Montana Law Review

Volume 58
Issue 1 *Winter 1997*

Article 7

1-1-1997

Getting Physical: Excluding Personal Injury Awards under the New Section 104(a)(2)

J. Martin Burke
University of Montana School of Law, jmartin.burke@umontana.edu

Michael K. Friel
University of Florida

ARTICLES

GETTING PHYSICAL: EXCLUDING PERSONAL INJURY AWARDS UNDER THE NEW SECTION 104(a)(2)

J. Martin Burke*
Michael K. Friel**

I. INTRODUCTION

The 1996 amendments to § 104(a)(2) of the Internal Revenue Code are an understandable, but fundamentally incorrect, reaction to a statutory rule that was seen to have careened out of control with respect to nonphysical personal injuries. The rule of § 104(a)(2), since its enactment in 1919, was that damages received on account of personal injury were excludable from gross income. After a brief initial period during which these qualifying personal injuries were administratively limited to physical injuries,[1] it became clear, during the 1920s and thereafter, that both physical and nonphysical injuries were within the scope of the rule.[2] For most of its history, however, the rule was a little-noticed backwater in the Code, confined in practice largely to damages from physical injuries and a limited number of nonphysical injuries such as defamation and loss of consortium.[3] But over

* J. Martin Burke, Visiting Professor of Law, New York University School of Law; Professor of Law, University of Montana School of Law; A.B., Gonzaga University, 1970; J.D., University of Montana, 1974; LL.M., New York University, 1982.

** Michael K. Friel, Professor of Law and Director, Graduate Tax Program, University of Florida; B.A., University of Florida, 1966; J.D., Harvard, 1969; LL.M., New York University, 1982.

1. *See* Sol. Mem. 1384, 1920-C.B. 71.

2. *See* Sol. Op. 132 I-1 C.B. 92 (1922); Hawkins v. Commissioner, 6 B.T.A. 1023 (1927), *acq.*, VII-1 C.B. 14 (1928).

3. *See* J. Martin Burke & Michael K. Friel, *Tax-Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13 (1989).

the past twenty-five years, through various judicial and administrative rulings, the exclusion came to encompass a new, wide variety of nonphysical injuries—most particularly those based on laws prohibiting discrimination in employment—as well as all the economic and noneconomic damages linked to them. This expansion of the scope of the statute in the nonphysical area was unchecked by any limiting definition of the term "personal injury" (neither the statute nor the regulations provided one) or by an articulated policy that § 104(a)(2) was designed to serve (the legislative history provided none, and no policy consensus emerged from the plethora of judicial, administrative and academic pronouncements on the provision). The 1996 legislative response to this expansion was to limit the § 104(a)(2) exclusion to physical injuries only.[4]

The dissatisfaction with the pre-1996 scope of § 104(a)(2) is indeed understandable: § 104(a)(2) seemed to stand for the proposition that any recovery—certainly any nonpunitive recovery—based on any tort or tort-like claim was nontaxable. The 1996 amendments represent a firm rejection of that proposition. But the remedy chosen to limit an overbroad statute, the drawing of a line between physical and nonphysical injuries, has introduced its own difficulties and is not supportable from a tax policy standpoint. The virtue of this particular line-drawing presumably lies in cutting back the scope of § 104(a)(2) in an apparently administrable manner; however, no substantial policy-based justification was advanced for distinguishing between physical and nonphysical injuries.

The thesis of this Article, then, is that while § 104(a)(2) was in need of remedy, the remedy chosen is both insupportable from the standpoint of tax policy and problematic in terms of administrability. A better remedy can be devised, and a proposal toward that end is revisited in Part V of this article. To provide background regarding § 104(a)(2), Part II of this article traces the recent history of the statute's judicial construction focusing on the decisions in *Threlkeld v. Commissioner*,[5] *United States v.*

4. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755, 1838-39 § 1605(a). The 1996 amendments also clarified that punitive damages, whether arising out of physical or nonphysical injuries, were not excludable. *See id.* This amendment built on a 1989 amendment that provided that punitive damages in connection with nonphysical injuries were not within § 104(a)(2) but was silent with regard to punitive damages in physical injury cases. *See* § 104(a) [1989]; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, 2379 § 7641(a).

5. 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

Burke,[6] and *Commissioner v. Schleier*,[7] and *O'Gilvie v. United States*.[8] Part III discusses the provisions of the 1996 amendments to § 104(a)(2). Part IV demonstrates the impact of the 1996 amendments on dignitary torts and highlights policy and interpretational problems associated with the amended provision.

II. PRELUDE TO THE 1996 AMENDMENTS: THE SUPREME COURT NARROWS THE EXCLUSION

The Supreme Court provided its only interpretation of § 104(a)(2) in three cases in the 1990s, with its 1995 decision, *Commissioner v. Schleier*,[9] significantly narrowing the scope of the exclusion. Prior to that time, the Tax Court in *Threlkeld v. Commissioner* marked out this scope, giving a sweeping breadth to § 104(a)(2) when it ruled that a "personal injury" referred to "any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."[10] This definition easily encompassed not only traditional nonphysical injuries such as defamation, but a broad array of newly-minted, and generally employment-related, actions for nonphysical injuries such as the denial of First Amendment rights,[11] discrimination on the basis of sex, race and national origin,[12] and retaliatory discharge from employment.[13]

Moreover, according to *Threlkeld*, the exclusion could not properly be limited only to those components of an award that compensate for noneconomic losses; economic losses were also excludable:

> Whether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim . . . and not to the consequences that result from the injury.[14]

The Tax Court noted that, with respect to physical injuries,

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6. 504 U.S. 229 (1992).
7. 115 S. Ct. 2159 (1995).
8. 117 S. Ct. 452 (1996).
9. 115 S. Ct. 2159 (1995).
10. 87 T.C. 1284, 1308 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).
11. *See* Bent v. Comissioner, 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (1987).
12. *See, e.g.*, Metzger v. Commissioner, 88 T.C. 834 (1987), *aff'd*, 845 F.2d 1013 (1988).
13. *See* Byrne v. Commissioner, 883 F.2d 211 (3rd Cir. 1989).
14. *Threlkeld*, 87 T.C. at 1299 (citation omitted).

which almost by definition are "personal" in nature, "the entire award is excluded from income even if all or a part of the recovery is determined with reference to the income lost because of the injury."[15] The same result was now obtained for nonphysical injuries, and the court would no longer mount an inquiry "to determine whether the components of the injuries for which the award [is] made are personal or professional."[16]

The *Threlkeld* standards largely survived the Supreme Court's first examination of § 104(a)(2) in 1992 in *United States v. Burke*.[17] In *Burke*, employees of the Tennessee Valley Authority (TVA) brought, and ultimately settled, an action against the TVA under Title VII of the Civil Rights Act of 1964, alleging that the TVA had engaged in illegal sex discrimination.[18]

In reversing the lower court's decision, which held the settlement amount excludable,[19] the Supreme Court emphasized that the regulation[20] interpreting § 104(a)(2) links "personal injury" with tort principles by defining damages received as an amount received through prosecution or settlement of a claim "based upon tort or tort-type rights."[21] According to the Court, the question to be asked in § 104(a)(2) cases is therefore whether the injury complained of is a tort type personal injury.[22] While acknowledging that discrimination is "an invidious practice that causes grave harm to its victims,"[23] the Court noted that such harm "does not automatically imply, however, that there exists a tort-like 'personal injury' for purposes of the federal income tax law."[24] The Court stressed that "remedial principles . . . figure prominently in the definition and conceptualization of torts. Indeed, one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff."[25] The Court noted the limited nature of the remedies afforded by Title VII, i.e., backpay and injunctive relief.[26] Because of the circumscribed remedies available, the Court conclud-

15. *Id.* at 1300.
16. *Id.*
17. 504 U.S. 229 (1992).
18. *See id.* at 230-31.
19. *See* Burke v. United States, 929 F.2d 1119 (6th Cir. 1991).
20. *See* Treas. Reg. § 1.104-1(c) (as amended in 1970).
21. *Burke*, 504 U.S. at 234.
22. *See id.* at 237.
23. *Id.* at 238 (citations omitted).
24. *Id.*
25. *Burke*, 504 U.S. at 234-35 (citations omitted).
26. *See id.* at 238.

ed that the amounts received by the taxpayers in settlement of their claims were not "damages received on account of personal injuries" within the meaning of § 104(a)(2).[27] Although *Burke* thus limited the § 104(a)(2) exclusion to some extent, it did so by focusing on the remedial scheme of the underlying statutory cause of action, not on the scope of the § 104(a)(2) exclusion itself.

