court explained the distinction as follows:

Interest as interest is compensation allowed by law or fixed by the parties for the use or detention of money. Interest as damages is compensation allowed by law as additional damages for lost use of the money due as damages during the lapse of time between the accrual of the claim and the date of judgment.

*Id.*

See also 22 AM. JUR. 2D, *Damages* §§ 648-674 (1988) (discussing generally interest as an element of damages).

203. Cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (holding sale of building attributable to corporation, not stockholders, because "[t]he incidence of taxation depends upon the substance of a transaction").

In *Vertex Investment Company v. Commissioner*,<sup>204</sup> a corporation sued a shareholder for misuse of approximately \$140,000 in corporate assets, proceeding on the theory that the funds had been borrowed. Despite the fact the corporation could have sued on a tort theory of fraud, it chose to pursue the contract theory for other reasons.<sup>205</sup> The parties subsequently settled the suit for a payment consisting of principal and interest. The Board of Tax Appeals ultimately concluded that it was unnecessary to determine whether the interest should be treated as damages because the taxpayer was bound by its own claim alleging a loan with interest. Regarding the prejudgment interest, the Board stated:

[P]etitioner's contention is that amounts to which a taxpayer is entitled as damages can be considered neither as 'income' nor as 'interest' within the meaning of the revenue acts. That 'damages' may in certain circumstances constitute taxable income is well established. That 'damages' may constitute 'interest' is also a conclusion warranted by the authorities, if the so-called damages represented a payment imposed by law for the use or detention of money. In *Joseph W. Bettendorf*, we said: 'Interest is the compensation allowed by law, or fixed by the parties, for the use or forbearance of money, or as damages for its detention', citing 33 Corpus Juris 178. And in the more recent case of *Elverson Corporation*, in defining 'interest, as generally understood' we used, among others, the same definition. If the amounts received by petitioner in the instant proceeding in excess of the principal amount claimed are to be considered as damages for the detention of money, they will come under the definitions given above and will constitute interest. In so far as they may be considered damages for the detention of money, the receipts in question differ materially from awards of damages *qua* damages rendered in legal actions arising from the conversion, either voluntary or involuntary, of property. Since the amounts here involved, if considered as such damages, come within our definition of 'interest', and since there are no cases involving similar facts which require a holding to the contrary, we question the validity of

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204. 47 B.T.A. 252 (1942)

205. *Id.* at 259.

petitioner's contention that amounts to which petitioner might be entitled as damages can not be 'interest' . . . .<sup>206</sup>

The only case authority considering pre-judgment interest in the context of a personal injury suit is *McShane v. Commissioner*.<sup>207</sup> In *McShane*, the jury returned a verdict of \$1,275,000 in favor of the taxpayers for personal injuries suffered in an explosion.<sup>208</sup> After an appeal, the defendants settled for \$1,529,134, fearing that a retrial would result in even greater damages.<sup>209</sup> The settlement represented the trial court's award plus statutory interest computed from an arbitrarily chosen date, less a five percent discount.<sup>210</sup> The Service argued that section 104(a)(2) did not exclude the interest component of the settlement from income. The taxpayers countered that the settlements were entirely for damages, and so, excluded by section 104(a)(2).<sup>211</sup>

The Tax Court began its analysis by noting that under state law each taxpayer would be entitled to statutory interest, or post-judgment interest, on a final judgment and that such interest would be included in gross income. In *McShane*, however, each of the plaintiffs settled with the defendant prior to any final decision.<sup>212</sup> While the Tax Court agreed with the taxpayer that there was no fixed indebtedness upon which to compute interest,<sup>213</sup> the court nonetheless reviewed "the settlement agreements and all other evidence . . . in order to determine whether the payments ultimately received included interest."<sup>214</sup> The Tax Court concluded that interest was not a component of the settlement,<sup>215</sup> and therefore

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206. *Id.* at 257-58 (citations omitted).

207. 53 T.C.M. (CCH) 409 (1987). In Priv. Ltr. Rul. 89-18-082 (Feb. 8, 1989), the Service addressed the taxation of interest paid on damages for personal injury. The ruling concluded that "amounts received . . . as interest are included in gross income under section 61(a)(4), and are not excluded under section 104(a)(2)." *Id.* The ruling did not specify whether the interest at issue was prejudgment or post-judgment interest. *Id.* See also I.R.S. PUB. 17, *supra* note 33, at 77 ("To determine if settlement amounts you receive by compromise or judgment must be included in income, you must consider the settlement that the item replaces. Include the following as ordinary income: 1) Interest on any award.")

208. *McShane*, 53 T.C.M. at 410.

209. *Id.*

210. *Id.*

211. *Id.* at 411.

212. *Id.*

213. A court ordinarily cannot award prejudgment interest where the damages are unliquidated. See *supra* note 194.

214. *McShane*, 53 T.C.M. at 412.

215. *Id.* The court based its decision on the following factors: (1) each settlement agree-

ruled that the entire settlement was excluded by section 104(a)(2).<sup>216</sup> Despite the final conclusion, the court's description of the interest portion of an award as income remained in accordance with earlier rulings.

In other contexts, courts regularly segregate the interest component of judgments to aid in determining appropriate tax treatment. For example, in a series of condemnation cases, several courts held that the amount awarded as interest was not part of the compensation or payment for the property and, consequently, was taxable as ordinary income.<sup>217</sup> Similarly, where damages have been awarded in cases involving stock fraud<sup>218</sup> and accountings for partnership profits,<sup>219</sup> courts have generally held that the pre-judgment interest portion of the award is taxable as ordinary income, not as capital gain from the sale of the asset.<sup>220</sup>

In summary, the conclusion that section 104(a)(2) does not exclude interest awarded in personal injury actions, whether as interest *eo nomine* or as damages, supports the proposition that an award of punitive damages does not fall within the exclusion. Interest in these cases is not awarded on account of personal injury, but rather is awarded for the use or forbearance of money or as damages for detention of money.<sup>221</sup> Similarly, punitive damages are not awarded on account of personal injury; they are awarded because of defendants' egregious conduct.<sup>222</sup>

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ment provided that it was without costs and interest; (2) the intent of parties was that no interest was payable; and (3) the settlement was based solely upon risks of litigation and not the tax consequences of the settlements. The court dismissed the settlement memorandum containing the interest computation as being written after the fact to justify the settlement. Moreover, the settlement memorandum was not prepared by the attorney who conducted the negotiations.

216. *Id.*

217. *Kieselbach v. Commissioner*, 317 U.S. 399 (1943); *Spangler v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963), *aff'd* 20 T.C.M. (CCH) 1783 (1961); *Smith v. Commissioner*, 59 T.C. 107 (1972); *Stewart v. Commissioner*, 43 T.C.M. (CCH) 1119, 1123 (1982), *aff'd*, 714 F.2d 977 (9th Cir. 1983).

218. *Commissioner v. Raphael*, 133 F.2d 442, 444 (9th Cir. 1943), *rev'g* *Lang v. Commissioner*, 45 B.T.A. 256 (1941), *nonacq.*, 1942-1 C.B. 25, and *cert. denied*, 320 U.S. 735 (1943); *Spangler v. Commissioner*, 20 T.C.M. (CCH) 1783, 1784 (1961), *aff'd*, 323 F.2d 913 (9th Cir. 1963).

219. *Specialty Eng'g Co. v. Commissioner*, 12 T.C. 1173, 1177 (1949).

220. *See, e.g.*, *Big Four Indus., Inc. v. Commissioner*, 40 T.C. 1055, 1060 (1963) (arguing that to extent the judgment substitutes for a capital asset, recovery of basis is tax free and the excess amount is taxed at capital gain rates), *acq.*, 1964-1 C.B. (Part 1) 4.

221. *See supra* text accompanying notes 194, 201.

222. *See supra* text accompanying notes 72-84.

### C. Internal Revenue Service's Position After *Glenshaw Glass*

Subsequent to *Glenshaw Glass*, the Service held that amounts received as compensation for personal injury do not constitute income.<sup>223</sup> Revenue Ruling 75-45,<sup>224</sup> which holds punitive damages excludable in income is the single exception to the Service's otherwise consistent position.<sup>225</sup> Although the 1975 ruling was later revoked, it has unfortunately served as the foundation for a line of cases holding punitive damages excludable from income.<sup>226</sup> An historical analysis reveals the significance of this ruling and its impact on the taxation of punitive damages.

Beginning with Revenue Ruling 58-418,<sup>227</sup> the Service issued its first pronouncement regarding the taxation of punitive damages subsequent to *Glenshaw Glass*.<sup>228</sup> The ruling did not, however, specifically address section 104(a)(2). It considered the taxation of a \$75x payment received in settlement of a libel suit which sought \$600x in compensatory damages and \$350x in exemplary damages. The Service turned to *Glenshaw Glass* to resolve the question:<sup>229</sup> "In . . . *Glenshaw Glass* . . . the Supreme Court . . . held, in effect, that the fact that amounts were received as exemplary and punitive damages from wrongdoers as punishment for their unlawful conduct does not detract from their character as income to the recipients."<sup>230</sup> The ruling then concluded that where an amount representing both compensatory and punitive damages is received in settlement of a libel suit for injury to personal reputation, the

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223. See, e.g., Rev. Rul. 58-578, 1958-2 C.B. 38.

