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Should Personal Injury Damage Awards Be Taxed?

Mark W. Cochran
SHOULD PERSONAL INJURY DAMAGE AWARDS BE TAXED?

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Section 104(a)(2) of the Internal Revenue Code excludes personal injury damage awards from gross income. However emotionally appealing this exclusion may be, under the modern definition of gross income personal injury damage awards clearly constitute an accession to wealth and would, but for the exclusion provided by section 104(a)(2), be taxable. This Article suggests that section 104(a)(2) is unsupported by tax theory and, as a tax subsidy, is incapable of equitable application because of differences in state law. Specifically, Professor Cochran argues that the exclusion is inconsistent with established principles of taxation and clashes with fundamental tort policy. Accordingly, the Author advocates the repeal of section 104(a)(2).

I. INTRODUCTION

SECTION 104(a)(2) OF THE Internal Revenue Code excludes from gross income “the amount of any damages received ... on account of personal injury or sickness.”¹ Originally enacted in 1918², the provision is almost as old as the modern federal income tax system.³ According to the committee report on the original

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1. § 104 Compensation for injuries or sickness
   (a) In general.—Except in the case of amounts attributable to (and not in excess of)
   deductions allowed under section 213 (relating to medical, etc., expenses) for any
   prior taxable year, gross income does not include—

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

I.R.C. § 104(a)(2) (West 1987). For a comprehensive discussion of section 104(a)(2), see
Henry, Tort and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries, 23
(discussing I.R.C. § 22(b)(3) (1952), the predecessor to I.R.C. § 104(a)(2), and the policy
reasons for excluding personal injury damages from taxation); Yorio, The Taxation of Dam-
ages: Tax and Non-Tax Policy Considerations, 62 Cornell L. Rev. 701, 706-09 (1977)
(“emotional factors behind the exemption”).

2. Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1066 (1919) (codified as amended
   at 26 U.S.C. § 104(a)(2) (1982)).

3. The income tax as we know it today dates from 1913, when the Sixteenth Amend-
legislation, the exclusion was enacted because it was “doubtful,” under existing law, whether such damages were required to be included in gross income.\(^4\) In other words, the Committee perceived the statutory exclusion as a mere clarification of existing law.

Courts have broadened the concept of gross income significantly since 1918,\(^5\) but the statutory exclusion for personal injury damage awards has survived.\(^6\) Absent the exclusion, most damage awards would constitute gross income under the modern definition.\(^7\) Thus, the original exclusion was based upon what now appears to be an erroneous assumption.\(^8\) To the extent that the original reasoning no longer supports the exclusion, a search for alternative reasons is appropriate. One might first ask whether there is any basis in “tax theory” for excluding personal injury damage awards from gross income.\(^9\) If no such basis can be found, the inescapable conclusion is that the exclusion is a tax subsidy\(^10\)—a benefit supported, if at all, by policy considerations. To the extent section 104(a)(2) represents a tax subsidy, an inquiry into the reasons for and consequences of the subsidy is appropriate.\(^11\)

\(^1\) The 1913 Income Tax Act was ratified and Congress enacted the 1913 Income Tax. See R. Rice, **FEDERAL INCOME TAXATION** 2 (1967).

\(^4\) The report states:

[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. The proposed bill provides that such amounts shall not be included in gross income.]


\(^5\) See, e.g., Hawkins v. Commissioner, 6 B.T.A. 1023, 1025 (1927) (where the Board of Tax Appeals held that proceeds from the settlement of a slander suit fell outside the definition of gross income in the absence of a statute requiring inclusion); but see, e.g., Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431-32 (1955) (gross income includes all “accessions to wealth” not specifically excluded by statute). For a discussion of prior doctrine which defined income “as the gain derived from capital [or] from labor,” see Eisner v. Macomber, 252 U.S. 189, 207 (1920) and Yorio, supra note 1, at 703-06.

\(^6\) I.R.C. § 104(a)(2) (West 1987).

\(^7\) Damage awards typically represent an increase in the taxpayer’s monetary wealth. As such, they would be included in gross income under the principle of Glenshaw Glass but for the exclusion provided by section 104(a)(2). See supra note 5 and accompanying text. See also Frolik, **Personal Injury Compensation as a Tax Preference**, 37 ME. L. REV. 1, 40 (1985) (where the author concludes that “personal injury reimbursement represents consumable, disposable income that is practically and theoretically indistinguishable from [other] taxable income”); Chapman, **No Pain-No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?**, 9 U. ARK. LITTLE ROCK L.J. 407, 408 (1986-87) (citing I.R.C. § 104(a)(2)); infra notes 10-37 and accompanying text.

\(^8\) See supra notes 4-5 and accompanying text.

\(^9\) See infra text accompanying notes 12-59.

\(^10\) See infra notes 61-70 and accompanying text.

\(^11\) See infra text accompanying notes 73-181.
II. Tax Theory

Gross income, according to section 61, includes "all income from whatever source derived" unless another provision specifically excludes the item in question. Section 104(a)(2) is, of course, such a specific exclusion. While the existence of section 104(a)(2) traditionally has been justified as a humanitarian gesture, more logical explanations occasionally have been offered. As illustrated below the proffered explanations either rest on erroneous assumptions or do not justify a blanket exclusion.

A. Return Of Capital

The most familiar justification for the exclusion from gross income of personal injury damage awards is that the recipient is merely being "made whole" by the award. In tax parlance, being "made whole" is viewed as a return of capital. For example, a taxpayer buys a share of stock for $100 and later sells the same share for $100, the taxpayer has no gross income because she is only recovering her original investment. Recovery of one's original investment is what is meant by "return of capital." The return of capital analysis is appealing, especially in the case of damages awarded for loss of a limb or organ. This type of injury graphically illustrates the concept of "human capital." The problem with this analogy is that a return of capital is excluded from gross income only to the extent of the taxpayer's basis in the capital. A taxpayer's basis in property is generally the amount paid for the

