Buffalo Law Review

Volume 46 | Number 2 Article 2

4-1-1998

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BUFFALO LAW REVIEW

VOLUME 46 SPRING 1998 NUMBER 2

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TABLE OF CONTENTS

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INTRODUCTION

The taxation of lawsuit recoveries is complicated because it must be analyzed on two levels. First, damage payments are treated identically with the thing for which they substitute. For instance, when a tenant fails to pay rent and the landlord sues for unpaid rent and recovers damages, the damages are treated as the receipt of rent.[1] To conclude otherwise would permit conversion of income, possibly from rental income to capital gain, through the mere expedient of filing lawsuits or asserting claims. The general rule, which sensibly obviates such income conversion, is encapsulated in the form of the question: in lieu of what were the damages awarded?[2] By using the "in-lieu-of" test plus the broad definition of income ("accessions to wealth, clearly realized, over which the taxpayers have complete dominion"),[3] nearly all damage recoveries give rise to taxable income.

Second, various statutory exclusions are available to exempt certain kinds of damages from income. Principally, statutory exclusion is applied to tort damages recovered in personal injury suits. However, other kinds of damages exclusions, such as the recovery of employee benefits, certainly do exist.

The second step, the statutory exclusion, is in conflict with the first, as by definition all exceptions negate the general rule to which they are exceptions. The exclusion converts what would be taxable income under the initial "in-lieu-of" test into income that is not taxable. However, courts often conflate the two steps when they deny application of an exclusion because the damages recovered are in lieu of something that would be taxable income. Such a conclusion solely addresses the first step, for it is only when the damages recovered pass the "in-lieu-of" test that we care about the application of a statutory exclusion. Indeed, the conflation reads the exclusion out of the tax law, for if § 104(a)(2) simply creates an "in-lieu of" test, then it repeats the general rule of damages taxation. Some have suggested that the

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1. *See* Hort v. Commissioner, 313 U.S. 28, 30 (1941).

2. *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1297 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

3. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (construing I.R.C. § 61).

"in-lieu-of" test is a theory for interpreting § 104(a)(2).[4] Instead of conflating the first step into the second, denial of exclusions must rest solely upon the interpretation of the exclusion's text and reach. Unfortunately, with regard to the exclusion from income for damages recovered on account of personal injury, the conflation has caused a lack of focus on the exclusion and a resultant failure to develop a coherent theory or policy underlying it.

Lawsuit recovery taxation issues have arisen when applying the exclusion from income in § 104(a)(2), which excluded (until amendment in 1996) "damages received on account of personal injury."[5] The Supreme Court construed that phrase three times in five terms, parsing "personal injury" in the first two cases and "on account of" in the last two.[6] Congress recently came close to lessening the need for judicidial interpretation by adding the word "physical" to now exclude damages received because of personal *physical* injury.[7] However, this clarification does not entirely eliminate the interpretation problems within the clause. Section 104(a)(2) litigation survives, for neither the Court nor Congress have resolved the fundamental tension between the exclusion and its purported tax policy foundation. Until that tension is resolved, indeterminacy in applying the rule will persist.

The purported tax policy behind § 104(a)(2) excludes damages which substitute for "personal assets that the Government does not tax and would not have taxed had the victim not lost them."[8] Consider spousal consortium, which Congress recently used to describe an application of § 104(a)(2).[9] Persons acquire the right to spousal consortium through marriage. Neither the wealth-enhancing "acquisition" of a right to spousal consortium by getting married nor the wealth-enhancing "use" of that consortium during marriage is taxed. Nonetheless, damages for loss

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4. *See* Debra Cohen-Whelan, *From Injury to Income: The Taxation of Punitive Damages "On Account Of"* United States v. Schleier, 71 NOTRE DAME L. REV. 913 (1996).

5. I.R.C. § 104(a)(2) (1994).

6. *See* O'Gilvie v. United States, 117 S.Ct. 452 (1996); Commissioner v. Schleier, 515 U.S. 323 (1995); Burke v. United States, 504 U.S. 229 (1992).

7. I.R.C. § 104(a)(2) (Supp. II 1996) (as amended by Small Business Jobs Protection Act, Pub. L. No. 104-188, § 1605, 110 Stat. 1755).

8. *See* O'Gilvie v. United States, 117 S.Ct. 452, 456 (1996) (explaining that excludable damages typically are those substituting for a normally untaxed personal or financial quality, good or asset—personal assets that the Government does not tax and would not tax had the victim not lost them).

9. *See* SMALL BUSINESS JOB PROTECTION ACT OF 1996, H.R. CONF. REP. No. 104-737, at 301, *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793.

of spousal consortium *would* be taxable under the first step, the "in-lieu-of" test of damages taxation, because the damages arise from a conversion of a personal right into cash.[10] While the existence and creation of personal rights is not taxed, the conversion of them into clearly realized accessions to wealth, such as cash, is taxable. For instance, the "right" to leisure is not taxed, but conversion (voluntarily or involuntarily) of the right to leisure into payment for services is taxable.

The exclusion of § 104(a)(2) negates the results of the first step regarding damages for lost spousal consortium. It reflects the view that because the wealth enhancement of spousal consortium is not taxed, damages substituting for lost consortium should not be taxed.[11] Similarly, other aspects of living, like the joy of life, are not taxed. Therefore, damages for lost joy of life should not be taxed either.

The aggregate of personal attributes and rights whose existence is not taxed is known as human capital.[12] Normally, the tax law ignores both accessions to, and losses of, human capital.[13] Section 104(a)(2)'s purported tax policy ignores, for tax purposes, the restoration of human capital tortiously damaged by another by excluding it from income. That is, if one loses spousal consortium from divorce or the death of a spouse, no tax deduction is allowed for the loss. Yet, if one loses spousal consortium because of a tortious act and recovers damages, the damages are excluded from income as restoration of tortiously damaged human capital. The fundamental tension in applying

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10. A recovery for lost consortium would not be taxable under step one if: (1) the taxpayer had an income tax basis in the consortium right exceeding the amount of cash, and (2) the basis-recovery-ordering rule was basis first.

11. Following amendment in 1996, § 104(a)(2) reflects a view that damages for lost spousal consortium are excluded when either spouse suffered physical injury and not excluded when neither spouse suffered physical injury. *See* H.R. CONF. REP. NO. 104-737, at 301, *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793.

12. *See* Paul B. Stephan, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357, 1358-59 (1984).

> Human capital, in economic terms, is equivalent to the present value of the flow of future satisfactions that an individual can command in the course of his life. Some portion of this capital constitutes endowment, the biological and social inheritance that accompanies a person into the world. The remainder is acquired through individual action, such as education, on-the-job training, migration and health care, and stems from exogenous changes such as technological or social transformation.

Id.

13. *See* Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927, 959 (1993).

§ 104(a)(2) arises because no case has limited the exclusion to damages fitting the human capital restoration policy.

The exclusion, developed in 1918 shortly after enactment of the modern income tax,[14] has always excluded some damages that would have been taxable had the victim not lost them. For instance, the exclusion has always included at least some kinds of lost wages,[15] yet the conflict with the purported policy is clear.

Consequently, the purported tax policy—tax-free restoration of tortiously damaged human capital—has never adequately explained either the courts' or Congress' construction of § 104(a)(2). The cases can be described only in an ad hoc manner. Perhaps worse than no theory is a bad theory,[16] and attempts by courts to fit case results within the purported tax policy have resulted in a stilted two-prong test.[17]

Oddly, all agree that the human capital restoration policy cannot explain the boundary cases.[18] The arguments center on

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14. The exclusion from taxation was originally created by administrative ruling and subsequently codified by the Revenue Act of 1918. *See* 31 Op. Att'y Gen. 304, 308 (1918); T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918); Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1066.

15. *See* O'Gilvie v. United States, 117 S.Ct. 452, 456 (1996).

> We concede that the original provision's language does go beyond what one might expect a purely tax-policy-related "human capital" rationale to justify. That is because the language 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 provision can make the compensated taxpayer better off from a tax perspective than had the personal injury not taken place.

Id.

16. A good theory requires satisfaction of two requirements: (1) the theory must use a model, containing few arbitrary elements, to accurately describe a large class of observations; and (2) the theory must make concise predictions regarding the results of future observations. *See* STEPHEN W. HAWKING, A BRIEF HISTORY OF TIME 9 (1988).

17. *See infra* note 72 and accompanying text.

18. *See* O'Gilvie v. United States, 117 S.Ct. 452, 456 (1996) ("We concede that the original provision's language does go beyond what one might expect a purely tax-policy-related 'human capital' rationale to justify."); Leandra Lederman Gassenheimer, *The Excludability of Employment Discrimination Awards under Code Section 104(a)(2) after* Burke v. United States *and* Commissioner v. Schleier, 28 ARIZ. ST. L.J. 315, 317 n.10 (1996) (citing Mark W. Cochran, *Should Personal Injury Damage Awards be Taxed?*, 38 CASE W. RES. L. REV. 43, 44 (1987)); Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 341 (1995) ("While there is uncertainty as to precisely what considerations led Congress to adopt the antecedent to section 104(a)(2), the background history of the provision suggests that Congress focused on a 'return of human capital' theory.") (citing Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 712); Kahn, *supra*, at 344 ("[S]ome courts and commentators have suggested that the human

the extent to which the statute deviates from its purported tax policy.[19] The boundary cases are scattered data points. They can be considered ad hoc decisions devoid of any theoretical coherence which could explain why the purported policy wins in some cases but loses in others. Two principal solutions present themselves: (1) conform the results to the theory (for example, fix the anomalous exclusion of lost wages); or (2) develop a coherent theory to explain the boundary cases. I develop both solutions in Part V and summarize them here.

First, the human capital restoration policy could be applied according to its pure terms, without exception. Such a pure human capital restoration policy requires a sharp theoretical distinction between lost wages due to a period of convalescence and lost wages due to impairment of earning capacity. The former would be treated as taxable current income, the latter as a recovery of principal.[20] Distinguishing between impaired earning capacity and convalescent lost wages has three benefits: it (1) conforms the human capital restoration policy to the larger principles of income tax law; (2) makes the accident tax-neutral; and (3) mirrors an allocation sourced in tort law.

Human capital restoration policy, and indeed much of income taxation, is based on the efficiency of distinguishing between income and principal.[21] Earning capacity is in the nature of principal, because it is a store of value from which periodic income issues.[22] When principal, sometimes called capital, is

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capital theory is undercut by the fact that the section 104(a)(2) exclusion extends to damages in substitution for lost income."); Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries under Federal Civil Rights Statutes: Income from Human Capital, Realization, and Nonrecognition*, 72 N.C. L. REV. 549, 608 (1995); Cohen-Whelan, *supra* note 4, at 918.

> However, debate over § 104(a)(2) began with congressional failure to incorporate the return of capital theory into the statutory language of its predecessor, § 22. The codification of § 22 and § 104(a) as exclusions from income makes the taxation of personal injury damages independent of their characterization as income. Thus, the return of capital analysis should be inapplicable to the taxation of personal injury awards.

Cohen-Whelan, *supra*. *See also* Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 147 (1992) ("At the core of section 104 is the issue of recoveries for injuries to 'human capital,' *i.e.*, damages for lost wage-earning capacity, including recoveries for lost past wages. Both historic and present-day theories of exclusion (or inclusion) ultimately derive from a conception of human capital."); Dodge, *supra*, at 155 ("[T]he conventional replacement-of-capital theory cannot sustain an exclusion for personal injury recoveries . . . .").

19. *See O'Gilvie*, 117 S.Ct. at 456.

20. *See infra* note 179 and accompanying text.

21. *See infra* note 179.

22. *See infra* note 180.

converted into a damages payment of cash, taxable income results under the "in-lieu-of" test unless the tax basis in the capital exceeds the recovery.[23] Calculating adjusted basis in human capital is notoriously difficult. A distinction between impaired earning capacity and convalescent lost wages interprets § 104(a)(2) in a manner which lessens the need for that difficult basis calculation.

Moreover, distinguishing impaired earning capacity and convalescent lost wages for the purposes of § 104(a)(2) restores the victim to pre-accident status, making the accident tax-neutral. While the restoration of the principal sum of human capital is not taxed, the income produced by the restored principal will be taxed, as financial income on the now monetized capital replaces what would have been labor income from human capital.[24] Furthermore, the process of making distinctions between impaired earning capacity and convalescent lost wages raises allocation issues; however, allocations are endemic to the law of damages taxation, for rarely does the litigant assert both a single claim and single element of damages. Perhaps it is for that reason that no court has ever permitted difficulties in allocation to trump policy in § 104(a)(2) cases.[25] Notwithstanding the three benefits to distinguishing between impaired earning capacity and convalescent lost wages, the theory would require either statutory amendment or retreat by the Supreme Court from dicta repeated in three recent cases. Neither is likely, although, as I note in Part V, it would solve the current problems of interpretation.