Commissioner v. Schleier,[28] addressing the excludability of awards for back pay and liquidated damages under the Age Discrimination in Employment Act (ADEA), shifted the focus to the statutory language, to the question of whether the damages received were "on account of" personal injury.[29] Prior to *Schleier*, considerable confusion existed in the lower courts as to the excludability of ADEA awards, but the confusion centered neither on the *Threlkeld* definition of personal injury, nor on its direction to focus on whether the injury is personal instead of whether its consequences include economic loss. The confusion centered on the interpretation of *Burke*, on whether an ADEA action could be considered a tort or tort-type action, rather than on the question of whether the damages were "on account of," i.e., actually compensated for personal injuries. *Schleier* would force a change in this focus.[30]

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27. *Id.* at 242.

28. 115 S. Ct. 2159 (1995).

29. *See id.*

30. Indicative of the impact of *Burke* on the interpretation and application of section 104(a)(2) is Rev. Rul. 93-88, issued by the Internal Revenue Service [hereinafter Service] immediately following the *Burke* decision. The ruling purports to apply the *Burke* standard to an action under amended Title VII. *See* Rev. Rul. 93-88, 1993-2 C.B. 61. The 1991 amendments to Title VII which were not applicable to the *Burke* litigation allowed complaining parties to recover compensatory and punitive damages under 42 U.S.C. § 1981(a) against an employer who engages in disparate treatment discrimination. Under § 1981(a), compensatory damages are available for future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses. *See* 42 U.S.C. § 1981(a). Given this broadened range of remedies, the Service in Rev. Rul. 93-88 concluded that actions under Title VII could now be characterized as tort or tort-type in nature. *See* Rev. Rul. 93-88. Rev. Rul. 96-65, 1996-53 I.R.B. 5. Applying its understanding of *Burke*, the Service therefore concluded that a taxpayer could exclude an award for disparate gender discrimination "even if the compensatory damages in such a case are limited to backpay." *Id.*

The Service in Rev. Rul. 93-88, thus, essentially interpreted *Burke* to mean that if an action sounds in tort because of the broad range of remedies available, then whatever damages are received, even backpay, are excludable. The fact that backpay does not compensate the taxpayer for any personal harms suffered is simply ignored.

In view of *Schleier* and the amendments to § 104(a)(2), Rev. Rul. 96-65, 1996-53 I.R.B. 5, made obsolete Rev. Rul. 93-88. The 1996 ruling considered whether

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In *Schleier*, a United Airline pilot argued that the backpay and liquidated damages that he received in settlement of a claim under the ADEA were excludable under § 104(a)(2). The claim was based on the fact that United fired him when he reached the age of sixty.[31] The Tax Court and the Fifth Circuit agreed with the taxpayer that both the backpay and liquidated damages recovered were excludable under § 104(a)(2).[32] The Supreme Court, reversing, held that based upon the plain language of § 104(a)(2), the taxpayer's claim must fail.[33] In a key part of its opinion, the Court reasoned that attaining the age of sixty or being discharged from employment on account of age did not itself constitute a personal injury.[34] The Court acknowledged that an illegal discharge could *cause* some personal injury, e.g., psychological injury, and it suggested that to the extent which the taxpayer was compensated for such an injury, the compensation received would be excludable.[35]

This distinction locates "personal injury" not in an event—an act of age discrimination itself—but in its impacts, in the harms it causes to the person. The Supreme Court, in making this distinction, effectively repudiated the *Threlkeld* standard, under which a personal injury consisted of "any invasion of the rights" granted by virtue of being a person in the eyes of the law.[36] Although the invasion of a right may give rise to a tort or tort type action for damages, critical questions remain: Did that invasion *cause* a personal injury and, if so, did the compensation received constitute damages "on account of" that personal injury? Thus, for example, the backpay in *Schleier* could be excluded, but only if it were "attributable" to a personal injury, i.e., if there was the

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backpay and damages for emotional distress "received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act, as amended in 1991," are excludable from gross income under § 104(a)(2) as amended. Rev. Rul. 96-65. The ruling concludes:

> Back pay . . . under Title VII is not excludable from gross income under Section 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under that section. Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludable from gross income under Section 104(a)(2), except to the extent they are damages paid for medical care . . . attributable to emotional distress.

Id.

31. *Schleier*, 115 S. Ct. at 2161.
32. *See id.* at 2162-63.
33. *See id.* at 2167.
34. *See id.* at 2164.
35. *See id.*
36. *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1308 (1986).

appropriate nexus (causal relationship) between the backpay and a personal injury. According to the Court, however, no such nexus or causal linkage existed in *Schleier* and therefore the "on account of" requirement of § 104(a)(2) was not satisfied.[37]

The Court explained its position as follows: In age discrimination, the discrimination may *cause* both personal injury (such as psychological harm) and loss of wages (due to the illegal discharge), but neither is linked to the other. Under the ADEA statutory scheme, "[t]he amount of back wages recovered is completely independent of the existence or extent of any personal injury."[38] In short, § 104(a)(2) does not permit the exclusion of Schleier's back wages because the recovery of back wages was not "on account of" any personal injury and because no personal injury affected the amount of back wages recovered. Absent the relationship required by the statute between the damages received and the personal injury complained of, exclusion under § 104(a)(2) was inappropriate.

The Court contrasted the taxpayer's situation to that of an individual injured in an automobile accident, who, as a result of her injuries, "suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision."[39] The Court noted that the amounts received in a settlement for the lost wages resulting "from time in which the taxpayer was out of work *as a result of her injuries*"[40] (as well as for her medical expense and pain and suffering) would be excludable "not simply because the taxpayer received a tort settlement, but rather because each element of the settlement satisfies the requirement set forth in section 104(a)(2) . . . that the damages were received 'on account of personal injuries or sickness.'"[41] The exclusion of the lost wages in the Court's hypothetical, as contrasted to the tax treatment of Mr. Schleier's award for back wages, is thus appropriate according to the Court because the relationship required by § 104(a)(2) between damages and personal injury exists: the automobile "accident causes a personal injury which in turn causes a loss of wages."[42]

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37. *See Schleier*, 115 S. Ct. at 2164.

38. *Id.* The Court's discussion suggests the same kind of analysis employed by the Fourth Circuit in its *Miller* decision when it distinguished between "but for" causation and "substantial causation." *See* Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990); *see also supra* notes 31-37 and accompanying text.

39. *Schleier*, 115 S.Ct. at 2163-64.

40. *Id.* at 2164 (emphasis added).