12. I.R.C. § 61(a) (West 1987). See also supra note 5.
15. See Henry, supra note 1, at 723-29.
16. See infra notes 19-59 and accompanying text.
17. See infra notes 19-45 and accompanying text.
18. See infra notes 46-59 and accompanying text.
19. See, e.g., Hawkins v. Commissioner, 6 B.T.A. 1023, 1025 (1927) (where the Board of Tax Appeals concluded that the award received by the plaintiff in a slander suit was merely "an attempt to make the plaintiff whole," yet stated that "character or reputation or other strictly personal attributes are not capital ...") If personal attributes are not capital, then it follows that compensation for the taxpayer's loss is not a recovery of capital. See infra note 28 and accompanying text.
21. See id., at ¶ 2.01, 25.
22. The Solicitor of Internal Revenue articulated the "human capital" concept in a 1920 opinion. Solic. Mem. 1384, 1920-2 C.B. 71, 72 (where the Solicitor disagreed that "the human body is a kind of capital" and recovery for bodily injury represents "a conversion of the capital lost through the injury").
property. Any receipt in excess of the taxpayer's basis constitutes a taxable gain. Thus, in the example above, if the taxpayer pays $100 for stock and sells it for $150, the taxpayer realizes a $50 taxable gain. However, in the personal injury context, a taxpayer's basis is zero because a taxpayer generally does not pay for his limbs or organs. The recipient of a personal injury damage award is being "made whole" in the same sense that the taxpayer selling her stock for $150 is being made whole—by receiving the full value of what is being given up. Like the taxpayer selling her stock, the personal injury plaintiff should be allowed to exclude only that portion of the award that represents recovery of an actual investment of capital. If the taxpayer's basis in the "capital" cannot be established, no part of the award can accurately be called a return of capital. Actually, it is unnecessary to speculate about whether a taxpayer has a basis in the various parts of his body. A personal injury damage award does not pay a taxpayer for the damage to his or her body per se; rather, the taxpayer is compensated for consequent economic loss (i.e., lost earnings) and, in some instances, pain and suffering. Such compensation clearly falls outside the scope of the return of capital concept, since no capital is being exchanged for the award.

B. Involuntary Transaction

Even if the plaintiff's recovery cannot accurately be characterized as a return of capital, one might be tempted to conclude that the damage award should not be taxed because of the involuntary nature of the transaction. After all, the plaintiff did not choose to be injured. The existence of other Internal Revenue Code provisions that grant special status to "involuntary gains" might be cited

23. Section 1012 provides that "the basis of property shall be the cost of such property." I.R.C. § 1012 (West 1987).
24. I.R.C. § 1001(a) (West 1987). See also Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944). In Raytheon, the court held that an antitrust recovery for damage to the goodwill of the taxpayer's business could be excluded from gross income as a recovery of capital but only to the extent of the taxpayer's basis in the goodwill. Since the taxpayer was unable to establish a cost basis in the goodwill, the entire award was taxable. Id. at 114.
26. For an explanation of why a taxpayer has no cost basis in his body, see Frolik, supra note 7, at 26-27; M. CHIRELSTEIN, supra note 20, at ¶ 2.04, 39-42. The return of capital analysis is criticized in Yorio, supra note 1, at 711-13.
27. Raytheon, 144 F.2d at 114.
29. See M. CHIRELSTEIN, supra note 20, at ¶ 2.04, 40-41.
in support of this conclusion. Specifically, section 1033 allows a taxpayer to postpone recognition of a gain resulting from an involuntary conversion of property in certain circumstances.\(^{30}\) Normally, if the taxpayer's property is destroyed and the taxpayer is compensated for the destroyed property (by insurance or otherwise), the taxpayer will recognize a gain to the extent the compensation exceeds the basis of the property.\(^{31}\) If the taxpayer invests the compensation in replacement property, however, section 1033 allows recognition of the gain to be postponed until the taxpayer disposes of the replacement property.\(^{32}\)

Section 104(a)(2)\(^{33}\) might appear to be analogous to section 1033, but there are two important differences. First, section 1033 does not render the gain from an involuntary conversion non-taxable. Rather, it merely allows recognition of the gain to be postponed.\(^{34}\) Second, in order to qualify for deferral under section 1033, the taxpayer must invest the compensation for the destroyed property in replacement property.\(^{35}\) By contrast, section 104(a)(2) provides an absolute exclusion rather than a mere deferral.\(^{36}\) Moreover, the exclusion is not dependent on the taxpayer's use of the award; she may spend the money any way she likes.\(^{37}\) It would seem that the personal injury plaintiff is more like the employee who is wrongfully discharged. The employee did not ask to be fired, and his firing may have been a breach of the contract under which he was employed, but the employee is free to spend his damage recovery however he sees fit and thus must include it in gross income.\(^{38}\)

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30. I.R.C. § 1033(b) (West 1987).
31. Raytheon, 114 F.2d at 113. See also I.R.C. § 1001(a) (West 1987); supra text accompanying note 25.
32. Section 1033(b) preserves the gain for later recognition by limiting the taxpayer's basis in the replacement property to the basis of the destroyed property. I.R.C. § 1033(b) (West 1987).
34. I.R.C. § 1033(b) (West 1987).
35. Id.
37. Section 119 is another example of special treatment for "involuntary income." Section 119 excludes the value of meals and lodging from an employee's gross income if they are provided on the employer's premises, for the convenience of the employer, and, in the case of lodging, required as a condition of the employee's employment. An explanation offered for section 119 is that an employee who receives meals and lodging in the course of his or her employment should not be taxed on the value of accommodations he would not have purchased if he had a choice. See M. Chirelstein, supra note 20, at ¶ 1.02, 18-20. Personal injury damage awards differ because the plaintiff has the free choice to determine how the funds are spent.
38. See, e.g., Gunderson v. Commissioner, 38 T.C.M. (CCH) 464, 465-66 (1979) (award
C. Imputed Income

The Internal Revenue Service and the courts have been reluctant to extend the concept of gross income to include so-called "imputed income." The generally accepted definition of imputed income is the "flow of satisfactions from durable goods owned and used by the taxpayer, or from goods and services arising out of the personal exertions of the taxpayer on his own behalf."39 For example, if the taxpayer, a mechanic, repairs her own car, she is enjoying the fruits of her labor. In an economic sense, the taxpayer has realized an accession to wealth.40 While such income arguably could be taxed,41 as a general rule it is not.

Damage awards sometimes represent compensation for the loss of what would have been imputed income. For example, if a husband is disabled as a result of an accident and his wife is awarded damages for the loss of the husband's household services, the damage award is a cash substitute for imputed income that would have been enjoyed tax free. Thus, it could be argued, logic requires that the damage award also be enjoyed tax free. While this is indeed the treatment under section 104(a)(2),42 it is far from clear that logic requires such a result. It is generally agreed that imputed income escapes taxation for practical rather than logical reasons.43 Specifically, difficulty in defining and valuing imputed income are the

must be included in gross income); Hodge v. Commissioner, 64 T.C. 616, 619 (1975) (where the Tax Court held that damages received on account of discrimination were includable in gross income because the damages represented back pay); but see, e.g., Seay v. Commissioner, 58 T.C. 32, 40 (1972) (holding that a terminated employee could exclude a settlement received from his former employer because the settlement was in consideration of the employee's relinquishment of a defamation claim against the employer); Metzger v. Commissioner, 88 T.C. (CCH) 3000, 3006-12 (1987) (holding that damages received by an employee in satisfaction of a claim of illegal discrimination, as opposed to a claim for back pay, were received on account of personal injury and thus excludable under section 104(a)(2)).

