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TAX LAW—THE TAXATION OF DAMAGES RECEIVED IN AN ACTION FOR DEFAMATION: DISTINGUISHING BETWEEN INJURY TO PROFESSIONAL REPUTATION AND INJURY TO PERSONAL REPUTATION—*Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983).

I. INTRODUCTION

As a matter of legislative grace, Congress has excluded from income "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness."[1] This seemingly unambiguous exclusion has produced considerable confusion[2] in determining the scope of section 104(a)(2), specifically with respect to "personal injuries." What injuries are encompassed by this phrase is not entirely clear since neither statutes nor cases provide any definition of "personal injuries."[3] The major difficulty in this area is in distinguishing between "personal injuries" and "business injuries." The distinction becomes clouded when an individual, defamed in his/her professional capacity, suffers injury to both his/her personal and professional reputation. When in such circumstances an action is brought under the state's defamation statute, it must be determined, for tax purposes, whether the damages received were for "personal injuries." Two alternative approaches to this problem were recently set forth by

1. I.R.C. § 104(a)(2)(West 1984). Congress exercised its discretion to exclude such payments from income on the assumption that they would otherwise be includible in income. The validity of the assumption, however, with respect to damages for defamation of character, was not totally beyond question until the advent of Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). Prior to *Glenshaw*, the Service had ruled that damages for defamation of character did not constitute income. *See* Sol. Op. 132, 1-1 C.B. 92 (1922). The Service based its ruling on the fact that such damages did not come within the then-prevailing definition of income under Eisner v. Macomber, 252 U.S. 189 (1920). The Court there had defined income as the "gain derived from capital, from labor, or from both combined." *Id.* at 207. The Service reasoned that since damages for defamation of character did not derive from capital or labor they were not income.

Thirty-five years later, the Court revised the definition of income in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), in which the Court defined income as an "undeniable accession to wealth." *Id.* at 431. Damages for defamation of character would clearly constitute income under the *Glenshaw* definition, thus making the Service's prior ruling of questionable validity.

2. Confusion in the area of personal injury recoveries has been academically recognized and has been the subject of much scholarly debate. *See, e.g.*, Comment, *Income Tax Effects on Personal Injury Recoveries*, 30 LA. L. REV. 672 (1970).

3. *Id.* at 675.

the Tax Court[4] and the Ninth Circuit Court of Appeals[5] in *Roemer v. Commissioner.*

II. FACTS OF *ROEMER*

The taxpayer, a licensed insurance broker, came before the court to resolve a dispute over the tax liability of damages he received[6] in a libel suit against the Retail Credit Company.[7] Roemer had been an insurance broker since 1941 and in the 1960's began doing business as Paul F. Roemer, Jr., Inc. Over the years, he had established an excellent reputation, both professionally and personally.[8] When the taxpayer applied in 1965 for a license to sell life insurance,[9] Retail Credit Company sent a grossly defamatory credit report to the reviewing company and other insurance companies.[10] In substance, it falsely stated that Roemer was incompetent in his business[11] and questioned his honesty.[12] Consequently, he could not obtain a license. In addition, it impinged his reputation in the community where he both worked and resided, as "most of his clients were also his friends." [13] As a result, Roemer sued under California libel law,[14] alleging damage to his reputation as a broker and loss of insurance business and profits.[15] An amended complaint in 1967 alleged that his business de-

4. Roemer v. Commissioner, 79 T.C. 398 (1982).

5. Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983).

6. The term " 'damages received' . . . means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." Treas. Reg. § 1.104-1(c) (1956).

7. The state appeals court found that Retail Credit was "in the business of providing commercial investigative reports to subscribers—many of whom are insurance underwriters who request such reports in determining whether to license applicant brokers with their companies." Roemer v. Retail Credit Co., 44 Cal. App. 3d 926, 930, 119 Cal. Rptr. 82, 84 (1975).

8. *Roemer*, 716 F.2d at 694.

9. *Roemer*, 79 T.C. at 398.

10. *Roemer*, 716 F.2d at 695. Retail Credit Co. prepared the report at the request of Penn Mutual Life Insurance Company, the reviewing company. *Id.*

11. *Id.* The report accused Roemer of neglecting his clients' affairs and wrongly stated that he had recently been fired from an insurance firm. *Id.*

12. *Id.*

13. *Id.*

14. *Id.* Roemer proceeded under section 45 of the California Civil Code which provides:

> Libel is a false and unprivileged publication by writing, printing, picture, effigy, or other fixed representation to the eye, which exposes any person to hatred, contempt, ridicule, or obloquy, or which causes him to be shunned or avoided, or which has a tendency to injure him in his occupation.

CAL. CIV. CODE § 45 (West 1982).