Second, instead of recognizing a theory distinguishing impaired earning capacity and convalescent lost wages, we could concentrate specifically on the boundary cases in applying § 104(a)(2). From the boundary cases, one can discern that an unexpressed coherent theory has been developed. Invariably, when courts limit the § 104(a)(2) exclusion, they do so by concluding that the damages at issue substitute for taxable income and are taxable as such. This is done so as not to provide a windfall to the taxpayer.[26] However, as noted, this conclusion

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23. I.R.C. § 1001 (1994).

24. *See infra* note 185.

25. In *Commissioner v. Schleier*, 515 U.S. 323, 332 (1995), the Court held that back pay and liquidated damages recovered in an employment discrimination action were not excludable, but that damages for the intangible harms of discrimination (which are permitted under some discrimination claims) would be excludable. That resolution obviously creates a need to allocate damages.

26. *See* O'Gilvie v. United States, 117 S.Ct. 452, 456 (1996) ("exclusion from gross income provides the taxpayer with a windfall"); Hemelt v. United States, 122 F.3d 204,

conflates the two steps of damages recovery taxation. Equally problematic is the labeling of some damages by courts as includible economic damages in contrast to excludable personal injury damages.[27] But not all such economic damages are denied exclusion, for lost wages—undeniably economic damages—sometimes are excluded from income.[28] When pressed, the Supreme Court described the exclusion of those lost wages as an "anomaly," and as a circumstance not justifying "the extension of the anomaly or the creation of another."[29] Consequently, the boundaries of the anomaly describe the reach of § 104(a)(2), and I concentrate on those cases in Part I.

I. THE ANOMALOUS EXCLUSION OF LOST WAGES IN SOME CASES

The boundary cases in application of § 104(a)(2) have always occurred where the tort victim and tortfeasor had an economic relationship prior to the rise of the tort claim. When the converse is true, for example, the victim and tortfeasor are strangers, § 104(a)(2) simply has governed and no finely sliced questions of human capital recovery versus economic damages are considered. That suggests that the real tax policy underlying § 104(a)(2) is kindness to tort victims,[30] which dissipates when the victim and tortfeasor have a pre-existing economic relationship.

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209 (4th Cir. 1997) ("Thus the decision to deny them a double windfall by denying a refund of the income taxes paid is a sound one."). Describing an exclusion from income as a windfall is not helpful; Congress has enacted some exclusions from income and, windfalls or not, they must be construed.

27. *Schleier*, 515 U.S. at 331. When the Tax Court ultimately abandoned the distinction of personal injuries and economic damages, it succinctly described the problems of that approach.

> Where, however, a taxpayer's injuries are nonphysical we have, in the past, ignored the personal nature of the claim and delved into an inquiry regarding the nature of the consequences of the injury. . . . Not only does the distinction between damages for injury to personal reputation and those for professional reputation create an inconsistency between physical and nonphysical personal injuries that is analytically irreconcilable, the distinction also lacks a firm foundation in the case law of this Court.

Threlkeld v. Commissioner, 87 T.Ct. 1294, 1300-01 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988) (citations omitted).

28. *Schleier*, 515 U.S. at 329.

29. *O'Gilvie*, 117 S.Ct. at 456 (citing Bernard Wolfman, *Current Issues of Federal Tax Policy*, 16 U. ARK. LITTLE ROCK L.J. 543, 549-50 (1994) (" 'To build upon' what is, from a tax policy perspective, the less easily explained portion 'of the otherwise rational exemption for personal injury,' simply 'does not make sense.' ")).

30. *See* Heen, *supra* note 18, at 560-61.

Kindness apparently dissipates because income taxation takes special interest in the exchange of contract rights and strains to ensure that exchanges of contract rights are not "hidden" as tort compensation. While we are kind to tort victims, we will police artful conversions by economically-related tortfeasors and victims of what otherwise would be taxable income (economic damages) into excludable income. Yet, the cases never articulate either the kindness rationale[31] or any other principled distinction to differentiate why economic damages are excluded in one case but not in another. Nonetheless, we can observe that in nearly all circumstances where "economic damages" are denied exclusion, the victim and tortfeasor were "economically related."[32]

The archetypal case involving § 104(a)(2), according to the Supreme Court (at least until increased frequency of dignitary torts), is a car crash, in which the victim recovers damages for medical expenses, lost wages and pain and suffering.[33] No court, including the Supreme Court, ever has suggested that lost wages in a car crash are not excludable, notwithstanding the conflict with the purported human capital restoration policy.[34] Yet, beginning in the mid-1970s and continuing through the recent actions of the Court and Congress, narrowing construction of the exclusion with respect to lost wages has occurred in cases involving employment discrimination.[35]

Courts began to balk at excluding lost wages in employment discrimination cases, notwithstanding universal recognition that employment discrimination causes personal injury.[36] At some

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31. *See* J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13, 43 (1989). The kindness rationale, as the reason for the anomalous exclusion for lost wages, always has seemed cramped to me. Apparently, we recognize the anomaly but limit it to victims of physical injury. *See* Kahn, *supra* note 18, at 357 ("In general, the plight of a victim who has suffered only nonphysical injuries does not arouse anything like the sympathy that is engendered by a physical injury."). Yet, if kindness is the reason, why are we not similarly "kind" to victims of employment discrimination or even to people who have been laid off and receive severance pay? If kindness really were our chief concern, I would imagine that we should focus on what it means to be "injured" and which injuries evoke compassion. No reason ever has been advanced why physically-injured persons uniquely deserve compassion.

32. *See infra* note 197.

33. *See Schleier*, 515 U.S. at 329.

34. *O'Gilvie*, 117 S.Ct. at 456.

35. *See infra* Part II.

36. *Schleier*, 515 U.S. at 332 n.6 (agreeing with dissenting opinion that employment discrimination causes personal injury but concluding that the Age Discrimination in Employment Act (ADEA) does not compensate for personal injuries).

fundamental level, the courts and the Internal Revenue Service have wanted to distinguish lost wages in car crashes from lost wages in employment discrimination cases, and multiple analytic modalities were employed.[37] No modality focused on the distinction I find critical: the pre-existing economic relationship of the victim and tortfeasor. Instead, the Courts and the Internal Revenue Service used: (1) a distinction between physical and nonphysical injuries not in the pre-1996 statute;[38] (2) a damages-focused "in-lieu-of" test conflating the general rule and its exception;[39] (3) a claims-focused test excluding nearly everything;[40] and (4) a false test of "causation" for employment discrimination cases.[41] Most recently, Congress settled upon one easier to state, but equally hard to understand,[42] when in 1996 it decided to distinguish physical and nonphysical injury cases.[43]

Not surprisingly, the shifting analytic modalities altered the results. Examination of the analytic modalities employed by courts in deciding the taxation of employment discrimination awards reveals a serpentine path, with results alternating between partially taxable, completely not taxable and completely taxable lost wages.

II. THE SERPENTINE PATH FOR EMPLOYMENT DISCRIMINATION RECOVERIES

Extensive prohibition against discrimination in employment began in the 1960s with the passage of the Federal Civil Rights Acts.[44] However, it was not until the mid-1970s that the tax consequences of those recoveries were decided.[45] Through a series of cases, the Tax Court construed the pre-1996 version of § 104(a)(2) to distinguish between physical and nonphysical injury cases and rarely excluded lost wages in nonphysical injury cases.[46] Although subsequently reversed by the Supreme Court

37. *See infra* Part II.

38. *See infra* note 59 and accompanying text.

39. *See infra* notes 51-56 and accompanying text.

40. *See infra* note 68.

41. *See infra* notes 75-76 and accompanying text.

42. Neither the 1996 Act nor its legislative history answers whether the physical injury requirement is a *Burke*-type requirement in that, once present, all damages are excludable, or is a *Schleier*-type requirement in that we must decide whether each element of damages is caused by physical injury.

43. *See infra* notes 83-88 and accompanying text.

44. Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241, 255 Title VII, § 703.

45. Hodge v. Commissioner, 64 T.C. 616, 619 (1975).

46. *See infra* note 52.

on the distinction between physical and nonphysical injuries,[47] the Tax Court's view ultimately prevailed in the 1996 amendment. While a certain symmetry describes the completed path, the route between beginning and end twists in serpentine fashion. As the analytic modalities changed, treatment of employment discrimination damages progressed as follows: first partially taxable, then completely not taxable, completely taxable, completely not taxable, partially taxable and now completely taxable.[48] No one analytic modality has ever overcome the other, because none could resolve the fundamental tension between the human capital restoration policy and the anomalous exclusion of lost wages in car crash cases. The persistent attempt to develop an analytic modality to distinguish lost wages in employment discrimination cases from those in car crashes suggests a widely held desire to limit the anomalous exclusion of lost wages when the victim and tortfeasor are economically related.

A. *Partially Taxable*

The first court to decide the taxation of employment discrimination recoveries was the Tax Court in 1975.[49] Three years earlier, the Tax Court distinguished between physical and nonphysical injury cases.[50] However, no reason was given for why

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47. *See Schleier*, 515 U.S. at 330 n.4 ("Though the text of § 104(a)(2) might be considered ambiguous on this point, it is by now clear that § 104(a)(2) encompasses recoveries based on intangible as well as tangible harms.") (citing *Burke*, 504 U.S. at 237 n.6.).

> Although the IRS briefly interpreted § 104(a)(2)'s statutory predecessor to restrict the scope of personal injuries to physical injuries, the courts and the IRS long since have recognized that § 104(a)(2)'s reference to "personal injuries" encompasses, in accord with common judicial parlance and conceptions of nonphysical injuries to the individual, such as those affecting emotions, reputation or character, as well. . . . Notwithstanding Justice Scalia's contention in his separate opinion that the term "personal injuries" must be read as limited to "health"-related injuries, the foregoing authorities establish that § 104(a)(2) in fact encompasses a broad range of physical and nonphysical injuries to personal interests.

Id. (citations omitted).

48. The textual discussion draws from and updates an earlier article. *See* F. Philip Manns Jr., *Down and Out: RIFed Employees, Taxes, and Employment Discrimination Claims After* Burke *and* Schleier, 44 U. KAN. L. REV. 103, 114-20 (1995). The serpentine path traced by analytic modalities in employment discrimination cases demonstrates the failure of any modality to carry the day, and provides headaches to tax lawyers who try to discern what law was effective when. As I had to answer those questions as I wrote this section, I prepared a chart of effective dates, and I have set out the chart as an Appendix.

49. *Hodge*, 64 T.C. at 616.

50. *See* Seay v. Commissioner, 58 T.C. 32, 40 (1972) (holding damages received for embarrassment, mental strain and injury to personal reputation excludable under

lost wages in physical injury cases are different from those in nonphysical injury cases.[51] Nonetheless, because no physical injuries are involved in employment discrimination,[52] the Tax Court, beginning with *Hodge v. Commissioner*,[53] applied the rule distinguishing between the two types of injuries to employment discrimination recoveries. Under this rule for nonphysical injury cases, each component of damages was analyzed separately. Those economic damage components substituting for otherwise taxable income were denied exclusion. Lost wages were not excludable because "had there been no discrimination against the petitioner, he would have received a better job without a lawsuit and would have paid more taxes on increased pay as received."[54] As generally applied to employment discrimination recoveries, the actual wage losses arising from the discriminatory employment action, commonly known as back pay,[55] were taxable. Liquidated damages, however, were excludable despite the fact that they are sometimes awarded in an amount equal to back pay.[56]

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§ 104(a)(2)).

51. *See* Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 LA. L. REV. 875, 916 (1988) ("[A]ny recovery that is purely for back pay will be found taxable.").

52. *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1300 (1986) ("Where, however, the damage award is received for a nonphysical injury, we have previously mounted an inquiry to determine whether the components of the injuries for which the award is made are personal or professional."), *aff'd*, 848 F.2d 81 (3d Cir. 1988).

53. 64 T.C. 616 (1975).

54. *Id.* at 619.

55. Most employment discrimination statutes then limited remedies to lost wages, also called back pay, and liquidated damages equal to back pay. 42 U.S.C. § 2000e-5(g)(1) (1994); 29 U.S.C. § 626(b) (1995). Availability of liquidated damages sometimes turns on the mental state of the defendant. 29 U.S.C. § 216 (1994). Employment discrimination statutes also typically include the remedy of reinstatement, and often money called "front pay" is awarded in lieu of reinstatement. In addition, attorneys' fees are awarded to the prevailing party, prejudgment interest is paid and the court is authorized to grant injunctive relief. *See* 2 SULLIVAN, ZIMMER & RICHARDS, EMPLOYMENT DISCRIMINATION § 14.1 (2d ed. 1988 & Supp. 1996).