The contrasting results in Metzger and Hodge demonstrate that the tax treatment of an award may depend upon the language used in the pleadings and settlement agreements rather than the substance of the claim. See Burke & Friel, Defining Personal Injury: The Tax Court Heals the Taxpayer, 11 REV. OF TAX'N OF INDIVIDUALS, 299, 310-11 (1987). See also infra notes 73-102 and accompanying text (discussing the impact of state law differences upon otherwise similarly situated taxpayers).


40. McIntyre & Oldman, Taxation of the Family in a Comprehensive and Simplified Income Tax, 90 HARV. L. REV 1573, 1607-24 (1977); see also supra note 4 and accompanying text.

41. Id.

42. See, e.g., Rev. Rul. 74-77, 1974-1 C.B. 33 (holding that damages for alienation of affection are excludable).

43. See McIntyre & Oldman, supra note 40, at 1607-24.
main obstacles to its taxation. It appears that these obstacles are removed when imputed income is reduced to cash. Thus, while damage awards sometimes represent a substitute for non-taxable imputed income, it does not follow that such awards should be excluded from gross income on that basis.

D. Administrative Considerations

In addition to the theoretical justifications discussed above, certain administrative considerations are served by the exclusion of damage awards from gross income. These considerations are discussed below.

1. Bunching of Income

A damage award often results in the plaintiff receiving in a lump sum income that otherwise would have been received over a number of years. This is especially true of awards compensating the plaintiff for loss of earning capacity. It might be asserted that it is unfair to subject such an award to the progressive rate structure of the federal income tax, since the bunching usually forces the recipient into a higher marginal rate bracket. This problem is avoided, of course, if the award is not taxed at all. The Tax Reform Act of 1986 lowered the maximum marginal income tax rate for individuals from 50 percent to 33 percent and reduced the number of rate brackets from 13 to three. These changes greatly reduce the perceived unfairness associated with bunching of income. To the extent that such unfairness continues to exist, some type of rate relief through averaging seems a more appropriate remedy than wholesale exclusion from gross income.

44. Id.
45. See Frolik, supra note 7, at 15-23; but see Yorio, supra note 1, at 713-14.
46. See Frolik, supra note 7, at 23; Yorio, supra note 1, at 714-19.
48. I.R.C. § 1 (West 1987). The nominal maximum rate is 28 percent, but Code Section 1(g) imposes an additional five percent tax on income within a certain range. Id.
49. Prior to 1981, marginal rates ranged from 14% to 70%. To the extent that it is perceived as unfair to tax bunched income at a rate higher than the individual is accustomed to paying, the jump from 11% to 33% should be much less objectionable than the jump from 14% to 70%. Indeed, Congress saw fit to repeal the income averaging provision, which allowed for some mitigation of the bunching problem in years prior to 1987. I.R.C. §§ 1301-1305 (1982), repealed by The Tax Reform Act, I.R.C. § 141 (West 1987).
51. See Frolik, supra note 7, at 11-12.
2. Medical Expenses

It may be argued that, if damage awards were taxed, plaintiffs incurring large amounts of medical expenses would be saddled with tax liability in excess of their ability to pay. Assume, for example, that plaintiff is injured and incurs $20,000 in medical expenses. If plaintiff’s $20,000 recovery is taxed, he or she will not have enough to pay both the tax liability and the medical bills. The deduction for medical expenses provided by section 213 is of no help here, because medical expenses are not deductible if they are “compensated for by insurance or otherwise.”52 Apparently, the tax character of the reimbursement is irrelevant.53 Thus, even if the damage award were taxed, section 213 would not allow a deduction for the medical expenses.54

Obviously, the medical expense problem is avoided by excluding the recovery from gross income. If the recovery were taxed, however, the problem also could be avoided by amending section 213 to provide that a taxable reimbursement of medical expenses will not preclude a deduction of those expenses.55

Since the deduction for medical expenses cannot exceed adjusted gross income for the year in which the expenses are paid,56 a timing problem could result if the expenses were paid in a year

52. Section 213(a) provides a deduction for “the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer . . . to the extent that such expenses exceed 7.5% of adjusted gross income.” I.R.C. § 213(a) (West 1987).

53. See Litchfield v. Commissioner, 40 T.C. 967 (1963), aff’d, 330 F.2d 509 (1st Cir. 1964) (the Tax Court stated that the reference in section 213 to compensation “by insurance or otherwise” is intended “as a catchall which would require the offsetting of any form of reimbursement received against the total medical expense payments.” (emphasis in the original)). Id. at 969. The language from the Tax Court’s Litchfield opinion is cited for the proposition that even a taxable reimbursement will preclude a section 213 deduction in James & Lowe, Consequences of Maintaining Discriminatory Self-Insured Medical Reimbursement Plans, 54 J. Tax’n 89, 91 (1981).

54. See James & Lowe, supra note 53, at 91.

55. In the context of taxable reimbursements under discriminatory medical expense reimbursement plans, Professor Bittker appears to suggest that the “or otherwise” language of section 213 does not extend to taxable reimbursements. B. BITTKER, FUNDAMENTALS OF FEDERAL INCOME TAXATION, ¶ 5.2, 5-12 (stud. ed. 1983). If this reading is correct, the amendment proposed in text would be a clarification. See also Frolik, supra note 7, at 11 (for suggested alternatives “which avoid the blanket exemption provided by section 104” in the medical reimbursement area); supra note 52 and accompanying text.

56. Under section 213, the deduction must be claimed for the taxable year in which the expenses are paid. Expenses in excess of income cannot be “carried over” to subsequent years. I.R.C. § 213 (West 1987). Cf. § 172, which allows excess business expense deductions to be carried over and deducted against income for subsequent years. I.R.C. § 172 (West 1987).
other than the year in which the recovery is received (and, under our supposition, taxed). For example, if plaintiff recovers a lump sum in year 1 to cover future medical expenses, the medical expenses might exceed plaintiff's income for the years in which they are paid. Thus, even if the expenses are otherwise deductible (as a result of the amendment suggested above), the deduction would be of no use to plaintiff. A similar problem could arise if plaintiff pays the expenses in year 1 (presumably with borrowed money) and recovers the award in year 2. This problem does not arise, of course, if the recovery is excluded from gross income.\(^5\) If the recovery were taxed, adding a carryover-carryback\(^5\) feature to section 213 would eliminate the potential problem.\(^5\)

III. JUSTIFICATION AS A TAX SUBSIDY

The preceding discussion demonstrates why the exclusion of personal injury damage awards from gross income cannot be justified as a logical application of tax theory.\(^6\) To the extent that such a justification is lacking, the exclusion should be evaluated as a tax subsidy. That is, a Congressional decision to forego revenues that otherwise would be due.\(^6\) Although Congress apparently did not originally intend the exclusion to be a subsidy,\(^6\) it functions as such in the context of modern tax law.