15. *Roemer*, 79 T.C. at 401.

pended upon his professional reputation, credit standing, and high standard of fiscal responsibility.[16] He further asserted that the report was published with the intent to damage his reputation, as well as to injure him in his business, profession, and occupation.[17] As to the evidence presented in the state court libel suit, the Tax Court found that Roemer's case was centered upon showing the business aspects of the alleged loss.[18] The jury awarded compensatory damages of $40,000 and punitive damages of $250,000,[19] without designating the business and personal elements of the loss. Roemer argued before the Tax Court that since the injury consisted of inseparable amounts of damage to both business and personal reputation, the entire award should be excludable under section 104(a)(2).[20] The court concluded that damages received in a libel suit for injured reputation are excludable only if the defamation results in injury to personal reputation, as opposed to business reputation.[21] Finding that the "predominant nature of [the taxpayer's] claims involved damages to his business . . . reputation,"[22] the court held that the compensatory damages were not on account of a personal injury and hence not excludable under section 104(a)(2).[23] The Ninth Circuit reversed, holding that since defamation under California law is a personal injury,[24] the damages

16. *Id.* The complaint also stated that the taxpayer "enjoyed a good name and business reputation, both generally and in particular with respect to high standards of business, . . . honesty, integrity, [and] financial responsibility" and that the continued success of his business was dependent on these attributes. *Id.*

17. *Id.*

18. *Id.* at 401-02 (stating that "little, if anything, was said about how [the report] affected his personal affairs. The evidence presented . . . was primarily directed at how the [taxpayer's] business relationships and planned business ventures were harmed by the false report of Retail Credit.") Notably, the court of appeals remained virtually silent as to the substance of the trial. The court did, however, relate that the jury was instructed that in assessing damages, it could consider any emotional suffering endured by Roemer, as well as his social status in the community. *Roemer*, 716 F.2d at 695.

19. *Roemer*, 79 T.C. at 403. The appropriate tax consequences of a punitive damage award in an action such as Roemer's exceeds the scope of this paper.

20. *Id.* at 405.

21. *Id.* at 405-06.

22. *Id.* at 406.

23. *Id.* at 407.

24. The court found significant "the fact that the California defamation statutes appear in the Civil Code at 'Division 1. Persons. Part 2. Personal Rights.' " *Roemer*, 716 F.2d at 699. It also emphasized that in the introductory statute to Part 2, "a general personal right to be protected from defamation" was recognized. *Id.* Hence, the court concluded that defamation constituted a personal injury under California law. *Id.* at 700.

While defamation was so characterized, the related action of disparagement or trade libel was considered, not as a personal injury, but as "an attack on the quality of the plaintiff's products or services." *Id.* at 699. Under the Ninth Circuit's rationale, if Roemer had brought an action for disparagement, any damages he recovered would not have been ex-

received by Roemer in his defamation action were on account of a personal injury.[25]

III. Determining the Scope of I.R.C. Section 104(a)(2)

This paper will attempt to define the proper scope of the term "personal injuries" within the meaning of I.R.C. section 104(a)(2). Specifically addressed will be whether a state's characterization of defamation as a "personal injury" should compel the application of section 104(a)(2). Also considered will be whether, given the inapplicability of state law, a distinction should be drawn between business reputation and personal reputation within a single defamation action.[26]

In determining whether a damage award is within the ambit of section 104(a)(2), it is appropriate to proceed according to the guidance provided by the Supreme Court.[27] In recognition of this directive and as a broad framework for analysis, this paper will progress upon the premise that "[t]he income taxed . . . should be broadly construed in accordance with an obvious purpose to tax comprehensively. The exemptions, on the other hand, are specifically stated and should

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cludable under section 104(a)(2) since the state did not characterize disparagement as a "personal injury." *See id.* at 699-700.

25. *Id.* at 700. The opposing conclusions reached by the Tax Court and the Ninth Circuit result from differing approaches to the problem. While both courts attempted to ascertain the nature or character of the claims litigated, *see Roemer*, 79 T.C. at 405; *Roemer*, 716 F.2d at 697, each proceeded from there with a different mode of analysis. In answering the commutual question, the Tax Court looked to the allegations in the complaints and the issues and evidence in the libel suit. *Roemer*, 79 T.C. at 406. The Ninth Circuit on the other hand consulted state law characterizations of defamation in determining "the nature of the claims litigated." *Roemer*, 716 F.2d at 697.

26. This was essentially the "threshold question" addressed by the Tax Court in *Roemer*. 79 T.C. at 405. After holding that such a distinction should be made, the court proceeded to examine the allegations and evidence in the libel suit, *id.* at 405-06, in order to estimate the portion of the award given for injured business reputation since this portion would not be excludable under section 104(a)(2).

The Ninth Circuit unnecessarily concerned itself with the business/personal distinction since, under California law, any damages received in a defamation action would, by definition, be on account of personal injuries. *See supra* note 24 and accompanying text.

27. *See* Hawkins v. Commissioner, 6 B.T.A. 1023, 1023 (1927) (stating that "[t]he consideration of the question whether damages received for libel and slander are taxable as income must proceed . . . according to such decisions of the Supreme Court as mark the course.")

Although never squarely addressing the issues under discussion, the Supreme Court has provided tangential guidance which should serve to "mark the course" for analysis. An examination of this "course" is particularly appropriate in the area of taxation since "the decisions relating to income tax law contain charts rather than definitions." Commissioner v. Glenshaw Glass Co., 211 F.2d 928, 933 (3d Cir. 1954), *rev'd on other grounds*, 348 U.S. 426 (1955).

be construed with restraint in light of the same policy."[28] In recognition of this guiding principle, lower courts have required a taxpayer to "bring himself squarely within the [section 104(a)(2)] exemption from tax"[29] in order to benefit from the exclusion.