56. *See* Hodge v. Commissioner, 64 T.C. 616, 619 (1975) (holding that Title VII back pay is taxable); Thompson v. Commissioner, 89 T.C. 632, 648 (1987) (classifying back pay under the Equal Pay Act as taxable, but liquidated damages under the Equal Pay Act as excludable); Rickel v. Commissioner, 92 T.C. 510, 521-22 (1989) (concluding that ADEA back pay is taxable, but ADEA liquidated damages are excludable); Wirtz v. Commis-

B. *Completely Not Taxable*

Next, while the Fourth Circuit appeared to agree with both the Tax Court's physical and nonphysical distinction between injuries and its analysis of the individual components in nonphysical injury cases,[57] every other court of appeals rejected that approach.[58] The component approach confused the nature of a claim with its consequences (the components of its relief). Therefore, the courts of appeal, except for the Fourth Circuit, uniformly concluded that whenever a claim arises under a statute, the claim is tort-like, for the duty arises by operation of law rather than express or implied contract.[59] Consequently, the

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sioner, 56 T.C.M. (CCH) 1596, 1598 (1989) (holding that ADEA front pay is taxable); Sparrow v. Commissioner, 57 T.C.M. (CCH) 816, 821 (1989) (classifying Title VII front pay as taxable).

57. *See* Thompson v. Commissioner, 866 F.2d 709, 712 (4th Cir. 1989) ("[W]e conclude that Thompson received the liquidated damages through prosecution of a tort-type claim for personal injuries. We conclude, however, that the claim for back pay was essentially a contractual claim for accrued wages."), *aff'g* 89 T.C. 632 (1987).

58. *See infra* note 104.

59. *See* Bryne v. Commissioner, 883 F.2d 211, 215 (3d Cir. 1989) ("This duty [against unlawful employment discrimination] is independent of any duty an employer might owe his employee pursuant to an express or implied employment contract; it arises by operation of law. Thus, the statutory claim seeks to remedy a statutory violation that the law has defined as wrongful."), *rev'g* 90 T.C. 1000 (1988); Pistillo v. Commissioner, 912 F.2d 145, 149-50 (6th Cir. 1990), *rev'g* 57 T.C.M. (CCH) 874 (1989).

> Reviewing the nature of Pistillo's claim, we conclude that his age discrimination lawsuit is analogous to the assertion of a tort-type right to redress personal injuries. Cleveland Tool discriminated against Pistillo on the basis of his age and invaded the rights Pistillo "is granted by virtue of being a person in the sight of the law." Contrary to the arguments of the Commissioner, Pistillo has not brought separate actions to seek back pay damages for his pain and suffering.

Id. (citing *Threlkeld*, 87 T.C. 1294, 1308 (1986)). *See also* Redfield v. Insurance Co. of North America, 940 F.2d 542, 546 (9th Cir. 1991) ("Nothing in the ADEA reflects a congressional attempt to rewrite the terms of employment contracts. ADEA actions are analogous to other federal discrimination causes of actions, many of which have been described in explicitly tort-like language."). The Third Circuit stridently rejected the components analysis of the Tax Court and the Service. Rickel v. Commissioner, 900 F.2d 655, 661-62 (3d Cir. 1990), *rev'g* 92 T.C. 510 (1989).

> [O]nce it found that age discrimination was analogous to a personal injury and that the taxpayer's ADEA action amounted to the assertion of a tort type right, the Tax Court should have ended its analysis and found that all damages flowing therefrom were excludable under § 104(a)(2). By going further and rummaging through the taxpayer's prayers for relief in order to determine the nature of his claim, the Tax Court was simply defining the nature of the taxpayer's injury by reference to its nonpersonal consequences, an approach we explicitly rejected in both *Bent* and *Byrne*, and the full Tax Court rejected in *Threlkeld*.

Rickel, 900 F.2d at 661-62. The court also noted:

near-uniform rule of the circuits treated physical and nonphysical injury cases the same and excluded *all* damages recovered on account of employment discrimination claims.[60] Thus, those courts applied a "nature of the claim" approach. Later, the Tax Court confessed error in the components analysis and agreed with the courts of appeal that § 104(a)(2) depends on a claims analysis. In doing so, the Tax Court reversed itself.[61]

C. *Completely Taxable*

The Supreme Court in *United States v. Burke*[62] agreed with the court of appeals' "nature-of-the-claim" focus when it concluded that a claim is tort-like only if it provides broad remedial components consistent with "traditional tort liability."[63] Sex discrimination under Title VII of the Civil Rights Act of 1964, which prohibits discrimination in employment on the basis of race, sex, religion and national origin, was not considered tort-like by the Court because Title VII then limited remedies to back pay.[64]

> Thus, to the extent that the Commissioner, in spending an inordinately large part of his brief attempting to establish that at least half of the settlement comprised payment for back pay, is arguing that "because the settlement was intended to compensate [the taxpayer] for economic losses it is therefore compensating [him] for non-personal injuries, we find this argument to have been rejected in *Bent* [and *Byrne*] and we reject it again here" for the *third* time.

Rickel, 900 F.2d at 662 n.9 (emphasis in original) (quoting *Byrne*, 883 F.2d at 214).

60. *See supra* note 59.

61. *See Threlkeld*, 87 T.C. at 1300. *See also* Downey v. Commissioner, 97 T.C. 150, 161 (1991), *aff'd on reh'g*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994).

> Although the direction of the necessary inquiry would seem straightforward, some confusion has arisen in the past when the focus has shifted from the source and character of the injury (a tortious invasion of personal rights) to its consequences. Those consequences are irrelevant for purposes of the inquiry required by § 104(a)(2).

Downey, 97 T.C. at 161 (citations omitted). In *Downey v. Commissioner*, the Tax Court concluded that ADEA damages are "damages received on account of personal injur[y]," and consequently not included in the recipient's gross income. 97 T.C. 150, 156 (1991).

62. 504 U.S. 229 (1992).

63. *Id.* at 237 ("We thus agree with the Court of Appeals' analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents' damages award.") (citing *Burke*, 929 F.2d at 1121).

64. *Id.* at 238. The Court said that Title VII "limits available remedies to back pay, injunctions, and other equitable relief." *Id.* at 238. The injunctions and other equitable relief to which the court refers grant the courts power to order reinstatement or monetary relief in lieu of reinstatement, sometimes called front pay. *See id.* at 238 n.9; *see also* 2 SULLIVAN, ZIMMER, & RICHARDS, EMPLOYMENT DISCRIMINATION, § 14.1 (2d ed. 1988 & Supp. 1996).

Under the court of appeals' "nature-of-the-claim" test, remedial components were considered only at the threshold in an effort to decide whether a claim is tort-like. Once the nature of the claim was decided, all damage elements were grouped together as either all taxable or all non-taxable. In *Burke*, the Court did not address this aspect, for it concluded that the claim in question was not tort-like.[65] However, the Court strongly implied that if broad remedies were available (making the claim tort-like), all damages recovered would be excludable.[66]

D. *Completely Not Taxable*

Following *Burke*, every court deciding the issue, except one district court,[67] interpreted *Burke* to hold that once a claim is judged "tort-like" all components of its relief are excluded from income.[68] This, coupled with the significant broadening of the

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65. 504 U.S. at 237.

66. *Burke* contrasted Title VII with 42 U.S.C. § 1981 (1988 & Supp. 1992) (prohibiting race-based employment discrimination) and Title VIII of the Civil Rights Act of 1968 (prohibiting housing discrimination), noting that § 1981 and Title VIII provide for awards of compensatory and punitive damages, while Title VII awards only back pay. *See Burke*, 504 U.S. at 240. The Court thereby implied that employment discrimination claims for which broad damages are available are tort-like. *Id.* The inherent conflict in *Burke* and *Schleier* on this point was recognized by the Supreme Court in *O'Gilvie v. United States*, 117 S.Ct. 452, 458 (1996) (noting that the *"[Burke]* dicta [supported] a view somewhat like that of petitioners" and contrary to the court's decision in *O'Gilvie*).

67. Every v. I.R.S., 74 A.F.T.R.2d (RIA) 5614 (W.D. Wash. 1994), *aff'd*, 51 F.3d 279 (9th Cir. 1995).

68. After *Burke* but before *Schleier*, in Rev. Rul. 93-88, 1993-2 C.B. 61, *suspended by* Notice 95-45, 1995-34 I.R.B. 20, *obsoleted by* Rev. Rul. 96-65, 1996-2 C.B. 6, the Service acknowledged exclusion for all amounts recovered under (1) Title VII gender-based disparate treatment claims as amended by the Civil Rights Act of 1991, (2) Title VII racial discrimination claims as amended, and (3) Americans With Disabilities Act claims, because the claims, as amended, gave rise to sufficiently broad remedies to be tort-like. The ruling was based itself on the Court's dicta in *Burke*, in which the Court implied that all damages recovered under § 1981 would be excludable. Rev. Rul. 93-88, 1993-2 C.B. 61 (citing *Burke*, 504 U.S. at 239-40). Thus, pre-*Schleier* the testing ground for applying *Burke* was the ADEA, because exclusion for virtually all other employment discrimination recoveries had been conceded.

Prior to *Burke*, the three courts of appeals deciding the issue, and ultimately the Tax Court as well, decided that ADEA claims were tort-like because they arise under a statute. *See* Redfield v. Insurance Co. of North America, 940 F.2d 542 (9th Cir. 1991); Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990); Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990); Downey v. Commissioner, 97 T.C. 150 (1991). *Burke* rejected that analysis, and focused instead on the remedies available for a claim. *Burke*, 505 U.S. at 239-40. Consequently, the ADEA decisions required reconsideration after *Burke*; the Tax Court and nine other courts decided the issue. Decisions of the Fifth Circuit, Ninth Circuit, Tax Court, Court of Federal Claims, Eastern District of California and District of New Jersey conclude that damages received on account of ADEA claims are excludable

remedies available for employment discrimination under the Civil Rights Act of 1991,[69] meant that damages received for employment discrimination were completely not taxable. The broadening of substantive remedies made such causes of action tort-like under *Burke*, and, once a cause of action is tort-like, all damages are excluded from income.

E. *Partially Taxable*

Although everyone interpreted *Burke* to mean that once the claim was tort-like all damages recovered were excludable,[70] the Supreme Court did not. In *Commissioner v. Schleier*,[71] the Court "clarified" *Burke* by holding that the "nature-of-the-claim" test is prong one of a two prong test.[72] At issue in this case was taxation of an ADEA recovery, by which persons discriminated against on the basis of age can recover lost wages and, if the violation is willful, liquidated damages in an amount equal to lost wages.[73] This constrained measure of damages was sufficient to decide the case under the *Burke* prong, for the Court decided that an ADEA claim was not "tort-like."[74] The Court developed the second prong [hereinafter *Schleier* prong], and in a later case, called both grounds alternative holdings.[75] Under the

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from income; the Seventh Circuit, two district courts in the Eleventh Circuit and a District Court in Illinois, which rendered its decision two weeks before the Seventh Circuit's decision in another ADEA case, conclude otherwise. *See* Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994), *rev'g* 100 T.C. 634 (1993); Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994), *vacated*, 515 U.S. 1139 (1995); Purcell v. Sequin State Bank, 999 F.2d 950 (5th Cir. 1993); Rice v. United States, 834 F. Supp. 1241 (E.D. Cal. 1993), *aff'd*, 35 F. 3d 571 (9th Cir. 1994), *vacated sub nom*, Commissioner v. Schmitz, 515 U.S. 1139 (1995); Bennett v. United States, 30 Fed. Cl. 396 (1994), *rev'd*, 60 F.3d 843 (Fed. Cir. 1995); Abrams v. Lightolier, Inc., 841 F. Supp. 584 (D. N.J. 1994), *aff'd*, 50 F.3d 1204 (3d Cir. 1995); Drase v. United States, 866 F. Supp. 1077 (N.D. Ill. 1994); Shaw v. United States, 853 F. Supp. 1378 (M.D. Ala. 1994); Maleszewski v. United States, 827 F. Supp. 1553 (N.D. Fla. 1993). As well, the General Counsel of the Equal Employment Opportunity Commission opined that under the *Burke* analysis, ADEA damages are excludable from income. However, within a week, he rescinded that conclusion "pursuant to the view of the Commissioner of Internal Revenue." Memorandum from Donald R. Livingston, General Counsel EEOC, to Regional Attorneys (Mar. 1, 1993), *reprinted in* 41 Daily Labor Report F-1 (BNA) (1993) (revising Memorandum (Feb. 23, 1993), *reprinted in* 34 Daily Labor Report E-1 (BNA) (1993)).

69. *See infra* note 80.

70. *See supra* note 68.

71. 515 U.S. 323 (1995).

72. "[S]atisfaction of *Burke*'s 'tort or tort type' inquiry is a necessary condition for excludability under § 104(a)(2), it is not a sufficient condition." *Id.* at 336.

73. *Id.* at 325-26.

74. *Id.* at 335-36.

