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THE TAXATION OF PUNITIVE DAMAGES: *HORTON* LAYS AN EGG?

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INTRODUCTION

The recent decision of the Sixth Circuit Court of Appeals in *Horton v. Commissioner*,[1] which affirmed a tax court decision holding that punitive damages recovered in personal injury tort actions are excludable from the gross income of the recipient under I.R.C. § 104(a)(2),[2] conflicts with three decisions in other circuits that have reached the opposite conclusion.[3] The circuit courts now stand deeply divided on the important and very basic question of whether punitive damages are taxable.

This article examines the conflict between the federal courts over the taxation of punitive damages recovered for personal injury. While this article focuses on the tax treatment of punitive damages recovered for personal injuries, it is necessary to touch upon the tax consequences of other elements of a personal injury recovery. To put this discussion in context, consider the example of Stella Liebeck. In 1992, Ms. Liebeck, a 79-year-old McDonald's customer, suffered third-degree burns when hot coffee spilled on her legs after she had removed the lid on her coffee cup and held the cup in her lap. Ms. Liebeck sued McDonald's, and in August 1994, in an outcome widely reported in the popular media,[4] an Albuquerque jury awarded Liebeck $2.9 million in damages.[5] On appeal, a state district court ordered the award reduced to $480,000,[6] and while further appeals were pending, the parties settled.[7]

The Liebeck litigation raises some timely and interesting questions concerning the federal income tax treatment of Ms. Liebeck's original damage award, had it stood. For example, assume that Ms. Liebeck's $2.9 million award consisted of the following:

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1. 33 F.3d 625, 630 (6th Cir. 1994), *aff'g* Horton v. Commissioner, 100 T.C. 93, 101 (1993).

2. I.R.C. § 104(a)(2) (1988).

3. *See* Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994); Reese v. United States, 24 F.3d 228 (Fed. Cir. 1994); Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990).

4. *See, e.g.*, Theresa Howard, *Jury 'Burns' McD in $2.9M verdict: Scalded Customer's Victory Puts Chains' Coffee Service in Hotseat*, NATION'S RESTAURANT NEWS, Aug. 29, 1994, at 1.

5. Liebeck argued that McDonald's had sold a defective product (due to the coffee's extreme temperature), had failed to warn customers of the coffee's temperature, and had breached an implied warranty of merchantability because it had failed to ensure that the coffee was fit for human consumption. *Id.*

6. *See* Theresa Howard, *Judge Slashes McD Settlement to $480,000*, NATION'S RESTAURANT NEWS, Sept. 26, 1994, at 1.

7. *See* Theresa Howard, *McD Settles Coffee Suit in Out-of-Court Agreement*, NATION'S RESTAURANT NEWS, Dec. 12, 1994, at 1.

Specific compensatory damages: hospital bills	$20,000
: lost wages	$10,000
: loss of future earnings	$25,000
General compensatory damages: pain and suffering	$170,000
Statutory prejudgment interest	$75,000
Punitive damages	$2,600,000

Had Ms. Liebeck consulted a tax advisor concerning the taxability of her original award, she would have learned that the federal income tax consequences of the first four components of the award were relatively well-settled: all the amounts received for those components would have been excludable under I.R.C. § 104(a)(2).[8] However, she would also have learned that the tax treatment of the punitive damage component of her award is very unsettled and controversial, and may vary among federal districts.[9]

This article will examine the current state of the law regarding the taxation of punitive damages. The resolution of the controversy is hampered by the historically inconsistent ruling and litigating position of the Internal Revenue Service, the uncertain effect of a 1989 amendment to I.R.C. § 104(a)(2),[10] the inconclusive application of relevant theories of taxable income to punitive damages, and the debatable impact of the Supreme Court's recent decision in *United States v. Burke*.[11]

The discussion begins by examining the history of the applicable provisions of the Internal Revenue Code[12] governing personal injury damage recoveries.

I. I.R.C. § 104(a)(2): OVERVIEW AND A SHORT HISTORY

Under § 61 of the Internal Revenue Code, a taxpayer's gross income means "all income from whatever source derived." This statutory definition of

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8. I.R.C. § 104(a)(2) (1988) states that "[e]xcept in the case of amounts attributable to . . . deductions allowed under section 213 . . . gross income does not include . . . the amount of any damages received . . . on account of personal injuries or sickness." However, had Mrs. Liebeck previously deducted her hospital bills and received a tax benefit under I.R.C. § 213 (Supp. V 1993), any recovery for those bills would have been includable in her income to that extent. For the income tax treatment of prejudgment interest, see discussion *infra* note 499.

9. The Tenth Circuit, in which Mrs. Liebeck resides, has not yet addressed the issue. At least one district court in the Tenth Circuit, however, has found punitive damages excludable from gross income. O'Gilvie v. Commissioner, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567 (D. Kan. 1992); *see infra* notes 438 and 504.

10. *See* discussion *infra* note 276 and accompanying text. I.R.C. § 104(a)(2) (Supp. V 1993) was amended as part of the Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (codified as amended in scattered sections of 26 U.S.C.) [hereinafter RRA '89].

11. 112 S. Ct. 1867 (1992).

12. The Internal Revenue Code is sometimes referred to herein as "the Code."

gross income is "admittedly somewhat tautological"[13] and of limited assistance, although I.R.C. § 61 does list fifteen types of enumerated receipts and transactions which constitute gross income. In attempting to interpret and apply I.R.C. § 61 over the years, the courts have never articulated a true definition of "income" for purposes of the Code.[14] However, it is clear that the courts hold that § 61 is all-encompassing and "sweeps broadly."[15] It is equally clear that a personal injury damage recovery falls within the scope of the section and will be includable in gross income unless specifically excluded under another section of the Code.[16] Such exclusions from income are construed narrowly.[17]

The exclusionary provision of the Code applicable to damage recoveries for personal injury is I.R.C. § 104(a)(2), entitled "Compensation for injuries or sickness." The section exempts from gross income "any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." This provision raises many difficult questions of statutory construction. For example, what is the exact scope of the phrase "personal injuries"?[18] What is to be made of the

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13. Collins v. Commissioner, 3 F.3d 625, 629 (2d Cir. 1993).

14. It is generally recognized that the Supreme Court abandoned its effort to define "income" in United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (holding that the taxpayer recognized taxable income from a retirement of its bonds at less than par value). The Court ignored its own earlier description of "income" as a "'gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets." Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)). Writing for the Court in *Kirby Lumber Co.*, Justice Holmes conceded that there was "nothing to be gained by the discussion of judicial definitions." *Kirby Lumber Co.*, 284 U.S. at 3; *see also* Stanley S. Surrey & William C. Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness*, 66 HARV. L. REV. 761, 771 (1953) (noting that in *Kirby Lumber Co.* the Court "recognized the futility of attempting to capture the concept of income and confine it within a phrase" and "explicitly abandoned the search for a definition" of income). Subsequently, in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), the Supreme Court repudiated the *Eisner* definition of income, stating that while "[i]n that context . . . the definition served a useful purpose," it was "not meant to provide a touchstone to all future gross income questions." *Id.* at 431. The Court stated, "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature." *Id.* at 429-30.

15. United States v. Burke, 112 S. Ct. 1867, 1870 (1992). The courts recognize that in I.R.C. § 61 Congress intended "to use the full measure of its taxing power." Helvering v. Clifford, 309 U.S. 331, 334 (1940). The Code describes income "in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively." Commissioner v. Jacobson, 336 U.S. 28, 49 (1949).

16. I.R.C. § 61 (1988) states that it applies "[e]xcept as otherwise provided in this subtitle." As noted by the Second Circuit, "the term gross income has been read expansively to include all realized gains and forms of enrichment, that is, 'all gains except those specifically exempted.'" *Collins*, 3 F.3d at 630 (quoting *Glenshaw Glass Co.*, 348 U.S. at 430).

17. *See, e.g.*, *Jacobson*, 336 U.S. at 49 (stating that "[t]he exemptions, on the other hand, as compared to income, are specifically stated and should be construed with restraint in the light of the same policy.").

18. The major issue that has arisen in this context is whether "personal injuries" means only *physical* personal injuries, or whether the phrase also encompasses *nonphysical* personal

phrase "*any* damages"—does it truly mean any *and all* damages arising out of a personal injury, or are there some components of a damage recovery that ought not qualify for the exclusion? Is the phrase "any damages" qualified in some fashion by the phrase "received *on account of* personal injuries" which follows? And is the entire provision in turn qualified by the title of the section, which refers to "compensation" for injuries (that is, should damages which do not demonstrably serve a compensatory purpose fall outside the scope of I.R.C. § 104(a)(2))?

The applicable Treasury Regulations provide little assistance in answering these questions. The Regulations are brief, and merely state that "[t]he terms 'damages received (whether by suit or agreement)' mean an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of prosecution."[19]

The legislative history of I.R.C. § 104(a)(2) is enlightening, although not dispositive. The predecessor of § 104(a)(2), section 213(b)(6)[20] of the Revenue Act of 1918,[21] excluded from income "[a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, *plus* the amount of any damages received whether by suit or agreement on account of such injuries or sickness."[22] The legislative history accompanying the Revenue Act of 1918 regarding this provision is sparse,[23] although the House Ways and Means Committee Report accompanying this provision stated, "Under the present law, it is

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injuries as well (e.g., those arising from torts such as defamation, employment discrimination, insurance bad faith, denial of first amendment rights, etc.).

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

20. When the Internal Revenue Code of 1939 was recodified and reorganized as the Internal Revenue Code of 1954, § 213(b)(6) became I.R.C. § 104(a)(2). The legislative history of I.R.C. § 104(a)(2), however, gives no indication that its scope or purpose was intended to be modified in any way.

21. The Revenue Act of 1918 came at a time when the federal income tax was only five years old:

> On February 3, 1913, the sixteenth amendment was ratified by the states and became part of the Constitution. In March of that same year, Woodrow Wilson became President and World War I was imminent. With the entry into the war by the United States, Congress appropriated nineteen billion dollars toward the war effort and enacted to raise income taxes and lower exemptions. The Revenue Act of 1918 was still in the Senate Finance Committee when World War I ended in November 1918. It eventually became law . . . .

Douglas K. Chapman, *No Pain—No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407, 413 (1986-87) (footnotes omitted).

22. Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1919) (current version at I.R.C. § 104(a)(2)) (emphasis added). The availability of punitive damages was well established by 1918. This gives rise to the argument that, had Congress desired to distinguish between compensatory damages and punitive damages when it enacted § 213(b)(6), it could have easily done so; that it did not is indicative of a congressional intent to treat these two components of damages identically. *See* Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990).

23. *See* Chapman, *supra* note 21, at 413-14 ("[O]n the actual expression of intent, the silence of Congress is deafening.").

doubtful whether amounts received . . . as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be including gross income. The proposed bill provides that such amounts shall not be included in gross income."[24]

Section 213(b)(6) was enacted against the backdrop of three prior government rulings. In early 1915, the Service ruled in Treasury Decision 2135[25] that insurance proceeds received on account of an accident, as well as recoveries for pain and suffering in a lawsuit, were includable in gross income. This result conflicted with the treatment of life insurance proceeds under the original Revenue Act of 1913, which were stated to be excludable.[26] The Service subsequently had misgivings, and in 1918 asked the United States Attorney General for his views on the tax treatment of the proceeds of an accident insurance policy. In Attorney General's Opinion 304,[27] the Attorney General replied by invoking what has come to be known as the "return of capital" theory:

> Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of *future* periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore "capital" as distinguished from "income" receipts.[28]

The opinion concluded that "the proceeds of an accident insurance policy are not 'gains or profits and income'" but are instead capital and therefore nontaxable.[29] On the heels of Attorney General's Opinion 304, the Service issued Treasury Decision 2747, ruling that proceeds received by an individual as the result of a suit or compromise for personal injury sustained are an accident is not income under the Revenue Acts of 1916 and 1917.[30] While the basis for the ruling was not stated, a later ruling by the Solicitor of Internal Revenue, Solicitor's Opinion 1384,[31] interpreted Treasury Decision 2747 as "rest[ing] . . . upon the theory of conversion of capital assets."[32]

Against the backdrop of the Service's inconsistent rulings in this area,

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24. H.R. REP. NO. 767, 65th Cong., 2d Sess. 9-10 (1918).

25. T.D. 2135, 17 Treas. Dec. Int. Rev. 39 (1915).

26. *See* Internal Revenue Act of 1913, ch. 16, 38 Stat. 114, 167 (1913) (providing that all amounts received in respect of a life insurance policy, including those received at maturity or upon surrender of the policy, were excludable). This generous provision was said to have been inserted at the urging of an article appearing in the Wall Street Journal. *See* GEORGE F. TUCKER, THE INCOME TAX LAW OF 1913 EXPLAINED 18 (1913). Under the current Code, amounts received under a life insurance contract are excludable only if paid by reason of the death of the insured. I.R.C. § 101(a) (1988).

27. Income Tax—Proceeds of Accident Insurance Policy, 31 Op. Att'y Gen. 304 (1918).

28. *Id.* at 308.

29. *Id.*

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

31. Sol. Op. 1384, 2 C.B. 71 (1920).

32. *Id.* at 72.

section 213(b)(6) of the Revenue Act of 1918 attempted to clarify the status of the law and adopted the conclusions expressed in Treasury Decision 2747 and Attorney General's Opinion 304. Because those rulings relied on the return of capital theory, section 213(b)(6) may be viewed, to some extent, as congressional approval of that rationale.