224. Rev. Rul. 75-45, 1975-1 C.B. 47, *revk'd*, Rev. Rul. 84-108, 1984-2 C.B. 32.

225. See, e.g., Rev. Rul. 58-418, 1958-2 C.B. 18, *sup's'd*, Rev. Rul. 85-98, 1985-2 C.B. 51.

226. See, e.g., *Burford v. Commissioner*, 642 F.Supp. 635, 636-37 (N.D. Ala. 1986) (rejecting Rev. Rul. 84-108 and excluding punitive damages received in a wrongful death action from gross income); *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983) (holding punitive damages for defamation excludable); *Commissioner v. Miller*, 93 T.C. 330 (1989) (holding that the broad language of § 104(a)(2) covers both compensatory and punitive damages in a defamation action), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

227. Rev. Rul. 58-418, 1958-2 C.B. 18, *sup's'd*, Rev. Rul. 85-98, 1985-2 C.B. 51; see also Rev. Rul. 84-108, 1984-2 C.B. 32 (holding punitive damages includible in gross income, while compensatory damages are not).

228. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432-33 (1955).

229. *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1024 (1927), had determined that damages for libel and slander are compensatory. See *supra* text accompanying notes 149-56. However, as the Service noted, *Hawkins* neither claimed nor was awarded punitive or exemplary damages. Rev. Rul. 58-418, 1958-2 C.B. 18, 19.

230. *Id.*

portion representing exemplary damages is includible in income.<sup>231</sup>

Subsequently, in Revenue Ruling 58-578,<sup>232</sup> the Service considered the taxation of proceeds paid by an employer's insurance company to an injured employee or, in the event of death, to his beneficiary or personal representative upon the execution of a release of all claims.<sup>233</sup> Although not expressly described in the ruling, the release included claims that might be made pursuant to the unidentified jurisdiction's compensatory-type wrongful death statute.<sup>234</sup> The relevance of this release is more apparent upon closer examination of the nature of wrongful death statutes.

Wrongful death statutes are predominantly of two types, compensatory and punitive.<sup>235</sup> Because the ruling held that the pro-

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231. *Id.* Note that the Service allocated the total amount of the award between compensatory and punitive damages based on the amounts requested in the complaint. *Id.*; see also Rev. Rul. 85-98, 1985-2 C.B. 51 (finding that the taxpayer's complaint represented the best evidence available for allocation between punitive and compensatory), *supra*g Rev. Rul. 58-418, 1958-2 C.B. 18; Rev. Rul. 75-230, 1975-1 C.B. 93 (basing allocation on previously paid medical expenses, a sum certain as compared with the speculative nature of damages for pain and suffering); SANDY KASTEN & BRAD SELIGMAN, TAX ASPECTS OF LITIGATION AND SETTLEMENTS § 3.12 (1989).

232. Rev. Rul. 58-578, 1958-2 C.B. 38, *supra*d, Rev. Rul. 75-45, 1975-1 C.B. 47. The Service had considered the estate tax consequences of an award pursuant to the New Jersey "Death by Wrongful Act" statute in Revenue Ruling 54-19, 1954-1 C.B. 179. Revenue Ruling 54-19 held that the proceeds were not includible in the decedent's gross estate because he had no right of action or interest in the proceeds at the time of his death. The ruling went on to note that "compensation for loss of life [is] not embraced in the general concept of the term 'income.'" *Id.*, 1954-1 C.B. at 180 (citation omitted).

233. Rev. Rul. 58-578, 1958-2 C.B. 38, 39.

234. According to Gen. Couns. Mem. 35,967, the administrative file supporting Revenue Ruling 58-578 indicated that the release was made, at least in part, with respect to possible claims under a wrongful death act. General Counsel Memorandum 35,967 noted that the Revenue Ruling could apply to either compensatory or punitive-type wrongful death statutes, and it suggested that a revenue ruling making this clear was appropriate. Gen. Couns. Mem. 35,967 (Aug. 27, 1974), *rev'd*, Gen. Couns. Mem. 37,398 (Jan. 31, 1978). See *infra* text accompanying notes 254-60.

235. At common law, when the victim of a personal injury died, any cause of action she may have had against the defendant terminated and could not be maintained by her estate or heirs. The defendant's death also terminated the cause of action. KEETON et al., *supra* note 46, § 125, at 940. In most jurisdictions, statutes have been adopted which allow the victim's estate or surviving spouse to continue an action, and allow an action to be continued against a deceased defendant's estate. Such statutes are known as survival statutes. Survival actions are viewed not as a new cause of action, but as a continuation of a claim which arose before death. *Id.* § 126, at 943. Damages in survival actions are generally limited to "economic loss" suffered by the victim before his death, such as lost wages and medical expenses. *Id.* Some jurisdictions permit damages for pain and suffering or punitive damages if those damages could have been recovered by the victim had she survived to bring the action herself. Other jurisdictions view such damages as a windfall

ceeds which arose from a compensatory-type statute were not includible in gross income, the Service continued to observe the distinction between compensatory and punitive damages for tax purposes.<sup>236</sup>

Later, in Revenue Ruling 75-45, the Service inexplicably reversed its position.<sup>237</sup> This ruling addressed the tax consequences of insurance proceeds received by the estate of an employee killed while a passenger in his employer's aircraft.<sup>238</sup> The employer's aircraft insurance policy provided for payment upon the execution of a release of all claims, including any claims brought under the wrongful death act of the decedent's state of residence.<sup>239</sup> Ac-

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to the victim's heirs and do not permit their recovery. *Id.*

The common law did not permit the spouse or family of a victim who died as a result of personal injury to bring a cause of action for such items as a loss of support, comfort, guidance or emotional distress. This too has been changed in most jurisdictions by what are known as wrongful death statutes. *Id.* § 127, at 945. Wrongful death actions, in contrast to actions under survival statutes, are viewed as "new and independent" causes of action which "compensate the individual beneficiaries (of the victim) for the loss of the economic benefits which they might reasonably have expected to receive from the decedent in the form of support, services or contributions." *Id.* § 127, at 949.

While most states have separate wrongful death and survival statutes, some simply expand the damages permitted by the survival statute to include the losses otherwise recoverable for the wrongful death. *Id.* § 127, at 946. Both wrongful death and the survival statutes are compensatory in nature because they award damages based on the actual harm suffered by the survivors. Alabama has a unique wrongful death statute. The Alabama statute is punitive in nature. It awards damages based on the egregiousness of the defendant's conduct, rather than on any harm suffered from the death. *See id.* § 127, at 946.

Under the compensatory-type statutes, damages are generally limited to pecuniary losses or the pecuniary value of losses such as services, comfort and consortium. Damages for mental grief and anguish or punitive damages are not typically allowed. *Id.* § 127, at 951. Damages awarded pursuant to these statutes are therefore the compensatory type excluded from income by § 104(a)(2). *Id.* Wrongful death statutes which permit recovery of punitive damages in addition to compensatory damages a closer look at § 104(a)(2). Determining the appropriate tax treatment of judgments in these cases requires that damages for harm suffered, i.e., compensatory, be separated from those which are based on defendants' egregious conduct, i.e., punitive.

236. The rationale was confirmed by Gen. Couns. Mem. 35,967. *See supra* note 234.

237. Rev. Rul. 75-45, 1975-1 C.B. 47, *superseding* Rev. Rul. 58-578, 1958-2 C.B. 38, *reversed*, Rev. Rul. 84-108, 1984-2 C.B. 32. The Ruling's genesis appears to be a 1972 law review comment concluding that damages awarded or received under Alabama's wrongful death statute, a "punitive" wrongful death statute, were not excluded by § 104(a)(2). Robert H. Brodgen, Comment, *Taxability of Damages Under Alabama's Wrongful Death Statute*, 3 CUMBERLAND-SANFORD L. REV. 164, 173 (1972). The proposed draft of Revenue Ruling 75-45 would have distinguished its conclusion from Revenue Ruling 58-578 on the basis that the wrongful death act being considered was compensatory in nature. *See* Gen. Couns. Mem. 35,967 (Aug. 27, 1974).

238. Rev. Rul. 75-45, 1975-1 C.B. 47.

239. Although not identified in the ruling, the jurisdiction was Alabama. Gen. Couns.



cording to the ruling, a series of court decisions established that the applicable jurisdiction's wrongful death act was punitive in nature.<sup>240</sup> As such, Revenue Ruling 75-45 held that the punitive damages received were excludable from gross income. The Service based its conclusion upon the following simple textual analysis:

Section 104 of the Code is a specific statutory exclusion from gross income within the "except as otherwise provided" clause of section 61(a). Section 104(a)(2) excludes from gross income "the amount of *any* damages received (whether by suit or agreement) *on account of* personal injuries or sickness." Therefore, under Section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income.<sup>241</sup>

General Counsel Memorandum 35,967,<sup>242</sup> which underlay Revenue Ruling 75-45, also rejected the application of section 104(a)(2) in the above circumstances. However, its rationale is unusual and perplexing.<sup>243</sup> Instead of focusing on the nature of the receipts as punitive or compensatory,<sup>244</sup> the Memorandum undertakes an unusually expansive interpretation of section 104(a)(2), notwithstanding the general rule that exclusions from income are narrowly construed.<sup>245</sup> According to a footnote in the Memoran-

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Mem. 35,967 (Aug. 27, 1974).

240. *But see* *Burford v. United States*, 642 F. Supp. 635 (N.D. Ala. 1986) (questioning whether Alabama's wrongful death act is punitive in nature). *See also infra* text accompanying notes 284-96.