75. O'Gilvie v. United States, 117 S. Ct. 452, 455 (1996).

Schleier prong the taxpayer, using principles of proximate causation, must show that each element of the damages was received "on account of personal injury or sickness."[76] The Court applied this causation test to each category of damages present in the ADEA case: lost wages and liquidated damages. According to *Schleier*, while the intangible harms of discrimination can constitute personal injury, neither ADEA lost wages nor ADEA liquidated damages compensates for the intangible harms of discrimination.[77] The Court contrasted lost wages in car crashes to those in age discrimination cases, because in car crashes, "the accident causes a personal injury which in turn causes a loss of wages."[78] However, "in age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other."[79]

Although *Schleier* authoritatively negates exclusion for lost wages and liquidated damages in an ADEA case, whether it articulates a rule of greater application is open to debate. Courts have divided on the question, and it is more fully explored in Part IV.

Consequently, following *Schleier*, employment discrimination damages generally became partially taxable. Although ADEA damages were fully taxable under *Schleier*, the remedies for most employment discrimination claims (aside from ADEA claims) had been expanded by the Civil Rights Act of 1991 to include compensatory damages for the intangible harms of discrimination.[80] Partial taxation for employment discrimination damages was ruled on in Revenue Ruling 96-65.[81] The Service decided that, under the law effective after *Schleier* and prior to

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76. "First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is 'based upon tort or tort type rights'; and second, the taxpayer must show that the damages were received 'on account of personal injuries or sickness.'" *Schleier*, 515 U.S. at 337. The court held that neither ADEA back pay nor ADEA liquidated damages met either of the "two independent requirements that a taxpayer must meet before a recovery may be excluded under § 104(a)(2)." *Id.*

77. *Id.* at 330-31.

78. *Id.* at 330.

79. *Id.* at 330.

80. Under the Civil Rights Act of 1991, a new section, 42 U.S.C. § 1981a (1994), applies concurrently with and in addition to Title VII. It permits recovery of "compensatory and punitive damages," 42 U.S.C. § 1981a(a)(1), subject to aggregate limits of between fifty thousand dollars and three hundred thousand dollars, depending on the size of the employer, for (1) "unlawful intentional discrimination" in employment on the basis of race, sex, religion and national origin under Title VII; and (2) Americans with Disabilities Act (ADA) disparate treatment claims. 42 U.S.C. § 1981a(b)(3)(A)-(D) (1994). Additionally, a jury trial is available for § 1981a claims. 42 U.S.C. § 1981a(c) (1994).

81. Rev. Rul. 96-65, 1996-2 C.B. 6.

the 1996 Act, lost wages were included in income, but damages received for emotional distress were excludable from gross income. The Tax Court agreed.[82]

F. *Fully Taxable*

The Small Business Job Protection Act of 1996,[83] amended § 104(a)(2) to exclude "damages (*other than punitive damages*) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries *or physical sickness.*"[84] It adds that "emotional distress shall not be treated as a physical injury or physical sickness" except to the extent of medical care for emotional distress.[85] The legislative history targets claims of employment discrimination or injury to reputation:

> Damages received on a claim not involving a physical injury or physical sickness (e.g., employment discrimination or injury to reputation) are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income. The confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The Congress believed that the taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made. . . . The Small Business Act provides that emotional distress is not consid-

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82. Barnes v. Commissioner, 73 T.C.M. (CCH) 1754 (1997) (awarding damages for emotional distress and punitive damages under a wrongful termination claim to an employee fired for giving a deposition against her employer and holding that the emotional distress damages were excludable from taxation). Similarly, in two allocation cases, *Simko v. Commissioner*, 73 T.C.M. (CCH) 1679 (1997) and *Phillips v. Commissioner*, 74 T.C.M. (CCH) 187 (1997), the Tax Court agreed that emotional distress damages recovered from a former employer could be excluded, but the taxpayers had failed to prove that the payor intended to pay personal injury damages rather than damages for breach of contract. *See also* Gassenheimer, *supra* note 18, at 315, 331-32.

> The more difficult question is whether the damages received as compensation for the emotional pain and mental anguish of discrimination would be excludable. Under *Schleier*, they seem to be received "on account of" intangible personal injuries. Although *Burke* requires characterizing the claim as a whole, it does not seem to prohibit separating damages into excludable and includible portions according to whether or not they meet the *Schleier* test. Thus, the best answer under the case law may be to allow exclusion of only the personal injury portion of the recovery received under a statute that passes the *Burke* test.

Gassenheimer, *supra*.

83. Pub. L. No. 104-188, 110 Stat. 1755, § 1605 (1996).

84. *Id.* (noting that the additions to the statute are in italics).

85. I.R.C. § 104(a)(2) (Supp. II 1996).

> ered a physical injury or physical sickness. Thus, for example, the exclusion from gross income does not apply to any damages received (other than for [certain] medical expenses . . .) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.[86]

Consequently, the 1996 Act negates the exclusion for all damages recovered from employment discrimination claims. First, the Act requires a physical injury, absent in employment discrimination. Second, it forecloses arguments that emotional distress attached to such discrimination is a physical injury. The serpentine path for employment discrimination seems to have found its end, with employment discrimination damages fully taxable. However, the application of the *Schleier* prong outside of employment discrimination cases has not been settled either by *Schleier* or the 1996 Act.

The 1996 Act's legislative history 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 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.[87]

Thus, the 1996 Act re-creates the *Schleier* causation issue. Is the damage flowing from the physical injury or from some other injury? To what extent is the *Schleier* causation prong applicable to the 1996 Act's new physical injury requirement? While settling the taxation of employment discrimination recoveries, in the majority of cases where there is no physical injury, the 1996 Act creates more problems of interpretation. Is the new physical injury requirement a *Burke*-type requirement in that once present all damages are excludable, or is the it a *Schleier*-type requirement in that we must decide whether each element of damages is caused by physical injury? I address that question in Part IV, but its existence makes me disagree with the observation by Professor Chirelstein that the "lively and interesting" discussion of § 104(a)(2) now belongs to the past given the passage of the 1996 Act.[88]

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86. STAFF OF JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS 223-24 (Comm. Print 1996).

87. H.R. CONF. REP. No. 104-737, at 301, *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793.

88. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO

III. POST-*SCHLEIER*: PROBING THE *SCHLEIER* CAUSATION PRONG

Prior to its creation by the Supreme Court, the *Schleier* prong had not been developed in the lower federal courts, the literature, or the parties' briefs; indeed everyone read *Burke* to negate any damages-based focus in applying § 104(a)(2).[89] In the *Schleier* prong, the Court struggles with the fundamental tension within § 104(a)(2), as the lower federal courts had for twenty years.[90] The tax policy underlying § 104(a)(2) does not tax damages restoring tortiously damaged human capital. However, that policy cannot decide all cases, because the Court assumes that lost wages recovered in car crashes are excludable.[91] Yet in *Schleier* the Court apparently shared the fundamental desire to distinguish lost wages in car crashes from lost wages in employment discrimination.[92] The distinction used by the Tax Court in 1975 in the first employment discrimination taxation case, the absence of physical injury in employment discrimination,[93] was not available to the Court because *Burke* had rejected it over the strong objection of Justice Scalia.[94] The Court failed to employ another possible distinction which had been developed by the D.C. Circuit in *Sparrow v. Commissioner*.[95] Arising from the ancient distinction between damages and equitable relief, the D.C. Circuit distinction found that lost wages recovered in an employment discrimination claim were taxable equitable relief, rather than damages recovered in a common-law tort.[96]

By removing itself from the tether of the purported tax policy of §104(a)(2) and by abandoning the distinction between physical and nonphysical injuries,[97] the Court used concepts of causation to distinguish between lost wages in car crashes and employment discrimination. In *Schleier* the Court found that neither ADEA lost wages nor ADEA liquidated damages (in an amount equal to lost wages when the violation was wilful) were caused by a personal injury. The lost wages were caused either

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THE LEADING CASES AND CONCEPTS 43 (8th ed. 1997).

89. *See supra* note 71.

90. *See supra* Part II.

91. *Schleier*, 515 U.S. at 329-30.

92. *Id.*

93. *See supra* note 52 and accompanying text.

94. *See supra* note 48.

95. 949 F.2d 434 (D.C. Cir. 1991).

96. *Id.* at 437-38.

97. Ultimately, Congress, not constrained by precedent, adopted the distinction between physical and nonphysical injuries. I.R.C. § 104(a)(2) (Supp. II 1996).

by the victim's "being fired" or his "attaining the age of 60."[98] The cause of the liquidated damages was discerned from the congressional purpose in enacting the ADEA, which disclosed that (1) those damages exist to punish the defendant, and (2) to the extent that they remedy rather than punish, they compensate for injuries that are "personal rather than economic."[99]

In *Schleier*, and more forcefully in *O'Gilvie*,[100] the Court concluded that damages caused by a desire to punish the defendant are not on account of personal injury.[101] In drawing that conclusion the Court returned to the purported human capital restoration tax policy.[102] Fully admitting that "from the perspective of tax policy one might argue that noncompensatory punitive damages and, for example, compensatory lost wages are much the same thing," the Court decided nonetheless that, under the statute, they are *not* the same thing.[103] Punitive damages are not excluded, but lost wages are. Quite obviously then, the purported tax policy is just that, purported, since it cannot decide the boundary cases. Further, neither in *Schleier* nor *O'Gilvie* does the Court tell us how lost wages in car crashes are excluded while lost wages in discriminatory firing cases are not. We are left with ad hoc decisions which designate when the purported tax policy is applied and when it is not. The reason why the policy is applicable to punitive damages and lost wages in discriminatory firing cases, but is not applicable to lost wages in car crashes is not discussed.

Trying to extract a rule of general application from *Schleier* (or *O'Gilvie*) is difficult, and most courts have read *Schleier* not to state a general rule. The Tax Court, as well as the Fifth and Ninth Circuits, have read *Schleier* extremely narrowly, as a rule limited to discriminatory firing cases.[104] The Tenth Circuit ap-

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98. *Schleier*, 515 U.S. at 330.

99. Commissioner v. Schleier, 515 U.S. 323, 331 (1995). *See* John W. Dostert, Note, Commissioner v. Schleier: *Adding Insult to "Personal Injury?"*, 74 N.C. L. REV. 1641, 1676-77 (1996) ("That is, punitive damages do not bear the direct causal link with the victim's personal injury required by *Schleier*, since the amount of punitive damages awarded generally co-varies positively with the degree of the tortfeasor's conduct, not with the extent of the injury sustained.").

100. O'Gilvie v. United States, 117 S.Ct. 452 (1996).

101. *Id.* at 455.

102. *Id.* at 456.

103. *Id.* at 456.

104. Banks v. United States, 81 F.3d 874 (9th Cir. 1996); Brabson v. United States, 73 F.3d 1040 (10th Cir. 1996), *cert. denied*, 117 S.Ct. 607 (1996); Kovacs v. Commissioner, 100 T.C. 124 (1993), *aff'd*, 25 F.3d 1048 (6th Cir. 1994).

In *Taxation of Damages After Schleier—Where Are We and Where Do We Go From Here*, 15 QUINNIPIAC L. REV. 305 (1995), when considering post-*Schleier*, pre-1996 Act

plied *Schleier* more broadly in *Brabson v. United States*, finding that the requirement of a direct link between the personal injury and the loss of wages extends beyond discriminatory firing cases.[105]

The issue addressed by the Tenth Circuit in *Brabson v. United States* was whether prejudgment interest awarded in a physical injury case was excluded from taxation under § 104(a)(2).[106] Unlike postjudgment interest, which accrues from the date of judgment, prejudgment interest is a statutory right to interest on judgments measured from some date prior to judgment, such as the date when the action accrued or when the suit was filed.[107] Because claims are litigated for years, the amount of prejudgment interest can exceed the amount of other damages. Prior to *Schleier*, the Tax Court held that prejudgment interest was not excludable under § 104(a)(2) because "interest" is not "damages."[108] In *Brabson*, the Tenth Circuit agreed that prejudgment interest is not excludable, but disagreed with the Tax Court's reasoning. Rejecting the focus on labels, *Brabson* instead focused on "substance over form" and identified the nature of the prejudgment interest in *Brabson* as compensation of a victim for the lost time value of money. As such, the court concluded that "though [prejudgment interest] is related to the injury, both in terms of existence and computation, the award of prejudgment interest is not linked to the injury in the same direct way as traditional tort remedies,"[109] because time is the relevant factor, rather than the injury itself.[110] Due to this "break" in causation, the Tenth Circuit found that prejudgment interest did not satisfy the *Schleier* requirement that there be a "direct

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law, Professor Douglas A. Kahn concluded that lost wages would be excludable in physical injury cases, defamation cases and sexual harassment cases, but taxable in discrimination cases and in wrongful discharge cases. Consequently, I interpret Kahn as agreeing with the Ninth and Fifth Circuits' limitation of *Schleier* to discriminatory firing cases. The only distinction between physical injury cases, defamation cases and sexual harassment cases on the one hand, and discrimination cases and wrongful discharge cases on the other, is that a "firing" occurs in the latter. Thus, the only cases in which lost wages are excluded are those in which the victim is fired, for only then do we have the convenient expedient of attributing cause to the firing rather than to the tort. Consequently, it is hard to read *Schleier* as announcing a principle of more general application.