A tax subsidy is an indirect but very real expenditure of public funds, Congress (at least in theory) having determined that such an appropriation serves the public interest.\(^6\) Typically, tax subsidies

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57. In some situations, taxpayers have been able to exclude the reimbursement from gross income and deduct the expenses. See, e.g., Niles v. United States, 710 F.2d 1391 (1983); see also infra notes 125-38 and accompanying text.

58. Both carryover and carryback of business loss deductions are provided for by I.R.C. § 172 (West 1987) and § 165(i) which allow deductions for certain disaster losses to be taken for the year preceding the year in which the loss occurred. The purpose of the latter provisions is to give disaster victims an expedited tax benefit to meet an immediate need. A carryback provision allows losses that exceed income for the year they are incurred to be deducted against income for earlier years, typically by filing an amended return. A carryover provision allows such losses to be deducted in years subsequent to the year they were actually incurred.

59. Any “bunching” problem resulting from including the award in gross income in a single year could be alleviated by an averaging provision. See supra notes 46-51 and accompanying text.

60. For at least thirty-five years, it has been recognized that exclusion of damage awards from gross income “is rooted in emotional and traditional, rather than logical factors.” Har nett, supra note 1, at 626.

61. For a thorough discussion on the impact of tax subsidies on Congressional spending policy, see S. SURREY & P. MCDANIEL, S.F. TAX EXPENDITURES (1985).

62. Cf. supra note 4 and accompanying text.

63. See S. SURREY & P. MCDANIEL, supra note 61, at 1-6.
are provided to encourage particular activities that are deemed to be "desirable." For example, by allowing accelerated depreciation deductions, Congress provides an incentive for manufacturers to invest in buildings and equipment, which in turn stimulates the general economy. Other tax subsidies represent government assistance through reduced tax liability to taxpayers finding themselves in unfortunate circumstances. Section 165(c)(3), for example, allows taxpayers to deduct certain casualty losses that would otherwise be nondeductible personal losses.

The exclusion provided by section 104(a)(2) compensates tort victims by allowing receipts that logically should be included in gross income to escape taxation. While an expenditure of government funds for the benefit of innocent tort victims has emotional appeal, a closer inspection of the ramifications of the subsidy reveals that it is not a wise investment of public resources. As explained below, the subsidy is not fairly allocated. More importantly, government subsidization of injuries is contrary to sound tort policy.

A. Allocation Of The Subsidy

Assuming, for the moment, that it is desirable for the government to subsidize tort feasors, tort victims, or both, it should go without saying that such a subsidy should be administered fairly and allocated consistently among those who qualify for its benefits. However, several recent developments indicate that the subsidy is not administered fairly and consistently. Rather, it is allocated in a

64. See I.R.C. § 168 (West 1987).
66. In order to be deductible, the loss must result from "fire, storm, shipwreck, or other casualty, or from theft." I.R.C. § 165(c)(3) (West 1987).
67. Section 262 provides that no deduction shall be allowed for "personal, living, or family expenses." I.R.C. § 262 (West 1987).
69. See supra note 7.
70. See supra note 60.
71. See infra notes 76-138 and accompanying text.
72. See infra notes 139-82 and accompanying text.
73. Id.
74. See infra notes 75-138 and accompanying text.
haphazard fashion that surely would not be tolerated in the context of a direct government expenditure.

1. Roemer and Threlkeld.\(^7\) Definition of Personal Injury

In order to be excluded under section 104(a)(2), damages must be awarded on account of a "personal injury."\(^7\) As is often the case, it has been up to the courts to define the parameters of the term. The necessity of judicial interpretation is not unusual, nor is it an appropriate reason for criticizing a statute. However, two recent cases illustrate the possibility of inconsistent interpretations arising out of otherwise meaningless differences in state law.

In Roemer v. Commissioner,\(^7\) the U.S. Court of Appeals for the Ninth Circuit, reversing the Tax Court,\(^7\) held that section 104(a)(2) excludes from gross income damages awarded in a defamation suit, even though the award represented compensation for injury to the plaintiff's professional reputation.\(^7\) In reaching its decision, the court set out an impressive exposition on the history of California's defamation law.\(^7\) On the basis of this historical background, the court concluded that defamation is a personal injury in California. Therefore, damages awarded in such an action are excluded from gross income for purposes of the federal income tax.\(^8\)

While the result in Roemer may be correct,\(^9\) the court's reliance on state law is troubling.\(^9\) Unfair results are inevitable if, as the Roemer court held, federal tax consequences turn on state law labels. A plaintiff in state X whose case is factually identical to Mr. Roemer's and who recovers the same amount of damages might be denied the benefit of section 104(a)(2) simply because state X does not label the plaintiff's injury as "personal."

The Tax Court appeared to follow Roemer in James E. Threl-
To its credit, the Tax Court emphasized that the label applied by state law is not determinative of whether a cause of action is based on a personal injury. Nevertheless, the court analyzed local law and in fact reached its conclusion "[b]ased upon our review of Tennessee law." In light of Threlkeld, the Ninth Circuit's Roemer opinion cannot be dismissed as an isolated example of mistaken analysis. Whether the potential for inconsistent results inheres in the statute or results from mistaken interpretation, the problem does exist. Nor is the problem limited to the courts, as the following discussion demonstrates.