241. Rev. Rul. 75-45, 1975-2 C.B. 47, *rev'd*, 84-108, 1984-2 C.B. 32. *See* Gen. Couns. Mem. 35,967 (Aug. 27, 1974).

242. Gen. Couns. Mem. 35,967 (Aug. 27, 1974), *rev'd*, Gen. Couns. Mem. 37,398 (Jan. 31, 1978).

243. Gen. Couns. Mem. 35,967 noted that, although Rev. Rul. 58-578 arguably applied to an award pursuant to either type of wrongful death statute, a further ruling was necessary because the Revenue Ruling did not distinguish between the two types of statutes

to inform taxpayers that punitive damages received in connection with personal injuries are not includible in gross income and because of the published comment in the *Cumberland-Sanford Law Review* . . . that concludes that the Service could tax proceeds recoverable under Alabama's wrongful death statute.

Gen. Couns. Mem. 35,967 (Aug. 27, 1974).

244. Gen. Couns. Mem. 35,967 (Aug. 27, 1974). Gen. Couns. Mem. 35,967 cited *Hort v. Commissioner*, 313 U.S. 28, 32 (1941), which held that there was no distinction between rent and a lump sum settlement of a broken lease for the purpose of determining income.

245. *See, e.g., Commissioner v. Jacobsen*, 336 U.S. 28, 49 (1949).

dum, "[t]here is nothing in the legislative history of § 104 or the regulations thereunder indicating that punitive damages awarded in connection with personal injuries should be includible in gross income."<sup>246</sup> But this analysis is mistaken. Proper analysis of the issue should focus on whether or not the legislative history indicates that punitive damages are to be *excluded* from gross income. If not, punitive damages are includible in gross income.

General Counsel Memorandum 35,967 also contains the same errors of statutory interpretation regarding the phrases "as compensation for," "any damages" and "on account of" previously discussed.<sup>247</sup> In particular, it fails to interpret section 104 in light of the intent of those who drafted the original exclusion contained in section 213(b)(6).<sup>248</sup> The Memorandum falls into the traps of defining the word "damages" as "any damages"<sup>249</sup> and of using an overly broad construction of the phrase "on account of."<sup>250</sup> Further, it confuses suits seeking lost wages as an element of damages for personal injury with suits seeking lost wages on other grounds.<sup>251</sup> Under the general rule requiring that the taxability of damages be determined by reference to the nature of the underlying claim,<sup>252</sup> compensation for personal injury would be excluded from income while compensation for lost wages would not be excluded.<sup>253</sup>

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246. Gen. Couns. Mem. 35,967 at n.1.

247. See *supra* text accompanying notes 162-72 (Section V).

248. See *supra* text accompanying note 113.

249. See *supra* text accompanying notes 114-23.

250. See *supra* text accompanying notes 124-26.

251. Gen. Couns. Mem. 35,967. For authority distinguishing these types of claims, see, e.g., *Starrels v. Commissioner*, 304 F.2d 574 (9th Cir. 1962) (distinguishing payments for injury to personal rights from payments for movie rights, the latter a clear accession to wealth); *Meyer v. United States*, 173 F. Supp. 920 (E.D. Tenn. 1959) (distinguishing payment for injury from release of legal rights); *Ehrlich v. Higgins*, 52 F. Supp. 5 (S.D.N.Y. 1943) (distinguishing compensation for injury from payments for release of personal privilege); Gen. Couns. Mem. 37,398 (Jan. 31, 1978), *revk'g* Gen. Couns. Mem. 35,967.

252. See *supra* note 44.

253. Gen. Couns. Mem. 35,967 recognized the general rule, noting "if the damages are a substitute for amounts that would have been includible in gross income, the damages are includible in gross income. Thus, damages received for lost profits or lost wages are includible in gross income." However, the Memorandum drew further support for its position from earlier rulings excluding from gross income settlements of personal injury claims even though a portion of the claim was considered compensation for lost time under the Railroad Retirement Tax Act. Gen. Couns. Mem. 35,967 (citing Rev. Rul. 61-1, 1961-1 C.B. 14.), *revk'd*, Gen. Couns. Mem. 37,398 (Jan. 31, 1978). Rev. Rul. 61-1 was amplified by Rev. Rul. 85-97, 1985-2 C.B. 50. Rev. Rul. 85-97 held that the § 104(a)(2) exclusion extends to personal injury damages allocable to lost wages. Rev. Rul. 85-97, 1985-2 C.B. 50. Cf. *Norfolk and Western Ry. v. Liepelt*, 444 U.S. 490, 498 (1980) (hold-

With its pronouncements in Revenue Ruling 75-45 and General Counsel Memorandum 35,967, the Service appears to adopt a uniform application of federal tax consequences for wrongful death awards. However, there is no legal basis for this position. General Counsel Memorandum 37,398 noted the lapse in the earlier opinions' analysis:

The conclusion reached in Rev. Rul. 75-45 also has the desirable effect of creating uniformity in the treatment of damages received under the wrongful death statutes of the various states. On the other hand *this consideration does not in itself furnish a legal basis for the ruling*. In an analogous situation the Tax Court noted that whether wrongful death damages are includible in the decedent's estate is subject to a great deal of fortuity due to the different types of wrongful death statutes. Nevertheless the court declined to eliminate the fortuity, although it noted that there was a great temptation to do so.<sup>254</sup>

Moreover, the analysis in Revenue Ruling 75-45 and General Counsel Memorandum 35,967 vitiates the rule that state law determines the nature of an interest or right, and federal law then determines the tax consequences of that interest or right.<sup>255</sup>

Just three years later, the Service issued General Counsel Memorandum 37,398 revoking General Counsel Memorandum 35,967.<sup>256</sup> This latter Memorandum concluded that exemplary damages received pursuant to a court award of damages for personal injury in a malicious prosecution action was income and, as such, not excluded by section 104(a)(2).<sup>257</sup> General Counsel Memorandum 37,398 also provided a much more extensive and thoughtful analysis than the revoked memorandum. After concluding that section 104(a)(2) applied to nonphysical personal injuries,

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ing that the lower court erred in refusing to instruct the jury that damages for lost wages are excluded from gross income).

254. Gen. Couns. Mem. 37,398 at n.2 (citations omitted) (emphasis added).

255. See, e.g., *Commissioner v. Estate of Bosch*, 387 U.S. 456, 474 (1967) (Harlan, J., dissenting); *Burnet v. Harnel*, 287 U.S. 103, 110 (1932) ("[S]tate law creates legal interests but the federal statute determines when and how they shall be taxed."); MERTENS, *supra* note 9, § 4.05.

256. Gen. Couns. Mem. 37,398 (Jan. 31, 1978), *revk'g* Gen. Couns. Mem. 35,967 (Aug. 27, 1974).

257. *Id.*

it addressed the taxation of punitive damages.<sup>258</sup> It concluded that while Revenue Ruling 75-45 was a "plausible interpretation of the statutory language, . . . the contrary conclusion is more appropriate."<sup>259</sup> The Service based this conclusion on a strict construction of the exemption statute and a determination that Congress' underlying purpose was to exclude only payments that were restorative.<sup>260</sup>

Subsequently, Revenue Ruling 75-45 was revoked by Revenue Ruling 84-108,<sup>261</sup> which considered the wrongful death acts of Virginia and Alabama. According to the 1984 Revenue Ruling, the Virginia act was a compensatory-type wrongful death statute, while Alabama's statute was "punitive in nature."<sup>262</sup> In this ruling, the Service adopted the compensation theory to explain which awards are excludable under section 104(a)(2). After discussing *Glenshaw Glass*<sup>263</sup> and the Ninth Circuit's decision in *Starrells v. Commissioner*,<sup>264</sup> the Service held that "punitive damages are not awarded 'on account of personal injury,' as required by section 104(a)(2). Instead, they are determined with reference to the defendant's degree of fault."<sup>265</sup> Accordingly, the proceeds received under the compensatory-type Virginia act were excluded from gross income under section 104(a)(2), while the proceeds received under the punitive-type Alabama act were included.

## VII. RECENT JUDICIAL INTERPRETATIONS OF THE EXEMPTION

Six recent opinions consider the application of section 104(a)(2)

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258. *Id.*

259. *Id.*

260. *Id.*; accord I.R.S. PUB. 17, *supra* note 33, at 77, which states:

*Damages.* Do not include in income any compensation you receive for damage to your character or for personal injury and illness. Damages for personal injury and illness are not income regardless of whether you receive a lump sum award or installments. Include in income any punitive damages and compensation you receive for lost wages or lost profits. Interest on the award must be included in income.

261. Rev. Rul. 75-45, 1975-1 C.B. 47, *rev'd*, Rev. Rul. 84-108, 1984-2 C.B. 32, 34; see also Gen. Couns. Mem. 39,390 (Aug. 1, 1985) (reaffirming Gen. Couns. Mem. 37,398 and Rev. Rul. 84-108).

262. Rev. Rul. 84-108, 1984-2 C.B. at 33. For a discussion of the difference between compensatory- and punitive-type wrongful death statutes, see *supra* note 235.

263. *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

264. 304 F.2d 574 (9th Cir. 1962), *aff'g* 35 T.C. 646 (1961).

265. Rev. Rul. 84-108, 1984-2 C.B. at 34.

to punitive damages.<sup>266</sup> In addition, the Supreme Court has recently construed section 104(a)(2) in relation to compensatory damages received in settlement of an employment discrimination claim.<sup>267</sup> This section reviews those decisions.