105. 73 F.3d 1040 (10th Cir.), *cert. denied*, 117 S.Ct. 607 (1996).

106. *Id.* at 1044.

107. *See generally id.* at 1044.

108. Kovacs v. Commissioner, 100 T.C. 124 (1993), *aff'd*, 25 F.3d 1048 (6th Cir. 1994).

109. *Brabson*, 73 F.3d at 1047.

110. *Id.*

link between the injury and the remedial relief."[111]

In *Brabson*, as in *Schleier*, the court made a naked conclusion that the causal chain between personal injury and remedy was interrupted. In *Schleier*, either the "firing" or Schleier's 60th birthday, which was the reason United Airlines fired him pursuant to its illegal mandatory retirement policy, was the interrupting element,[112] while in *Brabson* the passage of time interrupted the causal chain.[113] The passage of time severed the link to Brabson's antecedent physical personal injury from which both the tort claim arose and the attendant right to prejudgment interest arose. But *Brabson* does not articulate a principle of general application since various damages, including lost wages, can be caused by the passage of time. Lost wages are created when an injury prevents a victim from working for a time while prejudgment interest is created when an injury prevents a victim from employing the damaged capital for a time.

Three other courts which decided pre-1996 § 104(a)(2) cases limited *Schleier* to discriminatory firing cases.[114] In *Banks v. United States*,[115] a Bethlehem Steel employee recovered damages from his union because they permitted him to be fired.[116] Although it involved firing, *Banks* was not a discriminatory firing case, because Banks's employer did not fire him for a discriminatory reason. Bethlehem Steel fired Banks because it mistakenly thought that Banks had initiated a fight with another employee. Proper representation by Banks's union would have brought the error to the employer's attention and prevented Banks's termination. Damages of $134,532 were assessed against the union, an estimate of Banks's past and future

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111. *Id.*

112. *Schleier*, 515 U.S. at 330.

113. *Brabson*, 73 F.3d at 1044.

114. Knevelbaard v. Commissioner, 74 T.C.M. (CCH) 161 (1997); Dotson v. United States, 87 F.3d 682 (5th Cir. 1996); Banks v. United States, 81 F.3d 874 (9th Cir. 1996).

115. 81 F.3d 874 (9th Cir. 1996).

116. Bethlehem Steel fired Banks for fighting with a fellow employee. *Id.* at 874-75. The union grieved the termination and engineered a settlement in which Banks and the other employee quit and were paid $3000. *Id.* at 875. Banks vehemently objected, maintaining that he was the victim of another's aggression, and disputing the union's policy of not calling an employee to testify against another employee. *Id.* Banks sued Bethlehem Steel for racial discrimination, while also suing the union for breach of the duty of fair representation. *Id.* Though Bethlehem Steel won summary judgment, the district court held the union liable because Banks "was not discharged for just cause" and "would have been reinstated after an arbitration." *Id.* at 875. Moreover, the district court held that Banks had been prejudiced by the union's policy regarding employee witnesses and that the union had acted in bad faith by refusing to take the matter to arbitration. *Id.*

wages. In the tax case, the Ninth Circuit concluded that the recovery from the union was entirely excludable from income, reasoning as follows:

> *Schleier*, however, was determined by the specific limitations of the ADEA and has no application here where neither punitive damages nor back wages were offered in the settlement. Unions do not pay wages to their members, and what the Union paid in settlement here to Banks did not constitute wages. It paid damages to compensate for its unfair and arbitrary treatment of Banks, conduct that the court had found to be in bad faith and in violation of the Union's duty to fairly represent Banks. We look to the nature of the injuries that were being compensated. Banks' injuries were, as the district court found, personal injuries. Consequently, the settlement was of a tort-like cause of action and the sum paid was on account of personal injuries and by statute excluded from gross income.[117]

Judge Rymer, dissenting in *Banks*, read *Schleier* to extend beyond discriminatory firing cases.

> In this case, the parties agreed that Banks suffered a non-physical, personal injury. However, so far as I can tell, there is no indication that Banks's lost wages resulted from being out of work because of his intangible injuries. Thus, even though the Union's breach of duty may have caused intangible personal injury, that injury did not cause Banks to lose wages. He lost wages because he was discharged, and because the Union failed to grieve; the personal injury did not affect the amount of back wages recovered. As I read *Schleier*, the two must be linked in order for a recovery of lost wages to be "on account of" personal injury.[118]

The answer for this causation question depends upon what point in the chain of causation is examined. At the terminal link of the chain, both Schleier's and Banks's lost wages resulted from "being fired."[119] The reason neither could appear at his workplace was because he had been fired, and the cases are not distinguishable. Stepping back along the chain of causation, the cases are distinguishable, because Schleier's firing was due to the tortious conduct of his employer in committing age discrimination,[120] while Banks's firing was due to the tortious conduct of

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117. *Id.* at 876 (citation omitted).

118. *Id.* at 877 (Rymer, J., dissenting).

119. *Schleier*, 515 U.S. at 325 (using the passive voice to describe the firing); *Banks*, 81 F.3d at 874-75.

120. In fact, the Supreme Court in *Schleier* held that the ADEA was not tort-like under the first prong (*Burke* prong) of § 104(a)(2); consequently the conduct of Schleier's employers was not tortious in the § 104(a)(2) sense. *See Schleier*, 515 U.S. at 334. However, the Court did continue to announce the second prong, the *Schleier* causation prong, without confronting the point that its creation was unnecessary to decide the case. *Id.* at

another, specifically his union's malpractice in permitting his firing.[121] In *Banks*, the majority and dissenting opinions focus on different segments of the causal chain. The *Banks* dissent focuses on the terminal link and fails to distinguish *Schleier*, since both Banks and Schleier were fired.[122] By contrast, the *Banks* majority focuses on determining what party caused the injury, thus distinguishing *Schleier* by stating that "[u]nions do not pay wages to their members."[123]

In 1997, the Tax Court cited *Banks* when it limited *Schleier* to discriminatory firing cases. In *Knevelbaard v. Commissioner*, defendant financial institutions negligently permitted Knudsen Dairy to continue business operations although the Dairy did not pay for the milk it received during a one month period.[124] The Dairy's continued operation caused plaintiff dairy farmers who had entered into supply contracts with the Dairy to suffer emotional distress. The Tax Court described the resultant emotional distress as follows:

> When Knudsen defaulted, petitioners could not simply stop producing milk. Cows had to be milked and fed. Farmhands had to be paid. Grain had to be purchased. The farmers were operating on very slim profit margins. They faced the possibility of slaughtering their herds or pouring the milk onto the ground. For years (in some cases for more than one generation) they had relied on the regularity of the milk payments. Unexpectedly, they were faced with borrowing money, depleting their savings, and possible bankruptcy.
>
> The uncertainty of their situation produced enormous stress, which did not end on July 15, 1986. The financial problems caused by losing payment for 4 weeks' worth of milk persisted, because the loss was not repaid. Even when Knudsen began making daily payments, there was no guarantee that the money would be there from one day to the next. Petitioners had to rearrange their lives so they could be personally present when the milk was picked up, in order to see the money before they released the milk. The situation did not stabilize for months.[125]

The plaintiff dairy farmers in *Knevelbaard* were among one thousand milk producers who filed a twelve count complaint alleging fraud, misrepresentation, interference with contract and

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336. Thus, in considering the Schleier prong, we necessarily put aside the question of whether the cause of action is tort-like, because that is encompassed in the *Burke* prong.

121. *See Banks*, 81 F.3d at 875.

122. *See Banks*, 81 F.3d at 876; *Schleier*, 515 U.S. at 325.

123. *Banks*, 81 F.3d at 876.

124. 74 T.C.M. (CCH) 161 (1997).

125. *See id.* at 162-63.

negligent infliction of emotional distress.[126] The case settled and nearly all of the settlement proceeds were allocated to the emotional distress claim.[127] The value of the milk not paid for by Knudsen Dairy was thirty million dollars, and the defendant financial institutions paid a twenty million dollar settlement.[128] The settlement proceeds appeared to be distributed among plaintiffs' class in shares approximately proportionate to milk payments owed them by Knudsen Dairy.[129]

When the Tax Court excluded these settlement payments from income, it noted three relevant points. First, the plaintiffs' claims against the defendant financial institutions were separate and apart from their claims against Knudsen Dairy.[130] Although the plaintiffs undoubtedly suffered emotional harm at Knudsen Diary's hands from the default itself, the plaintiffs alleged additional and separate harm due to the defendant financial institutions' act of improperly financing the Dairy's continued operation.[131] Second, depositions and answers to interrogatories by plaintiff class members disclosed "specific emotional harm," although no evidence of expenses for medical or psychiatric care existed.[132] Third, although the damages were proportionate to defaulted milk payments, that did not mean that they were not received for emotional distress, as awards for personal injury may be measured by lost income and still be excluded under § 104(a)(2).[133] The court, citing *Banks*, summed up its case by declaring "banks don't buy milk."[134]

A Fifth Circuit decision about the tax consequences of a settlement of class action ERISA litigation with Continental Can presented interesting questions about the retroactivity of Supreme Court decisions and application of § 104(a)(2).[135] In the ERISA case, former employees of Continental Can alleged that it fired them to avoid pension liability.[136] At the time of that suit, it was not clear whether ERISA provided only equitable rights and remedies, or whether it also provided tort-type rights

126. *See id.* at 163.
127. *See id.* at 165.
128. *See id.* at 162, 165.
129. *See id.* at 166.
130. *See id.* at 163.
131. *See id.* at 168.
132. *Id.* at 168.
133. *See id.* at 169.
134. *Id.* at 168 n.8.
135. *See* Dotson v. United States, 87 F.3d 682 (5th Cir. 1996).
136. *See id.* at 684.

such as compensatory and punitive damages.[137] The ERISA case settled under supervision of a special master, who resolved the question in favor of a broader measure of damages and awarded plaintiffs damages for non-pecuniary losses including impairment of earnings ability, mental anguish, emotional distress and dignitary loss.[138] Though the Supreme Court later decided in *Mertens v. Hewitt Assoc.*[139] that ERISA did not permit recovery of tort-type damages but authorized only equitable relief, the Continental Can settlement had been completed by that time.[140]

Because Continental Can had withheld wages and income taxes from the settlement payments, some members of the class sought refunds of tax in federal district courts.[141] In the first tax case decided, the District Court for the Southern District of Texas held that the *Burke* prong of § 104(a)(2) was not met, because the narrow scope of remedies under ERISA, as construed by the Supreme Court in *Mertens,* makes the ERISA claim non-tort-like.[142] The Fifth Circuit vacated and remanded, concluding that the *Burke* prong should have been evaluated on the basis of the substantive ERISA law when the settlement was reached. "The characterization of damages received is not affected by the shifting sands of statutory interpretation after a bona fide settlement has been reached or a damage award rendered."[143]

Holding that the *Burke* prong was satisfied, the Fifth Circuit next addressed the *Schleier* prong, and determined that the settlement had compensated plaintiffs for both (1) "the stress, the stigma and the self-doubt that comes with losing a well-paid job," and (2) lost wages.[144] The court held the damages for stress, stigma and self-doubt excludable, but the lost wages were denied exclusion. According to the court, *Schleier* "mandates different treatment of back wages received pursuant to a discriminatory firing case. . . . The personal injuries themselves, as the Supreme Court distinguishes them, did not give rise to the loss of wages."[145] The court remanded for the district court to determine the amount of back wages. The *Dotson* court thereby read *Schleier* in the most narrow sense by construing the rule to apply only to back wages in discriminatory firing cases, for it

137. *Id.* at 686.
138. *See id.* at 688.
139. 508 U.S. 248 (1993).
140. *See Dotson,* 87 F.3d at 686.
141. *See id.* at 689.
142. *See id.* at 684.
143. *See id.* at 686.
144. *Id.* at 689.
145. *Id.*

did not apply the causal requirement to any of the other elements of damage recovered: impairment of earnings ability, mental anguish, emotional distress or dignitary loss.

A dissent in *Dotson*[146] asserted that the *Burke* prong had not been met because *Mertens* had to "be given full retroactive effect in all cases still open on direct review as to all events regardless of whether such events predate or postdate our announcement of the rule."[147] Later, the Fourth Circuit[148] agreed with the *Dotson* dissent, as did a federal district court in Ohio.[149] By deciding on the *Burke* prong, those cases obviated consideration of the *Schleier* prong.

IV. POST-*SCHLEIER*, POST-1996 ACT—MORE QUESTIONS OF CAUSATION

Deciding whether *Schleier* articulates a causation requirement of general application or is a decision limited to lost wages in a discriminatory firing case remains a point of indeterminacy after the 1996 Act, for neither the 1996 Act nor its legislative history settle the tax policy underlying § 104(a)(2). The Act authoritatively denies exclusion for lost wages in nonphysical injury cases,[150] but the announced reason for the rule, like the court cases adopting the distinction under "old" law, offers no principle for the distinction.