A. *The Role of State Law Definitions of Personal Injury in Applying Section 104(a)(2)*

The applicability of a federal statute is generally presumed not to be dependent upon state law.[30] The presumption applies with equal if not more compelling force to a federal taxing statute.[31] In terms of clarifying when state law should apply, however, the latter situation falls within its own analytical construct.[32]

A firmly grounded principle holds "that in the interpretation of the words used in a federal revenue act, local law is not controlling unless the federal statute by 'express language or necessary implication, makes its own operation dependent upon state law.' "[33] The appropriate application of the precept, however, is far from clear. Interestingly, while the Supreme Court has repeatedly grappled with the problem,[34] the Ninth Circuit in *Roemer* simply ignored it, summarily stating that "[s]ince there is no general federal common law of torts [citing *Erie Railroad Co. v. Tompkins*] nor controlling definitions [of personal injury] in the tax code, we *must* look to state law."[35]

In its concession to what state law regards as a "personal injury," the court's reliance on *Erie* is misplaced. While there is no federal common law of torts, it is of little importance in the instant case. We are here attempting to construe the term "personal injuries" within

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28. Commissioner v. Jacobson, 336 U.S. 28, 49 (1949).

29. Agar v. Commissioner, 19 T.C.M. 116, 119 (1960), *aff'd*, 290 F.2d 283 (2d Cir. 1961). *See also* Meyer v. United States, 173 F. Supp. 920, 925 (E.D. Tenn. 1959) (stating that the taxpayer has "the burden of proving that . . . the payment comes clearly within one of the stated exemption.")

30. Jerome v. United States, 318 U.S. 101, 104 (1943).

31. *See, e.g.* Burnet v. Harmel, 287 U.S. 103, 110 (1932).

32. Both the Supreme Court and the commentators have analytically addressed the applicability of state law to federal revenue statutes in a categoric manner. *See, e.g.*, Heiner v. Mellon, 304 U.S. 271, 279 (1938); Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940); Annot., 140 A.L.R. 717, 721 (1942); *see also* Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799 (1943); Scharf, *State law in the Tax Court—Controlling Precedents*, 26 TAX LAW. 293 (Winter 1973).

33. Heiner v. Mellon, 304 U.S. 271, 279 (1938) (quoting Burnet v. Harmel, 287 U.S. 103, 110 (1932)).

34. *See, e.g.*, Helvering v. Stuart, 317 U.S. 154 (1942); United States v. Pelzer, 312 U.S. 399 (1941); Lyeth v. Hoey, 305 U.S. 188 (1938); Heiner v. Mellon 304 U.S. 271 (1938).

35. *Roemer*, 716 F.2d at 697 (emphasis added).

the meaning of a federal revenue act, not the tort of defamation. When a federal statue is under scrutiny, the *Erie* doctrine should not apply.[36] The Supreme Court itself has recognized this limitation of *Erie*[37] and has called upon federal courts to establish "federal common law" when legislation is silent as to whose law should govern.[38] The need for such a body of law is particularly compelling when one deals with an integrated body of federal legislation such as the Internal Revenue Code.[39] In light of the foregoing, the Ninth Circuit's refusal to create or even consult federal decisional law regarding section 104(a)(2) represents an abdication of its "basic responsibility."[40]

The fact that no "controlling definitions in the tax code"[41] existed similarly provides insufficient ground for deferring to state law. On several occasions the Supreme Court has found that the absence of a tax code definition of a term in question does not compel application

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36. *Erie* merely "established the now familiar maxim that a federal court must look to the law of the state in which it sits to decide issues of *purely local law.*" Sharf, *State Law in the Tax Court—Controlling Precedents*, 26 TAX LAW. 293, 293 (Winter 1973) (emphasis added).

37. *See* United States v. Little Lake Misere Land Co., 412 U.S. 580, 592 (1973) (stating that "[s]ince *Erie*, and as a corollary of that decision, we have consistently acted on the assumption that dealings which may be 'ordinary' or 'local' as between private citizens raise serious questions of national sovereignty when they arise in the context of a specific constitutional or statutory provision.")

The limits of *Erie* have also been academically recognized. *See, e.g.*, Annot., 140 A.L.R. 717, 718 (1942). The annotation read *Erie* as the Court did in *Little Lake*:

> [T]he decision in the Tompkins Case was not that Federal courts should follow state laws or decisions in all cases, but that they should follow non-statutory general law of a state equally with statutory law or constructions of statutory law. This, of course, left untouched that large field, covering Federal questions, such as questions arising under the Constitution and laws of the United States, in which Federal courts have always been free and are now free to ignore state laws.

Id.

38. United States v. Little Lake Misere Land Co., 412 U.S. 580, 593 (1973). In construing the Migratory Bird Conservation Act, the Court stated:

> [There is] no provision of the . . . Act [that] guides us to choose state or federal law. . . . But silence on that score in federal legislation is no reason for limiting the reach of federal law. . . . To the contrary, the inevitable incompleteness presented by all legislation means that interstitial federal lawmaking is a basic responsibility of the federal courts.