#### A. *Roemer v. Commissioner*

One of the recent judicial pronouncements is the Tax Court's decision in *Roemer v. Commissioner*.<sup>268</sup> A jury awarded Mr. Roemer \$40,000 as compensatory damages and \$250,000 as punitive damages in an action for libel. The Tax Court determined that the compensatory damages were predominately for injury to his business and professional reputation as an insurance broker rather than for injury to his personal reputation.<sup>269</sup> Finding that the section 104(a)(2) exclusion is limited to compensation for personal injuries as opposed to professional ones, the Tax Court held that the compensatory damages should not be excluded from income.<sup>270</sup>

The court then considered taxation of the \$250,000 awarded as punitive damages.<sup>271</sup> While noting that punitive damages were not considered income prior to *Glenshaw Glass*, it acknowledged that *Glenshaw Glass* distinguished compensatory damages from punitive damages by concluding that the latter did not restore capital for tax purposes.<sup>272</sup> The Tax Court also examined Revenue Ruling 58-418, which held that exemplary damages awarded in a libel suit for injury to personal reputation were income,<sup>273</sup> but found that the ruling did "not relate to the specific exclusion from gross income of section 104(a)(2)."<sup>274</sup> In dicta, the Tax Court addressed

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266. *Miller v. Commissioner*, 914 F.2d 586, 590 (4th Cir. 1990), *rev'g* 93 T.C. 330 (1989); *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983), *nonacq.*, Rev. Rul. 85-143, 1985-2 C.B. 55; *O'Gilvie v. United States*, Civ. A. No. 90-1075-B, 1992 WL 123,806 (D.Kan. May 26, 1992); *Kemp v. Comm'r*, 771 F. Supp. 357 (N.D.Ga. 1991), *appeal dismissed*, No. 91-8610 (11th Cir. Dec. 3, 1991); *Burford v. United States*, 642 F. Supp. 635, 637-38 (N.D. Ala. 1986); *Roemer v. Commissioner*, 79 T.C. 398 (1982).

267. *United States v. Burke*, 60 U.S.L.W. 4404 (U.S. May 26, 1992), *rev'g* 929 F.2d 1119 (6th Cir. 1991).

268. 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

269. *Id.* at 406-07. The Ninth Circuit disagreed with this conclusion. *Roemer*, 716 F.2d at 700.

270. *Roemer*, 79 T.C. at 407.

271. *Id.* at 407-08.

272. *Id.* at 407.

273. Rev. Rul. 58-418, 1958-2 C.B. 18.

274. *Roemer*, 79 T.C. at 407.

Revenue Ruling 75-45. The court apparently questioned the Ruling's conclusion "that *any* damages, whether compensatory or punitive, received 'on account of personal injuries or sickness' are excludable from gross income."<sup>275</sup> According to the court,

[s]ince this interpretation *arguably* comes within the language of section 104(a)(4)[sic], the Commissioner, in his administrative discretion, has chosen to allow punitive damages to be excluded from gross income in the same manner as compensatory damages *provided they arise out of a personal injury*. Otherwise, an award of punitive damages in a libel suit must be included in gross income and taxed like other gain.<sup>276</sup>

Consequently, the Tax Court held that Mr. Roemer must include the compensatory damages in his gross income because those damages were awarded for injury to his business reputation rather than to his personal reputation. Similarly, the punitive damages were to be included in income because they were also not awarded "on account of personal injuries."<sup>277</sup>

The Tax Court's opinion in *Roemer* is important for two reasons. First, it highlights the difference between punitive and compensatory damages.<sup>278</sup> Second, by questioning the Service's rationale and holding in Revenue Ruling 75-45,<sup>279</sup> it provides a foundation for further criticism of the view that punitive damages fall within the section 104(a)(2) exclusion.

However, the Ninth Circuit reversed the Tax Court decision, finding that the compensatory damages awarded to Mr. Roemer were on account of a personal injury and, thus, excluded by section 104(a)(2).<sup>280</sup> Regarding the punitive damages awarded to Mr. Roemer, the Ninth Circuit stated:

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275. *Id.* at 408. The Tax Court cast further doubt on the Service's ruling in a footnote. *Id.* at 408 n.4. The Tax Court referred to Cal. Civ. Code § 3294 as well as several California cases in concluding "that under California law, punitive damages relate to the defendant's oppression, fraud and malice and are not directly related to personal injuries suffered by the plaintiff." *Id.*

276. *Id.*

277. *Id.*

278. *Id.* at 407.

279. *Id.* at 408.

280. *Roemer v. Commissioner*, 716 F.2d 700 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982). In its statement of nonacquiescence, the Service strenuously contested the Ninth Circuit's opinion on this issue, arguing that damages received on account of injury to professional rather than personal reputation are income. Rev. Rul. 85-143, 1985-2 C.B. 55, 56.

Normally, an amount awarded for punitive damages is includible in gross income as ordinary income . . . . Nevertheless, the Commissioner *liberally* interprets § 104(a)(2) to exclude punitive damages as well as all compensatory damages where there has been a personal injury. Therefore, according to the Commissioner's own interpretation, the punitive damages received by Roemer on account of his § 104(a)(2) personal injury (the defamation) are excludable from gross income.<sup>281</sup>

The vitality of the Ninth Circuit's decision is questionable in light of the Service's current interpretation of the exclusion and its revocation of Revenue Ruling 75-45.<sup>282</sup> On the other hand, at least one commentator has sharply criticized the Ninth Circuit's opinion in *Roemer* for the court's failure to question sua sponte the Service's interpretation of section 104(a)(2).<sup>283</sup>

#### B. *Burford v. United States*

*Burford v. United States*<sup>284</sup> was the next case to address the taxation of punitive damages under section 104(a)(2). Specifically, *Burford* considered the taxation of settlement proceeds received in an Alabama wrongful death claim. The court began its opinion by noting that "[t]he starting place in the construction of any statute is with the language of the statute itself."<sup>285</sup> Despite this pronouncement, however, the court failed to examine the applicable language critically. It simply wrote that "[t]he clear import of 'any damages received . . . on account of personal injuries' would seem to express clearly the Congressional intent to exclude wrongful death proceeds — regardless of whether those proceeds are classified as compensatory or punitive — from gross income."<sup>286</sup> Such a definitive conclusion about a controversial aspect of income taxation demonstrates the court's failure to adequately address the is-

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281. *Roemer*, 716 F.2d at 700 (citations omitted) (emphasis added). In *Church v. Commissioner*, 80 T.C. 1104, 1110 n.7 (1983), the Service conceded that punitive damages are excluded from gross income by section 104(a)(2) provided that those damages arise out of a personal injury.

282. See *supra* text accompanying notes 261-65.

283. *Morrison*, *supra* note 131, at 53-55, 80-83.

284. 642 F. Supp. 635 (N.D. Ala. 1986).

285. *Id.* at 636.

286. *Id.*

sues.<sup>287</sup> Moreover, such a sweeping interpretation of the statute violates the rule that exclusions from income are to be narrowly construed.<sup>288</sup>

Instead of examining the history of section 104(a)(2) to better understand its intended purposes, the court merely focused its attention on the disparate tax treatment accorded damages received under wrongful death statutes depending on their nature as either compensatory, as in Virginia, or punitive, as in Alabama.<sup>289</sup> This misguided perspective lead the court to reach a conclusion which does not comport with a careful historical analysis of the tax provision. The disparity which concerned the *Burford* court does not arise from inconsistent tax treatment of damages. The tax treatment is consistent; state laws dictating the nature of remedies for injuries are disparate.

The *Burford* court may have been correct in noting that the proceeds would be tax free if a claim were brought under the Federal Tort Claims Act or the law of another state.<sup>290</sup> However, the laws of other jurisdictions are inapposite. The court's comparison of results highlights its failure to understand the manner in which federal tax law relates to local law. The Internal Revenue Code is superimposed upon local, i.e., non-tax, law to determine the tax consequences of applicable remedies.<sup>291</sup> Consequently, the law of the governing jurisdiction determines the nature of the damages.

*Burford* also responded to the Service's position as expressed in the then-recent Revenue Ruling 84-108.<sup>292</sup> According to the court, "Revenue Ruling 84-108 constitutes an unwarranted administrative amendment of the clear language of the Internal Revenue Code . . . ."<sup>293</sup> It incorrectly found that "[t]he service's traditional position on punitive wrongful death . . . [is that they] are excludable from gross income."<sup>294</sup> In the court's view, "[o]nly a contorted reading of section 104(a)(2) could lead to the interpretation that wrongful death proceeds are not received on accidental

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287. See *supra* notes text accompanying notes 118-34.

288. See *infra* notes 313-14 and accompanying text.

289. See *supra* text accompanying note 235.

290. *Burford*, 642 F. Supp. at 637 n.4.

291. See *supra* note 16 and accompanying text.

292. Rev. Rul. 84-108, 1984-2 C.B. 32, 33 (finding damages awarded under the Alabama wrongful death statute punitive and, therefore, includible in income).

293. *Burford*, 642 F. Supp. at 636.

294. *Id.*



injury."<sup>295</sup> As such, it rejected the Revenue Ruling's conclusion as "neither logical nor realistic."<sup>296</sup> Contrary to the *Burford* court's assertion, however, the Service's position from the inception of federal tax law has been that only damages which compensate for injuries are excluded from income. Thus, Revenue Ruling 84-108 represented a return to the Service's long-standing position prior to Revenue Ruling 75-45.

### C. *Rickel v. Commissioner*

Subsequently, the Tax Court and the Third Circuit considered the taxation of punitive damages awarded on account of a personal injury in *Rickel v. Commissioner*.<sup>297</sup> *Rickel* involved liquidated damages awarded for a violation of the Age Discrimination in Employment Act of 1967 (ADEA).<sup>298</sup> The principal issue before the Tax Court and Third Circuit was whether such a claim was in the nature of an action for breach of contract or for a tort or tort-type injury.<sup>299</sup> After concluding that a portion of the damages awarded was compensation for a tort-like injury,<sup>300</sup> the Tax Court

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295. *Id.* at 637.

296. *Id.*

297. 92 T.C. 510 (1989), *aff'd in part and rev'd in part*, 900 F.2d 655 (3d Cir. 1990).