We are told that lost wages and lost profits are taxable in nonphysical injury cases because they "would otherwise be included in taxable income,"[151] but so would lost wages and lost profits in physical injury cases. Is the unstated reason that we offer our kindness only to victims of physical tortious injury, or should we read the legislative history as fully consistent with the human capital restoration theory, thereby making taxable *all* substitutes for taxable income? That is, how should we read the 1996 Act's silence as to physical injury lost wages? Under the 1996 Act, are physical injury lost wages taxable under a pure human capital restoration policy, or does the impure theory continue to exclude physical injury lost wages owing to kindness to physical injury victims?[152]

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146. *Id.* at 690-94.

147. *Id.*

148. Hemelt v. United States, 122 F.3d 204, 208 (4th Cir. 1997), *aff'g* 957 F. Supp. 562 (D. Md. 1996) (citation omitted).

149. Gerbec v. United States, 957 F. Supp. 122 (S.D. Ohio 1997).

150. *See supra* note 86.

151. *See supra* note 86 and accompanying text.

152. This interpretative indeterminacy rekindles a debate following a 1989 amend-

For instance, suppose a workplace is sexually hostile because of words, gestures and pictures. Further, suppose that the victim of the sexual harassment sensibly absents herself from a workplace in which she is sexually harassed and recovers: (1) damages for lost wages; (2) damages for emotional distress due to the humiliation and stigmatization attendant to harassment; and (3) punitive damages. None of the three types of damages is excludable. Express language of the 1996 Act (and the *O'Gilvie* decision for pre-1996 Act cases) denies exclusion of the punitive damages.[153] Lost wages and compensatory damages for emotional distress are denied exclusion, because there is no physical injury.[154]

Suppose we have an offensive touching in addition to a sexually hostile workplace; is there a physical injury? Several possibilities exist. Is any offensive touching a physical injury for these purposes, or must there be (1) some physical manifestation of injury, like a bruise or a breaking of the skin, (2) some injury requiring medical care, or (3) a period of convalescence?

The 1996 Act's legislative history provides:

> If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. 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

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ment to § 104(a)(2), which provided that the exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." I.R.C. § 104 note (1994) (Amendments). The 1989 amendment thereby expressly removed punitive damages from the § 104(a)(2) exclusion when those damages were recovered in a post-1989 case that did not involve physical injury or physical sickness. Courts, however, disagreed on the state of pre-amendment law, which the Supreme Court did not resolve until *O'Gilvie v. United States*, 117 S.Ct. 452 (1996). Prior to *O'Gilvie*, there was debate as to whether the 1989 amendment's exclusion from the § 104(a)(2) exclusion of post-1989 punitive damages that were not connected to physical injury or physical sickness implied that post-1989 punitive damages that were connected to physical sickness were included in the exclusion. The question was whether the 1989 amendment had both an "inclusionary component" as well as an "exclusionary component." *See generally* Kahn, *supra* note 18, at 367. Similarly, we might ask whether the fact that the 1996 Act excludes lost wages in nonphysical injury cases from the exclusion on human capital theory grounds might then imply an inclusion in the exclusion for lost wages in physical injury cases.

153. I.R.C. § 104(a)(2) (Supp. II 1996) (referring to those damages "other than punitive damages").

154. *See supra* note 50 and accompanying text.

gross income.[155]

Suppose we have a physical injury, we now must face the causation question. From *Schleier*, it appears that we focus on the reason why the victim absented herself from the workplace. Schleier's reason for not appearing at the workplace was that he was fired, and being fired is not a personal injury;[156] even if one is fired for an impermissible reason like age discrimination, this is an immaculate firing.[157] However, if a car crash victim suffers a broken leg which prevents her from going to work, her reason for not appearing at the workplace is a personal injury. Again, this merely restates the opinion of the *Schleier* Court that the firing interrupted the causal consequences following from the antecedent discriminatory act, and the *Schleier* rule must still be applied.[158]

Why is our hypothetical sexual harassment victim who also suffered an offensive touching not appearing at the workplace? Suppose it is because of the humiliation of a sexually hostile work environment. Do we say that humiliation and emotional distress are a closer cause of the not-appearing and, since by statute emotional distress is not a physical injury,[159] lost wages are not excluded from taxation? Or, does the presence of *any* physical injury mean that all damages are excluded? That is, is the physical injury requirement a *Burke*-type requirement where all damages are excludable once present, or a *Schleier*-type requirement where we must decide whether each element of damages is caused by physical injury? The 1996 Act legislative history suggests that the physical injury requirement is a *Burke*-type requirement, as it expressly provides that a spousal loss of consortium recovery by the spouse who is not physically injured nonetheless flows from the physical injury of the physi-

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155. H.R. CONF. REP. No. 104-737, at 301 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793.

156. *Schleier*, 515 U.S. at 330.

157. *Leading Cases*, 109 HARV. L. REV. 111, 324 n.1633 (1995).

> The text of the opinion suggests that the Court focused on the fact that termination, lawful or otherwise, automatically implies a loss of wages. If the injury itself consists of lost wages, then the injury cannot independently cause lost wages. Apart from this hint, however, the Court unfortunately leaves the reader to speculate about why being fired because of one's age is not a personal injury.

Id. See also Manns, *supra* note 48, at 123.

158. *See* Manns, *supra* note 48, at 125-27.

159. I.R.C. § 104(a) (Supp. II 1996) ("For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.").

cally injured spouse.[160]

If the physical injury requirement is a *Burke*-type requirement, then the definition of physical injury will decide our hypothetical. The determinative question will be the factual extent of the victim's injury measured against the legal extent of injury contained in the physical injury requirement.

If the physical injury requirement is a *Schleier*-type requirement, then the physical injury will have to meet the legal test of "physical injury" and, in addition, be regarded as the cause of damages in the *Schleier* sense. Suppose the reason that the sexual harassment victim absented herself from the workplace was an offensive touching that did not give rise to any physical manifestation of injury. For instance, imagine that the victim who endured an environment which was sexually hostile because of words, pictures and gestures decided she could no longer bear such environment when someone grabbed her;[161] did that physical injury cause the loss of wages? To answer this question, we must confront whether the *Schleier* prong applies to the new physical injury requirement and determine how it would fit within a theory that explains the application of § 104(a)(2).

V. DEVELOPING A THEORY THAT EXPLAINS THE CASES

The purported tax policy of tax-free human capital restoration, as applied by the Service and implied by the courts, fails of its essential purpose to explain the results of cases. The Service, as tax administrator, has applied an exclusion for all lost wages in physical injury cases by not litigating the exclusion.[162] The Supreme Court has admitted, or perhaps assumed, the anomalous exclusion of lost wages in car crash cases. Two principled solutions present themselves: (1) conform the results with the theory (that is, change the result in the boundary cases), or (2) develop a coherent theory to explain the boundary cases.

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160. *See supra* note 86 and accompanying text.

161. A preview of the Supreme Court case of *Oncale v. Sundowner Offshore Services*, 188 S.Ct. 998 (1998), noted that "[o]ther cases have arisen in workplaces where crude sexual jokes and grabbing of co-workers is surprisingly common." David D. Savage, *Workplace Bias to the Fore*, A.B.A. J., Oct. 1997, at 40, 42.

162. Compare Rev. Rul. 72-341, 1972-2 C.B. 32 with Rev. Rul. 61-1, 1961-1 C.B. 14, and Rev. Rul. 85-97, 1985-2 C.B. 50.

A. *A Pure Policy of Tax-Free Human Capital Restoration*

Divining a pure policy, pure in the sense of tax neutrality, for tax-free human capital restoration has been attempted in the literature, but not the courts. The Supreme Court recognizes an "anomaly," but has not tried to fix it. Consequently, the following is of academic interest only except in the unlikely, but possible, event the Court retreats from its car crash counter-example in *Schleier*.[163]

Tax neutrality starts with the major premise that recoveries for things not taxed, like spousal consortium, enjoyment of life or freedom from pain and suffering, should not be taxed once they are lost; but recoveries for things that would have been taxed absent the accident, like future earnings, should be taxed. Conforming a theory to that premise becomes difficult because the tort law, which generates the damages, usually is indifferent to such distinction.[164]

For most of the history of the exclusion, we can surmise that a majority of tort victims were victims of physical injury and recovered undifferentiated verdicts or settlements. The § 104(a)(2) exclusion applied to the entire recovery from a combination of administrative convenience (in not wanting either to differentiate damages or to calculate basis in human capital) and kindness to the victims of physical injury. But as Part II shows, with the increased frequency of dignitary torts, particularly employment discrimination, courts wanted to treat those recoveries differently from car crashes, although both were personal injury torts and both gave rise to recoveries of things that would have been taxable had the tort not occurred.[165] Commentators shared the desire to distinguish employment discrimination and car crashes but, unlike the courts, sought theoretical justification.

Professor Stephan suggested that, from a theoretical perspective, earnings replacement damages should be bifurcated into those affecting (1) ability to earn, and (2) ability to enjoy, with the former taxable and the latter not. He would create a rule of thumb that recoveries for injuries affecting work expec-

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163. "On rare occasions, however, the Supreme Court has spurned glosses of similar venerability in favor of rules that conform more closely to a tax on net economic income." Stephan, *supra* note 12, at 1416.

164. *See* Stephan, *supra* note 12, at 1413. Yet, while tort victims often recover undifferentiated amounts not allocated among different elements of damage, that did not stop the Supreme Court in *Schleier* from adopting a causation rule entirely dependent upon separate consideration of each element of damages.

165. *See supra* notes 30-42 and accompanying text.

tancy would be taxable and recoveries for injuries affecting life expectancy would not.[166] From a pragmatic perspective, Stephan noted favorably that the physical/nonphysical distinction under pre-1996 law, which had not been that negated by the Supreme Court, approximated his theoretical rule that damages to endowment human capital, existing in all persons from birth, are not taxable, while damages to personalized human capital, created by lifetime changes like education and training, are taxable.[167] Stephan criticized the personal/business distinction, the nascent form of the economic injuries argument more forcefully developed in employment discrimination cases after Stephan wrote, as utterly devoid of rationality because it turned on things like pleading rules.[168]

Professor Kahn argued that the exclusion of lost wages is not necessarily inconsistent with a human capital theory.[169] In physical injury cases, lost wages are used to estimate the overall quantum of the injury, rather than serving solely to replace income that would have been earned because few other devices exist which can be used to quantify the injury, and the precision of lost income's mathematical attributes lends respectability to the estimation. Thus, in the parlance of the tort lawyer, lost wages are used as one of many factors to arrive at a general damages amount, rather than being recovered as special damages in actual substitution for lost income.[170] That theoretical justification, coupled with administrative convenience in not having to allocate verdicts and settlements, leads Kahn to exclude lost wages recoveries in all physical injury cases.[171]

For nonphysical injury cases, Kahn argues, the theoretical justification fades because nonphysical injuries are more closely identified with commercial ventures, so there is "less justification to treat them as lying beyond the commercial sphere of the income tax system" and apparently more reason to believe that they are recovered as special damages rather than general dam-

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166. *See* Stephan, *supra* note 12, at 1389-91, 1397.

167. *Id.* at 1413.

168. *Id.* at 1414-15.

169. *See* Kahn, *supra* note 18, at 344-45, 352-53.

170. RESTATEMENT (SECOND) OF TORTS § 904 (1979) (distinguishing general and special damages: "general damages" are compensatory damages for a harm so frequently resulting from the tort that is the basis of the action that the existence of the damages is normally to be anticipated and hence need not be alleged in order to be proved; "special damages" are compensatory damages for a harm other than one for which general damages are given).

171. *See* Kahn, *supra* note 18, at 355.

ages.[172] Consequently, Kahn endorsed the physical/nonphysical distinction as a workable substitute for his preferred distinction of injuries associated primarily with commercial activities and those associated primarily with noncommercial activities, because of the administrative problems in applying a commercial/noncommercial distinction.[173]

Professor Kahn's physical/nonphysical approach essentially was adopted by Congress in the 1996 Act,[174] but now that the physical injury requirement has been codified, it is appropriate to focus on the anomalous exclusion of lost wages in physical injury cases and decide how a tax neutral policy of human capital restoration would treat such lost wages. Kahn argues that the human capital theory neither supports nor opposes exclusion of lost wages in physical injury cases.[175] However, the theoretical support for excluding them is based upon the independent justifications of (1) normal use of lost wages in physical injury cases as general damages, rather than as special damages, and (2) administrative convenience.[176]

It appears that the two justifications collapse into one of administrative convenience. Kahn agrees that lost wages in physical injury cases *should* be taxable when the lost wages damages are identified separately. Kahn nonetheless rejects that exception to the general rule of exclusion for physical injury cases, because victims should not be taxed on the happenstance of whether their lost wages were identified separately in a settlement or judgment. If they were, only the unwary would permit such an identification.[177] That overvalues administrative convenience, particularly in light of the Supreme Court decision in *O'Gilvie* which devalued administrative convenience as an ex-

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172. *Id.* at 357.