Id. This directive for the creation of federal common law, however, is limited to certain areas. Specifically, courts find it to exist "only in such narrow areas as those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of State or our relations with foreign nations, and admiralty cases." Texas Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 641 (1981).

39. *See* Sharf, *supra* note 32 at 293 (stating "it has become firmly established that a comprehensive body of federal legislation may warrant the creation of 'federal common law' to fill large gaps in a statutory scheme.")

40. *See supra* note 38 and accompanying text.

41. *See supra* note 35 and accompanying text.

of state law.[42] In such a case, a court must simply "look to the purpose of the statute to ascertain what is intended,"[43] rather than cavalierly to defer to state law.

In sum, the Ninth Circuit's summary treatment of the state law issue is judicially remiss: More importantly, however, it is dangerously misleading as legal precedent. The appropriate analysis, rather, should begin by determining whether the statute expressly or by "necessary implication, makes its . . . operation dependent upon state law."[44] A survey of the cases applying this principle should provide a general idea as to when state law governs.

The seminal case is *Burnet v. Harmel*.[45] In attempting to receive capital gains treatment, the taxpayer in *Burnet* argued that the execution of certain oil and gas leases in return for a bonus payment and stipulated royalties constituted a sale of capital assets.[46] He based his argument on the fact that Texas law regarded such leases as sale of oil and gas in place.[47] The Court held that the capital gains statute[48] neither said nor implied state law controlled and reasoned that while "state law creates legal interests, . . . the federal statute determines . . . how they shall be taxed."[49] The Court next looked to the particular characteristics which Texas law gave to the leases and determined

42. *See* Morgan v. Commissioner, 309 U.S. 78 (1940).

The Court in *Morgan* addressed, for tax purposes, whether a decedent had passed a general or special power of appointment under her will. The resolution was necessary since a then-existing Internal Revenue Code section included in the grosss estate the value of property "passing under a general power of appointment exercised by the decedent by will. . . ." *Id.* at 79 n.1 (quoting 26 U.S.C. § 411). The estate argued that the state of Wisconsin (the decedent's state of residence and the state under which the will was probated) defined the decedent's interest as a special power of appointment and hence when the property passed upon exercise of the power of appointment the property should not be included in the estate. *Id.* at 80. While the Court expressly noted that "[n]one of the revenue acts [had] defined the phrase 'general power of appointment,' " it ultimately held state law inapplicable. After consulting two treatises on powers, *id.* at 81 n.6, and the legislative history, *id.* at 81, the Court concluded that the decedent's powers were general within the meaning of the federal revenue act. *Id.* at 80. *See also* United States v. Pelzer, 312 U.S. 399, 403 (1941).

43. United States v. Pelzer, 312 U.S. at 403. An examination of the purpose of section 104(a)(2) and a determination as to whether Roemer's damage award fits within it is addressed in Part B of this paper. *See infra* notes 71-97 and accompanying text. The Court's command to look to the purpose of the statute here merely demonstrates the deficiency in the Ninth Circuit's analysis.

44. *See supra* note 33 and accompanying text.

45. 287 U.S. 103 (1932).

46. *Id.* at 109.

47. *Id.*

48. The statute afforded capital gains treatment to "gain from the sale . . . of capital assets." *Id.* at 110.

49. *Id.*

that those characteristics, whatever they were termed under state law, were not within the intendment of the capital gains statute.[50]

A situation in which the court held that state law controlled occurred in *Helvering v. Stuart.*[51] There, the taxpayer served with other appointed trustees as a trustee of trusts which he had created.[52] The Commissioner sought to attribute the net income of the trusts to the taxpayer-grantor under Sections 166 and 167 of the Revenue Act of 1934.[53] These sections essentially provided that where a person "not having a substantial adverse interest in the dispostion of . . . the corpus" possesses the power to invest in the grantor title to the corpus, the net income of the corpus will be charged to the grantor.[54] The initial question was whether state law would control in determining if the other trustees had the proscribed power.[55] The Court held that since the tax hinged upon the revesting of property, the "necessary implication" was that the possibility was to be determined by state law.[56] It reasoned that Congress had designated an event, the revesting of property, which could only occur by operation of state law.[57] In other words, if the event upon which the tax section operates depends for its creation on state law, the "necessay implication" is that state law applies.[58]

The more recent case of *United States v. Mitchell*[59] further bears out this interpretation. In *Mitchell,* the taxpayer and her husband resided in a community property state, which attributed one-half of the income of the community to each spouse regardless of who earned the