2. Revenue Ruling 84-108: Punitive Damages

According to the Service's position, the exclusion of section 104(a)(2) does not extend to punitive damages. While commentators generally agree that the Service's position is, in theory, a correct interpretation of the law, the difficulty of distinguishing punitive from compensatory damages can lead to unusual results. Revenue Ruling 84-108, the vehicle for the announcement of the Service's position, illustrates the potential for inconsistent results arising out of state law differences. The ruling concerns payments received by the personal representatives of corporate employees who were killed in accidents involving corporate aircraft. In order to receive the payments, which were funded by an insurance company by arrangement with the employer, the personal representatives were required to release any potential wrongful death claims against the employer. The ruling addresses identical facts arising in two different states and concludes that a payment in lieu of damages recoverable under Virginia law is excludable, while a payment in lieu of damages recoverable under Alabama law is not excludable. The Service based the distinction on the fact that damages under

84. 87 T.C. 1294 (1986).
85. Id. at 1305-06.
86. Id. at 1307.
87. Id.
88. See 87 T.C. 1294 (1986).
89. See 716 F.2d 693 (9th Cir. 1983).
90. See infra text accompanying notes 91-102.
92. Id.
95. Id.
the Alabama wrongful death act are determined solely on the basis of the degree of fault on the part of the defendant and thus are "punitive" in nature. Virginia law, on the other hand, provides for damages to be determined according to the actual loss suffered by the decedent's survivors. Thus, damages received under Virginia law are not punitive and therefore are excluded from taxation by section 104(a)(2).

While Revenue Ruling 84-108 dramatically illustrates the potential for unfair results under section 104(a)(2), its analysis rests on firmer ground than that of Roemer and Threlkeld. In Roemer and Threlkeld, the courts applied state law to define "personal injury"—the words of a federal statute. In Revenue Ruling 84-108, the term "person injury" was not in question. Starting from the admittedly supportable assumption that section 104(a)(2) excludes damages intended to compensate the plaintiff but not damages intended to punish the defendant, the Ruling looks to state law simply to determine the nature of the damages. The analysis is rigid, but unlike the analyses in Roemer and Threlkeld, it cannot be called incorrect. Thus, even if Roemer and Threlkeld can be dismissed as erroneous, Revenue Ruling 84-108 leads to the conclusion that a correctly interpreted section 104(a)(2) sometimes yields unfair results.

3. Evidence and Jury Instructions

Instructing the jury as to the tax treatment of a damage award presumably would have an effect on the amount of the award. For example, if the jury awards the plaintiff $1 million, believing that the plaintiff will have to pay tax on the award, it could be assumed that the jury would award something less than $1 million if instructed that the award is tax free. If at least part of the award

96. Id.
97. Id.
98. See 716 F.2d 693 (9th Cir. 1983).
100. See supra text accompanying notes 84-89.
101. See Morrison, supra note 93, at 60.
102. But see Morrison, supra note 93, at 47-48.
103. In Domeracki v. Humble Oil & Refining Co., the court stated that "there is always danger that today's tax-conscious juries may assume (mistakenly, of course) that the judgment will be taxable and therefore make their verdict big enough so that plaintiff would get what they think he deserves after the imaginary tax is taken out of it." 443 F.2d 1245, 1251 (3d Cir. 1971). See also Dempsey v. Thompson, 363 Mo. 339, 346, 251 S.W.2d 42, 46 (1952) (where the Missouri Supreme Court found it "reasonable to assume the average juror would believe" that damage awards are taxable).
constitutes a replacement for lost earnings, the size of the award would also be affected if the defendant is permitted to introduce evidence of the tax the plaintiff would have paid on those earnings. In other words, the defendant would want the award to be based on the plaintiff’s “take home pay,” while the plaintiff would prefer an award based on his “gross pay.”

In lawsuits arising under state substantive law, state law determines whether a defendant is entitled to introduce evidence on taxes and have the jury instructed that an award is non-taxable. Not surprisingly, the results are inconsistent from state to state, but courts in most states do not allow instructions to juries concerning the tax treatment of potential awards. The rationale behind the rule is that a jury instructed to find the actual amount of a plaintiff’s damages would not normally be expected to go beyond the given instructions and increase its award to cover the plaintiff’s perceived tax liability. Moreover, a jury may find that predicting future tax consequences is too complicated. The minority of state courts that have allowed evidence and instructions on taxability offer the converse rationale, for example, absent such evidence and instructions the jury might erroneously calculate the amount of the award, and, believing the award to be taxable, inflate the amount of the verdict to cover that presumed liability. It causes no harm, the courts reason, to dispel any possible misconceptions about the taxability of the award.

In Norfolk & Western Railway Co. v. Liepelt, the United States Supreme Court held that an Illinois trial court erred in refusing to allow evidence of tax liability on lost wages and a jury instruction on the non-taxability of a potential award under the

104. For example, assume that the plaintiff, prior to being injured, earned $2,000 per month but took home $1,500 per month after taxes. Assume also that, as a result of the injury, the plaintiff will be unable to work for two years. The defendant would contend that, since the damage award is tax free, he should pay plaintiff $36,000 ($1500 x 24 months). The plaintiff, on the other hand, will claim that he is entitled to $48,000 ($2,000 x 24 months). See supra text accompanying notes 132-59.


106. Id. at 72-73. See also Annotation, Propriety of Taking Income Tax Into Consideration in Fixing Damages in Personal Injury or Death Action, 16 A.L.R. 4th 589, 595 (1982).


108. See Comment, supra note 105, at 66.

109. See Annotation, supra note 106, at 602.

110. See, e.g., Burlington Northern, Inc. v. Boxberger, 529 F.2d 284, 297 (9th Cir. 1975).

111. 444 U.S. 495, 498 (1980).
Federal Employers' Liability Act.\textsuperscript{112} Writing for the Court, Justice Stevens observed that absent such evidence and instructions, jurors would be likely to arrive at an erroneous damage award and further inflate the amount of the award to take into account the presumed tax liability.\textsuperscript{113} Two dissenting justices argued that allowing such evidence amounted to appropriation for the defendant a subsidy intended for the plaintiff,\textsuperscript{114} and that the jury instruction would unnecessarily confuse the jury.\textsuperscript{115}

Since the Liepelt decision involved a federal cause of action, it is not binding for lawsuits based on state law.\textsuperscript{116} The extent to which state courts will follow the Court's lead remains to be seen, but it is unlikely that a uniform approach will evolve.\textsuperscript{117} As long as different states employ different rules, the potential exists for widely varying results. In the Liepelt case, for example, the original award was $775,000, while the correct amount, under the Court's analysis, apparently would have been $138,000.\textsuperscript{118} As discussed below, the result is unsatisfactory under both Liepelt and the majority of state courts' approach.\textsuperscript{119} Even if it is assumed that one approach or the other can be deemed "correct," and that section 104(a)(2) serves a worthwhile purpose,\textsuperscript{120} the potential for such wild variation in verdicts solely because of local rules of evidence and procedure suggests that section 104(a)(2) does not serve its purpose effectively.