173. The administrative problems with that distinction are chronicled in the Tax Court's short-lived attempt to distinguish commercial and noncommercial libel, which Stephan aptly called "devoid of underlying rationality." Stephan, *supra* note 12, at 1414. Two years after Stephan wrote his article, the Tax Court abandoned its attempt to distinguish personal and professional reputation. Threlkeld v. Commissioner, 87 T.C. 1294, 1301 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

174. *See supra* note 7.

175. *See* Kahn, *supra* note 18, at 344-45.

176. *See* Kahn, *supra* note 18, at 353-55.

177. *Id.* Nonetheless, the Service applies such a rule in a related context. In Revenue Ruling 75-232, 1975-1 C.B. 94, the Service concluded that the portion of an excludable personal injury settlement specifically allocated to future medical expenses offsets, and thereby denies a medical expense deduction for future medical expenses. Had the medical expenses not been allocated, all future medical expenses would be deductible as such. Niles v. United States, 710 F.2d 1391 (9th Cir. 1983).

ception to pure tax theory in § 104(a)(2) cases.[178] In *Schleier*, the Court adopted a damages-focused element-by-element test of causation, without regard to how difficult the allocation questions would be when employment discrimination victims recovered undifferentiated judgments or settlements.[179] Indeed, even if it hadn't been rejected by the Court, administrative convenience is not served by blanket rules in damages taxation cases; allocation issues are endemic to the law of damages taxation. Litigants rarely assert solely one claim or one element of damages, and the "in-lieu-of" test itself is a damages-element-focused test.

Thus, it appears that administrative convenience does not overcome the need to consider normatively the recovery of lost wages within the human capital theory. I argue that under the pure form of the human capital restoration policy, consideration of the heretofore unitary consideration of "lost wages" calls for a sharp distinction between damages for impaired earning capacity and damages for lost wages for convalescent time. The former should be treated as recovery of principal and the latter as a taxable current income. Distinguishing impaired earning capacity and convalescent lost wages provides three benefits: it (1) places the human capital restoration theory within the larger principal/income framework of tax law; (2) makes the accident tax neutral; and (3) mirrors a damages allocation sourced in the substantive tort law.

1. *Reconciling Human Capital Restoration Theory and the Principal/Income Framework.* The human capital restoration theory, and indeed much of income taxation, is based on the efficacy of distinguishing income from principal.[180] Earning capacity is considered principal because it is a store of value from which

178. *O'Gilvie*, 117 S.Ct. at 457 (arguing that even if administrative convenience explains the anomalous exclusion of lost wages by not requiring an allocation among the compensatory elements of a settlement, the administrative convenience of not having to distinguish punitive from compensatory damages does not trump the tax theoretical need to treat punitive damages as outside the § 104(a)(2) exclusion because they do not restore a loss).

179. *Schleier*, 515 U.S. at 330.

180. The principal/income distinction itself is artificial, for principal merely is the net present value of the income expected to be generated in the future. For instance, apple trees are principal and apple crops are income, yet the apple tree's value is simply the sum of value of expected future apple crops, discounted at an interest rate. Nonetheless, the income tax system (particularly in its regimes of capital gains and basic recovery) and the human capital theory depend upon maintaining the distinction.

income periodically issues, as apples issue from apple trees.[181] When principal (sometimes called a "capital asset" in tax parlance) is converted into cash, taxable income results unless the amount of cash is less than the adjusted tax basis in the principal.[182] Thus, when human capital is converted into a damages payment and the "in-lieu-of" test is applied, taxable income results unless the basis in human capital is greater than the amount of damages recovered. It is extremely difficult to calculate adjusted basis in human capital;[183] distinguishing between impaired earning capacity and convalescent lost wages would obviate this problematic basis calculation. If the lost wages are for convalescence, they are entirely includible in income without basis recovery, as is the case for all taxable wages, while if the lost wages are for impaired earning capacity, they are excludable from income (without need to calculate basis or basis carryovers).

2. *Creating Tax Neutrality.* Distinguishing between impaired earning capacity and convalescent lost wages places the victim status quo ante tax-wise while making the accident a tax neutral event. Prior to the accident, the victim owned her earning capacity worth X (although prior to the accident there had been no need to calculate its worth), and expected to employ that earning capacity in the labor markets to generate current labor income. Following the accident and damages recovery, she can employ the now monetized capital of X in the financial markets to earn current financial income. The income streams, labor and financial, are equal because tort law, which generates the damages amount, calculates X in a manner to make them equal.[184]

We can analogize to apples and apple trees. If a tortfeasor illegally harvests and keeps an orchardist's crop, the orchardist has suffered a loss of income; damages paid are "in-lieu-of" cur-

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181. Eisner v. Macomber, 252 U.S. 189 (1920) (holding unconstitutional the taxation of a stock dividend as income).

> The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time.

Id. at 206.

182. I.R.C. § 1001 (1994).

183. Kahn, *supra* note 18, at 344 (explaining that the possibility that an individual might have a basis in personal rights is remote, but even if theoretically justified, problems in determining the amount are "mind-boggling.").

184. RESTATEMENT (SECOND) OF TORTS §§ 913A, 924 cmts. c, d (1979).

rent income and are taxable in full. If a tortfeasor cuts down the trees in the orchard, the orchardist suffers a loss of principal. Under the "in-lieu-of" test and the broad sweep of the definition of income, the orchardist has income to the extent the damages recovery exceeds his basis in the apple trees. Yet, an exclusion exists in § 1033 to permit the orchardist to replace his trees tax-free.[185] Absent the exclusion, the orchardist might not have enough capital to replace all his trees; he would be short by the amount of the tax. Section 1033 permits the orchardist to take the monetized value of his orchard, undiminished by taxes, and completely replace his orchard, from which he will earn income by selling apples in the future. Similarly, the § 104(a)(2) exclusion attempts to permit an accident victim to substitute financial capital completely to replace her earning capacity capital, from which she will earn an equal—and equally taxable—stream of financial income.

Perfect tax neutrality between pre- and post-accident positions requires that the amount of damages, which is set by tort law, be the arithmetic sum of future earnings *not* reduced for income taxes discounted at a "reasonable rate."[186] Neutrality requires equality between the financial income stream and the labor income it replaces. If, in calculating the lump-sum award, the labor income stream is decreased for taxes, as sometimes is done in tort law, then the resulting financial income stream will be too small, because the financial income stream itself will still be subject to tax.[187] Had the accident not occurred, the future la-

185. Section 1033 usually is called a deferral provision rather than an exclusion because it defers taxation on the damages recovery until the replaced trees are sold or exchanged. I.R.C. § 1033 (1994). Section 1033 uses a carry-over basis in the replacement trees to ensure that taxation will occur at disposition of the replacement trees. But it is an exclusion in the same sense as the § 104(a)(2) exclusion in that both permit the tax-free restoration of tortiously damaged capital. The symmetry with § 104(a)(2) would be complete if the personal injury victim took a carry-over basis in the damages payment. That is, we would reassign the personal injury victim's basis in her destroyed human capital as her basis in the damages recovery that restores the damaged human capital. Because the damages recovery received by the victim is in the form of money, she is actually in a better position than the orchardist who receives new trees. When the orchardist disposes of his replacement trees, he will have to pay tax on the income he receives. However, the personal injury victim can dispose of her replacement principal tax-free. This phenomenon occurs because one's basis in cash equals the face value of the cash. Thus, carry-over basis in the damages payment would have to equal the damages payment itself, and upon disposal of the replacement principal, the victim would receive no income that exceeds her basis. The personal injury victim is therefore better off, because she can dispose of her replacement principal tax-free while the orchardist will pay tax when he disposes of his replacement trees. *See* Dodge, *supra* note 18, at 155-60.

186. RESTATEMENT (SECOND) OF TORTS § 913A (1979).

187. Rev. Rul. 65-29, 1965-1 C.B. 59. (stating that "[i]ncome realized from the in-

bor earnings would have been taxable, but the future financial return on the substitutionary financial capital will taxable as well. Lastly, perfect neutrality requires that the substitutionary financial capital be completely exhausted at the end of the victim's working life, as would her human capital would have been had no accident occurred and she had worked. The use in tort law of the economic concept of discounted cash flows ensures that this will occur.[188]

But while tax neutrality requires exclusion for damages for impaired earning capacity, it requires inclusion for convalescent lost wages. Here, we would distinguish typical car crash victims from surgeons who lose fingers. In a typical car crash, the victim suffers lost wages because of convalescence, but suffers no impaired future income as her career earnings are not affected; she stays out of work for some time, returns to her normal job, and progresses through her career as she would have absent the period of convalescence. By contrast, a surgeon who loses fingers incurs impaired future earnings; she no longer can practice as a surgeon and she loses her remaining income from a career in surgery. The difference between her income from a surgeon's career and what she can earn in mitigation, such as in another medical specialty, is the measure of her impaired future earnings. The surgeon thereby has suffered a destruction of human capital, for it is human capital (her education and training as a surgeon) that permits the earning of future income. Her acquisition of human capital when she acquired her medical education and training was not taxed, for after she finished her training, she was not taxed for being "richer" as a trained surgeon. Taxation awaits the returns from human capital, when the trained surgeon earns fees. Similarly, if the surgeon "lost" human capital by deciding to stop working, she is not taxed for "consuming

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vestment of a lump sum payment representing the discounted present value of a damage award for personal injury is not excludable . . . ."). If the defendant pays the damages periodically rather than as a lump sum, then the financial income stream, which is the implicit interest portion of the periodic payments, escapes taxation to the victim under the second parenthetical of § 104(a)(2). That is not anomalous to tax-neutrality, because the defendant will be taxed on the interest income.

188. RESTATEMENT (SECOND) OF TORTS § 913A (1979).

> The reduction process should be followed separately for each separate item of future loss. It is complicated and may appropriately be explained by the utilization of present-worth tables, indicating the present worth of a dollar, paid at regular intervals over a designated period of time and calculated at a particular interest rate.

Id. Both a discounted cash flow model and an annuity model will produce streams of income where all principal is exhausted upon final payment (much like a typical home mortgage).

her human capital," nor is she permitted a loss. Thus, normal additions and deletions to the store of human capital are not taxed.[189] If we intend to limit § 104(a)(2)'s exclusion to tortiously destroyed human capital, the exclusion for lost wages should be limited to impaired future earnings. The loss of the capacity to earn income is lost human capital. Though the current return on human capital normally is taxed as income, lost wages for a period of convalescence is a lost current return, and should not be excluded under the human capital restoration policy.

3. *Resembling Substantive Tort Law Damages Allocation.* Distinguishing impaired earning capacity and convalescent lost wages for § 104(a)(2) purposes would of course raise allocation issues, but allocation issues nearly always are raised in damages recovery cases, for litigants rarely assert a single claim or single element of damages. Given that allocations must occur in these cases on a near universal basis, this allocation between damages for impaired earning capacity and damages for lost wages for convalescent time is particularly easy to implement because tort law, which generates the damages, already distinguishes between them.[190] Nevertheless, a theory distinguishing impaired earning capacity and convalescent lost wages would require either statutory amendment or retreat by the Supreme Court from dicta repeated in three recent cases.

No court has been presented the opportunity to distinguish lost earning capacity and lost current wages.[191] In fact, no court has decided how to fit "lost wages" of either or both kinds in a

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189. *See* Dodge, *supra* note 18, at 959.

190. RESTATEMENT (SECOND) OF TORTS § 924 cmt. c (1979).

> A person physically harmed by the tort of another is entitled to receive as damages the amount of earnings he has been prevented from acquiring up to the time of the trial. This amount is the difference between what he probably could have earned but for the harm and any lesser sum that he actually earned in any employment or, if he failed to avail himself of opportunities, the amount that he probably could have earned in work for which he was fitted, up to the time of trial.

Id.; RESTATEMENT (SECOND) OF TORTS § 924 cmt. d (1979).

> The extent of future harm to the earning capacity of the injured person is measured by the difference, viewed as of the time of trial, between the value of the plaintiff's services as they will be in view of the harm and as they would have been had there been no harm. This difference is the resultant derived from reducing to present value the anticipated losses of earnings during the expected working period that the plaintiff would have had during the remainder of his prospective life, but for the defendant's act.

RESTATEMENT (SECOND) OF TORTS § 924 cmt. d (1979).

191. *See generally* Kahn, *supra* note 18, at 353-54; Dodge, *supra* note 18, at 165-66.

physical injury case. Physical injury cases are not litigated; they are discussed in case law only as contrasts to the nonphysical injury cases at bar, as done in *Schleier*.