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50. *Id.* at 110-11.
51. 317 U.S. 154 (1942).
52. *Id.* at 156-57.
53. *Id.* at 161.
54. *Id.* at 159-60.
55. *Id.* at 161.
56. *Id.*
57. The Court stated that "[w]hether that event may or may not occur depends upon the interpretation placed upon the instrument by state law." *Id.* at 162.
58. The *Burnet* case provides an instructive contrast. *See supra* notes 46-47 and accompanying text. The taxable event there was the sale or exchange of a capital asset. Although the state considered the oil lease a sale of the oil in place, the occurrence of the "sale" Congress contemplated could be ascertained without reference to state law. Congress intended a certain type of transaction, which it called a "sale," to be subject to capital gains treatment. Since Congress had its own criteria as to what constituted a "sale," the Court in *Burnet* could look to the substance of the oil lease to determine if it fell within Congressional concern. The same could not be done in *Stuart.* The triggering event there was the power to revest property to the grantor. *See supra* text accompanying note 54. Although the Court could look independently of state law to the essential powers the other trustees held, the revesting of property could only take place when the state held those powers to be sufficient for such an event. *Stuart,* 317 U.S. at 161.
59. 403 U.S. 190 (1971).

income. In anticipation of divorce, the taxpayer renounced her community under state law, which had the effect of relieving her of "debts contracted during marriage."[60] After discovering that the husband had failed to file tax returns in past years, the Commissioner assessed deficiencies against the taxpayer based upon half the community income.[61] The Court initially confronted sections 1 and 3 of the 1954 Code, which imposed a tax on the taxable income "of every individual."[62] The Court essentially held that since "of" denoted ownership,[63] it must look to state law to determine, who, in fact, owned the income.[64] Since the state had designated each spouse as the one-half owner of all income, each would be taxed as such.[65]

Although the Court did not expressly state that the operation of section 3 necessarily depended upon state law, that inference can be drawn.[66] The event which Congress fixed for taxation, i.e., the ownership of income, would or would not occur depending upon the effect of state law. In the words of the *Burnet* Court, therefore, the "necessary implication" of this revenue section "makes its own operation dependent upon state law."[67]

It follows from the teachings of the cited cases that state law should not determine the tax treatment of Roemer's damage award. As the courts have repeatedly stated, "state law creates legal interests and rights, . . . [while] the federal law designates which of these interests and rights shall be taxed."[68] In making the designation, furthermore, the federal law will determine that state law applies only when the tax section depends for its operation upon state law either expressly or by necessary implication.[69]

Application of the above principles leads to several findings. It must initially be noted that the state of California has created a legal right to be free from defamation, a right it considers "personal."[70]

60. *Id.* at 191.

61. *Id.* at 192.

62. *Id.* at 194 (quoting I.R.C. § 3 (West 1982)).

63. *Id.* at 194-95 (quoting Poe v. Seaborn, 282 U.S. 101, 109 (1930)).

64. *Id.* at 195-97.

65. *Id.* at 196.

66. The Court expressly mentioned several of the pioneer decisions dealing with this principle and cited both *Burnet* and *Stuart*, leaving the inference of the precedential vitality of those cases. *Id.* at 197.

67. *Burnet*, 297 U.S. at 110.

68. Estate of McNichol v. Commissioner, 265 F.2d 667, 670 (3d Cir. 1959) (citing Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940); Helvering v. Stuart, 317 U.S. 154, 162 (1942)).

69. *See supra* note 33 and accompanying text.

70. *See supra* note 24.

Federal law, therefore, should determine the federal tax status of this state-created right[71] unless the event which triggers the exemption can only occur by operation of state law. The crucial event under section 104(a)(2) is the personal injury,[72] the occurrence of which cannot depend upon state law.[73] Granted, certain injuries may be characterized as "personal" under state law, but to permit such classifications to control federal tax consequences would promote form over substance.[74]

In sum, the wholesale deference to state law in *Roemer* was misfounded. The true nature of a claim cannot be determined, for tax purposes, by the semantical characterizations of state law. In an appropriate case there are cogent reasons for separating the business and personal aspects of a claim for defamation.

B. *Damage to Reputation as a Personal Injury: The Need to Distinguish Between Business and Personal Reputation.*

In determining whether a damage award was "on account of personal injuries" and hence squarely within section 104(a)(2), the courts consistently looked to the nature of the claims in the original suit.[75] In a slightly different context, the Supreme Court examined the nature of the claim in the original suit for purposes of clarifying the business/personal dichotomy.[76] Specifically, the Court held that the designation of an expense as "business" or "personal" depends on "the origin

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71. The actual state-created right is the right to bring an action for defamation, which stems from the right to be protected from defamation. We are here evaluating the tax status of damages received in vindication of this right.

72. Although section 104(a)(2) exludes the "damages received" for personal injuries, such damages merely measure the extent of the personal injury.

73. Such an event will obviously depend upon the potential tort-feasor and any damaging consequences flowing from the wrongful act.

74. Courts must be particularly careful in the income tax area to give force to substance as opposed to form. *See* Eisner v. Macomber, 252 U.S. 189, 206 (1920) (stating that it is "essential to distinguish between what is and what is not 'income', . . . and to apply the distinction, as cases arise, according to truth and substance, without regard to form.")

75. *See, e.g.*, Farmers' and Merchants' Bank v. Commissioner, 59 F.2d 912, 913 (6th Cir. 1932) (stating that "[t]he fund involved must be considered in light of the claim from which it is realized and which is reflected in the petition filed [in the original suit]"); State Fish Corp. v. Commissioner, 48 T.C. 465, 474 (1967); Telefilm, Inc. v. Commissioner, 21 T.C. 688, 693 (1954).