It is important to note that both Treasury Decision 2747 and Attorney General's Opinion 304 involved a *physical* injury. After the enactment of section 213(b)(6), the Solicitor of Internal Revenue held that the "[m]oney received as damages in libel proceedings is subject to income tax."[33] In the setting of a *nonphysical* injury, the government took the position that the section 213(b)(6) exclusion did not apply. Thus, very early in the history of I.R.C. § 104(a)(2), a "physical-vs.-nonphysical" injury distinction was read into the statute.

The following year, the physical-vs.-nonphysical distinction was again invoked. In Solicitor's Memorandum 1384, damages received by a taxpayer on account of the alienation of the affections of his wife were found to be includable in gross income, and not within the scope of section 213(b)(6).[34] While the ruling specifically acknowledged that the language of section 213(b)(6), which refers broadly to "injuries of sickness," might arguably be construed to extend to personal injuries such as the one there involved,[35] the ruling concluded that "[n]evertheless, it appears more probable from the language of [the statute] taken as a whole, referring as it does, to accident and health insurance and workmen's compensation Acts, that the term 'personal injuries,' as used therein means physical injuries only."[36]

In distinguishing Attorney General's Opinion 304[37] and Treasury Decision 2747,[38] Solicitor's Memorandum 1384 stated that

> [t]hese conclusions rest . . . upon the theory of conversion of capital assets. It would follow that personal injury *not* resulting in the destruction or diminution in the value of a capital asset would not be within the exemption. From no ordinary conception of the term can a wife's affections be regarded as constituting capital.[39]

After Solicitor's Memorandum 1384, the Supreme Court in its 1920 *Eisner v. Macomber* decision, described income as the "'gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets."[40] Based on

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33. Sol. Op. 957, 1 C.B. 65 (1919).

34. *See* Sol. Mem. 1384, 2 C.B. 71, 72 (1920).

35. *Id.* at 71.

36. *Id.*

37. *See* 31 Op. Att'y Gen. 304 (1918).

38. *See* T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

39. Sol. Mem. 1384, 2 C.B. 71, 72 (1920) (emphasis added). This may be the earliest articulation of the view that a personal injury recovery, such as punitive damages, which does not compensate a loss in human capital, is taxable.

40. Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)). As discussed above, this definition was later abandoned by the Supreme Court and is no longer held in repute. *See supra* note 14. For a description of

Eisner, in 1922 the Solicitor of Internal Revenue held, in Solicitor's Opinion 132, that damages for alienation of affections, damages for slander or libel of personal character, and money received by a parent in consideration of the surrender of his right to the custody of his minor child, were all excludable from gross income.[41] Solicitor's Opinion 132 relied more on the absence of a "gain or profit" as required by *Eisner*, and less on the return of capital theory that formed the basis of the earlier rulings.[42] Solicitor's Memorandum 957 was modified in accordance with this opinion, and Solicitor's Memorandum 1384 was revoked.[43] Whatever its rationale, Solicitor's Opinion 132 clearly represented a retreat from the physical-vs.-nonphysical distinction.[44]

The preceding rulings set the stage for two important issues that will be discussed later in this article. First, these rulings suggest that the statutory predecessor of I.R.C. § 104(a)(2) was arguably predicated, at least in part, on the return of capital theory. More recently, the return of capital theory has played a major role in the cases that have examined the tax treatment of punitive damages, and its analysis has spawned very different conclusions. This theory and its weaknesses are discussed in Part III.[45]

Second, these rulings left unresolved the question of whether damages received for *nonphysical* injuries should be afforded exclusion under I.R.C. § 104(a)(2). In *Hawkins v. Commissioner*,[46] decided soon after *Eisner*, the Board of Tax Appeals (predecessor to the Tax Court) adopted the view that

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Eisner as an "Old Stone Age tax case," see Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 738 (1986).

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

42. The opinion stated:

> In the light of . . . [Strattons Independence, Ltd. v. Howbert, 231 U.S. 399 (1913) and Eisner v. Macomber, 252 U.S. 189 (1920)] it must be held that there is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character. In either case the right invaded is a personal right and is in no way transferable. While a jury endeavors roughly to compute the amount of damage inflicted, in the very nature of things there can be no correct estimate of the money value of the invaded rights. The rights on the one hand and the money on the other are incomparable things which can not be placed on opposite sides of an equation. If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, *it can not be held tha: he thereby derives any gain or profit*. It is clear, therefore, that the Government can not tax him on any portion of the sum received.

Id. at 93 (emphasis added).

43. *See* Sol. Op. 957, 1 C.B. 65 (1919).

44. In Revenue Ruling 74-77, the Service stated, without analysis, that damages received on account of alienation of affections or in consideration of the surrender of the custody of a minor child were excludable as income. Rev. Rul. 74-77, 1974-1 C.B. 33. These represented two of the three issues discussed in Solicitor's Opinion 132, and the latter ruling was declared superseded. *Id.* Interestingly, in both Solicitor's Opinion 132 and in Revenue Ruling 74-77, the Service failed to cite the applicable statute. *Id.* The rulings appear to have been predicated on a conclusion that the recoveries were not even "income" under I.R.C. § 61 and its predecessor.

45. See *infra* note 71 and accompanying text.

46. 6 B.T.A. 1023 (1927).

nonphysical injuries are "personal injuries" for purposes of the predecessor to I.R.C. § 104(a)(2). While *Hawkins* may have removed any doubt that nonphysical injuries can constitute "personal injuries" for purposes of I.R.C. § 104(a)(2), the Service and the courts have nevertheless historically afforded damages for nonphysical injuries less favored treatment under the statute. The details of this controversy have dominated litigation in the I.R.C. § 104(a)(2) arena in recent years and ultimately culminated in the Supreme Court's decision in *United States v. Burke*,[47] discussed in Part IV of this article.

II. THE NATURE OF PUNITIVE DAMAGES[48]

Punitive damages[49] have a long,[50] contentious,[51] and somewhat uncertain history in American law:[52] "sometimes used to punish, and sometimes used to compensate a plaintiff for injuries to pride, dignity, or reputation that would not otherwise be compensated through traditional tort awards intended

47. 112 S. Ct. 1867 (1992).

48. *See generally* Clarence Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173 (1931) (discussing how punitive damages serve an admonitory function); Tom Riley, *Punitive Damages: The Doctrine of Just Enrichment*, 27 DRAKE L. REV. 195 (1977-78) (examining the development of the law of punitive damages).

49. Punitive damages are also referred to as exemplary damages, vindictive damages, and in years past, "smart money." *See, e.g.*, WILLIAM B. HALE, HANDBOOK ON THE LAW OF TORTS 234 (1896) (Punitive damages are allowed "in view of the grossness of the wrong done, rather than as a measure of compensation. They are 'smart money' added to proper compensation."); FRANCIS HILLIARD, THE LAW OF REMEDIES FOR TORTS 598 (1873) (stating that "[p]unitive, vindictive, and exemplary damages are, in legal contemplation, synonymous terms").

50. *See* Day v. Woodworth, 54 U.S. (13 How.) 363, 371 (1851) (recognizing both the existence and propriety of punitive damages); *see also* Browning-Ferris Indus. of Vermont., Inc. v. Kelso Disposal, Inc., 492 U.S. 257, 274 (1989) (noting that the practice of awarding punitive damages was known to the framers of the Eighth Amendment of the United States Constitution). Punitive damages appear in reported cases at least as far back as 1791. *See* Coryell v. Colbaugh, 1 N.J.L. 90, 91 (Super. Ct. 1791) (instructing the jury "not to estimate the damages by any particular proof of suffering or actual loss; but to give damages for *example's* sake, to prevent such offenses in the future" and to "mark [the jury's] disapprobation and be an example to others"). *See generally* Melvin M. Belli, Sr., *Punitive Damages: Their History, Their Use and Their Worth in Present-Day Society*, 49 UMKC L. REV. 1 (1980); Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517 (1957).

51. *See* HILLIARD, *supra* note 49, at 597 n.(a) (stating that "[n]o question relating to damages has been so prolific of discussion, and still remains so unsettled, as the one, whether in any case, and if so in what cases, exemplary damages may be given"); *cf.* Fay v. Parker, 53 N.H. 342, 382 (1873) (The notion of punishing the defendant in such a way "is a monstrous heresy. It is an unsightly and unhealthy excrescence, deforming the symmetry of the body of the law."). For Judge Friendly's more recent and oft-cited economics-based criticism of punitive damages in the context of product liability cases, see Roginsky v. Richardson-Merrell, Inc., 378 F.2d 832 (2d Cir. 1967).

52. English law has a long history of punitive or exemplary damages. *See, e.g.*, Wilkes v. Wood, 98 Eng. Rep. 489, 498-99 (K.B. 1763) (stating that "[d]amages are designed not only as satisfaction to the injured person, but likewise as punishment to the guilty, to deter from any such proceeding for the future and as proof of the detestation of the jury to the action itself"); *see also Browning-Ferris Indus.*, 492 U.S. at 274 (tracing the roots of punitive damages in England to the Thirteenth Century).

to make a plaintiff whole."[53]

Under the majority view, punitive or exemplary damages are wholly penal[54] in nature and are recoverable "where the wrong done to [the victim] was aggravated by circumstances of violence, oppression, malice, fraud, or wanton and wicked conduct on the part of the defendant."[55] It is the "wanton, reckless, malicious or oppressive"[56] conduct of the defendant, and not any injury suffered by the victim, that is said to be the basis for an award of punitive damages. "Unlike compensatory or actual damages, punitive or exemplary damages are based upon an entirely different pubic policy consideration—that of punishing the defendant for his evil behavior or to make an example of him. . . . "[57] These criteria are often statutorily prescribed,[58] and the underlying purposes of punitive damages are frequently reflected in jury instructions describing such damages.[59]

While the foregoing characterization of punitive damages holds true in the

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53. Rein v. Pan Am. World Airways Inc., 928 F.2d 1267, 1272 (2d Cir. 1991).

54. Penal statutes have been contrasted with punitive damages statutes in that the former create an entirely distinct and independent cause of action (while the latter do not) and require no proof of actual damages as a condition precedent to recovery (contrary to the general rule for punitive damages). *See, e.g.*, Palmer v. A.H. Robins Co., 684 P.2d 187, 214 (Colo. 1984).

55. BLACK'S LAW DICTIONARY 390 (6th ed. 1990).

56. *Id.*

57. *Id.*; *see also* RESTATEMENT (SECOND) OF TORTS § 908(1) (1977) (describing punitive damages as "damages, other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct and to deter him and others like him from similar conduct in the future."). In light of the penal nature of punitive damages, an award of punitive damages is justified only for conduct "that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others." *Id.* § 908(2). While it is true that "facts [must] be established that, apart from punitive damages, are sufficient to maintain a cause of action," punitive damages are not awarded to compensate for an injury, they are designed to punish the tortfeasor and to deter him and others from similar conduct in the future. *Id.* § 908 cmts. a,c,e; *see also Palmer*, 684 P.2d at 213-14.

58. *See, e.g.*, COLO. REV. STAT. § 13-21-102 (1987 & Supp. 1994) (authorizing the jury to award exemplary damages in tort actions if "the injury complained of is attended by circumstances of fraud, malice, or willful and wanton misconduct"). The acknowledged purpose of exemplary damages in Colorado is to punish and penalize the wrongdoer and to serve as a warning to other possible offenders. *See Palmer*, 684 P.2d at 213-14 (upholding a landmark $6.2 million punitive damages award against manufacturer of the Dalkon Shield); Beebe v. Pierce, 521 P.2d 1263, 1264 (Colo. 1974); Ark Valley Alfalfa Mills v. Day, 263 P.2d 815, 817 (Colo. 1953) (holding that exemplary or punitive damages are not compensatory in nature but are for the purpose of punishing the wrongdoer as an example to others); Barnes v. Lehman, 193 P.2d 273, 274 (Colo. 1948). *But cf.* Murphy v. Hobbs, 5 P. 119, 122 (Colo. 1884) (rejecting punitive damages as not consistent with reason and justice).

59. *See* Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982), where the trial court stated:

> If you find that the Plaintiff has suffered actual damages as a proximate result of the acts of the Defendant on which you base your findings of liability, you may in your sole discretion award additional damages against the Defendant known as punitive or exemplary damages for sake of example and by way of punishing the Defendant. If, and only if, you find by a preponderance of the evidence that said Defendant has been guilty of oppression, fraud and actual malice.

Roemer, 79 T.C. at 403.

case of damages awarded in federal actions[60] and is accepted by a majority of state courts,[61] some states do not view punitive damages as entirely penal in nature. Punitive damages are sometimes said to rest "on the theory that the injury is greater, and the actual damages are increased, by reason of the aggravating circumstances" of the tort.[62] Punitive damages are also sometimes said to compensate the victim for elements of damage which are not otherwise legally compensable, such as attorneys' fees and costs[63] or wounded feelings.[64] Thus, some states view punitive damages as at least partially compensatory[65] and therefore not entirely penal in nature.[66] An examination of state law is therefore often necessary to ascertain the nature of punitive damages in the particular jurisdiction.

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60. The Supreme Court views punitive damages as penal in nature rather than compensatory. *See* Browning-Ferris Indus. of Vermont, Inc. v. Kelso Disposal, Inc., 492 U.S. 257, 297 (1989) (O'Connor, J., concurring in part and dissenting in part) (characterizing punitive damages as private fines to punish reprehensible conduct and to deter repetition of the injurious act); *see also* International Bhd. of Elec. Workers v. Foust, 442 U.S. 42, 48 (1979) (citing Gertz v. Welch, 418 U.S. 323, 350 (1974)).