41. *Id.*

42. *Id.*

With respect to the liquidated damages recovered, the taxpayer in *Schleier* argued that, even if the backpay was includable, the liquidated damages were not because they represented not a penalty or punishment but rather compensation for "damages too obscure and difficult of proof for estimate."[43] The Court agreed with the taxpayer "that if Congress had intended the ADEA's liquidated damages to compensate plaintiffs for personal injuries, those damages might well come within section 104(a)(2)'s exclusion."[44] The Court, however, disagreed with the taxpayer's characterization of the liquidated damages. Instead of being compensatory, the Court noted that it had previously concluded that "Congress intended for liquidated damages [under the ADEA] to be punitive in nature."[45] As such, the liquidated damages could not be characterized as having been received "on account of personal injuries."[46]

The standard articulated by the Court in *Schleier* appears to be that the only damages which are "on account of" personal injuries for § 104(a)(2) purposes are those that bear a close nexus to the personal injury, i.e., "the injury in and of itself justifies [the] damages"[47] or the damages are intended to compensate the taxpayer for the personal injury and the consequences causally linked to the injury. If that relationship between the damages and personal injuries does not exist, no exclusion is available. Thus, for example, in *Schleier*, because the Court concluded that the liquidated damages were not intended to compensate the taxpayer for any personal injuries, e.g., psychological harm, but rather were intended to punish the wrongdoer, no exclusion for the liquidated damages was appropriate. Similarly, the backpay was not excludable because the necessary nexus between the backpay and a personal injury did not exist, i.e, regardless of whether the taxpayer suffered any personal injury as a result of his discharge from employment at age sixty, he was still entitled to the backpay under the ADEA. In other words, the backpay was not intended to compensate the taxpayer for a personal

43. *Id.* (quoting Overnight Motor Transp. Co. v. Missel, 316 U.S. 572, 583-84 (1942)).

44. *Id.* at 2165.

45. *Id.* (quoting Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 125 (1985)).

46. The Supreme Court subsequently held in O'Gilvie v. United States, 117 S. Ct. 452 (1996), that the § 104(a)(2) exclusion (as it existed prior to the 1996 amendments) did not include punitive damages. *See infra* notes 52-53 and accompanying text.

47. Reese v. United States, 24 F.3d 228, 230-31 (Fed. Cir. 1994).

injury or its consequences but rather to ensure that the taxpayer received those wages which the taxpayer would have earned had the taxpayer not been illegally discharged.

This interpretation of the "on account of" language constitutes a far narrower test than the "but for" test employed by many courts, under which damages would be excluded if the taxpayer could establish that the damages were received "because" the taxpayer had sustained a tort or tort-type personal injury. Under this analysis, it was irrelevant whether the damages were actually intended to compensate the taxpayer for the personal injury. By contrast, the *Schleier* standard requires a much more direct relationship between the damages and the personal injury, i.e., the damages must be intended to compensate for the personal injury.

In some respects, the standard adopted by the *Schleier* Court is identical to the historic "in lieu of what" test of *Raytheon Production Corp. v. Commissioner*.[48] That test arguably provides the narrowest interpretation of the "on account of" language, ensuring that only those damages for personal injury (damages in lieu of the human capital lost to the injury) are excludable. Strictly applied, the "in lieu of what" test would result in backpay, lost wages and other damages for nonpersonal harms never being excluded unless it could be established that they were intended as measures of the personal injury.

But *Schleier*, in dictum, suggests a more generous test. The *Schleier* Court indicated that lost wages were excludable, at least in the car accident hypothetical where the lost wages are attributable to the "time in which the taxpayer was out of work as a result of her injuries."[49] This hypothetical indicates that excludable damages are not only those damages intended to compensate for the personal injury itself—loss of human capital—but also damages for economic losses if they are causally linked to the personal injury. Therefore, to the extent that an award or settlement compensates the taxpayer for a personal injury, it can be deemed to compensate the taxpayer for all losses flowing from that personal injury including economic losses. In the car accident hypothetical, the loss of wages is causally linked to the physical injury sustained (because of the personal injury the victim was unable to work) and therefore the amount received for lost wages is deemed an amount received "on ac-

48. 144 F.2d 110 (1st Cir. 1944).

49. *Schleier*, 115 S. Ct. at 2164 (citing *Threlkeld*, 87 T.C. at 1300).

count of personal injuries."[50]

Under *Schleier*, it is thus clear that the fact that losses might be economic in nature is not determinative if the appropriate causal linkage exists between the personal injury and the loss. Applying this standard to the *Schleier* Court's car accident hypothetical, the lost wages would be excludable because they were received to compensate the taxpayer for her inability to work, which was a direct consequence of the physical injuries she suffered as a result of the car accident. By contrast, the back pay awarded in *Schleier* was not excludable because it bore no relation whatsoever to any personal injuries Schleier may have suffered as a result of the discrimination.[51]

In its recent decision in *O'Gilvie v. United States*, the Supreme Court reaffirmed the *Schleier* interpretation of the "on account of" language of § 104(a)(2). *O'Gilvie* addressed the applicability of § 104(a)(2) to punitive damages recovered in a tort action by the spouse and children of a woman who had died of toxic shock syndrome. The taxpayers argued that § 104(a)(2) required only that they establish a "but for" connection between the punitive damages recovered and the personal injuries sustained. Rejecting this argument, the Supreme Court, relying on *Schleier*, agreed with the Government that the words "on account of" "impose a stronger causal connection making the provision applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries."[52] In short, the Court underscored the *Schleier* analysis that to be excludable under § 104(a)(2) the damages received must be "designed to compensate" a victim for the personal inju-

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50. *Id.* (quoting I.R.C. § 104(a)(2) (1996)).

51. Again, the transcript of the oral argument in *Schleier* offers an interesting insight into the thinking which may have prompted the Court to analyze the issues as it ultimately did. At one point in the argument, Mr. Joyce, counsel for the taxpayer, was questioned by Justice Scalia. Justice Scalia asked whether the person who brought the discrimination action had to have been aware at the time of her discharge that the employer was discriminating against her on the basis of age. Mr. Joyce responded that the individual did not have to show that she was aware at the time of the discrimination. The following exchange then occurred:

> Question: If the person didn't even know about it—but he's still entitled to damages, isn't he?
>
> Mr. Joyce: He is . . .
>
> Questions: With no personal injury. So it's not even but-for.
>
> Mr. Joyce: I disagree in one respect, Your Honor, respectfully. Congress presumes an injury to occur when invidious discrimination in violation of one of these classifications occurs.

52. *O'Gilvie*, 117 S. Ct. at 454.

ries sustained.[53]

III. THE 1996 AMENDMENTS

It was against this backdrop of *Burke* and *Schleier* that Congress amended § 104(a)(2) in 1996. The 1996 amendments had two main purposes: first, to eliminate the exclusion for damages received on account of nonphysical injury or sickness; and second, to establish that, subject to a limited exception, punitive damages are not excludable regardless of whether they are received in connection with a physical injury. As amended, the statute now provides that gross income does not include:

> (2) the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness . . . .
>
> For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress.[54]

The more controversial aspect of the 1996 amendments was the restriction of the exclusion to "physical" injury or sickness, along with the explicit statutory direction that "emotional distress" is not to be treated—save only for related medical care expenses—as a physical injury or sickness. It seems obvious from the Conference Committee Report that discrimination claims were the principal target of these provisions and that recoveries under these claims are intended to be taxable.[55]

Furthermore, the committee report appears to anticipate an argument that a nonphysical injury—e.g., one arising out of employment discrimination—may sometimes produce physical manifestations in the victim. To sort this out, the committee report appears to rely on "origin-of-the-claim" notions in conjunction with the rule that "emotional distress" (itself a statutorily undefined term) is not a physical injury or sickness. Thus, the report provides:

> [I]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of

53. *See id.* at 455.
54. I.R.C. § 104(a) (1996).
55. *See* H.R. CONF. REP. NO. 737, 104th Cong., 2d Sess. 142-43 (1996).

> physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income.[56]

The report goes on to note that because emotional distress is not a physical injury or physical sickness,

> the exclusion from gross income does not apply to any damages received (other than for medical expenses . . .) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress . . . . [T]he exclusion . . . applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.[57]

Emotional distress, according to the report, is intended to include "physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."[58]

The 1996 amendments, as filtered through the committee report, thus (1) place enormous weight on whether the "origin" of a claim lies in a physical injury, and (2) deny this all-important physical injury status to a significant, but undefined range of physical "symptoms" grouped under the term "emotional distress."