76. *See* United States v. Gilmore, 372 U.S. 39 (1963). The Court there faced the issue of the deductibility under section 23(a)(2) (current version of I.R.C. § 212(2) (West 1982)) of legal expenses incurred by the taxpayer in divorce proceedings. Upon successful defense against his wife's claims to certain of his properties, the taxpayer claimed his legal expenses were incurred for conservation of property held for the production of income and hence deductible under § 23(a)(2) (current version at I.R.C. § 212(2) (West 1982)) *Gilmore*, 372 U.S. at 42-43. The Court, noting that the only expenses deductible under that

and character of the claim."[77] In determining such "origin and character," the Court looked to the context in which the *claim arose* and characterized the expense as a business expense if the claim arose in that context.[78]

Although the characterization according to whence the claim arose developed to determine the proper treatment of an expense,[79] it does serve to "mark the course"[80] of analysis for treatment of defamation damages.[81] Its application to section 104(a)(2) indicates that damages received by a taxpayer will not be considered "on account of personal injuries"[82] if the taxpayer's claim arose in connection with his/her business.[83] A damage award for injury to business reputation would thus be outside the scope of section 104(a)(2).[84]

The distinction posed is further justified in theory. The Supreme

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section are those with a business purpose, narrowed the issue to whether the expense was business or personal in nature. *Gilmore*, 372 U.S. at 46.

77. *Id.* at 49.

78. "[T]he characterization, as 'business' or 'personal', of the litigation costs of resisting a claim depends on whether or not the *claim arises* in connection with the taxpayer's profit-seeking activities." *Id.* at 48 (emphasis added).

79. The issue in *Gilmore* was deductibility of an expense under what is now section 212(2). *See supra* note 76.

80. *See supra* note 27.

81. "The Internal Revenue Code . . . is to be construed as a whole and not as if each of its provisions were independent of the others. Other pertinent provisions in the Code may be consulted to determine the true meaning of the pertinent language in section 22(b)(5) (current version at I.R.C. § 104 (West 1982))" Townsend v. United States, 143 F. Supp. 150, 153 (S.D. Ill. 1956).

The construction of section 23(a)(2) (current version at I.R.C. § 212(2) (West 1982)) is being used here merely to ascertain "the true meaning of the pertinent language in section 22(b)(5) [current version at I.R.C. Sec. 104 (West 1982)]." *Id.*

82. I.R.C. § 104(a)(2) (West 1982).

83. The test in *Gilmore* does not have direct application to section 104(a)(2). It does, however, offer a guidepost to determine that section's meaning. The suggested analysis does not have absolute application. For example, a taxpayer who loses his/her leg while working in his/her construction business has a claim which arose in connection with his/her business. According to the analysis of this note, the taxpayer would not have sustained a personal injury within the meaning of section 104(a)(2), yet these types of injuries are clearly personal and within the scope of that section. This anomalous result is explained on the basis that the *Gilmore* test would not apply to physical injuries, which are clearly personal.

84. A strict application of the proposed test to injury to reputation could produce seemingly incongruous results. Suppose a taxpayer suffers injury to both his/her business and personal reputation after being defamed in a purely personal setting. Any claim for damage to either personal or business reputation would appear to have arisen in connection with the taxpayer's personal life and section 104(a)(2) would govern the taxability of any damage award. A closer inspection, however, reveals that although the claim for damage to business reputation was the result of defamation in a personal setting, the *claim* could not have arisen until the damage was felt in the taxpayer's buiness. Hence the claim arose in connection with his/her business.

Court has intimated that the exclusion of personal injury recoveries from income rests "on the theory that they roughly correspond to a return of capital."[85] The lower courts generally have accepted the theory.[86] As for the taxation of capital, an equally recognized theory holds that a taxpayer must prove a cost or other basis of the applicable capital asset since recovery of an amount in excess of that amount constitutes income.[87]

If a personal injury recovery be considered a return of capital, theoretically the taxpayer should demonstrate his/her basis in the asset damaged, his/her "personal capital." Yet taxpayers receiving damages on account of personal injuries receive a carte blanche exclusion from income, without having to prove any basis. An explanation of the theoretical inconsistency lies in recognizing the difficulty in assigning a basis to "personal capital."[88] This is especially true with respect to personal reputation, an "asset" of a most intangible nature. In recognition of this difficult if not impossible valuation problem, section 104(a)(2) totally excludes from income any damages received from personal injuries.[89]

The valuation impediment, however, does not exist with respect to business reputation. The courts generally regard business reputation as tantamount to good will, which is normally assigned a basis.[90] Although such assets are intangible, they may be more readily valued than personal assets such as personal reputation. For this reason, damages for injury to business reputation should not fall within the

85. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 432 n.8 (1955).

86. *See* Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962) (stating that "(d)amages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights—because, in effect, they restore a loss to capital"); *See also* Meyer v. United States, 173 F.Supp. 920, 924 (E.D. Tenn. 1959).