4. Niles v. United States:\textsuperscript{121} The Double Subsidy

As explained above, medical expenses are deductible except to the extent the taxpayer is reimbursed for those expenses.\textsuperscript{122} If the award or settlement allocates a specific amount to past or future medical expenses, the amount allocated to past medical expenses is included in the plaintiff's gross income to the extent the plaintiff

\begin{itemize}
  \item \textsuperscript{112} 444 U.S. at 501-02. (Blackmun, J. and Marshall, J., dissenting).
  \item \textsuperscript{113} Id. at 497-98. In Liepelt, the jury awarded the plaintiff $775,000. Without regard to tax consequences, the plaintiff's expert witness estimated the plaintiff's pecuniary loss at $302,000. If tax consequences were considered, an award of $138,327 would have "made the plaintiff whole." Apparently, the inflation of the award from $302,000 to $775,000 resulted from the jury's mistaken belief that the award should be increased to cover taxes. Id. at 491-92, 497.
  \item \textsuperscript{114} 444 U.S. at 501-02. (Blackmun, J. and Marshall, J., dissenting).
  \item \textsuperscript{115} Id. at 502-03.
  \item \textsuperscript{116} See Comment, supra note 105, at 68-73.
  \item \textsuperscript{117} Id.
  \item \textsuperscript{118} 444 U.S. at 491-92.
  \item \textsuperscript{119} See infra notes 148-75 and accompanying text.
  \item \textsuperscript{120} Id.
  \item \textsuperscript{121} 710 F.2d 1391 (9th Cir. 1983).
  \item \textsuperscript{122} See I.R.C. § 213(a) (West 1987); supra note 52.
\end{itemize}
deducted the expenses when they were originally paid.\textsuperscript{123} Future medical expenses will be deductible only to the extent such expenses exceed the amount allocated to them in the award.\textsuperscript{124}

Problems arise when the award or settlement is a lump sum with no allocation among the various components. The Service's position is that a portion of the settlement must be allocated to medical expenses on the basis of all the facts and circumstances.\textsuperscript{125} Once the appropriate amount has been determined, the tax consequences are the same as outlined above.\textsuperscript{126} The Court of Appeals for the Ninth Circuit rejected the Service's position in \textit{Niles v. United States}\textsuperscript{127}. In \textit{Niles}, the taxpayer had recovered a $25,000 verdict against the City of San Rafael, California, as a result of an injury sustained on the school playground, and a $4,000,000 verdict against the hospital that was allegedly negligent in treating the injury.\textsuperscript{128} The jury did not allocate its verdict among the various components, but on appeal the taxpayer presented an itemization of the award in response to the defendants' claim that the award was excessive.\textsuperscript{129} That hypothetical itemization allocated $1,588,176 to future medical expenses and attendant care.\textsuperscript{130} In a later year, when the taxpayer claimed a deduction for those expenses, the Service denied the deduction because the expenses had been compensated for by the award. The district court held that the medical expenses were fully deductible,\textsuperscript{131} and the court of appeals affirmed, stating "[m]edical expenses of a taxpayer are not 'compensated for' within the meaning of I.R.C. [Section] 213(a) by any portion of a previous lump-sum personal injury award."\textsuperscript{132}

The \textit{Niles} holding results in a double subsidy for the taxpayer. The award is excluded from gross income, and the expenses the award compensates for are deductible. Setting aside the question of whether a subsidy for medical expenses is appropriate,\textsuperscript{133} subsi-

\textsuperscript{123} Treas. Reg. § 1.213-1(g)(1) (as amended in 1979).
\textsuperscript{124} Rev. Rul. 75-232, 1975-1 C.B. 94.
\textsuperscript{125} Rev. Rul. 79-427, 1979-2 C.B. 120.
\textsuperscript{126} See supra notes 123-25 and accompanying text.
\textsuperscript{127} 710 F.2d 1391 (9th Cir. 1983).
\textsuperscript{129} Id. at 241, 116 Cal. Rptr. at 739.
\textsuperscript{130} Id.
\textsuperscript{131} Niles v. United States, 520 F. Supp. 808 (N.D. Cal. 1981), aff'd, 710 F.2d 1391 (9th Cir. 1983).
\textsuperscript{132} 710 F.2d at 1395.
dizing them twice is a waste of public funds. Nevertheless, such a result is inevitable unless the Service's position is followed. The problem with the Service's position, as pointed out by the Niles court, is that it requires speculation as to what portion of an award represents compensation for medical expenses. The Ninth Circuit's rule, on the other hand, creates the potential for radically different results for similarly situated taxpayers solely on the basis of whether the jury itemizes its verdict. The problem could be solved by taxing the award and allowing a deduction for the medical expenses, even though "compensated for," provided the compensation is included in gross income.

B. Tort Policy

The primary function of the tort system is cost allocation. In appropriate circumstances, the cost of an injury is shifted from the injured party to the party causing the injury. Presumably, the party causing the injury passes the cost on to its customers, employees, and other constituents. This allocation of cost has the secondary effect of regulating conduct. In theory, if the accident costs associated with an activity exceed the benefits derived from the activity, people will find a safer way of engaging in the activity or abandon it altogether. This line of analysis is suggested by Judge Hand's definition of negligence in United States v. Carroll

135. 710 F.2d at 1394.
136. Presumably, the plaintiff/taxpayer would have presented evidence supporting each component of the damage award. In most cases, this evidence should provide a reliable basis for allocating a lump sum award. This was, in fact, the methodology suggested by the government in Niles. 710 F.2d at 1392.
137. An itemized verdict would fall squarely within the rule of Rev. Rul. 75-232, 1975-1 C.B. 94. Thus, the court of appeals is suggesting that the plaintiff/taxpayer is entitled to deduct all of his future medical expenses if the verdict is unallocated and none of his future medical expenses if the verdict is allocated. The Niles decision is criticized as a frustration of Congressional policy in Note, Niles v. United States: Double Tax Benefits Arise From the Ninth Circuit's Questionable Interpretation of Section 213, 4 VA. TAX REV. 427, 438-39 (1985).
138. See supra note 48 and accompanying text.
139. "The law of torts ... is concerned with the allocation of losses arising out of human activities." W. PROSSER, HANDBOOK OF THE LAW OF TORTS 6 (5th ed. 1971).
140. Liability typically is based upon fault (i.e., negligence), but tort doctrine sometimes provides for strict liability. See generally W. PROSSER, supra note 139, at 534-83.
141. See generally Calabresi, Some Thoughts on Risk Distribution and the Law of Torts, 70 YALE L.J. 499 (1961) (for a comprehensive analysis of risk distribution theory); Posner, A Theory of Negligence, 1 J. LEGAL STUD. 29, 34 (1972) (for "the hypothesis that liability for negligence is designed to bring about an efficient level of accidents and safety").
142. Calabresi, supra note 141, at 500-01.
143. Posner, supra note 141, at 32.
Towing Co., which suggests that conduct is negligent if the cost of a potential injury, multiplied by the likelihood of that injury occurring, exceeds the burden of taking precautions adequate to prevent the injury.