IV. ANALYSIS OF THE 1996 AMENDMENTS

This part of the article addresses five significant points regarding the 1996 amendments to § 104(a)(2). First, dignitary torts have lost their tax-favored status. Second, Congress has apparently endorsed the exclusion of economic damages in particular circumstances. Third, Congress has left unanswered a major question, i.e., what constitutes a physical injury for purposes of § 104(a)(2)? Fourth, by eliminating an exclusion for awards received on account of dignitary torts, Congress has perhaps unwittingly rendered out-of-court settlement of employment discrimination cases and other dignitary tort actions less likely. Finally, in amending § 104(a)(2), Congress has failed to provide employers and other tortfeasors with any assistance in address-

56. *Id.*
57. *Id.* at 143.
58. *Id.* at 142-43.

ing the difficult problems associated with allocating settlements.

A. *Impact on Dignitary Torts*

In *Schleier*, the Supreme Court substantially restricted the applicability of § 104(a)(2) to employment discrimination awards. However, *Schleier* stopped short of eliminating an exclusion for such awards. Congress went the next step—and further. The 1996 amendments to § 104(a)(2) eliminate entirely the exclusion of awards received not only on account of employment discrimination, but also awards received on account of all dignitary torts, i.e, injuries to one's personality or the dignity one has as a person. By conditioning exclusion under § 104(a)(2) on the existence of a personal physical injury, the 1996 amendments negate any exclusion for damages resulting from dignitary torts such as libel, slander, malicious prosecution, intentional infliction of mental anguish, invasion of privacy, denial of first amendment rights, and alienation of affections. In so doing, the amendments effectively reverse seventy-five years of judicial and administrative development of § 104(a)(2).[59]

In enacting § 104(a)(2) in 1919, Congress may have understood the term "personal injuries" as used in § 104(a)(2) to embrace only physical injuries. However the courts and the Service, for the last seventy-five years, have interpreted "personal injuries" to include both physical and nonphysical injuries. For Congress in 1996 to reverse this longstanding interpretation of § 104(a)(2) and create a dichotomy between physical and nonphysical injuries seems ill-conceived and unjustifiable. Since 1919, the concept of what constitutes personal injury has developed dramatically. Much of the body of law related to dignitary torts has developed since then, and scientific research has brought an awareness of the potentially devastating physical impacts of psychological injuries. To provide tax-favored treatment when one's action is grounded in a personal physical injury but not if the action is grounded in an equally debilitating psychological injury requires some strong justification. The justification offered by Congress, however, is anything but compelling.

Congress explained its radical limitation on the § 104(a)(2) exclusion on the basis that most awards received by taxpayers in employment discrimination cases were intended to compensate

59. *See generally* Burke & Friel, *supra* note 3.

the claimant for lost wages or lost profits.[60] Indeed, lost profits and wages are probably the best measure of damages sustained by victims of employment discrimination. The suggestion of Congress in the legislative history to the 1996 amendments seems clear—§ 104(a)(2) should not provide an exclusion for awards received for economic injuries.

It is not uncommon for dignitary torts to involve economic injury in addition to mental distress, loss of self-esteem and other personal injuries. Employment discrimination cases, which represent the great majority of reported § 104(a)(2) cases in the last twenty-five years, present the classic situations where the injured party suffers both personal injury and economic loss. Likewise, malicious prosecution, libel or slander may injure a person's reputation in a community, resulting not only in serious damage to her personal relationships with family, friends and colleagues, but also in damage to her business or professional standing.

Exclusion of the economic damages resulting from either physical injuries or nonphysical injuries (the dignitary torts noted previously) is difficult, if not impossible, to justify. Because salary, wages and profits are the quintessential examples of gross income,[61] to permit tort victims to exclude from gross income awards for the loss of such items represents a windfall. Yet the exclusion of lost wages posited in the *Schleier* car accident hypothetical was reaffirmed in the Supreme Court's recent "concession" in *O'Gilvie*. Specifically, the language of § 104(a)(2):

> excludes from taxation not only those damages that aim to substitute for a victim's physical or personal well-being—personal assets that the Government does not tax and would not have taxed had the victim not lost them. It also excludes from taxation those damages that substitute, say, for lost wages, which would have been taxed had the victim earned them. To that extent, the provisions can make the compensated taxpayer better off from a tax perspective than had the personal injury not taken place.[62]

The primary beneficiary of this exclusion may well be the tortfeasor who will likely be able to settle claims for less because the victim can exclude the settlement from gross income. For example, assume that an employer fired an employee based upon

60. *See* H.R. CONF. REP. NO. 737, at 142-43.
61. *See* I.R.C. § 61(a)(1) (1996).
62. *O'Gilvie*, 117 S. Ct. at 455.

the employee's race or sex. In the settlement of the subsequent action based on wrongful discharge and sex or race discrimination, the employer may pay the employee an amount which is primarily intended to compensate the employee for wages she might otherwise have earned. Only part, and sometimes a rather small part, of the settlement may represent compensation for noneconomic injuries, i.e., injuries to the employee's personal dignity. To exclude the entire award—a possibility which certainly continued to exist even after *Schleier* (but before the 1996 amendments)—would permit the employee to exclude income which, but for the illegal actions of the employer, would have been includable. At the same time, if the exclusion were not available, the employee might very well have demanded a far larger settlement so as to take into account the impact of taxes. The net result of the exclusion under such circumstances is to create a tax benefit that the parties may share in some fashion, and this reduces the amount that the employer must pay. Rather than view only the employee as receiving a windfall because of the exclusion of damages for economic injuries, it may also be accurate to see the employer-tortfeasor as the real beneficiary of the exclusion.

Were the judicially created "in lieu of what" standard[63] consistently applied to damages awards in personal injury cases, and were appropriate allocation of judgments and awards made between economic damages and compensation for the personal elements of an award (e.g., broken arm, pain and suffering, mental distress), the congressional concerns would have been laid to rest. However, allocating an award will often not be feasible. Perhaps Congress understood this, and for that reason chose to eliminate the exclusion completely for damages arising out of nonphysical injuries because cases involving such injuries, particularly the employment discrimination cases, typically involve primarily economic damages. However, the fact is that in some contexts, as discussed below, a very significant part of the award may be intended as compensation for serious noneconomic personal injuries.

B. Continued Exclusion of Economic Awards

Ironically, the amendments to § 104(a)(2) do not fully address the problem of exclusion of economic damages. While Con-

63. *See Raytheon*, 144 F.2d at 110.

gress expressed grave concern about the exclusion of economic damages, the legislative history suggests that lost wages will be excludable under § 104(a)(2) when they are a consequence of a physical injury.[64] In this regard, Congress appears to have adopted the less stringent *Schleier* definition of the "on account of" language of § 104(a)(2).[65] That taxpayers can exclude lost income when the injury claim has its origin in a physical injury is unwarranted and only exacerbates the problems associated with the dichotomy that Congress has drawn between physical and nonphysical injuries.

Consider the following hypotheticals.

> HYPOTHETICAL 1: Doctor, a surgeon in a solo-practice, is seriously injured in a ski accident and brings a negligence action against the owner of the ski resort. Doctor seeks damages for all past and future medical expenses associated with the accident, damages for pain and suffering, and damages for lost income as a result of being unable to perform surgery for more than a year following the accident. Doctor and the ski resort settle the matter out of court for $1,500,000.

This hypothetical presents the classic personal *physical* injury for which § 104(a)(2) has traditionally provided an exclusion. The personal injury requirement of § 104(a)(2) is clearly satisfied in this case. In addition, under the *Schleier* standard, the award is received "on account of" the personal physical injury. The requisite linkage exists between the damage award and a personal injury, i.e., the ski resort intended to compensate Doctor for the personal injury and the consequences stemming therefrom. As a result, all damages flowing from the personal injury, including the lost income, will be excludable.