61. Belli, *supra* note 50, at 6. For example, Wyoming courts are in accord with the majority view of punitive damages. *See, e.g.*, Sinclair Oil Corp. v. Columbia Casualty Co., 682 P.2d 975, 978 (Wyo. 1984) (holding that the purpose of punitive damages "is to publicly condemn some notorious action or inaction, to punish a defendant, and to serve as a warning and a deterrent to others"); Adel v. Parkhurst, 681 P.2d 886, 890 (Wyo. 1984) (finding that "[i]t is not the purpose of punitive damages to compensate the plaintiff; instead punitive damages are awarded as a punishment to the defendant and with the purpose of deterring others from such conduct in the future"). In New Mexico, punitive damages are awarded as punishment of the offender and as a warning to others. *See, e.g.*, Fredenburgh v. Allied Van Lines, Inc., 446 P.2d 868, 873 (N.M. 1968) (citing Bank of New Mexico v. Rice, 429 P.2d 368 (N.M. 1967)).

62. 22 AM. JUR. 2D *Damages* § 735 (1988) (footnotes omitted).

63. *See* HILLIARD, *supra* note 49, at 600 ("[T]he jury are not limited, in assessing damages, to mere compensation, but may give exemplary . . . or vindictive damages, in view of the degree of malice or wantonness, and, as is sometimes held, may take into consideration the plaintiff's expenses of the prosecution of his suit.") (footnote omitted).

64. *See* W. PAGE KEETON, ET. AL., PROSSER & KEETON ON THE LAW OF TORTS § 2, at 9 (5th ed. 1984); Note, *supra* note 50, at 520-21.

65. *Compare* CHARLES T. MCCORMICK, HANDBOOK OF THE LAW OF DAMAGES § 78, at 279 (1935) (noting that in some states punitive damages are regarded not as punishment but as "extra compensation" for injured feelings or sense of outrage, while in other states, although allowed, punitives are limited to litigation costs) *with* THEODORE SEDGWICK, A TREATISE ON THE MEASURE OF DAMAGES § 347, at 502 (1891) ("It might be said, indeed, that the malicious character of the defendant's intent does, in fact, increase the injury, and the doctrine of exemplary damages might thus be reconciled with the strict notion of compensation; but it will appear from the cases we now proceed to examine that the idea of compensation is abandoned, and that of punishment introduced.").

66. Over the years, many justifications for punitive damages have been offered: (i) punishment of the defendant; (ii) specific deterrence, aimed at the defendant; (iii) general deterrence, to prevent others from committing similar acts; (iv) preservation of the peace; (v) inducement for private law enforcement; (vi) compensation to victims for otherwise noncompensable losses; and (vii) payment of the victim's litigation costs. *See* Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1, 3 (1982); Stephan Daniels & Joanne Martin, *Myth and Reality in Punitive Damages*, 75 MINN. L. REV. 1, 7 (1990).

Part V of this article examines in detail the four recent cases that have created a split among the federal courts over the taxation of punitive damages.[67] One of the basic disagreements leading to the current uncertainty over the taxation of punitive damages is whether (i) the nature and purpose of punitive damages under state law is *irrelevant*, making punitive damages completely excludable as long as the underlying personal injury suffered by the taxpayer is "tort-like" so as to implicate I.R.C. § 104(a)(2), or (ii) the purpose of punitive damages *controls*, the theory being that the statute requires the recovery to be "on account of" a personal injury. Under the latter view, punitive damages may or may not be awarded "on account of" a personal injury, depending upon whether such damages are considered under state law to compensate the injury (in which case they are excludable from income) or to merely punish the tortfeasor's outrageous conduct (in which case they awarded "on account of" the tortfeasor's conduct, not the injury, and are not excludable). The nature and purpose of punitive damages under state law played a particularly key role in *Commissioner v. Miller*[68] and *Horton v. Commissioner*,[69] as will be explored in Part V.

III. THE THEORETICALLY CORRECT TREATMENT OF PUNITIVE DAMAGE RECOVERIES

A. *The Return of Capital Theory*

Any discussion of the theoretically correct income-tax treatment of punitive damage recoveries[70] must begin with the Haig-Simons[71] conception of

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67. *See* Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994); Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994); Reese v. United States, 24 F.3d 228 (Fed. Cir. 1994); Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990).

68. *See* 914 F.2d 586 (4th Cir. 1990).

69. *See* 33 F.3d 625 (6th Cir. 1994).

70. *See generally* Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform*, 56 TENN. L. REV. 661 (1989); Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759 (1988); J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13 (1989); Chapman, *supra* note 21; Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43 (1987-88); Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143 (1992); Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701 (1986); Malcolm L. Morris, *Taxing Economic Loss and Recoveries in Personal Injury Actions: Towards a Capital Idea?*, 38 U. FLA. L. REV. 735 (1986); Edward Yorio, *The Taxation of Damages: Tax and Non-tax Policy Considerations*, 62 CORNELL L. REV. 701 (1977).

71. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) ("Serious thought about personal income tax policy has come to be dominated by an ideal in which taxable income is set equal to total personal gain or accretion, without distinctions as to source or use."); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 320 (1972) (recognizing that the Simons model is "now the most widely accepted definition of personal income for tax purposes"); Charles O. Galvin, *Tax Reform: What? Again? A Rose by any Other Name . . .*, 39 *Major Tax Planning* ¶ 1201, at 12-3 (1987) (The Haig-Simons "classical definition has

income.[72] In his classic treatise published in 1938,[73] Henry Simons[74] defined income as:

> the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.[75]

Stated in its short form, the Haig-Simons model equates taxable income to the sum of a taxpayer's "consumption" and his or her "accumulation" during the taxable period.[76]

The application of the Haig-Simons model to a personal injury recovery should result in exclusion of the recovery from the recipient's taxable income to the extent that the recovery merely *compensates* the recipient-taxpayer for a loss in the "accumulation" component of the accretion equation as applied to the taxpayer. Under this view, an injury suffered by a tort victim does indeed negatively impact the accumulation component of the Simons equation, assuming the taxpayer's accumulation includes a monetary value assignable to personal rights and well-being—that is, the taxpayer's "human capital." The subsequent recovery, whether by award or by settlement, serves to compensate this injury and merely restores the human capital impaired by reason of the injury. The loss and recovery negate each other; thus, the recovery should be excludable from gross income.

The Haig-Simons model of taxable income can be illustrated by comparing two hypothetical taxpayers. Taxpayer A has suffered no injury. Taxpayer B is identical in all respects to Taxpayer A, except that Taxpayer B has suffered a personal injury inflicted by a third-party wrongdoer. Assume also that Taxpayer B sues the wrongdoer and recovers an award in compensation of that injury. As a result, Taxpayer B is now in the same economic position as

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become the starting point for any in-depth analysis of the income tax system.").

72. It is recognized that while conceptual models such as the Haig-Simons formulation "are helpful in indicating possible overall objectives of an income tax, they are neither appropriate for statutory use nor intended to be." Surrey & Warren, *supra* note 14, at 770.

73. HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938).

74. The income model formulated by Simons is often referred to as the Haig-Simons model to reflect the contributions of Robert Haig to an earlier statement of the definition. Professor Haig viewed income as "the money value of the net accretion to one's economic power between two points in time," assuming one includes power exercised for consumption purposes. Robert M. Haig, *The Concept of Income—Economic and Legal Aspects, in* THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921). In deference to Haig's statement of the definition, the Haig-Simons model is also sometimes referred to as the accretion model. Simons thought the Haig definition to be interchangeable with his own. *See* Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 932 (1967).

75. SIMONS, *supra* note 73, at 50.

76. *Id.* at 130 (The definition of taxable income can be restated "as the algebraic sum of consumption and accumulation. . . [and] affords the best available basis for personal taxation.").

Taxpayer A. Therefore, Taxpayer B should be entitled, as a matter of sound tax policy, and as a legitimate extension of the Haig-Simons model, to exclude his recovery from taxable income.[77]

The Haig-Simons conceptualization of taxable income has never been widely accepted as a model for either the Code[78] or judicial interpretations of the Code. As discussed in Part III, however, the Haig-Simons model does have an analogy in the federal income tax law known as the "return of capital" theory. Under this theory, an injured taxpayer who recovers a compensatory personal injury award should not be taxed on that award because he is merely recovering human capital impaired as a result of the injury. In other words, the recovery is a "capital" receipt rather than an "income" receipt.[79] This theory has long been recognized by the courts.[80]

Under the return of capital approach, the $170,000 hypothetically awarded to Ms. Liebeck as compensatory damages for her pain and suffering would be viewed as the jury's best approximation[81] of the loss in human capital suffered by her as the result of her injury. The $170,000 merely compensates Ms. Liebeck for a diminution of the value of her pre-injury well-being. Therefore, the return of capital theory would dictate that the $170,000 be received by Ms. Liebeck on a tax-free basis. Similar arguments can be fashioned for a wide range of general compensatory damages, including damages for loss of personal reputation recovered in a libel action.[82]

Conversely, the return of capital theory would indicate that a recovery of punitive damages, assuming it is true that such a recovery serves no compensatory purpose, should be fully taxed. In that case, "there is no compelling fairness argument for excluding" punitive damages from taxable income.[83] As

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77. This result can also be defended on the additional argument that, given the relative positions of these taxpayers, it is fair and equitable to exempt Taxpayer B's award from taxation, or conversely, that it would work an injustice on Taxpayer B if he is taxed on the award. *See, e.g.*, Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 90-91 (1990).

78. For example, under the Haig-Simons model, individual property transactions are essentially irrelevant and ignored. In applying the accumulation component of taxable income, the model merely compares a taxpayer's net worth at the beginning of the measurement period with his net worth at the end of the measuring period. Whether the taxpayer entered into several property transactions during the period, or none at all, has no direct effect on the computation. The Internal Revenue Code, on the other hand, does not adopt this "balance sheet" approach to property transactions, but consistent with the realization principle, imposes a tax upon the gain or loss incurred by the taxpayer on each individual transaction. *See* Eisner v. Macomber, 252 U.S. 189, 207 (1920).

79. *See, e.g.*, 31 Op. Att'y Gen 304, *supra* note 27, at 308.

80. *See, e.g.*, Glenshaw Glass Co. v. Commissioner, 348 U.S. 426, 430 n.6. (1955).

81. It is of course arguable that the jury system is imperfect and will often fail in accurately ascribing a value to a tort victim's loss and that the resulting award may overcompensate the victim and thereby present him with a windfall. *See* Thuronyi, *supra* note 77, at 91.

82. Recoveries for loss of business reputation will also fall within the scope of § 104(a)(2), provided that the underlying theory of recovery involves a tort characterized under state law as "personal." *See, e.g.*, Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983).

83. Thuronyi, *supra* note 77, at 91.

the Supreme Court stated in *Commissioner v. Glenshaw Glass Co.*[84] in a related context,

> The long history of rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages. . . . Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.[85]

Under the return of capital theory, punitive damages are a windfall to the recipient and as such should be taxed in full. Thus, Ms. Liebeck's hypothetical $2.6 million punitive damage award should be taxable.

B. *Deficiencies in the Return of Capital Theory*

Despite its apparent appeal, the return of capital theory suffers from several deficiencies when applied to the tax treatment of damage recoveries for personal injury.

1. Treatment of the Uncompensated Victim. First, the return of capital theory does not adequately describe the Internal Revenue Code's treatment of a hypothetical Taxpayer C, who is identical to Taxpayer B in all respects except that Taxpayer C is not compensated for her injury. Here, Taxpayer C is in a worse economic position than both Taxpayer A and Taxpayer B, and it can be forcefully argued that Taxpayer C should be entitled to a deduction[86] to place her in a relatively equal after-tax position compared to Taxpayers A and B. The Code, however, does not afford Taxpayer C a deduction in recognition of her reduced economic position.[87] In this respect, the return of capital theory is an imperfect predictor of the results obtained under the Code and does not accurately reflect the tax theory underlying the Code.[88]

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84. 348 U.S. 426 (1955). In this landmark case, the taxpayers sued a competitor and received punitive damages for fraud and treble damages for antitrust violations. *Id.* at 431. The taxpayers argued that the punitive damages constituted punishment imposed on the wrongdoer and a mere windfall, which under the definition of income stated in *Eisner*, could not be treated as "income derived from capital, from labor, from both combined." *Id.* (citing Eisner v. Macomber, 252 U.S. 189, 207 (1920)). The Supreme Court repudiated the *Eisner* definition and found damage awards to be taxable because "[h]ere we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients." *Glenshaw Glass Co.*, 348 U.S. at 431.

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

86. The deduction would be equal to the monetary value of Taxpayer C's reduced well-being and loss of human capital. This amount would admittedly be difficult, if not impossible, to determine. Such a deduction would presumably be characterized as a casualty loss deduction, governed by I.R.C. § 165(c)(3) (1988). *See* Kovacs v. Commissioner, 100 T.C. 124, 151 n.22 (1993) (Beghe, J. dissenting).

87. *See* Thuronyi, *supra* note 77, at 90-91.

88. The absence of a deduction for Taxpayer C can be explained in part by the Internal Revenue Code's strong bias against allowing a deduction for any expenditure bearing more than an insubstantial element of personal consumption. *See, e.g.*, I.R.C. § 262 (1988)

2. Treatment of Recoveries for Lost Income. The return of capital theory also fails to explain, and is in fact inconsistent with, the established position of the Service and the courts concerning recoveries for lost wages suffered as the result of a personal injury. If Ms. Liebeck were awarded $10,000 to compensate her for lost income suffered during her hospital stay, the theoretically correct treatment of that portion of the recovery would tax it in full. Had Ms. Liebeck not been injured and continued to work and receive her regular wages in the amount of $10,000, those wages would have been taxed. The $10,000 recovery received by her in lieu of lost wages should, likewise, be fully taxed, because it represents not a return of capital but a wage substitute.[89] Failing to tax Ms. Liebeck's lost income recovery places her in a better after-tax economic position than had she not been injured at all; this is an anomalous result.