Regardless of whether one subscribes to the interpretation of Judge Hand's standard as a law of economics, it must be conceded that the tort system discourages reckless conduct and encourages the safest manner, within reason, of carrying out worthwhile activities. The following discussion explores the impact of section 104(a)(2) on the cost allocation and regulatory functions of the tort system.

As outlined above, a personal injury damage award represents an accession to wealth not inherently different from any other and therefore logically should be included in gross income. Accordingly, taxation of the award will be treated as the "correct" result and used as a basis for evaluating various alternative results that are possible under the present rule of excluding the award from gross income.

Let us assume that a plaintiff has been injured as a result of a defendant's negligent conduct. The plaintiff's lost wages, lost earning capacity, and pain and suffering have a total value of $100,000. If the jury awards the plaintiff $100,000, plaintiff's wealth has been increased by $100,000 and defendant has been assessed with the cost of the injury he caused. Since the plaintiff has been enriched, he should pay tax the same as if he had earned the money. For simplicity, a 28 percent rate will be assumed.

144. 159 F.2d 169 (2d Cir. 1947).
145. Id. at 173.
146. See Posner, supra note 141.
147. Judge Posner suggests that the negligence system results in an allocation of accident costs in a manner that encourages economic efficiency. In other words, potential defendants are encouraged to take safety precautions so long as the cost of those precautions is less than the potential cost of an accident, taking into account the likelihood of an accident occurring. Posner, supra note 125, at 32-33. By denying compensation for avoidable accidents, the doctrine of contributory negligence encourages potential plaintiffs to take reasonable precautions. Id. at 39-40.
148. See supra note 69 and accompanying text.
149. See supra note 1 and accompanying text.
150. See supra note 145 and accompanying text.
151. The plaintiff's medical expenses will be disregarded on the assumption that a deduction under section 213 would offset any inclusion in gross income. See supra note 55 and accompanying text.
152. See supra note 141 and accompanying text.
153. See supra notes 7, 10-37 and accompanying text.
154. Under the Tax Reform Act of 1986, the maximum marginal rate for individuals is 33 percent, but the maximum effective rate is 28 percent. See supra notes 47-48.
Thus, plaintiff will owe $28,000 in tax, leaving plaintiff with $72,000, the proper “after tax” recovery.

Situation #1 — The Typical Result Under Current Law

On the facts outlined above, the result under current law is that the plaintiff gets to keep the entire $100,000 instead of paying $28,000 in tax. The cost to defendant, $100,000, is the same. Plaintiff is receiving an extra $28,000, which ultimately comes, of course, from the federal government. This is objectionable for a number of reasons. First, allowing the federal government to contribute toward the cost of injuries is contrary to the basic premise of tort law: that the party negligently causing the injury should bear its cost.

If the public desires a government-funded accident insurance program, Congress should address the idea directly. A subsidy to the plaintiff also creates economic distortions. First, the plaintiff is being told that $10 of compensation for lost wages is worth $14 of income earned on the job. This is economically unsound. In addition, if an injury with a true after tax economic value of $72,000 will net an after tax return of $100,000, the $28,000 premium adds an incentive to pursue questionable claims. Finally, if

155. See supra notes 150-54 and accompanying text.
156. This $28,000 of foregone revenue is properly viewed as a tax subsidy. See supra notes 54-61 and accompanying text.
157. See supra note 140 and accompanying text.
158. In THE COMMON LAW, Oliver Wendell Holmes comments negatively on the prospect of state sponsored accident insurance:
   The state might conceivably make itself a mutual insurance company against accidents, and distribute the burden of its citizens' mishaps among all its members. There might be a pension for paralytics, and state aid for those who suffered in person or estate from tempest or wild beasts. As between individuals it might adopt the mutual insurance principle pro tanto, and divide damages when both were in fault, as in the rusticum judicium of the admiralty, or it might throw all loss upon the actor irrespective of fault. The state does none of these things, however, and the prevailing view is that its cumbersome and expensive machinery ought not to be set in motion unless some clear benefit is to be derived from disturbing the status quo. State interference is an evil, where it cannot be shown to be a good. Universal insurance, if desired, can be better and more cheaply accomplished by private enterprise.

O. HOLMES, THE COMMON LAW 96 (1881).

159. If the plaintiff earns $14 in wages, he will be left with $10.08 after paying tax at the rate of 28%. Professor Yorio concludes that non-taxability of damages based on lost earnings results in overcompensation of the plaintiff but suggests that taxation of an award for pain and suffering would result in undercompensation of the plaintiff. See Yorio, supra note 1, at 733-35.

160. See supra notes 150-54 and accompanying text.

161. Cost efficiency analysis can be applied here also. If X represents the cost of litigation, plaintiff can be expected to pursue a claim if L (the likelihood of recovery) times R (the amount that can be recovered) exceeds X. If R is increased (as here, through a tax subsidy), the value for L at which plaintiff will pursue his claim is correspondingly decreased.
an injury will yield compensation in excess of the actual loss, there is, at least in theory, an economic incentive to become an accident victim.\textsuperscript{162}

Situation #2 — The Jury Inflates the Award to Cover Imaginary Taxes

Let us assume the same facts outlined above except that the jury, erroneously believing that the award will be taxed, increases the award to \$139,000 to allow for the taxes.\textsuperscript{163} Now the plaintiff, who should end up with \$72,000 after taxes,\textsuperscript{164} walks away with \$139,000 tax free. Of the extra \$67,000, the defendant pays \$39,000 and the federal government pays \$28,000. The message to the plaintiff is the same as in Situation #1,\textsuperscript{165} only louder. The plaintiff now learns that \$10 of compensation for lost wages is worth \$19 of wages earned on the job,\textsuperscript{166} or, put another way, sitting at home injured for one month pays the same as working for two months. The incentive to pursue questionable claims\textsuperscript{167} and the premium on becoming an accident victim\textsuperscript{168} are correspondingly increased.

On the other side of the equation, the defendant is now being charged \$139,000 for a \$100,000 injury. Although the extra \$39,000 was not intended to be a punitive damage award, it functions as one. If this scenario is repeated often enough, the defendant will be driven out of business without economic justification.\textsuperscript{169}

Situation #3 — The Jury Reduces the Award Because It is Tax Free

Once again, let us assume that defendant has negligently caused a \$100,000 injury to plaintiff. This time, however, assume that the

\textsuperscript{162}Admittedly it is unrealistic to assume that a person would intentionally incur a bodily injury. A more appropriate statement would be that the subsidy decreases the potential plaintiff's economic incentive to take reasonable precautions. See Posner, supra note 141, at 40.