> HYPOTHETICAL 2: A newspaper printed a story falsely accusing Doctor (the same individual in Hypothetical 1) of committing a serious felony. As a result, Doctor was suspended from practicing surgery, was required to defend herself in a grueling license revocation proceeding before the state medical board, and ultimately lost a significant number of her patients. Doctor suffered severe emotional distress and, at one point, was hospi-

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64. *See* H.R. CONF. REP. NO. 737, at 142. The Conference Committee Report does not specifically state that economic damages such as lost wages or lost profits will be excludable. Rather, it simply states that "[i]f an action has its origin in a physical injury, then *all damages* (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness . . . ." *See id.* (emphasis added).

65. *See id.* (mentioning specifically the Supreme Court's decision in *Schleier*).

talized for depression. The pressures experienced by Doctor's family as a result of the problems associated with the libelous statements in the press and the license revocation procedures and Doctor's resulting psychological problems had a deleterious impact on Doctor's marriage and ultimately resulted in a divorce. In settlement of the libel action brought by Doctor, the newspaper paid Doctor $1,500,000 in compensation for her loss of personal and business reputation, the emotional distress that she suffered and is suffering, her medical costs and her lost income.

Doctor in Hypothetical 2 would presumably have been entitled to exclude the entire amount of the award under § 104(a)(2) prior to its amendment. It appears that all of the requirements of the old § 104(a)(2) as interpreted by *Schleier* are satisfied.[66] However, as a result of the amendments to § 104(a)(2), the award will be taxable in its entirety.[67] Because Doctor's libel action did not have its origin in a personal physical injury, she is not entitled to exclude any part of the award. As in Hypothetical 1, it is likely that a significant portion of the award is allocable to lost income. Focusing specifically on that part of the award, § 104(a)(2), as amended, reaches an appropriate result in Hypothetical 2 in denying an exclusion.

It is difficult to justify the difference in treatment between the lost income portion of the award in Hypothetical 1 and that in Hypothetical 2. The legislative history fails to explain why economic damages should be excludable when they have their origin in a physical injury, but not be excludable when they have their origin in a nonphysical personal injury. Congress seems to have adopted the same interpretation of the "on account of" language of § 104(a)(2) as that provided by the Supreme Court in *Schleier*, that is, any damages including lost wages that flow directly from a personal injury are excludable as being "on account of personal injury" if the payor intends to compensate the victim for the personal injury.[68] However, as previously noted the Supreme Court in *Schleier* failed to interpret § 104(a)(2) as

66. Doctor suffered a personal injury, i.e., libel, and as a direct result of the injury suffered emotional distress and lost a considerable amount of income. The newspaper intended to compensate Doctor for her personal injury and the consequences flowing from it.

67. To the extent that the award is allocable to medical expenses attributable to emotional distress, the amendments specifically provide for exclusion. However, the exclusion is limited, to amounts actually paid. No exclusion apparently exists for amounts awarded to cover future medical expenses.

68. *See supra* text accompanying notes 34-35.

narrowly as it might have.[69]

Hypothetical 2 also underscores a further problem with the 1996 amendments, i.e., the treatment of emotional distress. As noted previously, Congress in amending § 104(a)(2) specifically provided that emotional distress is not considered a physical injury or sickness. As a result, Doctor in Hypothetical 2, although suffering severe emotional distress and associated physical ailments, e.g., headaches, vomiting, loss of appetite and sleeplessness, could not ground a claim for exclusion under § 104(a)(2) on emotional distress and related symptoms. The fact that Doctor had to be under the constant care of a physician and even hospitalized for a period would not change the result.

Conversely, amounts received for emotional distress are excluded if they have their origin in a physical injury. Again, consider Hypothetical 1 and assume that Doctor in that case had suffered emotional distress as a result of being unable to practice her profession. She would be entitled to exclude the award received for emotional distress. As the legislative history indicates: "[b]ecause all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness."[70]

The difference in treatment suggests a fundamental distrust on the part of Congress in the reality of emotional distress and associated problems in conjunction with dignitary torts, especially claims of employment discrimination. Only if the emotional distress is attributable to a personal physical injury will damages for emotional distress be excludable. Otherwise, it will be ignored. One can only surmise that Congress recognized that if emotional distress constituted a physical injury for purposes of § 104(a)(2), the congressional purpose of negating an exclusion for damages on account of dignitary torts like employment discrimination would be largely thwarted. For example, in virtually every case of employment discrimination, a victim could be expect-

69. Indeed, the Supreme Court subsequently in *O'Gilvie* explicitly suggested that the exclusion of lost wages might be "something of an anomaly" from the standpoint of tax policy. *See O'Gilvie*, 117 S. Ct. at 456. Nonetheless, the Court noted that it was an anomaly grounded in the "language and history" of § 104(a)(2). *See id.* at 117 S. Ct. at 459. As *O'Gilvie* acknowledged, the "on account of" language of §104(a)(2) is inherently ambiguous. *See id.* at 455. Surely, it would have been preferable for both the *Schleier* and *O'Gilvie* Courts to interpret the language in a manner consistent with tax policy rather that perpetuate an unjustifiable windfall.

70. H.R. CONF. REP. NO. 737, at 142-43.

ed to argue that she suffered emotional distress as a result of the employer's actions and was suing the employer to recover for that injury. But for the amendment language denying physical injury or physical sickness status to emotional distress, the taxpayer's action would come within the exclusionary rule of amended § 104(a)(2).

In so treating claims of emotional distress, Congress has devalued the suffering experienced by individuals as a result of psychological injury. That suffering can be—and often is—even greater than the pain and suffering associated with a physical injury. There is, for example, as much reality to the emotional distress experienced by Doctor in Hypothetical 2 as there is to the pain suffered by Doctor in Hypothetical 1. And yet for tax purposes, Doctor's suffering in Hypothetical 2 is ignored while the award for her pain and suffering in Hypothetical 1 is excluded. The message is clear: if one is psychologically injured, one receives little sympathy from the Congress; if one is physically injured, Congress makes significant tax relief available. The difference in treatment of the taxpayers in the hypothetical emphasizes the questionable nature of the policy underlying the physical and nonphysical dichotomy wrought by the 1996 amendments.

The emphasis on physical injuries will in some cases permit exclusion of substantial damages where the personal injuries are trivial while disallowing an exclusion in situations like Hypothetical 2 where the personal injuries are very serious. Consider, for example, a situation where Photographer, seeking to take a photograph of Celebrity, is slugged and restrained by Celebrity's bodyguard. Photographer suffers nothing more than a black eye as a result of the confrontation. Photographer sues Celebrity, who, because of embarrassment over the situation and a desire to avoid a trial, which would be highly publicized, settles with Photographer for a large sum of money. Under these circumstances, Photographer will be entitled to exclude the full amount of the recovery even though his actual injuries pale by comparison to those of Doctor in Hypothetical 2.

C. What Constitutes a "Physical Injury?"

Aside from the problems relating to economic damages and the treatment of emotional distress, the amendments also leave unanswered an important question, i.e., what is a "physical injury"? Must there be serious bodily harm? Is a mere slap in the face enough? What about unlawful sexual contact? To the extent

that any unlawful physical contact constitutes a "physical injury" for purposes of § 104(a)(2), one can expect some very questionable tax distinctions in situations which are difficult to distinguish. Compare the possible tax results in the following hypotheticals:

> HYPOTHETICAL 3: Boss continually invites Secretary on dates and makes suggestive comments about her attire. Secretary refuses Boss's advance and warns him that she will report him to the company's management. Boss subsequently fires Secretary. Secretary can establish that she has suffered significant emotional distress as a result of Boss' action and has incurred expense for both medical and psychological care associated with her emotional distress problems. Secretary files a sex discrimination charge against the company and Boss, seeking damages for emotional distress and lost wages. Secretary also seeks reinstatement in her position. Assume that Secretary and the company enter into a settlement agreement whereby the company pays Secretary $150,000 for release of all of her claims including her claim for reinstatement.
>
> HYPOTHETICAL 4: Assume the same facts as in Hypothetical 3 and, in addition, assume that the day before Boss fired Secretary an incident occurred in which Boss walked up behind Secretary and began rubbing her shoulders and fondling her. Enraged by Boss's conduct, Secretary left the office and did not return to work that day. Fearing that Secretary might report him, Boss fired her the next day. Again, the company settled Secretary's claim for $150,000.[71]

In Hypothetical 3, Secretary's award will not be excludable. Secretary's claim did not have its origin in a physical injury. The reality is that a substantial portion of the award would likely be allocable to lost wages and, as a matter of policy, should not be excludable. As in Hypothetical 2, Secretary has suffered a significant noneconomic injury as well and yet, while it is compensated for to some extent, no exclusion is available.