> Assume that a taxpayer is in an automobile accident, is injured and as a result of that injury suffers (1) medical expenses; (2) lost wages; and (3) pain, suffering and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for $30,000 (and if the taxpayer has not previously deducted her medical expenses, see § 104(a)), the entire $30,000 would be excludable under § 104(a)(2). . . . [T]he recovery for lost wages is also excludable as being "on account of personal injuries," as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries. *See, e.g.*, Threlkeld v. Commissioner, 87 T.C. 1294, 1300, (1986) (hypothetical surgeon who loses finger through tortious conduct may exclude any recovery for lost wages because "[t]his injury . . . will also undoubtedly cause special damages including loss of future income"), *aff'd*, 848 F.2d 81 (CA6 1988).[192]

I argue that there is a difference between the hypothetical surgeon in *Threlkeld* and the car crash victim in *Schleier*. While the surgeon certainly suffered impaired future income, as the Tax Court's hypothetical clearly demonstrated, the car crash victim in *Schleier* probably did not. It is of course possible that a car crash victim could suffer impaired future income, for instance if the driver was a surgeon who lost fingers, but car crash victims normally do not suffer impaired future income. The *Schleier* court's hypothetical did not limit its conclusion to impaired future income, although the referenced hypothetical in *Threlkeld* arguably did. Consequently, the door is open for the Supreme Court to clarify its dicta in *Schleier* and limit the exclusion to impaired future income. Given that the *Schleier* Court abandoned the strong dicta of *Burke*,[193] it is conceivable that the Court could hold that the 104(a)(2) exclusion limited to impaired future income even in physical injury cases.

B. *A Coherent Theory to Explain the Boundary Cases*

Because neither the courts nor Congress (nor apparently the Service) has distinguished convalescent lost wages from impaired future earnings, perhaps the exclusion really does rest upon a policy other than the tax neutral restoration of human capital. The boundary cases in applying § 104(a)(2) always occur when the tort victim and tortfeasor have an economic relation-

192. *Schleier*, 515 U.S. at 329-30.
193. *See supra* note 66.

ship prior to the arisal of the tort claim.[194] This suggests that the real tax policy underlying § 104(a)(2) is kindness to victims, which dissipates when the victim and tortfeasor have a pre-existing economic relationship.

Kindness dissipates because income taxation takes special interest in the exchange of contract rights and strains to ensure that exchanges of contract rights are not "hidden" as tort compensation.[195] Here, tax law diverges from the substantive law of contract and torts, for taxation demands the distinction, yet contract and tort law converge.[196] While cases never articulate the kindness rationale, or any other principled distinction to differentiate why economic damages are excluded in one case but not in another, we can observe that in nearly all circumstances when "economic damages" are denied exclusion, the victim and tortfeasor were "economically related."[197]

With kindness to tort victims as the policy of § 104(a)(2), we exclude all damages, except punitive damages, recovered by physically injured victims when tortfeasor and victim are not economically-related; but, when the victim and tortfeasor have a pre-existing economic relationship, we apply the element-by-element causation test of *Schleier*. *Schleier* acknowledged that "the intangible harms of discrimination can constitute personal injury, and that compensation for such harms may be excludable under § 104(a)(2),"[198] meaning that compensatory damages for emotional distress caused by an "economically-related" tortious employer would be excludable (until effectiveness of the 1996

194. *See supra* note 31.

195. *Cf. Maxwell v. Commissioner*, 95 T.C. 107 (1990), in which the Tax Court held that a corporate officer could assert a tort claim against, and recover excludable personal injury damages from, his controlled corporation, although the court must carefully scrutinize the transaction because the parties were not at arm's length.

196. *See generally* GRANT GILMORE, THE DEATH OF CONTRACT (1974) (discussing the changes that have taken place in contract law which support the hypothesis that contract law has been reabsorbed into the mainstream of tort law).

197. The Service, as tax administrator, has applied an exclusion for all lost wages in physical injury cases by not litigating the exclusion, whether or not the damages are economic in nature. Rev. Rul. 72-341, 1972-2 C.B. 32. By contrast, the Service attempts to make a personal/economic distinction in nonphysical injury cases, an overwhelming majority of which involve victims who were employed by the tortfeasors. For a list of some of the many employment discrimination cases, see *infra* Part II. Other pre-existing-economic-relation cases include situations where (1) the tortfeasors bought the victim's business, Fono v. Commissioner, 79 T.C. 680 (1982); (2) the tortfeasor supplied services to the victim, Baca v. Commissioner, 60 T.C.M. 1433 (1990); and (3) the tortfeasor and victim were involved in a real estate sale and related litigation, Threlkeld v. Commissioner, 87 T.C. 1294, 1296 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

198. *Schleier*, 515 U.S. at 332 n.6.

Act's physical injury requirement).[199] Similarly, since the 1996 Act's physical injury requirement came into effect, physical injury damages received from an economically-related tortfeasor can be excluded.

The causation rule of *Schleier* appears to presume that, when a pre-existing economic relationship exists, damages are caused by the relationship's pre-existing economic rights, rather than by tort claims, unless a direct link is shown between the injury (now a physical injury) and the damages.[200] The few post-*Schleier* cases are consistent with that reading. Both in *Banks* and *Knevelbaard*, the shorthand rationales used by the courts graphically demonstrate the point; in *Banks*, "Unions do not pay wages,"[201] and in *Knevelbaard*, "banks do not buy milk."[202] The central element in each description is the absence of any pre-existing economic relationship. Without that relationship, we know that the damages calculations, whether made with regard to lost wages or unpaid-for milk, were made to approximate tortiously caused harm and were not made to satisfy pre-existing contract rights.

When describing the proper boundary of § 104(a)(2), Professor Kahn argued that the distinction should be between injuries associated primarily with commercial activities and those primarily associated with noncommercial activities, but rejected it in favor of a physical/nonphysical distinction because of the administrative problems in applying a commercial/noncommercial distinction.[203] The administrative problems with that distinction are chronicled in the Tax Court's short-lived attempt to distinguish personal and business libel,[204] but administrative convenience is not the only difficulty. As the Tax Court found out when trying to apply that distinction, persons do not cleave easily into commercial and noncommercial halves or into personal and business halves.[205]

Conversely, § 104(a)(2) cases easily cleave into those which involve and do not involve economically-related persons, a distinction which serves two aims: (1) fitting within the kindness rationale, since the anomalous exclusion of lost wages cannot be

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199. *See supra* note 82 and accompanying text.

200. Brabson v. United States, 73 F.3d 1040, 1047 (10th Cir. 1996), *cert. denied*, 117 S.Ct. 607 (1996).

201. *Banks*, 81 F.3d at 876.

202. *Knevelbaard*, 74 T.C.M. (CCH) at 168 n.8.

203. *See* Kahn, *supra* note 18, at 357-58.

204. *See supra* note 12 and accompanying text.

205. *See supra* notes 50-56 and accompanying text.

adequately explained by the human capital theory; and (2) preserving the tax system's signal focus on the exchange of contractual rights. We are kind to tort victims, but much as *Burke* defined "tort" for tax purposes as a cause of action for which broad remedies are available, we define "tort victims for tax purposes" as those (1) victims of not-economically-related persons or (2) victims of economically-related persons who have overcome the presumption that their recovery was rooted in the economic relationship.

Let's return to our hypothetical sexual harassment victim and apply the *Schleier* presumption on causation. Absent physical injury, no exclusion issue arises. Assume our range of physical injury: (1) any offensive touching, (2) some physical manifestation of injury, like a bruise or a "breaking of the skin," (3) injury requiring "medical care" or (4) injury requiring a period of convalescence. *Schleier* suggests that only in the last situation are the lost wages "caused" by physical injury. For any of the other three, we would say under *Schleier* that the reason that the victim absented herself from the workplace was emotional distress, or fear of being touched, not physical injury.

VI. APPENDIX—THE EFFECTIVE DATES QUESTIONS

In *Burke*, the Supreme Court held that sex discrimination under Title VII of the Civil Rights Act of 1964, which prohibits discrimination in employment on the basis of race, sex, religion and national origin, was not tort-like because Title VII then limited remedies to back pay.[206] In *Schleier*, the Supreme Court concluded that the ADEA was not tort-like because:

> Like the pre-1991 version of Title VII, the ADEA provides no compensation "for any of the other traditional harms associated with personal injury." Monetary remedies under the ADEA are limited to back wages, which are clearly of an "economic character," and liquidated damages, which we have already noted serve no compensatory function. Thus, though this is a closer case than *Burke*, we conclude that a recovery under the ADEA is not one that is "based upon tort or tort-type rights."[207]

The damages recoverable under the employment discrimination statutes were broadened significantly by the Civil Rights Act of 1991. A new section, 42 U.S.C. § 1981a (1994), applies concurrently with and in addition to Title VII. It permits recov-

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206. *See supra* notes 62-66 and accompanying text.

207. *Schleier*, 515 U.S. at 336.

ery of "compensatory and punitive damages," subject to aggregate limits of between $50,000 and $300,000, depending on the size of the employer, for "unlawful intentional discrimination" in employment on the basis of race, sex, religion and national origin under Title VII and Americans with Disabilities Act ("ADA") disparate treatment claims.[208] Additionally, a jury trial is available for § 1981a claims.[209]

After *Burke* but before *Schleier*, the Service acknowledged in Revenue Ruling 93-88[210] an exclusion for all amounts recovered under (1) Title VII gender-based disparate treatment (intentional discrimination) claims as amended by the Civil Rights Act of 1991; (2) Title VII racial discrimination claims as amended; and (3) Americans with Disabilities Act claims, because the claims, as amended, gave rise to remedies sufficiently broad to be considered tort-like.[211] The ruling based itself on the Court's dicta in *Burke*, in which the Court implied that all damages recovered under § 1981 would be excludable.[212] Following the decision in *Schleier* on June 14, 1995, the Service suspended Revenue Ruling 93-88.[213]

In Revenue Ruling 96-65,[214] published December 30, 1996, and with an effective date of June 14, 1995 (the date of decision in *Schleier*), the Service ruled that under post-1996 Act §104(a)(2), post-1991-CRA, backpay and damages for emotional distress are included in income.[215] However, under pre-1996 Act §104(a)(2), post-1991-CRA, backpay is included in income while damages received for emotional distress are excludable from gross income.[216]

208. 42 U.S.C. § 1981a (1994).
209. 42 U.S.C. § 1981a(c) (1994).
210. 1993-2 C.B. 61.
211. *Id.* at 62-63.
212. *Id.* at 62.
213. I.R.S. Notice 95-45, 1995-34 I.R.B. 20.
214. 1996-2 C.B. 6.
215. *Id.* at 7.
216. *Id.*

	ADEA				Title VII									
					pre-1991-Civil Rights Act				*post-1991-Civil Rights Act*					
	Backpay		Liquidated Damages & Frontpay		Backpay		Frontpay		Backpay		Compensatory Damages including Frontpay		Punitive Damages	
	Income	Wages	Income	Wages	Income	Wages	Income	Wages	Income	Wages	Income	Wages	Income	Wages
pre-*Schleier*, pre-96 Act settlement or judgment binding or paid before 6/14/95	Yes *Schleier* for all open yrs.	Yes	Yes *Schleier*	No Rev. Rul. 72-268	Yes *Burke* for all open yrs.	Yes Rev. Rul. 72-268	Yes *Burke*	No Rev. Rul. 55-520	No Rev. Rul. 93-88; Rev. Rul. 96-65	n.a.	No Rev. Rul. 93-88; Rev. Rul. 96-65	n.a.	Yes *O'Gilvie*	No
pre-1996 Act settlement or judgment binding before 9/13/95 or settlement or judgment paid before 8/20/96	Same as above	Same as above	Same as above	Same as above	Same as above	Same as above	Same as above	Same as above	Yes Rev. Rul. 96-65	Yes Rev. Rul. 96-65	No Rev. Rul. 96-65	n.a.	Yes *O'Gilvie*	No
post-1996 Act	Yes *Schleier*	Yes	Yes *Schleier*	No Rev. Rul. 72-268	Yes	Yes	Yes	No Rev. Rul. 55-520	Yes Rev. Rul. 96-65	Yes Rev. Rul. 96-65	Yes Rev. Rul. 96-65	No Rev. Rul. 96-65	Yes *O'Gilvie* plus stat. change	No

	Other Employment Torts especially State Law Causes of Action	
	Income	Wages
pre-*Schleier*, pre-96 Act settlement or judgment binding or paid before 6/14/95	same as below; special transition rule for post-91 Title VII n.a.	same as below
pre-1996 Act settlement or judgment binding before 9/13/95 or settlement or judgment paid before 8/20/96	*Schleier* two-prong test. A recovery of solely lost wages is taxable (*Simko*), but when lost wages are part of a larger damages calculation they are excludable (*Banks*), although outside 9th Cir. if lost wages are distinct from personal injury, then they are probably taxable.	A pure backpay claim is wages. If backpay is part of a larger damages calculation, *Banks* suggests that it is not income and not wages, but IRS might argue all is wages if backpay is not separately allocated. Rev. Rul. 80-364.
post-1996 Act	Because there must be some physical injury, employment tort damages are not excludable. If facts permit, plead a physical injury tort and base recovery on it.	Taxable recoveries based on past services are wages; other taxable recoveries are not, but IRS requires allocation or else entire amount is wages. Rev. Rul. 80-364.