Even though recoveries for lost income theoretically should be taxed in full, both the Service[90] and the courts[91] have held that such recoveries (for both past and future earnings) fall within the scope of I.R.C. § 104(a)(2) if awarded or obtained in respect of a personal injury. They are therefore excludable from income. The courts have extended this analysis to recoveries for lost income due to nonphysical injuries as well as physical injuries. In so doing, the courts have acknowledged that the victim is thereby placed in a better after-tax economic position than had he never been injured in the first place. This anomaly, however, has not led the courts to withhold the § 104(a)(2) exclusion from lost income recoveries.[92]

(precluding the deduction of expenditures for personal, living, or family expenses).

89. As has been noted, this notion is so well established in the federal income tax that the taxpayer in *Glenshaw Glass Co.* had included the compensatory one-third of its recovery in income, representing lost revenues, and did not challenge its taxability. Brooks, *supra* note 70, at 764.

90. *See, e.g.*, Rev. Rul. 85-97, 1985-2 C.B. 50, in which the taxpayer was struck by a bus and settled his multiple count claim prior to trial. The ruling concludes that the "entire . . . settlement amount, including the amount allocable to the claim for lost wages, represents compensation for personal injuries" and is therefore excludable. *Id.* at 51; *see also* Rev. Rul. 61-1, 1961-1 C.B. 14.

91. *See, e.g.*, Roemer v. Commissioner, 716 F.2d 693, 696-97 (9th Cir. 1983); *see also* Threlkeld v. Commissioner, 87 T.C. 1294, 1300 (1986), where this approach was:

> graphically illustrated by considering the case of a young surgeon who los[t] a finger because of the tortious conduct of another. . . . This injury will surely cause the surgeon compensable general damages, such as physical and emotional pain and suffering, but it will also undoubtedly cause special damages including loss of future income. In order to prove the extent of the damages flowing from a clearly personal injury, the surgeon will likely produce evidence of both his actual pain and suffering and his loss of income. However, because it is easier to place a present dollar value upon the loss of future income than upon an intangible such as emotional pain, the surgeon will quite predictably place greater emphasis on lost income as a measure of his damages and will perhaps, thereby, receive a greater recovery. In such a case, the entire damage award or settlement amount received will be excluded from income. The fact that the tortious conduct causing the severed digit manifested itself in the loss of future income to the surgeon raises no troubling questions as to the exclusion of the award.

Id. at 1300.

92. In Rickel v. Commissioner, 900 F.2d 655, 660 (3d Cir. 1990), the Third Circuit

In extending the scope of § 104(a)(2) to encompass recoveries for lost income, the courts have implicitly failed to recognize the return of capital theory in a context where its application is clearly indicated.[93] Therefore, it is again arguable that the return of capital theory does not adequately explain the underlying rationale of the courts' application of the Internal Revenue Code to recoveries for personal injuries.

3. Treatment of Punitive Damages for Physical Injury After RRA '89. As will be discussed at greater length in Part IV of this article,[94] Congress amended I.R.C. § 104(a)(2) as part of RRA '89 to provide that the statutory exclusion *will not* be available for punitive damages that *are not* received on account of a physical injury. While the meaning of this amendment, and the intent of Congress in enacting it, are far from clear, a reasonable interpretation of the amendment is that following RRA '89, the exclusion *will* be available for punitive damages that *are* received on account of a physical injury.[95] This result remains contrary to the return of capital theory and once again fails to explain accurately the Internal Revenue Code's intended treatment of personal injury damage recoveries.

4. Treatment of Recoveries for Damages to Property. The consequences of applying the return of capital theory to personal injury recoveries must be compared to its application to recoveries for property damages. Assume, for example, that Taxpayer Y owns Blackacre, a parcel of unimproved land. Assume also that Blackacre is rendered worthless and must be abandoned by Taxpayer Y due to contamination from toxic waste introduced onto Blackacre by Taxpayer Y's negligent neighbor. Any recovery by Taxpayer Y against his neighbor to compensate Taxpayer Y for the loss of Blackacre will be considered a return of capital with respect to Blackacre.[96] This does not, however, lead to the result that the entire recovery is necessarily nontaxable. To the contrary, Taxpayer Y must compare the recovery to his basis in Blackacre,[97]

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concluded that the taxpayer's recovery for lost wages in a successful age discrimination lawsuit was fully excludable under § 104(a)(2). The court acknowledged:

> [I]t might be troubling to some that a successful plaintiff in an ADEA suit will make out better, vis-a-vis federal income tax liability, than if the plaintiff had not been discriminated against in the first place. Although this concern is understandable, we note that . . . the successful ADEA plaintiff is being treated no better (or worse now) than the typical tort victim who suffers a physical injury. We see no reason to treat one personal injury victim any differently than another.

Rickel, 900 F.2d at 664; *see also* Pistillo v. Commissioner, 912 F.2d 145, 150 (6th Cir. 1990) (finding a back pay award in a successful age discrimination lawsuit to be excludable and conceding that the taxpayer "will have less federal tax liability than if he had not suffered age discrimination in the first place").

93. Professor Dodge has argued that there may be circumstances where the exclusion of a recovery for lost income would be logical and correct, depending upon whether certain factors (such as the amount of the award, the discount rate, or the projected amount of future earnings) have been applied on an after-tax or before-tax basis. *See* JOSEPH M. DODGE, THE LOGIC OF TAX 109-14 (1989).

94. *See infra* text accompanying note 276.

95. *See infra* text accompanying note 283.

96. *See infra* text accompanying note 125. *See generally* Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944).

97. For the rules governing the determination of a taxpayer's basis in property, see

and any difference between these two amounts is either a taxable gain or loss.[98] Thus, if Taxpayer Y's basis in Blackacre was $60,000, and he recovered $100,000 (Blackacre's then-fair market value) to compensate him for the loss of Blackacre, Taxpayer Y must report a taxable gain of $40,000.[99]

This result does not conform to the proposed operation of the return of capital theory in the context of compensatory personal injury recoveries, which are argued to be fully tax-exempt under that theory. Completely exempting the personal injury recovery ignores the possibility that the recovery ought to be tax-exempt only to the extent of the taxpayer's basis in the converted asset. Yet in the context of personal injuries, this begs the question: what is the converted asset? Perhaps the best answer that can be given is that the converted asset is "human capital," an admittedly nebulous concept that may be described to include the sum total of the taxpayer's personal rights, health, and welfare. Is it possible for a taxpayer to prove that she has a "basis" in such human capital? This seems highly unlikely.[100] It appears that any recovery by a tort victim to compensate her for the diminution in value of her personal well-being should in fact be fully taxed because the victim has no basis in the asset being converted and compensated.[101]

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generally I.R.C. §§ 1011-1016 (1988). Generally, a taxpayer's basis in a particular asset will be the taxpayer's cost to acquire the asset. I.R.C. § 1012 (1988).

98. *See* Telefilm, Inc. v. Commissioner, 21 T.C. 688, 695 (1954), *nonacq.* 1954-2 C.B. 6, *rev'd on other grounds*, 55-1 U.S. Tax Cas. (CCH) ¶ 9,453 (9th Cir. 1955):

> Surely, to the extent that damages for the destruction of property, whether tangible or intangible, do not exceed the cost or other unrecovered basis of such property, they are merely a return of capital and are not taxable at all. But to the extent that such damages exceed the unrecovered basis of the property the excess represents a profit which constitutes taxable income.

Id. at 695; *see also* Freeman v. Commissioner, 33 T.C. 323, 327 (1959); Cullins v. Commissioner, 24 T.C. 322, 327 (1955). *See generally* ROBERT W. WOOD, TAX ASPECTS OF SETTLEMENTS AND JUDGMENTS, Tax Mgmt. (BNA) No. 522, at A-3 (1993).

99. This result does not obtain under the Haig-Simons model of taxable income, under which the concept of "basis" is unknown. *See generally* SIMONS, *supra* note 73 and accompanying text.

100. *See, e.g.*, DODGE, *supra* note 93, at 108. Dodge argues:

> [A] person has a basis equal to the sum of "human capital" expenditures, which initially might seem to include such items as outlays for food, education, preventive health care, vitamins, and the like. Unfortunately, nobody keeps track of these outlays, nor would it be feasible to do so.

Id.; *see also* United States v. Garber, 607 F.2d 92, 98 (5th Cir. 1979). *Garber* was a criminal tax case in which the court relied upon a perceived uncertainty in proving the defendant's basis in her blood plasma to remand her conviction for tax evasion for failing to report the substantial income she generated from the sale of the plasma. The dissent argued that Mrs. Garber had not persuasively shown that she "had anything but a zero basis in her plasma." *Id.* at 103 (Ainsworth, J., dissenting); *see also* Roemer v. Commissioner, 716 F.2d 693, 696 n.2 (9th Cir. 1983) ("Since there is no tax basis in a person's health and other personal interests, money received as compensation for an injury to those interests might be considered a realized accession to wealth. Nevertheless, Congress in its compassion has retained the exclusion (now codified at I.R.C. § 104(a)(2)."). *See generally* Dodge, *supra* note 70, at 152-53. For a light hearted look at this issue, see Note, *Tax Consequences of Transfers of Bodily Parts*, 73 COLUM. L. REV. 842 (1973).

101. There may be alternate theories of exclusion for personal injury recoveries in this

Analogizing to the application of the return of capital theory to recoveries for property damage, the theory would not result in a tax-exempt personal injury recovery. Again, the proper tax treatment of personal injury recoveries under the return of capital theory is at best problematic, and the theory as applied yields inconclusive results.

C. *Summary*

The Haig-Simons model of taxable income provides an excellent starting point for evaluating the tax treatment of personal injury recoveries. Its corollary in federal income tax law, the return of capital theory, has likewise proven to be an attractive rationale for those courts concluding that punitive damages should not be excluded under I.R.C. § 104(a)(2). Indeed, if Congress and the courts were writing on a clean slate, the return of capital theory would be extremely persuasive, if not compelling, in resolving the question. The slate, however, is hardly clean. The return of capital theory has severe limitations given its uncertain application to other issues in this area.[102] Reliance on this theory to explain or justify the tax treatment of punitive damage recoveries is hazardous at best.

IV. OTHER FACTORS INFLUENCING THE CONSTRUCTION AND APPLICATION OF I.R.C. § 104(a)(2)

A. *History of the IRS's Ruling Stance on Punitive Damages*

A major factor contributing to the current uncertainty over the taxation of punitive damages has been the Internal Revenue Service's own inconsistent

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context. For example, exclusion may be defended on the argument that most of the expenditures incurred by a taxpayer in creating "human capital," such as food, preventive health costs, education, and the like, are nondeductible personal expenditures and are not capital expenditures. *See* I.R.C. § 262 (1988). Therefore, it is arguably appropriate to mirror this treatment by allowing a recovery compensating for a loss of human capital to be received tax-free. *See* DODGE, *supra* note 93, at 108; *see also* Paul B. Stephan III, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357, 1391-95 (1984).

The fact that the typical tort victim is being compensated for injuries inflicted in an *involuntary* transaction may also provide an explanation for the exclusion of the recovery. Under I.R.C. § 1033(a)(2)(A) (1988), if a taxpayer's property is converted involuntarily such as by destruction or condemnation, the taxpayer may nevertheless avoid gain on the conversion by reinvesting the conversion proceeds (e.g., insurance proceeds, condemnation award) into property which is "similar or related in service or use to the property so converted." Any realized gain (i.e., the difference between the proceeds and the property's adjusted basis) will not be recognized and will be *deferred* by means of adjustments to the basis of the replacement property. *See* I.R.C. § 1033(b) (1988). Exemption of a compensatory recovery for personal injuries may simply reflect that, in the case of human capital, there is simply no ability to reinvest the proceeds of the recovery in a similar fashion and that in the interest of fairness, the tort victim ought to enjoy exemption. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 42-43 (7th ed. 1994); DODGE, *supra* note 93, at 112-13; *see also* Cochran, *supra* note 70, at 46-47 (criticizing this rationale and noting that I.R.C. § 1033 does not provide for exclusion, only deferral, of the realized gain).

102. *See* Burke & Friel, *supra* note 70, at 42.

rulings and litigating positions. Over the years, the Service has struggled to develop a coherent analytical approach to punitive damages; however, the results have been confusing. The following rulings illustrate the unpredictable course charted by the Service in this area.

Revenue Ruling 58-418[103]

In Revenue Ruling 58-418, the taxpayer received both compensatory and punitive damages in settlement of a libel suit. Relying on *Commissioner v. Glenshaw Glass Co.*,[104] the Service ruled that the punitive damages were taxable.

Revenue Ruling 75-45[105]

The Service subsequently reversed its position in Revenue Ruling 75-45, ruling punitive damages to be within the scope of I.R.C. § 104(a)(2) exclusion. The taxpayer in this ruling was an estate. The decedent had been killed in an airplane crash, and in return for a release of all wrongful death claims against the airplane's owner, the executor accepted a check from the owner's insurance company.[106] The ruling conceded that under the law of the decedent's state of residence, a series of court decisions had established that payments made under the wrongful death act were strictly punitive in nature.[107] In holding these damages to be excludable, the ruling stated,

> Section 104 of the Code is a specific statutory exclusion from gross income within the "except as otherwise provided" clause of section 61(a). Section 104(a)(2) excludes from gross income "the amount of any damages received (whether by suit or agreement) *on account of personal injuries or sickness*" (emphasis added). Therefore, under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income.[108]

Under this analysis, the treatment of punitive damages mirrors the treatment afforded to compensatory damages: if compensatory damages received on account of a particular injury are excludable, then any punitive damages arising out of the same injury would likewise be excludable; and if the compensatory damages are taxable, then any punitive damages arising from the same injury are also taxable.