In contrast, Secretary in Hypothetical 4 arguably has a claim that has its origin in a personal physical injury, i.e., the unwanted touching. If successful in arguing the physical injury origin of the action, Secretary may be entitled to exclude the entire $150,000 under § 104(a)(2) as amended. Assume, for ex-

71. These hypotheticals are drawn from a previously-published article by the authors. *See* J. Martin Burke & Michael K. Friel, *What* Schleier *and Amended § 104(a)(2) Mean to Your Practice*, TRIAL, Nov. 1996, at 64, 66.

ample, that the lost income portion of the award is attributable to the fact that because of the psychological injury suffered as a result of the unwanted touching, Secretary was unable to work for a number of months. Under these circumstances, the necessary linkage as required by *Schleier* exists to support an exclusion.[72] The damages are intended to compensate Secretary for the physical injury and the consequences flowing therefrom, i.e., the psychological injuries and the consequent inability to work.

As discussed previously, the difference in the tax treatment in situations such as these is not justifiable. If, in fact, the term "physical injury" as used in amended § 104(a)(2) is capable of being read as requiring something less than a serious bodily injury,[73] one would expect thorough trial attorneys to search for, and occasionally find, a plausible physical injury that their clients who are victims of dignitary torts have also suffered.

However, for Treasury to attempt to negate an exclusion for Secretary's damage award in Hypothetical 4 by drafting a regulation creating a more stringent physical injury standard presents its own problems. How does one draw the line between a physical injury which is cognizable under § 104(a)(2) and one that is not? Must the taxpayer have received medical attention? Obviously, that would not solve the problem. Must the injury be something which at a minimum would be considered greater than a bruise, but less than a broken bone? As one considers the various possibilities, what becomes clear is that Congress, in attempting to rectify the perceived problems associated with the application of § 104(a)(2), has only created new problems by creating a dichotomy between physical and nonphysical injuries.

D. Impact on the Settlement of Cases

A further problem potentially created by the amendments to § 104(a)(2) is the negative impact which the denial of exclusion of awards in dignitary tort cases may have on the settlement of those cases. To comprehend this problem, one only has to consider the financial position in which the amendments may place an employer.

Assume again, for example, the facts of Hypothetical 3 involving Secretary and Boss in the situation where the entire

72. *See supra* text accompanying notes 31-38.

73. Except for its treatment of emotional distress, Congress provided neither guidance as to definition of the term "physical injury" nor did it suggest that the severity of a physical injury would be relevant in the application of § 104(a)(2).

award is taxable under amended § 104(a)(2). The employer will likely face a problem settling the case for the dollar amount indicated. Presumably, the attorney representing Secretary will inform her that anything she recovers by way of a settlement or judgement will be subject to federal income tax, state income tax, and employment taxes. These taxes will have an enormous impact on the amount which Secretary ultimately receives. When combined with the amount of fees which she has to pay the attorney, Secretary will likely receive less than half of the $150,000 award.[74] As a result, taxpayers who, like Secretary in Hypothetical 3 or Doctor in Hypothetical 2, are victims of dignitary torts may refuse to settle unless the tortfeasor offers enough to offset the tax impact.

Therefore, the settlement of employment discrimination and other dignitary tort cases may cost businesses far more. That result is not necessarily all bad. As suggested above, under prior law, the tortfeasor can be considered the beneficiary of the § 104(a)(2) exclusion to the extent that the tortfeasor was able to settle cases more cheaply because of the exclusion. In contrast, however, avoidance of costly litigation is not only a benefit to the parties but also to society generally. To the extent that the amendments to § 104(a)(2) result in fewer negotiated settlements and the trial of more personal injury cases, everyone loses.

E. Allocation of Award

One of the vexing problems in the application of § 104(a)(2) prior to its amendment was the proper allocation of awards. Employers have been particularly concerned about the amount of the award to be treated as income and therefore subject to withholding. Likewise, employers have been concerned about the payment of various employment taxes related to the lost wages or back pay portions of certain damage awards. In one sense, the

74. One of the interesting twists of the amendments to § 104(a)(2) has to do with the deductibility of attorneys fees. Section 265(a)(1) will prevent a § 212 deduction for attorneys fees in situations where § 104(a)(2) excludes an amount from income. Thus, prior to the amendments to § 104(a)(2), awards for a range of dignitary torts were excludable. The attorneys fees for such awards were therefore not deductible. Now that the amendments to § 104(a)(2) have largely rendered damages for dignitary torts includable in income, taxpayers receiving such awards will now be entitled to claim a § 212 deduction for the attorneys fees incurred in producing this income. Unfortunately, the deduction will be subject to the 2% rule of § 67 and the overall limitation on itemized deductions under § 68, thus rendering the deduction less valuable.

amendment to § 104(a)(2) may be greeted by employers as simplifying the issues regarding withholding. The employer may now assume that, in situations where there is no physical injury, employment discrimination awards will simply be taxable and appropriate withholding must occur. However, the fact remains that a determination will nonetheless have to be made regarding amounts allocable to lost wages or back pay for purposes of employment taxes. Here again, the very existence of the § 104(a)(2) exclusion becomes problematic as the 1996 amendments supply no solution.

Consider once more Hypothetical 4, involving Secretary who recovered an award to compensate her for the unwanted touching by her Boss. If one assumes that some of the award represents lost income as a result of Secretary's inability to find work following her being fired, the lost income under those circumstances would apparently not be excludable given the *Schleier* standard. The loss of income in that case would not be a consequence of the unwanted touching but rather a consequence of the illegal firing. This is to be contrasted to the situation where the lost income is a result of Secretary's inability to work because of the psychological injuries suffered. The employer is faced with the task of determining how much of the award represents lost income for purposes of withholding tax and other employment taxes.

The allocation issue, of course, extends to cases beyond the employment context. Consider again, for example, Hypothetical 2 involving Doctor who is injured as a result of the false newspaper story. As noted in the discussion of that hypothetical, one presumes that a large portion of the settlement is allocable to lost income. An interesting question arises here with respect to self-employment taxes: Will Doctor be required to allocate part of the award to lost income and pay a self-employment tax with respect to that amount? Arguably, that allocation should be required. The difficulty will be found in determining the appropriate sum to be allocated to lost income. Assume that Doctor, who is already required to include the entire amount of the award in income, negotiates a settlement with the newspaper indicating that the entire award is allocable to the emotional distress and resulting personal difficulties which Doctor suffered as a result of the newspaper's conduct. Nothing is allocated to lost income, or only a relatively small amount is allocated to lost income.