87. Cullins v. Commissioner, 24 T.C. 322, 328 (1955). *See also* Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir. 1944); Yorio, *The Taxation of Damages Tax: and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 702 (1977).

88. Such difficulty has been expressly recognized. Raytheon Production Corp. v. Commissioner 144 F.2d 110, 114 (1st Cir. 1944); Cullins v. Commissioner, 24 T.C. 322, 328 (1955).

89. The contention holds that section 104(a)(2) excludes the full amount of any "personal" capital returned to the taxpyer in the form of damages received. The section allows the exclusion instead of forcing the taxpayer to prove a basis in his "personal asset" and then taxing him on the excess of the "personal capital" returned over the basis in the "personal asset."

90. *See* Wallace v. Commissioner, 35 T.C.M. 954, 959 (1976) (stating that "insofar as the . . . proceeds were for injury to . . . business reputation, they would be analogous to a loss of good will, a capital asset.") *See also* State Fish Corp. v. Commissioner, 48 T.C. 465, 476 (1967) (stating that "it is obvious that petitioner's complaint had alleged . . . damage to reputation (goodwill)").

section 104 exclusion. When it is possible to value an asset's basis so as to tax the excess of a damage recovery over basis, tax law should do so. This merely follows the fundamental premise that Congress intended "to exert in this field the full measure of its taxing power."[91]

The forgoing analysis takes into consideration that in many cases establishing a basis in a business asset such as reputation will be just as elusive as doing so for personal reputation.[92] When the basis in the damaged business asset cannot be established, however, the courts uniformly hold the proceeds of any damage recovery to be taxable in full.[93] Although the cases so holding have dealt with valuations to good will, the fact that business reputation has been analogized to good will[94] justifies its similar treatment.

Defamation of business reputation has long been treated as a distinct injury, apart from injury to personal reputation.[95] A problem arises, however, when the defamation reflects upon a taxpayer's personal reputation as well as his/her business reputation.[96] In such a case, the courts, for tax purposes, look to the taxpayer's primary purpose in bringing the original defamation action.[97] The pivotal question is whether "the primary purpose to [the] litigation [was] to vindicate the personal reputation and character of [the] taxpayer."[98]

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91. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955).

92. *See also* Telefilm, Inc. v. Commissioner, 21 T.C. 688, 695-96 (1954) (taxpayer could not establish a basis in the business asset which was damaged). *See also* Cullin v. Commissioner, 24 T.C. 322, 328 (1955) (taxpayer could not establish the value of any business asset which was allegedly lost.).

93. *See also* Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir. 1944) (the court, finding the record "devoid of evidence . . . of the basis of the business and good will," held the entire damage recovery taxable); Telefilm, Inc. v. Commissioner, 21 T.C. 688, 685-96 (1954) (damage recovery for the destruction of busness and good will held fully taxable since taxpayer could not show cost or other basis).

94. *See supra* note 90 and accompanying text.

95. *See* Glynn v. Commissioner, 76 T.C. 116, 120 (1981) (stating that "payments for injury to professional reputation are not excludable from gross income, since any damages alleged to have been paid as a result of such injury would not fall within the exlusion afforded payments for injuries to personal reputation"); *See also* Agar v. Commissioner, 19 T.C.M. 116, 119 (1960) (stating that "damages . . . paid . . . would not fall within the exemption from tax afforded payments for injuries to personal reputation. Rather, they would more properly be characterized as payments made in satisfaction of injuries to . . . business reputation"), *aff'd*, 290 F.2d 283 (2d Cir. 1961); Wallace v. Commissioner, 35 T.C.M. 954, 959 (1976) (distinguishing between personal reputation and business reputation for exclusionary purposes).

96. The principal case supplies an especially evident example. Statements that an individual is dishonest and incompetent in his business will undoubtedly reflect on that individual's personal reputation.

97. *See, e.g.* Draper v. Commissioner, 26 T.C. 201, 204 (1956).

98. *Id.* An affirmative answer will result in any damage recovery being held nontaxable.

The answer may be ascertained by examining "the claims made in the . . . complaint filed in the prior action and the issues and evidence there presented to the jury."[99] Although a particular defamatory incident may injure a taxpayer in both his/her business and personal capacities, the taxpayer can never receive "damages . . . *on account* of personal injuries"[100] if he/she neither alleges nor presents evidence of damage to his/her personal reputation.[101] Further, he/she should not subsequently be heard to claim that the suit was brought for damage to his/her personal reputation, a claim that may be a "tax-motivated afterthought."[102] Hence, when the nature of the defamation affects both business and personal reputations, the "primary purpose" test enables a court to determine whether damages resulted from injury to personal reputation or to business reputation.