Revenue Ruling 84-108[109]

In *Roemer v. Commissioner*,[110] the Service argued before the Ninth Circuit Court of Appeals that a punitive damages award received by a successful plaintiff in a libel and defamation action was taxable, despite the Tax Court's

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103. 1958-2 C.B. 18.
104. 348 U.S. 426 (1955).
105. 1975-1 C.B. 47.
106. *Id.*
107. *Id.*
108. *Id.*
109. 1984-2 C.B. 32.
110. 716 F.2d 693 (9th Cir. 1983).

previous holding that compensatory damages arising out of the same injury were excludable. This litigating position was inconsistent with the Service's own Revenue Ruling 75-45. To the Service's chagrin, the Ninth Circuit in *Roemer* relied heavily on Revenue Ruling 75-45 in holding punitive damages excludable, despite the court's strong doubt that the ruling was correct.[111] That same year, in *Church v. Commissioner*,[112] the Tax Court also relied on Revenue Ruling 75-45 in concluding that a punitive damages award in a libel action was excludable, having held that the compensatory damages portion of the taxpayer's award was also excludable.

Saddled with a Revenue Ruling undercutting its current litigation position, the Service reconsidered its liberal application of I.R.C. § 104(a)(2) to punitive damages set forth in that ruling. One year later, in Revenue Ruling 84-108, the Service revoked Revenue Ruling 75-45.[113]

In Revenue Ruling 84-108, the Service revisited the facts of Revenue Ruling 75-45 and assumed that the decedent was domiciled in, alternatively, Virginia or Alabama. Under the wrongful death act of Virginia, the amount recoverable was limited to the amount necessary to compensate the survivors for their loss sustained because of the wrongful death. Punitive damages, however, were recoverable.[114] In Alabama, the applicable wrongful death act provided exclusively for the payment of punitive damages based on the degree of fault of the liable party as opposed to the loss sustained by the survivors.[115]

Focusing on the fact that payments made under the wrongful death act of Alabama were strictly punitive in nature, the ruling continued:

> In *Commissioner v. Glenshaw Glass Co.*, . . . the Supreme Court held that punitive damages received in an antitrust case and punitive damages received in a fraud case are includable in gross income. In arriving at this decision, the Court examined the nature of these damages and concluded that punitive damages are not a substitute for any amounts lost by the plaintiff or a substitute for any injury to the plaintiff or plaintiff's property, but are extracted from the wrongdoer as punishment for unlawful conduct. The Court held that these damages represent accessions to wealth and are includable in gross income. . . .
>
> An award of punitive damages . . . does not compensate a taxpayer for a loss but add to the taxpayer's wealth. Furthermore, punitive damages are awarded not "on account of personal injury," as required by section 104(a)(2), but are determined with reference to the defendant's degree of fault.[116]

The ruling concluded that payments made under the Virginia wrongful

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111. *See infra* text accompanying note 301.

112. 80 T.C. 1104 (1983).

113. *See* Mary J. Morrison, *Getting a Rule Right and Writing a Rule Wrong: The IRS Demands a Return On All Punitive Damages*, 17 CONN. L. REV. 39 (1984).

114. Rev. Rul. 84-108, 1984-2 C.B. at 33.

115. *Id.*

116. *Id.* at 33-34.

death act were excludable under I.R.C. § 104(a)(2), but that payments made under the Alabama act were taxable.[117] Revenue Ruling 75-45 was revoked.[118]

In Revenue Ruling 84-108, the Service articulated two arguments that subsequently became the bases of its litigating position concerning punitive damages. First, in its discussion of *Glenshaw Glass*, the Service concluded that the return of capital theory is relevant to the interpretation of I.R.C. § 104(a)(2) and requires punitive damages to be included in income. Second, the phrase "on account of" personal injuries has an independent vitality and represents a separate test in applying I.R.C. § 104(a)(2). The phrase requires punitive damages to be included in gross income because punitive damages are received not "on account of" a personal injury, but rather, on account of the tortfeasor's egregious or malicious conduct.

The Service's inconsistent ruling history has contributed greatly to the lack of consensus in the federal courts over the taxation of punitive damages.

B. United States v. Burke

A second factor tending to cloud rather than clarify the proper tax treatment of punitive damages is the Supreme Court's decision in *United States v. Burke*.[119] The *Burke* controversy has its roots in the early government rulings that left some doubt as to how the I.R.C. § 104(a)(2) exclusion was intended to apply to recoveries for nonphysical and physical injuries.[120] From this fairly innocuous origin, the physical-vs.-nonphysical question mushroomed into a full-fledged and well-chronicled[121] controversy that has yet to be resolved and that has continuing implications for the taxation of punitive damages. To

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117. *Id.* at 34. A federal district court, later addressing the tax treatment of damages received under the very Alabama wrongful death statute at issue in Revenue Ruling 84-108, concluded that the Ruling was erroneous and that the phrase "any damages" as used in I.R.C. § 104(a)(2) extended the exclusion to punitive damages as well. Burford v. United States, 642 F. Supp. 635 (N.D. Ala. 1986).

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

119. 112 S. Ct. 1867 (1992).

120. *See supra* note 27 and accompanying text.

121. *See generally* Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 TAX LAW. 755, 766 (1993); Robert B. Fitzpatrick, *Taxation of Awards and Settlements Under Employment Discrimination Statutes*, C932 A.L.I.-A.B.A. 795 (1994); Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Awards Under Federal Civil Rights Statutes: Income from Human Capital, Realization, and Nonrecognition*, 72 N.C. L. REV. 549 (1994); Richard T. Helleiod & Lucretia S. W. Mattison, *Has the Scope of the Personal Injury Exclusion Been Changed by the Supreme Court?*, 77 J. TAX'N 82 (1992); Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 TAX LAW. 783 (1992); David G. Jaeger, *Taxation of Punitive Damage Awards: The Continuing Controversy*, 57 TAX NOTES 109 (1992); Susan W. Matlow, *Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?*, 44 VAND. L. REV. 369 (1991); Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 LA. L. REV. 875 (1988); Robert W. Wood, *Taxing Discrimination Recoveries: Bucking Burke*, 56 TAX NOTES 363 (1992).

gain an appreciation of the controversy that the Supreme Court encountered in *Burke*, a review of the leading cases that culminated in *Burke* is appropriate.

1. Pre-*Burke* Case Law Developments

Roemer[122] and *Threlkeld*[123]

Prior to the Ninth Circuit's opinion in *Roemer*, it was well established that all compensatory damages received because of a *physical* personal injury were excludable under I.R.C. § 104(a)(2), including those components of the recovery that compensated for such distinctly nonpersonal elements as lost wages and profits. Recoveries for items such as lost wages have been held non-taxable despite the fact that had the victim never been injured and had earned the wages in the first instance, the wages would have been taxable.[124] Thus, in the case of physical personal injury, the nature and character of the *injury* as a personal injury was all-controlling, and the fact that some of the consequences flowing from the injury were nonpersonal or business-related was irrelevant.

On the other hand, the Service had never conceded that the same rule would control in the case of *nonphysical* injury. Until recently, the Service had maintained instead that the proper analysis was to analyze the *consequences* of the nonphysical injury to determine the tax treatment of the recovery.[125] Under this theory, the various components of an award would be taxed by reference to what the award is intended to replace. Thus, if one consequence of a nonphysical injury—such as defamation—is lost wages, any subsequent recovery for those lost wages would *not* be excludable under I.R.C. § 104(a)(2), notwithstanding that the injury was decidedly personal in nature, because wages are ordinarily taxable. The validity of this physical-vs.-nonphysical distinction was the central issue in *Roemer*.

The taxpayer in *Roemer*, a casualty insurance salesman, claimed he was injured by a defamatory credit report prepared by Retail Credit Co. Roemer sued Retail Credit in 1965, claiming libel and defamation, and following trial he was awarded $40,000 in compensatory damages and $250,000 in punitive

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

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

124. *See supra* notes 90 and 91.

125. This approach would be consistent with the general rule applicable to damage recoveries. Under this general rule, the federal income tax treatment of a damage award depends on the nature of the underlying claims asserted, not the nature of the injury. United States v. Gilmore, 372 U.S. 39 (1963). The inquiry is in lieu of: what were the damages awarded? *See, e.g.*, Fono v. Commissioner, 79 T.C. 680 (1982); Raytheon Prod. Corp. v. Commissioner, 1 T.C. 952 (1943), *aff'd*, 144 F.2d 110, 113 (1st Cir. 1944). Thus, if ABC Corporation sues XYZ Corporation and recovers lost profits caused by XYZ's tortious act, the recovery is taxable just as the profits would have been taxable if received in the first place. § 104(a)(2) is an exception to this general rule, applicable only to cases of personal injury that fall within its scope. Despite the fact that nonphysical injuries are acknowledged to qualify for treatment under I.R.C. § 104(a)(2), the Service has nevertheless historically applied the "in lieu of what were the damages awarded" analysis to determine the tax consequences of nonphysical injury recoveries.

damages.[126] Most of the evidence produced at trial related to Roemer's lost business, damage to his business relationships, and his general reputation in the insurance industry.[127]

After the Service determined that the entire award was includable, Roemer argued before the Tax Court that the jury awarded him compensatory and punitive damages based on personal injuries to his personal and professional reputation, and thus the damages should be excluded from his gross income under § 104(a)(2).[128] The Service argued that because the injury inflicted on Roemer was nonphysical, it was appropriate to look not to the nature and character of the injury suffered, but rather to the consequences of that injury to determine if the damages received by Roemer were excludable because of those consequences.[129] Here, the consequences were lost profits and income; therefore, the Service argued that the damages received by Roemer in compensation for those lost profits were includable in Roemer's gross income.

The Tax Court majority sided with the Service in *Roemer*,[130] thus validating the Service's physical-vs.-nonphysical distinction.[131] In dissent, Judge Wilbur noted that where a taxpayer is physically injured, as in an accident, the entire award is nontaxable under § 104(a)(2), including components such as lost income. In fact, lost income often represents the best measure of the damages suffered by the victim and may even constitute the entire award.[132] Judge Wilbur saw no reason to place lost wages and other business injury recoveries outside the scope of § 104(a)(2) in cases where the injury was nonphysical, as long as the injury was in fact a "personal" one.[133]

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126. *Roemer*, 79 T.C. at 403.

127. *Id.* at 401-02.

128. *Id.* at 404.

129. *Id.*

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

131. *Id.* at 405-406. The next year, prior to the Ninth Circuit's reversal of the Tax Court in *Roemer*, the Tax Court again analyzed the tax consequences of a nonphysical personal injury recovery in Church v. Commissioner, 80 T.C. 1104 (1983). The taxpayer in *Church* had been libeled by the Arizona Republic while serving as Attorney General for the State of Arizona. After the Republic called Church a "communist" in print, Church's public life was ruined, causing him embarrassment, humiliation, emotional distress, and other pain and suffering. After protracted litigation, Church was awarded $250,000 in compensatory damages and $235,000 in punitive damages. Reiterating its analysis from *Roemer*, the Tax Court noted that in defamation actions there is a distinction between damages received for personal reputation (nontaxable) and damages received for loss of business and professional reputation affecting income (taxable). In the instant case, however, unlike in *Roemer*, there was no evidence that any of Church's recovery was in any way tied to lost income, nor had Church asserted any claims for lost income. Rather, his compensatory damages related solely to the pain and suffering of a ruined career. While Church lost his public career, he did not lose his career as an attorney; he simply was limited to private practice. Thus, there was no evidence of lost income. Holding his compensatory damages recovery excludable, the court noted that "[i]n our opinion, shattered dreams, ruined careers, and the mental anguish that follow are just as personal as, for instance, loss of limb." *Church*, 80 T.C. at 1105-06, 1108-09.

132. *Roemer*, 79 T.C. at 413-14 (Wilbur, J., dissenting).

133. In an example that was to echo through subsequent cases, Judge Wilbur noted:

> A young surgeon who loses a finger will recover damages that for the most part replace future earnings otherwise taxable, but the loss is not bifurcated into its

On appeal, the Ninth Circuit reversed the Tax Court's ruling.[134] The Ninth Circuit rejected the Tax Court's analytical approach[135] and concluded that its "analysis of this matter confuses a personal injury with its consequences and illogically distinguishes physical from nonphysical personal injuries."[136] The court continued:

> The relevant distinction that *should* be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries. I.R.C. § 104(a)(2) states that damages received on account of *personal* injuries are excludable; it says nothing about physical injuries. "[T]he words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." . . . The ordinary meaning of a personal injury is not limited to a physical one.[137]

The Court of Appeals concluded that, for both physical and nonphysical injuries, the proper inquiry is into the nature and character of the injury and not the consequences that flow from that injury. Consistent with Judge Wilbur's dissent,[138] the Ninth Circuit noted that although lost wages and other business-related damages often represent the best indicator of the extent of the injury suffered by the tort victim, those consequences should not *define* the injury.[139] Because this rule had long been recognized in the case of physical damages, the Ninth Circuit did not feel that the nonphysical nature of an inju-

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economic and personal components, thereby subjecting the former to taxation. Neither should damages for defamation of character, since defamation is by definition personal to the plaintiff. In both cases, section 104 excludes the damages from income—both the economic and personal components—from income.