Clearly, the Service, as it demonstrated in the recent cases

of *McKay v. Commissioner*,[75] *Robinson v. Commissioner*,[76] and

75. 102 T.C. 465 (1994). In *McKay*, the taxpayer alleged that his employer had breached their employment contract and had wrongfully discharged the employee in violation of public policy. *See id.* at 470. A jury awarded taxpayer over $1.6 million for lost compensation and over $12.8 million for "future damages." *See id.* at 470-71. The damages were then trebled to over $43 million for the employer's violation of RICO. *See id.* at 471. The taxpayer and the employer ultimately settled for approximately $16 million, with over $12 million specifically allocated in the settlement agreement to taxpayer's wrongful discharge tort claim and the balance allocated to taxpayer's contract claim. *See id.* at 472. The settlement negotiations were adversarial, the employer insisting that nothing be allocated to either RICO violations or punitive damages. *See id.* at 472-73. The settlement agreement specifically provided that the amount allocated for the wrongful discharge tort claim "represent[ed] compensatory damages payable on account of an alleged tort-type invasion of the rights that McKay is granted by virtue of being a person in the sight of the law [and] are properly excludable from McKay's gross income under Section 104(a)(2). . . . " *Id.* at 472. The agreement also provided that the balance of the payments were includable in McKay's gross income. *See id.* The district court judge approved the settlement agreement and concluded that the terms of that agreement, including the allocations, were reasonable under the circumstances. *See id.* at 474.

The Service argued that, because the payments made by the defendant were deductible regardless of their allocation between tort and contract claims, the settlement negotiations were not adversarial. *See id.* at 484-85. The Tax Court rejected the Service's arguments, emphasizing that where a settlement agreement is the result of arms-length, adversarial negotiations the allocations will generally be respected. *See id.* at 483-85. The court specifically distinguished this case from *Robinson v. Commissioner* on the grounds that the settlement negotiations in the latter case lacked the adversarial dimension present in *McKay*. *See id* at 483-84.

Emphasizing the importance of the settlement agreement and other documents, the court noted:

> If no lawsuit was instituted by the taxpayer, then we must consider any relevant documents, letters, and testimony. . . . If a lawsuit was filed but not settled, or if settled but no express allocations among the various claims are contained in the settlement agreement, we must consider the pleadings, jury awards, or any Court orders or judgments . . . . If the taxpayer's claims were settled and express allocations among the various claims are contained in the settlement agreement, we carefully consider such allocations. . . . [I]n order to be respected, the express allocations must be negotiated at arm's length between adverse parties.

Id. at 482-483.

It is obvious from the language used in the pleadings and settlement agreement in *McKay* that counsel was well aware of the relevant case law under § 104(a)(2) and used that to the advantage of McKay. By contrast, the settlement agreement in *Robinson* (discussed *infra* note 76) is silent on the matter of allocation.

76. 102 T.C. 116 (1994). In *Robinson*, the taxpayers sued a bank for failing to release a lien on the taxpayers' property. *See id.* at 120-21. The taxpayers alleged that, as a result of the bank's actions, their business failed, they were forced to sell their business inventory and property at substantial losses, and that Sandra Robinson developed severe psychological problems requiring hospitalization. *See id.* The taxpayers complained that the bank's failure to release the lien was "willful, an act of malice and in reckless and conscious disregard of petitioners' rights, unconscionable, based on false representations, tortious, and a cloud on title." *Id.* at 120.

The jury agreed and awarded damages for lost profits, actual damages, damage to taxpayers' credit reputation, past and future mental anguish of the parties,

Bagley v. Commissioner[77] is prepared to dispute allocations re-

attorneys fees and $50 million in punitive damages. *See id.* at 121. The parties ultimately entered into a settlement agreement whereby the bank paid the taxpayers $10 million in cash in exchange for complete release from all liability. *See id.* at 122-23. Recognizing the taxpayers desire to avoid taxes, the bank agreed that the taxpayers could allocate the settlement agreement any way they chose. *See id.* at 123. The settlement agreement did not allocate the $10 million. *See id.* The taxpayers, with the agreement of the bank, unilaterally prepared a formal Final Judgment allocating 95% of settlement proceeds to tort-like personal injuries and the presiding judge signed the final judgment. *See id.*

The Tax Court held that it was not bound by the judgment. *See id.* at 129. The court determined that it could make an independent determination of the proper allocation of the settlement proceeds: "[T]his Court will not blindly accept the terms contained in a settlement agreement, especially when the circumstances behind the agreement indicate that the allocation of the amounts contained therein was uncontested, nonadversarial, and entirely tax motivated." *Id.* The Tax Court ultimately held that the taxpayers could exclude 37.3% of the settlement under § 104(a)(2) with the balance being includable in gross income. *See id.* at 135-36.

77. 105 T.C. 396 (1995). In *Bagley*, the taxpayer and his employer entered into a settlement agreement whereby the employer agreed to pay the taxpayer $1.5 million to settle a libel action which was being retried in a federal district court. *See id.* at 402. In view of the prior history of litigation between the parties, the employer, in settling the matter, was aware that if the matter were retried, the taxpayer would receive punitive damages. *See id.* at 403. However, the settlement agreement allocated the entire award to actual injuries (i.e., invasion of privacy, injury to personal reputation including defamation, emotional distress and pain and suffering). *See id.* at 403-04. The court emphasized that the critical question in determining the tax status of a settlement was "in lieu of what was the settlement amount paid." *Id.* at 406. The court, considering the facts and circumstances of the case, noted that the total amount of compensatory damages that the taxpayer would have likely recovered in the libel action had taxpayer been successful would have been $1 million, the amount a jury had previously awarded. *See id.* at 408. (The same jury had awarded $5 million in punitive damages. The jury award was reversed not because of its amount but because of faulty jury instructions. *See id.*) The court stated:

> Although the record supports the fact that counsel for IBP [the tortfeasor] did not want to show an allocation to punitive damages, the record as a whole, including the discussion and give-and-take between the parties as to the amount to be paid to petitioner [the taxpayer], shows that both parties considered the clear possibility of petitioner recovering punitive damages. In fact, the testimony of the attorneys shows that this was in the minds of the attorneys when the negotiations were going on. Furthermore, it was clearly in the interest of both parties not to show an amount allocated to punitive damages.

Id. at 409.

The court ultimately allocated $500,000 of the settlement to punitive damages and $1 million to compensatory damages. *See id.* at 410. The court distinguished *McKay*, noting that the tortfeasor in *McKay* specifically stated in the settlement agreement that no part of the settlement was allocable to the alleged RICO violation; in *Bagley* by comparison there was no specific statement in the settlement agreement with respect to punitive damages. *See id.* at 408. The *Bagley* decision also emphasized that *McKay* involved an adversarial situation between the tortfeasor and the plaintiff/taxpayer and that the taxpayer "was never given freedom to structure the settlement on his own." *Id.* Together, *McKay* and *Bagley* emphasize the importance of arm's length, adversarial settlement negotiations where both parties have a stake in

sulting from settlement negotiations which it does not consider to be arms-length.[78] Given that the payor, like the newspaper in Hypothetical 2, will often be indifferent to the allocations made in the settlement agreement,[79] a strong likelihood exists that allocations generally will be subject to careful scrutiny by the Service. Under the circumstances presented in the above hypothetical, one would expect the Service, consistent with its position in *McKay*, *Robinson*, and *Bagley*,[80] to challenge the allocation and insist that some, if not most, of the settlement be allocated to the lost income.

One can easily imagine the enormous difficulty associated with allocating settlements in situations in which multiple claims for relief are alleged. In its Brief *Amicus Curiae* in *Schleier*, the Equal Employment Advisory Council, arguing in favor of the exclusion of ADEA awards, posited a hypothetical in which the plaintiff in an employment discrimination case is a disabled, fifty-five year-old black woman.[81] The brief notes that "there are at least four causes of action to which the settlement could be allocated: ADEA, ADA, Title VII and section 1981, not to mention state statutory and tort claims that may offer other remedies."[82] As the brief emphasizes, "[e]ven if the parties undergo extensive discovery of the facts, it often will be impossible to unravel this 'bundle' of rights in order to place a separate value upon each specific claim the plaintiff might have asserted in the charge or complaint."[83]

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the characterization of the award and the significance of specific language in the settlement agreement indicating that none of the settlement amount is allocable to punitive damages or other non-excludable amounts.