298. 29 U.S.C. §§ 621-634 (1985)

299. *Rickel*, 92 T.C. at 515. *Rickel* split the award equally between the two types of claims, contract and tort. *Id.* at 522. Consequently, the portion attributable to the contract claim was included in income while the portion received on account of the tort claim was excluded from income. *Id.* The Third Circuit reversed the Tax Court's separation of the award. *Rickel*, 900 F.2d at 664. The circuit court adopted the Ninth Circuit's analysis in *Roemer* that once the nature of an injury is determined to be personal, the damages that flow from the injury are excluded. For other cases focusing on the personal nature of the underlying claim, see *Byrne v. Commissioner*, 883 F.2d 211 (3rd Cir. 1989) (determining the entire award for compensation of economic loss pursuant to Fair Labor Standards Act and New Jersey wrongful discharge law was for violation of personal right); *Bent v. Commissioner*, 835 F.2d 67 (3d Cir. 1987) (concluding that recovery for violation of the First Amendment is excludable); *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986) (holding that recovery for injury to professional reputation is personal and thus excludable), *aff'd*, 848 F.2d 81 (6th Cir. 1988). *But see* *Pistillo v. Commissioner*, 57 T.C.M. (CCH) 874 (1989) (deciding that backpay is not excludable under § 104(a)(2)), *rev'd*, 912 F.2d 145 (6th Cir. 1990), *overruled by* *Downey v. Commissioner*, 97 T.C. 150 (1991); *Wirtz v. Commissioner*, 56 T.C.M. (CCH) 1596 (1989) (holding damages awarded under the ADEA included in gross income because they were wage-related and distinguishing *Rickel* because the jury found no willful violation of ADEA which would constitute a tort-like injury).

300. *Rickel*, 92 T.C. at 521. The court distinguished the remedies available under the FLSA, which include "'unpaid minimum wages' or 'unpaid overtime compensation,' as well as an equal amount of mandatory 'liquidated damages'" from those available under the ADEA such as "compelling employment, reinstatement or promotion, or enforcing the

addressed the Service's argument that the amounts were nonetheless taxable as punitive damages.<sup>301</sup> The court was "concerned with the nature of the award in the hands of the recipient, and from that standpoint it [was] compensatory."<sup>302</sup> Furthermore, it noted that "the liquidated damages available under the ADEA are intended to compensate for those difficult to measure personal injuries that are the consequence of age discrimination."<sup>303</sup> Thus, the court held that "gross income does not include liquidated damages received under a 29 U.S.C. § 626 claim based on a violation of petitioner's statutory right to be free from discrimination on the basis of age."<sup>304</sup>

A careful reading of *Rickel* confirms that the Tax Court recognized that different tax consequences follow from a characterization of an award as compensatory or punitive. The court undertook an extensive and thoughtful analysis of the nature of damages awarded under the ADEA. Such an analysis would be unnecessary if the court concluded that all punitive damages awarded in a personal injury action are excluded by section 104(a)(2).

On appeal, the Third Circuit considered the Service's position regarding the taxation of punitive damages awarded in personal injury cases in connection with the Service's decision not to award the taxpayer reasonable litigation expenses under section 7430.<sup>305</sup>

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liability for amounts deemed to be unpaid minimum wages or unpaid overtime compensation." *Id.* at 518. The court noted that violations of the ADEA typically do not involve a failure to pay minimum or overtime wages and, therefore, monetary damages are more difficult to measure. The Court also observed with respect to the ADEA that "monetary awards may deter employers from engaging in prohibited employment practices. In that sense, they are punitive in nature . . . [M]onetary awards also recompense individuals for injuries caused by their employers' discriminatory conduct." *Id.* at 521.

A complete discussion of whether damages awarded under the ADEA are compensatory or punitive in nature is beyond the scope of this article. The Supreme Court has noted that the "legislative history of the ADEA indicates that Congress intended for liquidated damages to be punitive in nature." *Trans World Airlines, Inc. v. Thurston*, 469 U.S. 111, 125 (1985). The *Rickel* Tax Court concluded, however, that the liquidated damages under the ADEA are "intended to compensate for . . . personal injuries that are the consequence of age discrimination" and held them excluded from gross income. *Rickel*, 92 T.C. at 522.

301. *Rickel*, 92 T.C. at 521. In *Downey v. Commissioner*, 97 T.C. 150 (1991), the Tax Court overruled its earlier decision that backpay awarded as non-liquidated damages for an Age Discrimination Act claim cannot be excluded under § 104(a)(2).

302. *Id.* (emphasis added).

303. *Id.* at 522.

304. *Id.*

305. *Rickel v. Commissioner*, 900 F.2d 655, 665-66 (3d Cir. 1990), *aff'g in part and rev'g in part* 92 T.C. 510 (1989). I.R.C. § 7430 provides that the prevailing party may

The Third Circuit determined that the Service's position was substantially justified.<sup>306</sup>

[I]t was not unreasonable for the Commissioner to have interpreted *Glenshaw Glass* as standing for the proposition that all punitive damage awards are includible in gross income. Although the court [sic] in *Glenshaw Glass* was apparently considering only whether treble damages under the antitrust laws were taxable under the I.R.C., its language was much broader: "Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes." . . . Both courts and commentators have generally interpreted *Glenshaw Glass* as having enunciated the broader proposition.<sup>307</sup>

Although only dicta as it relates to section 104(a)(2), the Third Circuit appeared to acknowledge merit in the Service's position that punitive damages are not covered by the exclusion.<sup>308</sup>

#### D. *Miller v. Commissioner*

The most recent Tax Court decision to consider the punitive damage issue was *Miller v. Commissioner*.<sup>309</sup> *Miller* involved the taxation of \$525,000 received in settlement of a \$950,000 jury award in two defamation actions. The jury award allocated \$500,000 for compensatory damages and \$450,000 for punitive damages.<sup>310</sup> Following its reasoning in *Rickel*,<sup>311</sup> the Tax Court excluded both the compensatory and punitive damages from gross income pursuant to section 104(a)(2).<sup>312</sup> By repeating the *Rickel*

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be awarded reasonable administrative and litigation costs. The "prevailing party" is defined as any party (other than the U.S. or any creditor of the taxpayer) which established that the United States' position was substantially unjustified, and has substantially prevailed with respect to the amount in controversy or with respect to the most significant issue or set of issues presented. I.R.C. § 7430(c)(2).

306. *Rickel*, 900 F.2d at 666.

307. *Id.*

308. *Id.* at 666-67.

309. 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

310. *Id.* at 333.

311. *Id.* at 335-36. The Tax Court refused to follow its decision in *Roemer v. Commissioner*, 79 T.C. 398 (1982), which was subsequently adopted by the Service in Revenue Ruling 85-143, 1985-2 C.B. 55. The court followed the Ninth Circuit's opinion in *Roemer* instead. See *supra* text accompanying notes 280-83.

312. *Miller*, 93 T.C. at 341. The Service took the position that the entire settlement

analysis, the *Miller* opinion also repeated the same analytic and interpretational errors.

The genesis of the Tax Court's error was its failure to recognize and appreciate the ambiguities inherent in the statute. In examining the exclusion, the Tax Court found that the statute had a "plain meaning."<sup>313</sup>

[At the time the predecessor to section 104(a)(2) was enacted,] the availability of punitive or exemplary damages had long been established . . . . Congress, aware of that fact, could have excluded only "compensatory damages" or provided that only damages received "as compensation for" personal injuries be excluded. Cf. *Browning-Ferris Industries of Vermont, Inc. v. Kelco Disposal, Inc.* . . . . (Framers of the Bill of Rights, aware of punitive damages, could have subjected them to Eighth Amendment limitation if they had so intended.). It did neither, and the plain meaning of the broad statutory language simply does not permit a distinction between punitive and compensatory damages. *Crane v. Commissioner*, 331 U.S. 1, 6 (1947) ("the words of statutes — including revenue acts — should be interpreted where possible in their ordinary, everyday senses."). Thus, we read "any damages" to mean "all" damages, including punitive damages. Webster's Third New International Dictionary (1981).<sup>314</sup>

The error in this conclusion lies in the lack of any meaningful analysis of the legislative history or statutory language.<sup>315</sup> Moreover, the court failed to consider the word "damages" separately from the phrase "any damages." Because the plain meaning of the word "damages" is quite different than the definition employed by the Tax Court, the court's conclusion is, at best, tenuous. A more careful and narrow construction would compel a decision that the word "damages" does *not encompass* punitive damages unless

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constituted punitive damages because the taxpayer failed to establish the portion of the net settlement proceeds which represented excludable compensatory damages. *Id.* at 337-38. Proper practice should be to make such an allocation of settlement proceeds as a matter of course, *especially* if the views of the author are adopted.

313. *Id.* at 338. The court cited *Burford* as having held that the statute "is susceptible of only one reasonable interpretation." *Id.*

314. *Id.* at 338.

315. According to the court, the legislative history provided "no sound basis for disregarding the plain meaning of the statute." *Id.* at 341.

punitive damages are specifically *included* in a statutory definition.<sup>316</sup>

Similarly, the Tax Court incorrectly defined the phrase "as compensation." With respect to this term, the court failed to recognize that a reasonable interpretation of the 1918 version of section 104(a)(2) permitted its application to, and limitation of, the "any damages" clause.<sup>317</sup> As a result of the Tax Court's failure to undertake an historic analysis, its conclusion does not comport with the original drafters' intention.