\textsuperscript{163}Such an assumption is not unfounded. See supra note 113. The \$139,000 represents the amount that, if taxed at 28\%, would leave \$100,080 after tax.

\textsuperscript{164}See supra text accompanying notes 150-54.

\textsuperscript{165}See supra notes 159-62 and accompanying text.

\textsuperscript{166}If imaginary taxes of 28\% are added, the \$10 award is increased to \$14 (\$14 \times 72 \% = \$10). The \$19 of wages would have an after tax value of \$13.68 (\$19 \times 72 \% = \$13.68).

\textsuperscript{167}See Norfolk & Western Railway Co. v. Liepelt, 444 U.S. 495 (1980) and text accompanying note 161.

\textsuperscript{168}See supra note 162 and accompanying text.

\textsuperscript{169}Under cost efficiency analysis, an activity ceases to be economically viable if the cost of the injuries resulting from the activity exceeds the benefits to be derived from the activity. See Calabresi, supra note 141, at 502.
jury knows its award is tax free and therefore reduces the award to $72,000 on the theory that the plaintiff is receiving an indirect subsidy of $28,000 from the federal government.\textsuperscript{170} Under this scenario, plaintiff walks away with the correct amount — $72,000.\textsuperscript{171} The defendant, however, has caused a $100,000 injury and is paying only $72,000. Quite simply, the jury has taken the $28,000 government subsidy away from the plaintiff and given it to the defendant, converting the section 104(a)(2) exclusion into a pure, government-funded insurance program.\textsuperscript{172} This conversion frustrates the regulatory function of the tort system.\textsuperscript{173} When the cost of an accident to the defendant is reduced through a government subsidy, the economic incentive to avoid an accident is reduced.\textsuperscript{174} In legal terms, the standard of care is lowered.\textsuperscript{175}

\textit{Situation #4 — The Award is Taxed But the Jury Erroneously Assumes It Is Tax Free}

Finally, one should consider what happens if the award is taxed, but the jury erroneously assumes that it is tax free and therefore reduces the amount of the award. As outlined above,\textsuperscript{176} the “correct” result is achieved if the award is taxed and the jury ignores tax considerations in arriving at the amount. Under that scenario, the defendant pays the full cost of the injury and the plaintiff gets to keep his or her “fair share.”\textsuperscript{177} If, however, the award is taxed and the jury reduces the amount believing it is tax free, the situation is as egregious as any of the other possibilities discussed above. Using the same dollar amounts, if the jury found that the defendant caused $100,000 worth of damage, but reduced the award to $72,000 thinking it was tax free, the defendant would pay less than the “correct” amount. As stated above, reducing the cost of the accident to the defendant reduces the standard of care.\textsuperscript{178} At the same time, the plaintiff is not adequately compensated. Instead of the correct recovery of $72,000, the plaintiff is left with only $51,840 after tax.\textsuperscript{179} Besides the unfairness of undercompensation

\begin{itemize}
  \item[170.] Admittedly, this result is unlikely unless the jury is comprised of economists and tax professors.
  \item[171.] See supra notes 150-54 and accompanying text.
  \item[172.] See supra note 158 and accompanying text.
  \item[173.] See supra notes 143-47 and accompanying text.
  \item[174.] Id.
  \item[175.] See supra notes 143-45 and accompanying text.
  \item[176.] See supra text accompanying notes 150-54.
  \item[177.] Id.
  \item[178.] See supra text accompanying notes 173-75.
  \item[179.] At a 28\% rate, tax on $72,000 would be $20,160.
\end{itemize}
on an individual basis, repeated undercompensation of plaintiffs would reduce the incentive to sue and thus frustrate the regulatory function of the tort system.\textsuperscript{180}

The preceding examples illustrate that regardless of how the jury deals with the tax character of a non-taxable award,\textsuperscript{181} economic distortions and frustrations of tort policy are inevitable. The inescapable conclusion is that an exclusion of damage awards from gross income is fundamentally unsound from a tort policy standpoint.\textsuperscript{182}

Even if awards were taxed, distortions could still result if the jury were not properly instructed.\textsuperscript{183} In the case of a taxable award, the logically correct instruction would be none at all, since tax considerations should be ignored. This assumes, however, that the jury will not engage in misguided speculation as to tax consequences. The potential consequences of such speculation, as illustrated above,\textsuperscript{184} warrants a cautionary instruction to the jury that they should not consider the effect of income taxes in arriving at the amount of the award.

IV. CONCLUSION

The exclusion of personal injury damage awards from gross income is inconsistent with established principles of taxation.\textsuperscript{185} Damage awards cannot accurately be characterized as a return of capital.\textsuperscript{186} Nor does the involuntary nature of the transaction justify the exclusion.\textsuperscript{187} While so-called imputed income is not taxed,
the reasons supporting its non-taxability do not extend to damage awards representing a cash substitute for such income. 188 Excluding damage awards avoids certain administrative problems that may otherwise arise, but those problems could be resolved by less drastic means. 189

Absent a logical explanation based on tax theory, the exclusion of damage awards must be viewed as a tax subsidy—a decision (conscious or otherwise) to forego revenue that otherwise would be due. 190 Because of definitional, evidentiary, and choice of law problems, the subsidy afforded by section 104(a)(2) is unfairly administered. 191 More importantly, government subsidization of accident costs is inconsistent with tort policy objectives. 192

There appear to be few, if any, valid reasons for the existence of section 104(a)(2). 193 The reasons for its repeal appear numerous and persuasive. 194 If damage awards were taxed, the policy goals of the tort system would be advanced rather than frustrated, since defendants would not be under-penalized and plaintiffs would not be overcompensated. 195 In order to assure this result, however, juries should be cautioned to ignore tax consequences in determining the amount of awards. 196

188. See supra notes 39-45 and accompanying text.
189. See supra notes 46-59 and accompanying text.
190. See supra notes 61-70 and accompanying text.
191. See supra notes 73-138 and accompanying text.
192. See supra notes 139-73 and accompanying text.
193. But see B. BITTKER, supra note 182.
194. Professor Frolik reaches a similar conclusion. See generally, Frolik, supra note 7, at 40 ("[r]epeal of [section 104] would allow the sympathy for the injured and disabled to focus on appropriate and selective deductions rather than forming the basis for over-broad exemptions . . . .").
195. See supra text accompanying notes 149-83.
196. See supra text accompanying notes 181-83.