Id. at 414; *see also supra* note 91.

134. Roemer v. Commissioner, 716 F.2d 693, 694 (9th Cir. 1983), *nonacq.*, 1985-2 C.B. 55.

135. The court stated:

> When an individual recovers damages for a physical personal injury, the lump-sum award is not allocated between the personal aspects of the injury and the economic loss occasioned by the personal injury, nor is the taxpayer precluded from use of § 104(a)(2) when the predominant result of the injury is a loss of income. However, when the injury is nonphysical, as is defamation, the majority of the tax court would require the taxpayer to allocate an award between the excludable and the otherwise taxable components of the damages.

Roemer, 716 F.2d at 697.

136. *Id.* at 696-97.

137. *Id.* at 697 (emphasis added) (citation omitted).

138. *See supra* note 133 and accompanying text.

139. The court noted:

> Although there are different types of defamation actions (libel or slander) depending on the form of the defamatory statements, all defamatory statements attack an individual's good name. This injury to the person should not be confused with the derivative consequences of the defamatory attack, *i.e.*, the loss of reputation in the community and any resulting loss of income. The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect.

Roemer, 716 F.2d at 699 (footnote omitted).

ry calls for the application of a different rule.[140]

The question thus became whether the nature and character of the injury compensated in a California tort action for defamation was such that damages received in compensation of that injury were on account of a "personal" injury for purposes of I.R.C. § 104(a)(2). Turning to state law,[141] the Ninth Circuit examined the nature of an action for defamation in California[142] and concluded that, under the law of California, "defamation of an individual is a personal injury."[143] Therefore, Roemer's compensatory damages were excludable under § 104(a)(2) as were compensatory damages received because of any personal injury.[144]

In *Threlkeld*,[145] the Tax Court had the opportunity to reconsider its analytical approach in *Roemer* in light of the Ninth Circuit's reversal.[146] Threlkeld had sued Williams for malicious prosecution and settled his claims for $300,000. The settlement allocated the damages to Threlkeld's professional reputation; his credit reputation; his personal indignity, humiliation, inconvenience, and pain and distress of mind; and the settlement of an outstanding judgment that Threlkeld held against Williams.[147] Threlkeld did not report any of the settlement. The Service, still clinging to its physical-vs.-nonphysical injury distinction,[148] asserted that the damages received from injury to professional reputation were taxable under the theory that the consequences of the injury, not the nature of the injury itself, were dispositive of the settlement's tax treatment. Under this theory, the damages received by Threlkeld for injury

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140. *See id.* at 697.

141. Following the Erie Doctrine, the court concluded that "[s]ince there is no general federal common law of torts nor controlling definitions in the tax code, we must look to state law to analyze the nature of the claim litigated." *Id.*

142. *Id.* at 697-700.

143. *Id.* at 700.

144. *Id.*

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

146. In *Threlkeld*, the Tax Court summarized this approach:

> If a taxpayer receives a damage award for a physical injury, which almost by definition is personal, the entire award is excluded from income even if all or a part of the recovery is determined with reference to the income lost because of the injury. 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.

Threlkeld, 87 T.C. at 1300.

The court compared this approach to that applied to the victim of a physical injury, such as the surgeon who loses a finger in Judge Wilbur's hypothetical:

> The fact that the tortious conduct causing the severed digit manifested itself in the loss of future income to the surgeon raises no troubling questions as to the exclusion of the award. 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.

Id. at 1300-01. For the origin of the hypothetical, see Roemer v. Commissioner, 79 T.C. 398, 414 (1982) (Wilbur, J., dissenting).

147. *Threlkeld*, 87 T.C. at 1296.

148. The Service had entered a nonacquiescence to the Ninth Circuit's decision in *Roemer*. Rev. Rul. 85-143, 1985-2 C.B. 55.

to business reputation were not on account of a "personal" injury for purposes of I.R.C. § 104(a)(2).

The Tax Court abandoned the analysis it articulated in *Roemer* and declared it incorrect.[149] The court stated, "for purposes of section 104(a)(2), there is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury to professional reputation."[150] Thus, the Tax Court concluded that it would no longer focus on the monetary consequences flowing from a nonphysical injury to determine whether it was a "personal" injury for purposes of § 104(a)(2); instead, it would consider the nature and character of the injury itself. If that injury was of a personal nature, then damages paid therefor were to be considered "personal injuries" for purposes of the exclusion.[151] In so holding, the Tax Court articulated a test cited by virtually all courts subsequently confronted with the question: "Section 104(a)(2) excludes from income amounts received as damages on account of personal injuries. Therefore, *whether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry.*"[152]

This approach became *Threlkeld's* major contribution to the law developing around I.R.C. § 104(a)(2). It has also served as the central point of contention in the punitive damages area. Recent decisions grappling with the question of the taxation of punitive damages have disagreed sharply as to whether the *Threlkeld* analysis is still viable after the Supreme Court's decision in *United States v. Burke*. If so, the logical conclusion is that if an underlying personal injury is "tort or tort-type" in nature, then *all* damages recovered from the tortfeasor—including punitive damages—are excludable under I.R.C. § 104(a)(2). On the other hand, if the *Threlkeld* analysis has not survived *Burke*, perhaps it is appropriate to further examine the nature and purpose of the recovery under state law to determine whether it is truly recovered "on account of" personal injury or "on account of" something else. Part VI of this

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149. The court stated:

> We do not lightly decline to follow one of our prior decisions; no court bound by the doctrine of stare decisis does. But where one of our decisions lacks a firm foundation in the case law and an appellate court issues a well-reasoned reversal of that decision, the weight of precedent must give way to a better approach. Therefore, we will no longer distinguish between personal reputation and professional reputation for the purpose of deciding whether a damage award received in a tort action is excludable from gross income under section 104(a)(2).

Threlkeld, 87 T.C. at 1304-05.

150. *Id.* at 1298.

151. The court stated:

> To determine whether the injury complained of is personal, *we must look to the origin and character of the claim and not to the consequences that result from the injury.* No doubt a defamatory statement that injures a person's professional reputation will result in lost income. In such cases, the amount of income lost is an accurate measure of the damages sustained because of the injury to reputation. However, the extent to which income is decreased, even though this may be the best measure of loss, in no way changes the nature of the claim.

Id. at 1299 (emphasis added).

152. *Id.* (emphasis added).

article explores this issue in detail.

How is the beginning-and-end-of-the-inquiry analysis from *Threlkeld* to be undertaken? How is a "personal injury" to be identified? In *Threlkeld*, the central question was whether Threlkeld's malicious prosecution claim was one for "personal injury" under § 104(a)(2). If so, then the damages received by Threlkeld were received "on account of personal injuries" and therefore excludable. In this regard, the court concluded:

> The determination of whether damages are received on account of a personal injury properly depends on the nature of the claim. The regulations under section 104(a)(2) narrow the scope of damages received to those amounts received through prosecution of *tort or tort-type rights*. Therefore, "the essential element of an exclusion under section 104(a)(2) is that the income involved must derive from some sort of tort claim against the payor." As a result, *common law tort law concepts are helpful* in deciding whether a taxpayer is being compensated for a "personal injury."[153]

Under the *Threlkeld* analysis, the critical inquiry is whether the underlying claim seeks to vindicate "tort or tort-type" rights, which in turn implicates common law tort concepts. Because there is no federal common law of torts, recourse to common law tort concepts necessarily requires examination of the relevant tort law of the state in which the underlying action was brought.[154] In attempting to establish guidelines for identifying a tort or tort-type claim, the court noted that "[e]xclusion under section 104 will be appropriate if compensatory damages are received *on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law*."[155]

With this in mind, the Tax Court looked to Tennessee law for guidance as to the nature and character of Threlkeld's claim.[156] Finding the tort of malicious prosecution to be similar to the tort of defamation (found in *Roemer* to be a tort for personal injury under California law), the court concluded based on their analysis of Tennessee law that "an action for malicious prosecution would be classified as an action for personal injuries."[157] Any damages Threlkeld received were received as compensation for the invasion of rights granted to him "by virtue of being a person in the sight of the law." Threlkeld's settlement was thus held within the scope of I.R.C. § 104(a)(2) and therefore excludable from gross income. The Sixth Circuit Court of Ap-

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153. *Threlkeld*, 87 T.C. at 1305 (emphasis added) (citations omitted).

154. In this context, the court stated:

> We find that the use of the terms "damages" and "personal injury" by Congress necessarily implies that the exclusion under section 104(a)(2) depends, to some degree, upon classifications under State law. This is confirmed by use of the term "tort or tort type rights" in the regulations under section 104(a)(2).

Id. at 1306 n.6.

155. *Id.* at 1308 (emphasis added). Note that the cited passage refers to compensatory damages.

156. *Id.* at 1307.

157. *Id.*

peals[158] subsequently affirmed.[159]

Threlkeld established an analytical approach to I.R.C. § 104(a)(2) that might be termed a "one-step" approach.[160] The Tax Court abolished any distinction between physical injuries and nonphysical injuries in applying the exclusion. All that mattered was whether the damages were received "on account of personal injuries." This represented the "beginning and end of the inquiry."[161] The *Threlkeld* inquiry requires an examination of the taxpayer's underlying claim in light of relevant state tort law to determine if the claim is a "legal suit or action based upon tort or tort-type" rights as called for under the Regulations, that is, whether the claim is one arising from the invasion of rights granted to the taxpayer "by virtue of being a person in the sight of the law." Put another way, so long as the taxpayer's claim is one that is advanced in an action based upon tort or tort-type rights, nothing more needs to be said. In such a case, any damages received from successfully prosecuting the claim are received "on account of personal injuries" for purposes of the statute.

The principle developed by the Ninth Circuit in *Roemer* was followed in a subsequent pro-taxpayer decision, *Bent v. Commissioner*.[162] The taxpayer in

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158. The Sixth Circuit has been called upon in recent years to provide its views on virtually all of the important questions litigated under I.R.C. § 104(a)(2): the physical vs. nonphysical injury controversy (Threlkeld v. Commissioner, 848 F.2d 81 (6th Cir. 1988)); the long battle over the taxation of back pay awards that ultimately led to the Supreme Court's decision in United States v. Burke, 112 S. Ct. 1867 (1992) (Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990)); the *Burke* case itself (Burke v. United States, 929 F.2d 1119 (6th Cir. 1991)); and the taxation of punitive damages (Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994)).

159. Threlkeld v. Commissioner, 848 F.2d 81 (6th Cir. 1988). The Court of Appeals concluded:

> We agree with the Ninth and the Third Circuits [in *Roemer* and in the subsequently-decided case of Bent v. Commissioner, 835 F.2d 67 (3rd Cir. 1987)] that the nonpersonal consequences of a personal injury, such as a loss of future income are often the most persuasive means of proving the extent of the injury that was suffered, and that the personal nature of an injury should not be defined by its effect. Injury to a person's hand or arm is a personal injury. This is so even though it may affect a person's professional pursuits. All income in compensation of that injury is excludable under section 104(a)(2). Similarly, the injury to taxpayer's reputation in this case was a personal injury. This is so even though it affected his professional pursuits. All income in compensation of that injury is excludable under section 104(a)(2).

Id. at 84.

160. Concededly, the analysis is not truly a "one step" test. The underlying action, in addition to being tort or tort-type, must also be *personal* in nature. There are many torts, such as trespass, that are not personal in nature, and recoveries for which would not qualify under I.R.C. § 104(a)(2). *See* Horton v. Commissioner, 100 T.C. 93, 112 (Whalen, J., dissenting), *aff'd*, 33 F.3d 625 (6th Cir. 1994); *see also supra* text accompanying note 212 (describing this approach as a two-step analysis); Every v. Internal Revenue Serv., 94-2 U.S. Tax Cas. (CCH) ¶ 50,478 (W.D. Wash. 1994) (recovery of lost income by fishermen in settlement of claims against Exxon for damages suffered as a result of Exxon Valdez oil spill is taxable; while action sounded in tort, it was not in respect of a *personal* injury).

161. *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

162. 835 F.2d 67 (3d Cir. 1987).

Bent, a Delaware teacher, had sued his school district under 42 U.S.C. § 1983, claiming he had been denied re-employment for reasons which abridged his First Amendment rights.[163] Bent had been fired after making critical remarks about the school, the staff, and the administration, and he had been denied a re-employment hearing.[164] The Court of Chancery agreed that Bent had been denied re-employment "for reasons which, in part, abridged his First Amendment right to express his views as to the public employer and school administrators for whom he worked—regardless of his obvious lack of tact in so doing."[165] The state court denied certain of Bent's claims, including reinstatement, leaving only his First Amendment claim.[166] The Chancery Court continued the case on the issue of the amount of money damages. Before any hearing on damages was held, however, the parties settled the case by a payment by the school district's insurance carrier to Bent of $24,000, computed at least in part by reference to lost wages.[167]

Bent did not report the $24,000 in his gross income, but the Service asserted that the portion of the settlement that constituted compensation for lost wages should be taxable. The Tax Court sided with Bent, concluding that the settlement payment was an amount received based upon "tort or tort-type rights."[168] The government appealed, contending that the settlement "represented compensation for lost wages which was not excludable from gross income under section 104(a)(2)."[169]

The Third Circuit affirmed the Tax Court in a brief opinion.[170] Acknowledging that an award of damages for the violation of a constitutional right may be measured in whole or in part by the amount of lost wages,[171] the court approvingly cited the Ninth Circuit in *Roemer* for the proposition that "[t]he personal nature of an injury should not be defined by its effect."[172] Accordingly, the settlement was held excludable.[173]

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163. Bent v. Commissioner, 87 T.C. 236, 240 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987).
164. *Id.* at 237-39.
165. *Id.* at 240-41.
166. *Id.* at 241.
167. *Id.* at 242.
168. *Id.* at 249.
169. Bent v. Commissioner, 835 F.2d 67, 70 (3d Cir. 1987).
170. *Id.*
171. *Id.* at 70.
172. *Id.* (citing Roemer v. Commissioner, 716 F.2d 693, 699 (9th Cir. 1983)). The court stated:

> The Commissioner urges that since the settlement admittedly included a sum based on the taxpayer's lost wages [rather than on pain and suffering], that sum represented compensation for lost wages which was not excludable from gross income under section 104(a)(2). We do not agree. For an award of damages for the violation of a constitutional right may be measured in whole or in part by the amount of lost wages.