78. For a general discussion of the *McKay* and *Robinson* decisions and issues associated with the allocation of damage awards, see Jon. O. Shields, Note, *Exclusion of Damages Derived from Personal Injury Settlements: Tax-Planning Considerations in Light of* McKay v. Commissioner, 56 MONT. L. REV. 603 (1995).

79. The newspaper would generally be entitled to claim a § 162 deduction for the award regardless of how the award is allocated. *See* I.R.C. § 162 (1994). In some circumstances, for example, employer-tortfeasor, the payor may be very concerned about the allocation. The employer presumably would prefer that as little as possible is allocated to lost income because of employer's exposure to employment taxes for such amounts.

80. In both *Robinson* and *Bagley*, the Service, emphasizing that allocations must reflect the merits of a case, suggested that it would weigh the evidence in each case to determine the appropriateness of allocations. *See Robinson*, 102 T.C. at 117; *Bagley*, 105 T.C. at 406. The Tax Court in both cases adopted this approach of the Service.

81. *See* Brief *Amicus Curiae* of the Equal Employment Advisory Council in Support of Respondents at 20.

82. *Id.*

83. *Id.*

The brief argues that the Service is ill-equipped to conduct the kind of investigation needed to determine the appropriate allocation of awards and that the threat of such investigation will in and of itself distort, if not chill, the negotiation process.[84] Those concerns seem well founded. Allocation of settlement amounts may require not only a careful weighing of the relative strength of different causes of action which have been plead, but also of other factors. For example, in *McKay*, the defendant's desire to avoid admitting RICO violations resulted in the defendant agreeing to compensate the taxpayer on certain claims for relief and not others. Presumably, it will be quite difficult for the Service to determine when a defendant's stated concerns are genuine and when they merely represent an accommodation of a plaintiff-taxpayer seeking the benefit of § 104(a)(2).[85] In addition, because the parties will want some certainty regarding the tax treatment to be accorded a settlement, the threat of the Service challenging the allocations in cases involving multiple claims may so distort the settlement negotiation process that one or both parties may insist on taking the case to trial.

V. SOLUTION

The difficulties with the new § 104(a)(2) are such that the obvious solution appears to be to repeal the exclusion in its entirety. Such a solution, however, runs counter to the congressional solicitude, expressed in §§ 104(a)(3) and 105(b) and (c), for those compensated through accident and health insurance for their personal injuries or sickness. Section 104(a)(3) excludes all

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84. *See id.* at 20-21. The brief states:

> [D]ifferential tax treatment of various causes of action would put the IRS and courts adjudicating tax disputes in the business of evaluating the strength and weaknesses of the causes of action when overseeing the parties' allocation of damages. The IRS does not have the expertise and the courts will not necessarily have the resources to make such judgments and should not be put in the position of second-guessing the parties' own evaluation of the value of the various claims to which the settlement is allocated. Such judgments are inherently subjective and cannot be resolved without extensive discovery and examination of witnesses—the very types of inquiry that a settlement is designed to avoid.

Id.

85. Another instructive case in which the court respected a specific allocation in a settlement agreement is McShane v. Commissioner, 56 T.C.M. (CCH) 409 (1987). There the settlement agreement, entered into after a jury verdict, provided that none of the settlement constituted prejudgment interest. *See id.* at 410. The court concluded that it was not unreasonable for the parties to negotiate a settlement which did not include an interest element. *See id.* at 412.

amounts received through such insurance, provided those amounts are not attributable to nontaxable employer contributions and were not paid by the employer. To the extent those amounts are so attributable, § 105 provides a narrower exclusion: amounts paid to the taxpayer to reimburse the taxpayer for medical care expenses are generally excludable under § 105(b) and amounts paid for permanent disfigurement or permanent loss (or loss of use) of a member or function of the body are excludable under § 105(c) provided those payments are computed with reference to the nature of the injury and without regard to the period of absence from work.

Several years ago, in a previous article in this journal, the authors suggested that there "would likely be little quarrel with a congressional decision to exclude from income for humanitarian reasons a limited category of personal injury awards,"[86] and that an exclusion patterned on § 105 "might offer the most promise of a policy-based tax treatment of damages for personal injuries or sickness."[87] At the time, we reasoned as follows:

> The Section 104(a)(2) exclusion for personal injuries or sickness should be no greater than that provided by other provisions of § 104 and § 105. Section 104(a)(3) and section 105 distinguish between the tax treatment of proceeds of health and accident insurance based on whether the insurance is employer-provided or employee-provided. As between the two, the damages received by a tort victim may be better analogized to employer-provided insurance, since in both instances the recipient has no after-tax "investment" attributable to the amounts received. If the analogy is accepted, then consistent with § 104(a)(3) and 105, the damages received under § 104(a)(2) should be includable in income—except to the extent they are attributable to amounts expended for medical care in a manner similar to § 105(b), and except to the extent they are attributable to permanent disability or disfigurement in a manner similar to § 105(c). Such an approach would end the exclusion for nonphysical injuries and for physical injuries that are not serious ones, yet would maintain a compassionate response for recoveries on account of the most serious physical injuries.[88]

Consider the operation of a § 105 approach to the earlier hypotheticals. Were § 105(b) and (c) to replace amended § 104(a)(2), Doctor in Hypothetical 1 could only exclude that

86. Burke & Friel, *supra* note 3, at 45.
87. *Id.* at 46.
88. *Id.* at 46-47.

amount of the settlement which was allocable to the medical expenses Doctor incurred as a result of the ski accident. In contrast to the results under current law, Doctor could not exclude any amounts received for pain and suffering or for lost income. A § 105-approach would provide the same results as under current law for Doctor in Hypothetical 2 who was the victim of libel—she could only exclude the medical expenses she incurred as a result of the emotional distress caused her by the libelous actions of the newspaper. A § 105-based approach would thus negate the unjustifiable differences in the tax treatment of the settlements in the hypothetical under current law.

Similarly, the potentially different tax treatment of Secretary in Hypothetical 3 and 4 dealing with sex discrimination would not exist if a § 105 approach were used instead of the exclusion standard of amended § 104(a)(2). There would be no need to determine whether a physical injury had occurred when Boss rubbed Secretary's shoulders and fondled her. Secretary in each hypothetical situation would be entitled to exclude only those amounts intended to compensate her for medical expenses.

Section 105 may thus provide an imperfect, but reasonable template for a future § 104(a)(2). To the extent one's personal injuries are compensated for by tortfeasors—as by employers' insurance plans—the payments are taxable, except for medical expense reimbursements and a narrow class of injuries or sickness where the loss of human capital is terribly severe and the payment therefore is demonstrably unconnected with loss of wages. The focus on the severity of the human capital loss and the disconnection from lost wages are the central features of § 105(c). They remain conspicuously absent from the new § 104(a)(2), which now, paradoxically, continues to preserve tax benefits for the mundane physical personal injury award, including its lost wages component, while denying those benefits to even the most severe nonphysical personal injury or sickness award that contains no lost wages component.

VI. CONCLUSION

Congress, in amending § 104(a)(2), has dramatically limited the scope of the exclusion for damages received on account of personal injuries and sickness. The 1996 amendments place enormous weight on whether the "origin" of the claim lies in a physical injury and deny physical injury status to a significant, but undefined range of physical "symptoms" grouped under the term "emotional distress." As demonstrated by the hypotheticals

presented in this article, the new legislative limits not only raise serious interpretational questions but also produce tax results which are not supportable from the standpoint of tax policy. While old § 104(a)(2) was in need of remedy, Congress could have devised a better remedy than that reflected in the 1996 amendments. An exclusion standard based upon the § 105 paradigm would have been far superior to that chosen by Congress. The new § 104(a)(2) is expedient, understandable, and wrong.