Construing the phrase "on account of," the Tax Court referred to Revenue Ruling 75-45 and noted that "[a]t one time, the Commissioner also viewed the statute as free from ambiguity."<sup>318</sup> The court then criticized the Service's rationale in Revenue Ruling 84-108, which revoked Revenue Ruling 75-45, concluding that "[t]he Commissioner has given the statute a strained and unnatural interpretation."<sup>319</sup> To support its contrary position, the Tax Court simply turned to *Webster's Dictionary* to define the phrase "on account of."<sup>320</sup> *Webster's* suggested that a type of causation is implicit in the phrase, a characteristic tending to support the conclusion that punitive damages should be treated in the same manner as compensatory. The court further noted that in most jurisdictions punitive damages are not available unless some actual or compensatory damages are also awarded. Based on this rule, the court reasoned that "punitive damages are received 'on account of' personal injury, although personal injury alone may not justify an award of punitive damages."<sup>321</sup> Consequently, the court ruled that compensatory and punitive damages are interchangeable for purposes of the section 104(a)(2) exclusion.

In a sharply worded and critical dissent, Judge Whalen made a far more incisive analysis of the phrase. Appropriately, Judge Whalen began his opinion with an extensive analysis of Maryland law to determine the nature of the taxpayer's claims.<sup>322</sup> He concluded that:

under Maryland law [the taxpayer's] claim for punitive

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316. See *supra* text accompanying notes 114-23.

317. *Miller*, 93 T.C. at 341.

318. *Id.* at 339.

319. *Id.*

320. *Id.* (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (1981)).

321. *Id.* at 340.

322. *Id.* at 344-50 (Whalen, J., dissenting).

damages is not an adjunct to or substitute for compensatory damages, but represents an entirely different claim based upon different proof and a different theory than her claim for compensatory damages . . . . [P]unitive damages . . . represent a form of civil punishment.<sup>323</sup>

Based on this finding about the underlying award, he rejected the majority's "causation" analysis. He noted that under Maryland law, at least with respect to a defamation action, the plaintiff is "*presumed* to have been injured . . . and is entitled to compensatory and punitive damages *without* a showing of actual injury."<sup>324</sup> Judge Whalen also observed that the majority confused the prerequisites for asserting the defamation claim with the nature of the claim itself.<sup>325</sup>

Although the *Miller* court pieced together support for its position, such reasoning can hardly substitute for a careful historical examination of the exemption. Interestingly, toward the end of the opinion the Tax Court referred back to the exclusion's origin.

Including punitive damages within the ambit of section 104(a)(2) does not produce an absurd result. Punitive damages have served as a means of compensating plaintiffs for intangible harm and for costs and attorneys' fees . . . . Although they may serve these purposes to a lesser extent now than in the past, the fact that punitive damages may possess a compensatory aspect renders it reasonable to afford them the protection of section 104(a)(2). It also might explain why in 1918 Congress did not expressly limit the statutory exclusion to compensatory damages.<sup>326</sup>

If taken at face value, the Tax Court's statement indicates that it misunderstood the *fundamental* difference between compensatory

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323. *Id.* at 346.

324. *Id.* at 350 (emphasis added).

325. *Id.* Judge Whalen criticized the majority's approach as inconsistent with earlier cases distinguishing different types of damages "caused" by personal injury. *Id.* at 351 (citing a number of opinions distinguishing damages for lost wages from damages for personal injuries). While Judge Whalen was correct in recognizing this inconsistency, he erred in concurring with those opinions. Both Whalen and the earlier cases overlooked the point that lost wages are one *measure* of the compensation excluded by § 104(a)(2). In contrast, punitive damages are not, and never were, intended to compensate plaintiffs for their injuries. The Third Circuit recognized this further distinction in partially reversing the *Rickel* Tax Court. *Rickel v. Commissioner*, 900 F.2d 655, 664 (3d Cir. 1990), *rev'g in part* 92 T.C. 510 (1989).

326. *Id.* at 341.

and punitive damages. Viewed cynically, the statement casts doubt on the intellectual honesty of the opinion's preceding rationale, making them appear purely result-oriented. Although compassionate to the taxpayer, this Tax Court's approach makes for poor tax law.

The Tax Court's opinion in *Miller v. Commissioner* was deficient in several other respects as well. For example, the opinion did not address the court's previous expressions of doubt concerning the Service's "liberal" interpretation of the statutory exclusion.<sup>327</sup> In particular, the *Miller* court failed to mention the observation made in *Burford* that *Glenshaw Glass* is generally thought to stand for the broader proposition that punitive damages are not excluded from gross income.<sup>328</sup> The court thus inappropriately applied an Eighth Amendment interpretation of damages to an exclusion section.<sup>329</sup>

In addition, while it is interesting that punitive damages existed in the law of torts when Congress enacted the predecessor of section 104(a)(2), but that fact is not as probative as the Tax Court suggests.<sup>330</sup> As discussed above, it appears that Congress intended not to tax amounts paid to taxpayers to compensate for their losses and to make them whole. Loss compensation is not the function or purpose of punitive damages; "punitive damages are a windfall to the plaintiff [and] . . . an incentive for plaintiffs to bring petty outrages into court . . . ."<sup>331</sup>

The Tax Court's *Miller* opinion stands alone in construing section 104(a)(2) as excluding punitive damages from gross income if *Burford* is interpreted generously as holding that Alabama's wrongful death statute is compensatory in nature and the *Roemer* decision is viewed as lacking vitality because of the Service's subsequent reversal of its position.<sup>332</sup> However, the Fourth Circuit reversed the Tax Court, correctly reasoning that the portion of the settlement allocable to punitive damages is taxable.<sup>333</sup> The Fourth

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327. See *Roemer v. Commissioner*, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

328. *Burford v. Commissioner*, 642 F. Supp. 635, 637 (N.D. Ala. 1986).

329. *Id.* at 638.

330. *Miller*, 93 T.C. at 338 ("Punitive damages have long been a part of traditional state tort law.").

331. KEETON et al., *supra* note 46, at 14.

332. See *supra* text accompanying notes 268-96.

333. *Commissioner v. Miller*, 914 F.2d 586, 591 (4th Cir. 1990), *rev'g* 93 T.C. 330 (1989). The Fourth Circuit remanded the case for an allocation of the settlement between compensatory and punitive damages. *Id.* at 592.

Circuit's approach is more consistent with legislative intent and prior judicial decisions than the Tax Court's.

The Fourth Circuit began its analysis by examining "the nature of the cause of action and the injury to be remedied."<sup>334</sup> It found that, under Maryland law, a defamation action is an action for personal injury.<sup>335</sup> The court emphasized the distinction between punitive and compensatory damages.

A punitive damages award 'does not attempt to compensate the plaintiff for harm suffered by him, but rather is exemplary in nature and is over and above any award of compensatory damages . . . . [E]xemplary or punitive damages, as the name connotes, are rather a punishment for and deterrent to wrongdoing [rather] than a means of recompensing the victim. To the victim they are a windfall not necessarily related to the injury he has suffered.'<sup>336</sup>

The court proceeded to reject the Tax Court's conclusion that "the 'plain meaning' of section 104(a)(2) compels exclusion of punitive damages from gross income."<sup>337</sup> Although it agreed with the Tax Court that "causation" is suggested by the phrase "on account of," the appeals court found that the Tax Court failed to distinguish between "but for" causation and "sufficient" causation.<sup>338</sup> First, the Fourth Circuit summarized the "but for" causation analysis:

The fact that a plaintiff has to sustain a personal injury as a prerequisite to an award of punitive damages leads to the conclusion that the punitive damages were 'on account of' the plaintiff's injury, even though a punitive damage award requires the additional showing of, and is responsive only to, egregious conduct by the defendant.<sup>339</sup>

It then contrasted "sufficient causation."

The fact that personal injury is a prerequisite to punitive damages does *not* lead to the conclusion that the puni-

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334. *Id.* at 589 (quoting *Thompson v. Commissioner*, 866 F.2d 709, 711 (4th Cir. 1989)).

335. *Id.* (citing *New York, Phila. and Norfolk R.R. v. Waldron*, 82 A. 709, 711 (Md. 1911)).

336. *Id.* (footnote omitted).

337. *Id.*

338. *Id.*

339. *Id.* (footnote omitted).



tive damages were 'on account of' the plaintiff's injuries because, even if the other elements of the tort are present, personal injury alone does not sustain a punitive damage award. The fact that a plaintiff seeking punitive damages has to show egregious conduct by the defendant indicates that the plaintiff's injury was not a sufficient cause of the punitive damages. Thus, the mere fact that 'on account of' suggests 'causation' does not answer the question of whether 'on account of' suggests but-for causation or sufficient causation.<sup>340</sup>

Given these variations, the court concluded that section 104(a)(2) is ambiguous.<sup>341</sup> To resolve the ambiguity, the court turned to two principles of statutory construction. First, exclusions from income are to be narrowly construed,<sup>342</sup> and second, the statute should be interpreted in a manner that furthers the underlying purpose of the law.<sup>343</sup> Adhering to these two principles, the court adopted the Service's "more restrictive" interpretation as "comport[ing] better with the section's underlying purpose" to exclude damages for personal injury from gross income "because, in effect, they restore a loss to capital."<sup>344</sup>

The Fourth Circuit also characterized the Tax Court's reliance on *Burford* as "misplaced."<sup>345</sup> It read *Burford* as having found the Alabama wrongful death statute compensatory.<sup>346</sup> In contrast, punitive damages awarded under the defamation statute in *Miller* served purely to punish the wrongdoer and not to compensate the plaintiff in any way.<sup>347</sup> Consequently, the differences in the underlying claims warranted different tax treatment of the resulting damages.