Id.

173. On petition for rehearing, the Service argued that no personal injury was present in this case because the injury resulting from the tort was economic. Following this argument, Bent's suit was merely for lost wages, not personal injury. *Bent*, 835 F.2d at 70. The court rejected this position, stating that the denial of a civil right "involves a personal injury just

2. The Federal Antidiscrimination Cases

In a series of controversial decisions, the principles of *Roemer* and *Threlkeld* were applied with mixed results to particularly nettlesome areas: back pay and liquidated damage awards, and settlements obtained by employees alleging violations of federal antidiscrimination statutes such as the Fair Labor Standards Act,[174] the Age Discrimination in Employment Act,[175] and Title VII of the Civil Rights Act[176] prior to its amendment in 1991.[177] Although the recovery scheme set forth in each statute varies slightly, the basic underlying remedy is the recovery of back pay: the amount that the victim should have been paid as compared to what the victim was in fact paid during the victim's term of employment, or the amount the victim would have earned absent an improper termination in violation of the applicable statute. In addition, under the ADEA and the FLSA (but *not* under pre-amendment Title VII), the successful claimant may recover liquidated damages in an "additional equal amount"; that is, an amount equal to the award of back pay.[178] Under most statutes of this nature, a claimant may also seek equitable relief, such as reinstatement and an order prohibiting further discriminatory practices. General compensatory damages (such as for pain and suffering or mental anguish) and punitive damages, however, are not available to a plaintiff under these statutes.

The limited recovery scheme reflected in the federal antidiscrimination statutes immediately raises the question of whether a taxpayer's recovery under these statutes is really in the nature of personal injury tort recoveries or more analogous to breach of contract recoveries for earned but unpaid wages. If the latter, the § 104(a)(2) exclusion would not apply.

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as much as a physical assault." *Id.* at 70-71. The fact that the resulting damages were measured by reference to lost wages was of no significance.

174. 29 U.S.C. §§ 201-19 (1988 & Supp. V 1993) [hereinafter FLSA]. Under the FLSA, a successful claimant may be entitled to "such legal or equitable relief as may be appropriate to effectuate the purposes of [the FLSA], including without limitation employment, reinstatement, promotion, and the payment of wages lost and an additional equal amount as liquidated damages." 29 U.S.C. § 216(b) (1988).

175. 29 U.S.C. §§ 621-634 (1988 & Supp. V 1993) [hereinafter ADEA]. The remedial scheme of the ADEA is taken directly from the FLSA and, in fact, is simply cross-referenced in the ADEA rather than set out at length therein. 29 U.S.C. § 626(b) (1988). Thus, the FLSA scheme and the ADEA scheme are virtually identical, with one exception: liquidated damages are "payable only in cases of willful violations of" the ADEA. *Id.*

176. 42 U.S.C. §§ 2000e to 2000e-17 (1988) (amended 1991) [hereinafter pre-amendment Title VII].

177. Civil Rights Act of 1991, Pub. L. 102-166, 105 Stat. 1071 (codified as amended in scattered sections of 42 U.S.C.). As indicated in the text, prior to the enactment of the Civil Rights Act of 1991, successful complainants were limited to equitable relief and an award of back pay. The 1991 Act significantly expanded these remedies to include (i) compensatory damages, such as for "future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses," and (ii) punitive damages, provided the complainant demonstrates that the respondent "engaged in a discriminatory practice or discriminatory practices with malice or with reckless indifference to the federally protected rights of an aggrieved individual." § 102, 105 Stat. at 1072-1073 (codified at 42 U.S.C. § 1981a (Supp. V 1993)).

178. *See supra* notes 174-75.

In one of the first cases to address this question, *Byrne v. Commissioner*,[179] the taxpayer claimed she was the victim of a retaliatory discharge in violation of the FLSA. Byrne asserted that she was treated discriminatorily and eventually terminated by her employer, Grammer, Dempsey & Hudson, Inc., a steel firm, because she had cooperated with an EEOC investigation of wage disparity at her workplace.[180] Although Byrne initially sought reinstatement, she eventually accepted $20,000 in a lump sum settlement of her case.[181] Byrne did not report the $20,000 in income. The Tax Court, after concluding that a plaintiff's claims in a retaliatory discharge lawsuit under the FLSA exhibit equally demonstrable characteristics of both a personal injury tort claim[182] and a breach of contract claim,[183] held one-half of the $20,000 to be includable, and one-half to be excludable.[184] The Tax Court concluded that the *Roemer/Threlkeld* principle did not apply in this case because the claims settled were not solely claims of a tort-like nature.[185]

The Third Circuit reversed:[186]

> Based upon our ruling in *Bent*, we reject the Commissioner's argument in this case that the settlement is taxable because it was intended, at least in part, to compensate Byrne for lost wages due to her wrongful firing. The relevant inquiry, as the Tax Court noted, is whether the settlement was received on account of personal or nonpersonal injuries, not whether the damages compensate the taxpayer for economic losses.[187]

The court acknowledged, however, that "[r]ejecting this argument . . . does not settle the issue of whether the settlement Byrne received was on account of personal or nonpersonal injuries."[188] The court proceeded to analyze Byrne's FLSA claim[189] and her related New Jersey state law wrongful discharge claim[190] and concluded that "both the FLSA and state law wrong-

179. 90 T.C. 1000 (1988), *rev'd*, 883 F.2d 211 (3d Cir. 1989).

180. *Byrne*, 90 T.C. at 1001-02.

181. *Id.* at 1004.

182. Byrne analogized the nature of her FLSA claim to similar claims under New Jersey state law, such as retaliatory or abusive discharge, which she characterized as being in the nature of a personal injury tort claim. *Id.* at 1008.

183. After reviewing cases at the state level involving abusive, retaliatory, and unlawful discharges, which occasionally characterized such claims as sounding in contract, the Tax Court concluded that "the contract action [analogy] appears to apply equally well to the facts here." *Id.* at 1009.

184. *Id.* at 1011.

185. *Id.* at 1011 n.10.

186. Byrne v. Commissioner, 883 F.2d 211 (3d Cir. 1989).

187. *Id.* at 214. The court added, "[t]o the extent that the Commissioner argues that because the settlement was intended to compensate Byrne for economic losses it is therefore compensating her for non-personal injuries, we find this argument to have been explicitly rejected in *Bent*, and we reject it again here." *Id.*

188. *Id.*

189. The court concluded that such a claim was "more tort-like than contract-like" because it sought redress for violation of a duty owed by the employer to the employee by operation of law (the FLSA) and not pursuant to an express or implied employment contract. *Id.* at 215.

190. *Id.* at 215-16. The Court of Appeals, more so than the Tax Court, viewed the set-

ful discharge claims settled by Christine Byrne qualify for the section 104(a)(2) exclusion"[191] because they were more analogous to tort claims than contract claims. Accordingly, Byrne's recovery was held tax-exempt.

Despite its losses in *Bent* and *Byrne*, the Service continued to argue that statutory recoveries for back wages were analogous to contract recoveries, and the Tax Court still seemed receptive to the argument. The matter came to a head in *Rickel v. Commissioner*.[192] The taxpayer in *Rickel* received $80,000 from his former employer in 1983 and $25,000 in 1984 pursuant to a settlement of his ADEA lawsuit.[193] Rickel had been general sales manager of Malsbary Manufacturing Company. Rickel was passed over for a promotion to president because the company "wanted someone younger" and was subsequently terminated after the new president told Rickel he "wanted a younger person as general sales manager."[194] Rickel sued his former employer under the ADEA, seeking, *inter alia*, (i) back wages, benefits, and other compensations with interest, and (ii) a sum equal to back pay as liquidated damages.[195]

Rickel's ADEA case was tried before a jury in 1983. While the jury was deliberating, the parties reached a settlement under which the employer agreed to pay Rickel $80,000 immediately and $25,000 during each of the next four years.[196] The settlement agreement did not allocate the settlement amount among Rickel's various claims for relief.[197]

Rickel did not report the $80,000 or the $25,000 as gross income on his 1983 and 1984 tax returns. After the Service issued a notice of deficiency stating that the entire amount of $105,000 was taxable income, Rickel petitioned. The Tax Court first examined the ADEA and concluded that because the remedial scheme provided for matching the "additional equal amount" liquidated damages to the back pay award, it would be logical to conclude that Rickel's settlement should be split 50-50 between back pay and liquidated damages.[198] The court, therefore, found that one-half, i.e. $40,000 in 1983 and $12,500 in 1984, of the settlement was attributable to each element of recovery.[199]

The Tax Court then held that the one-half attributable to back pay constituted taxable income, while the other one-half representing liquidated damages was not taxable. The court likened the back pay award to damages received in an action for breach of contract and, as such, held them includable.[200] The

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tlement as also releasing Grammer from claims by Byrne under state law wrongful discharge doctrines. *Id.*

191. *Id.* at 216.

192. 92 T.C. 510 (1989), *rev'd*, 900 F.2d 655 (3d Cir. 1990).

193. *Id.* at 513.

194. *Id.* at 512.

195. *Id.* at 512-13; *see also supra* note 175.

196. *Rickel*, 92 T.C. at 513. The settlement was contingent upon the jury answering in the affirmative to four special interrogatories submitted to them; this subsequently occurred.

197. *Id.*

198. *Id.* at 522.

199. *See id.*

200. *See id.* at 521-22.

court viewed the "additional equal amount" liquidated damages as merely a substitute for difficult-to-measure personal injuries resulting from discriminatory employment practices and, accordingly, held them excludable.[201]

On appeal, the Third Circuit reversed the Tax Court.[202] The Third Circuit began by reviewing the lessons of *Roemer* and *Threlkeld*.[203] The court approvingly cited the Tax Court's beginning-and-end-of-the-inquiry analysis from *Threlkeld* and agreed that in determining whether the injury complained of is personal, the origin and character of the claim must be considered rather than the consequences that result from the injury."[204] The Third Circuit then proceeded to chastise the Tax Court for failing to apply its own tests to the case at hand:

> [T]he Tax Court then slipped into the old analysis previously abandoned by the full Tax Court in *Threlkeld*, i.e., "mount[ing] an inquiry to determine whether the components of the [taxpayer's discrimination] injuries for which the [settlement was] made are personal or [economic]." Instead, once 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 . . . the full Tax Court rejected in *Threlkeld*. . . . [T]he nonpersonal, economic effects of the employer's act of discrimination, e.g., loss of wages, does not transform a personal tort type claim into one for nonpersonal injuries.[205]

Thus, under the *Threlkeld* analysis, the only question the Tax Court should have considered was whether an action under the ADEA was "tort or tort-type." If so, all damages recovered by Rickel should have been considered as received on account of a personal injury. Turning to this question, the Court of Appeals concluded that an ADEA action is in fact more akin to a personal injury tort action, and not to a breach of contract action:

> [F]ocusing on the nature of the claim, we are convinced that the taxpayer's discrimination suit under the ADEA was analogous to the assertion of a tort type right to redress a personal injury. By discriminating against the taxpayer on the basis of his age, Malsbary invaded the rights that the taxpayer "is granted by virtue of being a person in the sight of the law." The taxpayer merely sought the remedies afforded by the statute as compensation for the personal injury he suffered as a result of his employer's act of discrimination; the requested

201. *Id.* at 522.
202. Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990).
203. *Id.* at 659.
204. *Id.* (quoting *Threlkeld*, 87 T.C. at 1299); *see also supra* note 151.
205. *Rickel*, 900 F.2d at 661-62 (citations omitted).

> remedies were not separate claims in themselves to redress the employer's breach of a contract. The nonpersonal consequences of the discrimination, e.g. the loss of wages, does not transform discrimination into a nonpersonal injury.[206]

As in *Bent* and *Byrne*, the Third Circuit sided with the taxpayer in *Rickel* and held the taxpayer's ADEA recovery fully excludable under § 104(a)(2).[207]

The Service continued to litigate cases involving recoveries under statutes such as the ADEA and the FLSA, arguing that such statutes evince a recovery scheme that is predicated on theories of breach of contract and not tort law. Generally speaking, the courts were unimpressed with this view and frequently held that the entire amount of such recoveries fell within the scope of I.R.C. § 104(a)(2).[208] For example, in *Pistillo v. Commissioner*,[209] the Sixth Circuit Court of Appeals adopted the reasoning of the Third Circuit in *Rickel* and held that the taxpayer's recovery in an ADEA lawsuit was fully excludable.[210]

Subsequently, in *Downey v. Commissioner*,[211] the Tax Court itself fell

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206. *Id.* at 663 (citations and footnotes omitted).