IV. Conclusion

Although state law may characterize defamation as a "personal injury," such a determination should not control the operation of I.R.C. Sec. 104(a)(2). That section exempts from income the amount of damages recovered for personal injuries. It must operate according to federal standards which alone should determine whether a particular defamatory incident was "personal" in nature. Resort to state law, when a tax statute is in question, should only obtain when the statute's operation is necessarily dependent upon state law. This situation oc-

99. State Fish Corp. v. Commissioner, 48 T.C. 465, 474 (1967). The court in *State Fish* looked to these factors in determining the nature of recovery, as other courts have unanimously done. *See, e.g.*, Wolfson v. Commissioner, 651 F.2d 1228, 1230 (6th Cir. 1981) (court looked to complaint); Telefilm, Inc. v. Commissioner, 21 T.C. 688, 693 (1954); Cullins v. Commissioner, 24 T. C. 322, 328 (1955). Although no court has expressly held that these factors must be utilized in determining a taxpayer's "primary purpose" in bringing a suit, they logically provide the best indication of a taxpayer's purpose.

100. I.R.C. § 104(a)(2) (West 1982) (emphasis added).

101. The principal case provides a prime example. The taxpayer argued that since the injury consisted of inseparable amounts of damage to both business and personal reputation, the entire award should be excludable under section 104(a)(2). *Roemer*, 79 T.C. at 404. The taxpayer, in effect, sought an inference of injury to his personal reputation, because "little, if anything, [was said] about how [the report] affected his personal affairs." *Id.* at 401-02. If a party never afforded the jury an opportunity to hear evidence of such injury, the jury cannot very well award damages *on account* of it.

102. *Roemer*, 79 T.C. at 410. Courts have been sensitive to such claims in determining whether an award represents damages received from personal injuries. *See, e.g.*, Knuckles v. Commissioner, 23 T.C.M. 182, 185 (1964) (stating that "petitioner's insistence upon settlement based on a tort claim for personal injury was an afterthought [based on] the possible tax advantages which might result"); O.S.C. Corp. v. Commissioner, 43 T.C.M. 1430, 1433 (1982) (stating that "the decision to allocate . . . the largest part of the . . . settlement to damages to reputation was an afterthought" based on favorable tax treatment).

curs when the event upon which the tax section is triggered depends for its creation on state law. Although California generally considers defamation a personal injury, the state cannot create a personal injury, which is the crucial event for section 104(a)(2). Federal law alone, therefore, should determine whether a single defamatory incident, for which damages are recovered, constitutes a personal injury.

The tax court in *Roemer* proceeded in this manner, distinguishing between injury to business and personal reputation. The distinction is a sound one, supported by the broad directives of the Supreme Court and firmly grounded in theory.

The tax consequences of a damage recovery flow from the nature of the claims in the original suit. The Supreme Court has indicated that the nature or character of a claim will be termed "business" or "personal" according to the context in which it arose.[103] Injury to reputation should not be considered a "personal injury," therefore, if the claim arose in connection with the taxpayer's business. Such a construction merely follows the precept that exclusions must be read narrowly.

The distinction posed is also justified in theory. Damages for personal injuries are excluded from income on the basis that they are a return of the taxpayer's "personal capital." This unqualified exclusion exists in lieu of the normal practice of requiring a taxpayer to prove a basis in the asset damaged so as to tax him on the excess of the recovery over basis. The total exclusion recognizes the difficulty of assigning a basis to "personal capital." This difficulty, however, does not exist with respect to business reputation. As the courts recognized, business reputation is analogous to good will, which is uniformly given a basis.[104] Failure to show a basis in good will results in the full taxation of any damages recovered for loss of good will.[105] In light of the avowed similarity between good will and business reputation, damages for loss of business reputation should receive similar treatment.

While the bifurcation of reputation into business and personal

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103. *See* United States v. Gilmore, 372 U.S. 39, 48 (1963).

104. *See* Wallace v. Commissioner 35 T.C.M. 954 (1976) (stating that "insofar as the . . . proceeds were for injury to . . . business reputation, they would be analogous to a loss of goodwill, a capital asset"). *See also* State Fish Corp. v. Commissioner, 48 T.C. 465, 476 (1967) (stating that "it is obvious that petitioner's complaint had alleged . . . damage to reputation (goodwill). . . ."). *See also id.* at 466 (taxpayers assigned separate amount of money to goodwill in their accounting journal). *See also* Cullins v. Commissioner, 24 T.C. 322, 328 (1955) (court requiring taxpayers to show a basis in goodwill).

105. *See* Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir. 1944).

components has strong support, in some cases such an approach may impose a harsh burden on the taxpayer. This is particularly evident in *Roemer*. Defining the "personal" portion of a damage award may be a difficult task, especially when a particular defamatory incident may inextricabaly effect one's personal and professional reputation. Moreover, a taxpayer in the above situation faces a dilemma when he/she tries the merits of his/her claim. While his/her business and personal reputation may have been inseparably impinged, he/she will most naturally focus on the business aspects of the loss in order to maximize the damage award. Yet, in doing so, any damages received would, under the proposed approach, not be excludable under section 104(a)(2). While these harsh realities may be somewhat disconcerting, it must be remembered that certain damage awards, which otherwise would be income, were legislatively excused from such treatment. As a legislative exclusion, section 104(a)(2) must be read narrowly, or, at the very minimum, in accord with the cases and theory. It was the Tax Court's position in *Roemer* which gave force to this guideline and which should ultimately prevail so as to restore proper tax treatment in this area.

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