From *Miller* it is clear that, at least in the Fourth Circuit, determining the amount of damages that may properly be excluded from income under section 104(a)(2) requires an examination of

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340. *Id.* at 589-90.

341. *Id.* at 590.

342. *Id.* (citing *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949)).

343. *Id.*

344. *Id.* (citing *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)).

345. *Id.*

346. *Id.* ("[T]he *Burford* court's close inspection of Alabama law uncovered an Alabama case 'rejecting the precise argument advanced in [*Burford*]'—that such damages are obtained for punitive rather than compensatory purposes." (quoting *Burford v. United States*, 642 F. Supp. 635, 637 (N.D. Ala. 1986))).

347. *Id.*

both the type of injury and the type of damages received.<sup>348</sup>

### E. *United States v. Burke*

In *United States v. Burke*,<sup>349</sup> the Supreme Court considered the taxation of settlements awarded in Title VII claims.<sup>350</sup> Although the opinion considers directly only the taxation of Title VII awards, the opinion may have more far-reaching effect. *Burke* probably supports the thesis of this article that punitive damages awarded in personal injury cases are not excluded from income. The opinion is less than clear, however, and may not provide a guiding principle upon which future punitive damage cases may be determined. Thus, the opinion only adds to the confusion surrounding the tax consequences of punitive damages.

The *Burke* opinion concludes that awards in Title VII cases are not subject to the exclusion of section 104(a)(2).<sup>351</sup> Although the proper taxation of damages under Title VII is beyond the scope of this article, a persuasive argument can be made that the Court's result is correct. However, the Court's underlying rationale was not carefully articulated, and the opinion contains dicta which may cause confusion when punitive damages are at issue.

The Court reaches a result which appropriately applies section

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348. *Id.* The taxpayer argued that past decisions compelled a result in her favor. The Fourth Circuit disagreed, commenting that "the making of an error does not recommend, let alone necessitate, its repetition." *Id.* at 591 (citing *Becker v. Commissioner*, 751 F.2d 146, 150 (3d Cir. 1984)). Because the parties to the underlying settlement failed to allocate the sum between compensatory and punitive damages, the Fourth Circuit remanded. *Id.* at 592.

349. 60 U.S.L.W. 4404 (U.S. May 26, 1992). See also *Crossin v. United States*, No. 91-C-5029, 1992 WL 87,914 (N.D. Ill. Aug. 9, 1991) (reaching same conclusion as *Burke*).

350. Civil Rights Act of 1964, tit. VII, 42 U.S.C.A. §§ 2000e to 2000e-17 (West Supp. 1992). Title VII makes it unlawful for an employer "to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex or national origin." *Id.* § 2000e-2.

351. *Burke*, 60 U.S.L.W. at 4407. In *Leib v. Commissioner*, 1992-354 T.C. Memo. (June 23, 1992), the taxpayer contended that a payment in settlement of a sex discrimination suit was excluded by § 104(a)(2), as it was in the nature of a tort action. The Tax Court dismissed the taxpayer's motion for summary judgment. Citing *Burke*, the court held that there was a question of material fact at least to the extent the claim related to a Title VII claim or other claims which might result in including some or all of the payment in income. The bifurcation of the backpay claim from other claims may represent a departure from earlier decisions in which once it was determined that a tort or tort claim was present, all other causes of action were merged, notwithstanding that the other claims would have resulted in income inclusion.

104(a)(2) narrowly.<sup>352</sup> It also purports to follow traditional section 104(a)(2) analysis examining the nature of the claim to determine the tax consequences of the damages received.<sup>353</sup> But the Court's discussion emphasizes remedial measures in a manner apt to continue confusion in this area.

A more thoughtful articulation by the Court would have placed greater emphasis on elements other than remedies to distinguish between tort and contract actions.<sup>354</sup> Its analysis of the difference in traditional *remedies* led to unfortunate dicta. The Court noted that compensatory and punitive damages are traditional remedies for tort or tort-like claims.<sup>355</sup> The Court contrasted then-applicable Title VII remedies, which generally were limited to backpay. Backpay is a remedy for commonly associated with contract actions.

This dicta may lead to future conundrums for lower courts. The relevant statutory provision excludes from gross income "any damages" awarded "on account of" personal injury. This dicta arguably could be read as supporting an argument that the phrase "any damages" includes both compensatory and punitive damages. This interpretation would restrict the Court's adoption of the narrower construction of this phrase suggested earlier.<sup>356</sup>

The phrase "on account of" remains the avenue for the Court to reach the proper result. Without regard to the merits of the proposition that punitive damages are a traditional remedy for torts,<sup>357</sup> as argued earlier, punitive damages are not awarded "on

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352. See *supra* text accompanying notes 13-15.

353. *Burke*, 60 U.S.L.W. at 4406. The Court recognizes the nature of the claim analysis in two footnotes. In the first, the Court notes "the concept of a 'tort' is inextricably bound up with remedies — specifically damages actions. Thus, we believe that consideration of the remedies available . . . is critical in determining the 'nature of the statute' and the 'type of claim' brought . . . for purposes of § 104(a)(2)." *Id.* at 4406 n.7. This language suggests that, despite the emphasis placed on the remedy, the Court used the traditional analysis of § 104(a)(2). See *supra* note 44 and accompanying text.

In the second footnote, the Court notes that Congress has recently expanded the remedial scope of Title VII to allow recovery of compensatory damages other than backpay and punitive damages. *Burke*, 60 U.S.L.W. at 4407 n.12. The Court did not consider the change as affecting its analysis of the statute as it existed when *Burke's* injury arose. *Id.*

354. The Court "agree[d] with the Court of Appeals' analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents' damage award." *Id.* at 4406.

355. *Id.* at 4405-06. The *measure* of damages in traditional tort cases often is determined in an "economic character," to use the Court's language. *Id.* at 4407. In order to prove compensatory damages, the monetary value of injuries sustained must be proved. For example, the compensation for a tort is often measured by the amount of lost wages.

356. See *supra* text accompanying notes 114-23.

357. Punitive damages are not traditionally awarded in tort cases, but must be specially

account of" personal injury, but rather are awarded "on account of" the defendant's egregious conduct. The *Burke* opinion's narrow interpretation of section 104(a)(2) suggests the Court would similarly interpret the phrase "on account of" narrowly.

F. *Kemp v. Commissioner* and *O'Gilvie v. United States*

Two recent district court decisions held on summary judgment that punitive damages received were includible in gross income and not excluded by section 104(a)(2). Both *Kemp v. Commissioner*<sup>358</sup> and *O'Gilvie v. United States*<sup>359</sup> concluded that punitive damages are not awarded "on account of" personal injuries.<sup>360</sup> Each court found that punitive damages do not serve a compensatory purpose, but rather are awarded on account of the defendant's egregious conduct and serve to punish and deter the wrongdoer.<sup>361</sup>

*Kemp* considered the taxation of punitive damages received in connection with an action brought under 42 U.S.C. § 1983.<sup>362</sup> The decision followed the analysis of the Tax Court in *Burke*.<sup>363</sup>

In a well-reasoned and carefully considered opinion, *O'Gilvie* assessed the tax consequences of punitive damages received in a wrongful death action. The court reviewed the earlier cases considering taxation of punitive damages and distinguished those holding punitive damages excludable from income under section 104.<sup>364</sup> In addition, the court rejected an argument by the taxpayer that the 1989 amendment to section 104(a) indicates that the law prior to the amendment excluded punitive damages from income.<sup>365</sup> The court construed the exclusion narrowly, holding that the punitive damages were not received "on account of" personal injury," and were therefore includible in gross income.<sup>366</sup>

VIII. THE CURRENT STATUS OF SECTION 104(A)(2)

The Omnibus Budget Reconciliation Act of 1989,<sup>367</sup> amended

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proven. See *supra* text accompanying notes 72-84.

358. 771 F. Supp. 357 (N.D.Ga. 1991).

359. Civ. A. No. 90-1075-B, 1992 WL 123,806 (D.Kan. May 26, 1992).

360. *O'Gilvie*, 1992 WL 123,806 at \*4; *Kemp*, 771 F. Supp. at 359.

361. *O'Gilvie*, 1992 WL 123,806 at \*2; *Kemp*, 771 F. Supp. at 359.

362. *Kemp*, 771 F. Supp. at 358.

363. *Kemp*, 771 F. Supp. at 358.

364. *O'Gilvie*, 1992 WL 123,806 at \*2-3.

365. *Id.* at \*4. See *infra* text accompanying notes 376-82.

366. *O'Gilvie*, 1992 WL 123,806 at \*4.

367. Pub. L. No. 101-239, 101st Cong., 1st Sess. § 7641, 103 Stat. 2106, 2379 (1989).

section 104(a) to provide that "[p]aragraph (2) [of section 104(a)] shall not apply to any punitive damages [received] in connection with a case not involving physical injury or physical sickness."<sup>368</sup> Despite its brevity, the legislative history of the amendment is illuminating. As originally introduced, the amendment would have limited the section 104(a)(2) exclusion to cases involving physical injury or physical sickness.<sup>369</sup> The report of the House Ways and Means Committee explained the purpose of the change:

Courts have interpreted this exclusion [section 104(a)(2)] 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 employment discrimination and injury to reputation where there is no physical injury or sickness.

. . . The committee believes that such treatment is inappropriate where no physical injury or sickness is involved.<sup>370</sup>

The conference agreement approved a less sweeping change. It limited the section 104(a)(2) exclusion so that only punitive damages awarded in cases not involving physical injury or sickness would be specifically eliminated.<sup>371</sup> The Conference Committee report merely restated that the exclusion for damages received for personal injury "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."<sup>372</sup>

The Ways and Means Committee report reflects the House's view courts were not according proper tax treatment to proceeds received on account of nonphysical injury.<sup>373</sup> The House probably reasoned, but failed to articulate, that employment discrimination

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368. *Id.* § 7641(a), 103 Stat. at 2379.

369. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1355 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2825. The House version of the bill would have amended § 104(a)(2) by inserting "in a case involving physical injury or physical sickness" after "on account of personal injuries or sickness." *Id.* The amendment would have applied to damages received after July 10, 1989, except those received pursuant to a binding written agreement or court decree issued or in effect on or before July 10, 1989. *Id.*

370. *Id.* at 1354-55, *reprinted in* 1989 U.S.C.C.A.N. at 2824-25.

371. Omnibus Budget Reconciliation Act of 1989, § 7641, 103 Stat. at 2379.

372. H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 6233 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3226.

373. *See* H.R. REP. NO. 247 at 1355, *reprinted in* 1989 U.S.C.C.A.N. at 2825.

suits are primarily contractual in nature rather than tortious and, thus, are beyond the scope of the section 104(a)(2) exclusion.<sup>374</sup> This supposition was recently confirmed in *Burke*, which held that awards in Title VII cases are not excluded by section 104(a).<sup>375</sup> Similarly, the tax cases involving awards for libel all had a substantial business aspect to them. Consequently, the House appears to have concluded that courts were improperly characterizing those damages as personal and, thus, excludable by section 104(a)(2).

In *O'Gilvie v. United States*, the taxpayer argued that the 1989 amendment to section 104(a)(2) added meaning to the pre-amendment statute.<sup>376</sup> The taxpayer claimed that the amendment was meaningless unless punitive damages had been excluded from income prior to it. If punitive damages were not excluded, the amendment would merely restate, in part, the existing law.<sup>377</sup> Therefore, the taxpayer reasoned, the amendment "reflects a congressional judgment to partially limit the scope of section 104(a)(2). . . ."<sup>378</sup>

The *O'Gilvie* court rejected the taxpayer's interpretation of the amendment. It noted that since punitive damages were not considered income until the decision in *Glenshaw Glass* in 1955, Congress did not consider punitive damages when it enacted the predecessor to section 104(a)(2).<sup>379</sup> In addition, the court did not find the legislative history of the 1989 amendment supportive of the taxpayer's position.<sup>380</sup>

While the court reached the proper conclusion, its assertion that punitive damages were not considered income until 1955 is not supported by either legislative history or early judicial decision. Enactment of the original exclusion for personal injury damages reflects the concern of the 1918 Congress about taxation of compensatory damages.<sup>381</sup> Congressional silence with respect to punitive damages when enacting the statutory exclusion does not provide support for the court's presumption. Such a presumption is

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374. See *Burke & Friel*, *supra* note 136, at 24 (discussing the definitional limitations of section 104(a)(2) to personal injuries analogous to torts and excluding contracts).

375. *Burke v. United States*, 60 U.S.L.W. 4404, 4407 (U.S. May 26, 1992), *rev'g* 929 F.2d 1119 (6th Cir. 1991).

376. Civ. A. No. 90-1075-B, 1992 WL 123,806 at \*4 (D.Kan. May 26, 1992).

377. *Id.*

378. *Id.*

379. *Id.*

380. *Id.*

381. See *supra* text accompanying notes 112-14.

dubious in light of the evolving definition of "income." Moreover, in *Hawkins v. Commissioner*, the first case to address the taxation of damages awarded in a personal injury action, the court specifically reserved judgment on the issue of punitive damages.<sup>382</sup>

Although the 1989 amendment appears unambiguous, it leaves several important questions unanswered. The 1989 amendment does not address, and thus fails to resolve, the taxation of punitive damages awarded in cases involving physical injury.<sup>383</sup> Following the rule of statutory construction requiring that exemptions from income not be inferred but proven unambiguously, the tax status of punitive damages awarded for physical injuries remains open for further legislative clarification or judicial decision.<sup>384</sup> The Fourth Circuit decision in *Miller* and the *Kemp* and *O'Gilvie* decisions strongly support the proposition that such damages are not excluded from gross income.

A number of commentators have reasoned by negative implication that even if punitive damages awarded for physical injuries were not to be excluded from income under section 104(a)(2) prior to the 1989 amendment, they are to be excluded since the change in that provision.<sup>385</sup> The Service also appears to have adopted informally this interpretation. In two publications, the Service advises taxpayers that punitive damages awarded in cases not involving physical injury or sickness are taxable.<sup>386</sup> The obvious implication is that punitive damages awarded in cases involving physical injuries are not taxable. This position unfortunately represents an unwarranted return to the analytic errors marked by Revenue Ruling 75-45.<sup>387</sup>

Furthermore, the 1989 amendment is ambiguous with respect to the situation it did address, taxation of punitive damages awarded in "a case not involving physical injury or physical sickness."<sup>388</sup> A hypothetical illustrates the ambiguity. First, assume that a tax-

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382. 6 B.T.A. 1023, 1024-25 (1927). For a discussion of *Hawkins*, see *supra* text accompanying notes 149-56.

383. I.R.C. § 104(a)(2), as amended by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641.

384. Mark W. Cochran, *1989 Tax Act Compounds Confusion Over Tax Status of Personal Injury Damages*, 49 TAX NOTES 1565 (December 31, 1990).

385. See sources cited *supra* note 32.

386. I.R.S. PUB. 525, *supra* note 33, at 15; I.R.S. PUB. 17, *supra* note 33, at 77.

387. See *supra* text accompanying notes 254-65.

388. I.R.C. § 104(a), as amended by Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641.

payer (T) was libeled by the defendant (D). T alleged and received \$1,000,000 of actual damages and \$5,000,000 of punitive damages. Since the 1989 amendment, the punitive damages are includible in gross income. Assume, however, that in addition to the damage done to T's reputation, T suffers an ulcer as a result of the libel. Congress' intent clearly was to tax the punitive damages received in connection with a non-physical personal injury.<sup>389</sup> But what about the punitive damages attributable to the physical manifestation of the tortious conduct?

The House report accompanying the 1989 amendment provided that the origin of the claim, physical or nonphysical, governs the treatment of the punitive damages.<sup>390</sup> "If an action has its origin in a physical injury or physical sickness, then all damages that flow therefrom are treated as payments involving physical injury or physical sickness."<sup>391</sup> The legislative history thus defines the statute's use of the word "involving" as meaning "originating with." According to this construction of the statute, T, the hypothetical taxpayer, would have to include the punitive damages in income because the origin of the claim, libel, is nonphysical.

In contrast, the plain meaning of "involving" suggests that *all* of punitive damages are to be excluded from income if any part of the underlying claim relates to physical injuries. "Involving" means to "include"<sup>392</sup> and, as such, it does not encompass an "originating with" definition.

Moreover, the argument for giving "involving" its plain meaning is reinforced by the statute's use of the word "case." "Case" arguably encompasses all of the causes of actions alleged by the parties. Thus, "a case not involving physical injury or physical sickness" means an action which alleges *no* claim for physical injury or sickness.

If Congress in fact intended to limit the exclusion for punitive damages to those cases originating with a claim for physical injury, it could have adopted such language specifically. For example, had the statute provided that the exclusion for punitive damages would

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389. See *supra* note 131 and accompanying text.

390. H.R. REP. NO. 247 at 1355, *reprinted in* 1989 U.S.C.C.A.N. at 2825.

391. *Id.* The report also provided that "[n]o allocation of damages is required among multiple claims if more than one type of claim is alleged in a personal injury action." *Id.*

392. This portion of the article borrows from Paul C. Feinberg, *The Omnibus Reconciliation Act of 1989 Provides That Punitive Damages Received In Personal Injury Case Not Involving Physical Injury or Sickness Are Includible in Income*, 14 CONNECTICUT BAR ASSOCIATION TAX SECTION NEWSLETTER 1 (Sept. 30, 1990).



not apply in 'a case not *brought on account of* a physical injury or physical sickness' or in 'a case not *originating out of* a physical injury or physical sickness,' the more narrow construction suggested by the House report would be easier to defend.

The plain meaning interpretation of the 1989 amendment is also supported by one very early authority. In Solicitor's Memorandum 1384,<sup>393</sup> the Service considered the taxation of damages received by the taxpayer for the alienation of his wife's affection. At that time, the Service held that the predecessor to section 104(a)(2) excluded only damages received for physical injuries.<sup>394</sup> Notwithstanding this conclusion, the Memorandum contained the following statement:

However, even though the alienation of a wife's affections be not regarded as such a personal injury as is contemplated by the statute, it is still possible that damages therefor might be measured in part by sickness resulting therefrom and, of course, *the amount received on account of such sickness would be exempt under the express language of the statute.*<sup>395</sup>

Thus, the Memorandum tends to support the conclusion that a physical manifestation of a nonphysical injury would be sufficient to avoid the limitation of the 1989 amendment on excluding punitive damages from income.

#### CONCLUSION

The taxation of punitive damages has a long and involved history. A proper analysis of section 104(a)(2) requires a return to its origin. Congress enacted the earliest version of the section 104(a)(2) exclusion in response to uncertainty about the taxation of payments made as compensation for personal injury. Because punitive damages do not compensate victims for their injuries, such damages should not be excluded from income. To resolve any confusion which continues with respect to punitive damages, Congress should further amend section 104 stating clearly this rule.

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393. Sol. Mem. 1384, 2 C.B. 71 (1920). See also *supra* text accompanying notes 149-61.

394. Sol. Mem. 1384, 2 C.B. at 71.

395. *Id.* at 72 (emphasis added).