207. When *Rickel* came before the Third Circuit in 1990, the Service made the same previously rejected arguments. The Third Circuit reacted as follows:

> [T]o 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 nonpersonal injuries, we find this argument to have been rejected in *Bent* [and *Byrne*], and we reject it again here" for the *third* time.

Id. at 662 n.9 (quoting Byrne v. Commissioner, 883 F.2d 211, 214 (3d cir. 1989)) (emphasis added).

208. In addition to the cases discussed in the text, see Wulf v. City of Wichita, 883 F.2d 842, 873 (10th Cir. 1989) (in a non-tax case, holding an award of damages specifically allocated to back pay as a result of a wrongful discharge in violation of First Amendment rights nontaxable under I.R.C. § 104(a)(2)); Redfield v. Insurance Co. of N. Am., 940 F.2d 542, 549 (9th Cir. 1990) (also in a non-tax case, holding awards under ADEA and the California Fair Employment and Housing Act excludable).

209. 912 F.2d 145 (6th Cir. 1990).

210. Pistillo had been awarded $55,000 in back pay by a jury, and while the case was on appeal, the parties settled for approximately that amount. Therefore, Pistillo's *entire* recovery was merely for back pay and no part of the settlement was attributable to "additional equal amount" liquidated damages. The Tax Court accepted the view of the Service that this recovery was more similar to a breach of contract recovery and therefore fully includable. At that time, the Tax Court's decision in *Rickel I* had not yet been reversed by the Third Circuit. On appeal of *Pistillo*, the Sixth Circuit reversed. After approvingly citing the *Threlkeld* beginning-and-end-of-the-inquiry analysis, the Court of Appeals stated:

> 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.". . . Pistillo's loss of wages—a substantial non-personal consequence of his employer's age discrimination—did not transform the discrimination into a non-personal injury.

Pistillo, 912 F.2d at 149-150 (quoting *Threlkeld*, 87 T.C. at 1308) (citations omitted).

211. 97 T.C. 150 (1991). For a discussion of the subsequent history of *Downey*, see

into line and held the taxpayer's entire ADEA recovery to be excludable. Downey had received $120,000, one-half of which was specifically allocated to back pay, and one-half of which was allocated to "additional equal amount" liquidated damages. In a lengthy opinion, the Tax Court reviewed the history of I.R.C. § 104(a)(2), the relevant Regulations, and past cases. The court then noted:

> [t]he inquiry under section 104(a)(2) is whether the nature of the claim giving rise to the payment is tort or tort-like and whether the nature of the injury is personal. If the above two questions are answered in the affirmative, *then our inquiry should end*, and the settlement amount received on account of the personal injury is excludable from gross income under section 104(a)(2).[212]

Applying the foregoing principles, the court decided that the task was to focus on the nature of the claim on which Downey's ADEA suit was founded.

> [T]he consequences of a personal injury, or the actual damages suffered, do not affect our inquiry under section 104(a)(2). Whether the damages paid to the tort victim reflect a substitute for amounts or items otherwise taxable or a substitute for amounts or items to be enjoyed without a tax consequence is irrelevant. . . .
>
> We seek to determine whether petitioner's claim under the ADEA sounded in tort and whether the nature of the injury arising from age discrimination is personal for purposes of section 104(a)(2). If we answer those questions in the affirmative, *then our inquiry has ended*, and the payment petitioner received in settlement of the age discrimination claim is excludable under section 104(a)(2). We need not consider the nature of the consequences of the personal injury (such as whether the victim suffered pain and suffering or was deprived of all or a portion of his livelihood).[213]

Following the lead of the various appellate court decisions finding the ADEA recovery scheme based on concepts of personal injury tort law and not breach of contract, the Tax Court explicitly overruled and abandoned its former position in *Rickel* and *Pistillo*[214] over the dissent of seven judges.[215]

The Service, however, did not fight completely in vain. In *Thompson v. Commissioner*,[216] the Fourth Circuit agreed with the government and the Tax Court.[217] The Fourth Circuit held that amounts recovered as back pay in a

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infra note 260 and accompanying text.

212. *Downey*, 97 T.C. at 161 (emphasis added) (citations omitted).

213. *Id.* at 163-64 (emphasis added) (citations omitted).

214. *Id.* at 168-70.

215. The majority opinion was joined by ten other Tax Court judges. In a dissent joined by six other judges, Judge Cohen argued that the beginning-and-end-of-the-inquiry analysis was misguided and concluded that the "dual nature" approach followed by the Tax Court in *Rickel* was correct. *Downey*, 97 T.C. at 174-80.

216. 866 F.2d 709 (4th Cir.1989).

217. Thompson had instituted a class action lawsuit against her employer, the United States Government Printing Office, asserting gender discrimination claims under the Equal

gender discrimination suit under the Equal Pay Act[218] and pre-amendment Title VII of the Civil Rights Act[219] were taxable, although the portion of the taxpayer's recovery representing "additional equal amount" liquidated damages was not.

> After analyzing the statutory scheme [of the Equal Pay Act and Title VII] we 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.* Thus, the Tax Court correctly held the liquidated damages award excludable under section 104(a)(2), and the award of back pay includable in gross income.[220]

The Fourth Circuit was convinced, based on its analysis of the Equal Pay Act and Title VII, that recoveries for back pay under those statutes were essentially contractual in nature and therefore taxable.[221] Recoveries for liquidated damages under the Equal Pay Act, however, were received through a "tort or tort-type" action for personal injuries and therefore excludable.[222]

As in *Thompson*, the Service often enjoyed success in taxing back pay recoveries under pre-amendment Title VII. As previously noted, the *sole* monetary remedy available in a pre-amendment Title VII action (in addition to equitable relief) is a recovery of back pay.[223] This fact strengthened the

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Pay Act and Title VII. *Thompson*, 89 T.C. 632, 633 (1987). In 1982, Thompson received approximately $66,000 in back pay under the Equal Pay Act and Title VII and approximately $66,000 in liquidated damages under the Equal Pay Act. *Id.* at 637. The Tax Court held that the back pay award, but not the liquidated damages award, was includable in her income, consistent with its decisions in *Byrne* and *Rickel*. *Id.*

218. 29 U.S.C. § 206(d) (1988).

219. *See supra* note 176 and accompanying text.

220. *Thompson*, 866 F.2d at 712 (emphasis added).

221. The court stated:

> Thompson performed essentially the same work as her male co-workers for which she should have received equal pay. The back pay award was simply recovery for earned, but unpaid, wages which distinguishes her award of back pay from awards for lost wages or lost income in traditional personal injury/tort actions. She received compensation for services rendered whereas a tort plaintiff receives compensation for the inability to earn an income due to the tortious action of a defendant.
>
> Further, the purpose of the Equal Pay Act is to ensure equal pay for equal work regardless of the gender of the employee. The amount of the award is calculated based on the wage differential between similarly situated male and female employees without regard to tax consequences. If the back pay award were excluded from gross income, Thompson would be placed at an advantage over her male co-workers, who presumably reported their total earned wages as gross income.

Id. (citations omitted).

222. The court concluded:

> In contrast to the award of back pay, Thompson's liquidated damages award was not earned income. Rather, it served both as a deterrent to ensure compliance with the Act, and as "compensation for the retention of a workman's pay which might result in damages too obscure and difficult of proof for estimate other than by liquidated damages." As such, the liquidated damages award constituted compensation received through a tort or tort-type action for personal injuries.

Id. (quoting Brooklyn Sav. Bank v. O'Neil, 324 U.S. 697, 710 (1945)).

223. *See supra* note 177 and accompanying text.

Service's arguments that the remedial scheme of the statute was more analogous to breach of contract recovery rather than tort.[224]

The taxpayer in *Sparrow v. Commissioner*[225] was a computer specialist for the Navy. He resigned after receiving a notice of removal, and subsequently filed a Title VII complaint with the Navy alleging racial discrimination.[226] After the Navy rejected the complaint, the case was reviewed by the EEOC. The EEOC found for Sparrow and ordered his reinstatement. Sparrow opted to settle with the Navy and received $69,284 in back pay.[227]

The Court of Appeals for the D.C. Circuit adopted a two-part test in analyzing I.R.C. § 104(a)(2): the amount received (1) must be for damages and (2) must result from a personal injury.[228] Under this unique approach, which has never been adopted by any other federal court, the Court of Appeals concluded that the first test was not satisfied. The amount received by Sparrow was not received as "damages" but rather as equitable relief. The court noted that, in enacting Title VII, Congress did not make the legal remedies of compensatory and punitive damages available. Instead, Congress limited the remedy to equitable relief.[229] The court concluded that an award of back pay under Title VII did not constitute a remedy of damages. Therefore, the award was not excludable income under section 104(a)(2).[230]

In so holding, the Court of Appeals specifically rejected the *Threlkeld* beginning-and-end-of-the-inquiry analysis, noting that it "leapfrogged over the damages requirement directly to the personal injury inquiry, at the same time fusing the distinction between damages and back pay universally recognized in Title VII cases."[231]

While the two-part test proposed in *Sparrow* has not won adherence outside the D.C. Circuit, the opinion seems to be the first to foreshadow the approach ultimately adopted by the Supreme Court in *United States v. Burke*.

3. United States v. Burke[232]

In *Burke*, the taxpayers had recovered back pay from their employer (the Tennessee Valley Authority) in settlement of a Title VII sex discrimination action brought in 1984.[233] The TVA paid a lump sum of $5 million to be

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224. In Crossin v. United States, 789 F. Supp. 906 (N.D. Ill. 1991), the taxpayer had received $214,913.66 in 1989 for participating in the settlement of a class action Title VII gender discrimination lawsuit against the FBI. The amount represented wages Crossin would have earned from 1977 through 1988 had the FBI hired her. *Id.* at 907. In a somewhat indecipherable opinion, the District Court for the Northern District of Illinois agreed with the government that the entire back pay settlement award was taxable. The basis of the court's holding is unclear.

225. 949 F.2d 434 (D.C. Cir. 1991).

226. *Id.* at 434-35.

227. *Id.* at 435.

228. *Id.* at 436.

229. *Id.* at 437.

230. *Id.* at 438.

231. *Id.* at 439.

232. 112 S. Ct. 1867 (1992).

233. Burke v. United States, 929 F.2d 1119, 1120 (6th Cir. 1991), *rev'd*, 112 S. Ct.

distributed among the plaintiffs under a formula devised by the employees' union. The formula considered the length of service in the affected rates of pay and salary schedule.[234] *Burke* raised the question of whether those payments were excludable under I.R.C. § 104(a)(2).

The District Court ruled that, because the taxpayers sought and obtained only back wages due as a result of TVA's discriminatory underpayments rather than compensatory or other damages, the settlement proceeds did not result from a "tort or tort-type" action and could not be excluded from gross income as damages received on account of personal injuries.[235]

The Sixth Circuit reversed on appeal.[236] Viewing the issue "as a quite narrow one,"[237] the Sixth Circuit approvingly restated the *Threlkeld* beginning-and-end-of-the-inquiry test and then noted:

> In other words, determining whether the § 104(a)(2) exclusion applies requires an examination of the nature of the injury to determine whether the injury and claim are personal and tort-like in nature, and not whether the consequences of the injury resulted in an award of compensatory damages or damages for back pay. Thus, our inquiry is limited to whether injuries resulting from sex discrimination in violation of Title VII are "personal injuries" for the purposes of § 104(a)(2).[238]

The court answered this latter question in the affirmative.[239] The government had argued, however, that a Title VII lawsuit is distinguishable from other types of actions (such as those brought under the ADEA) because in a Title VII action the *only* monetary remedy available is an award of back pay. Thus, the taxpayer was recovering only for economic injury, not personal injury.[240] The Sixth Circuit disagreed, concluding that the government's argument improperly focused "on the *consequences* of a Title VII violation (the payment of back pay for lost wages) rather than the personal *nature* of the

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1867 (1992).

234. *Id.*

235. Burke v. United States, 90-1 U.S. Tax Cas. (CCH) ¶ 50,213 (E.D. Tenn. 1990), *rev'd*, 929 F.2d 1119 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992).

236. *Burke*, 929 F.2d 1119 (6th Cir. 1991).

237. *Id.* at 1121.

238. *Id.* at 1121 (citations omitted). The court concluded:

> In sum, *Threlkeld* and its progeny require that for the purposes of § 104(a)(2), this court determine whether the injury is personal and the claim resulting in the damages is tort-like in nature. If the answer is in the affirmative, then that is "the beginning and end of the inquiry." . . . . At no point do we inquire into the nature of the damages involved. Rather the narrow scope of our gaze is properly limited to the "origin and character of the claim, . . . and not to the consequences that result from the injury."

Id. at 1123 (quoting *Threlkeld*, 87 T.C. at 1299) (citations omitted).

239. The court noted, "Courts have long held that injuries resulting from invidious discrimination, be it on the basis of race, sex, national origin or some other unlawful category, are injuries to the individual rights and dignity of the person." *Burke*, 929 F.2d at 1121.

240. *Id.* at 1122.

injury (invidious discrimination)."[241]

Finding no convincing reason to distinguish an award under the ADEA, as was held nontaxable in *Pistillo*, from an award under Title VII, the Sixth Circuit found the settlement awards in *Burke* to be nontaxable.[242]

Recognizing a conflict among *Sparrow*, *Thompson*, and *Burke*, the Supreme Court granted certiorari,[243] and reversed in a 7-2 decision. In holding a pre-amendment Title VII back pay recovery to be taxable, the Supreme Court fashioned an entirely new "scope of the remedies" test for identifying "tort or tort-type" actions.[244]

After reviewing the Sixth Circuit's test,[245] Justice Blackmun, writing for the majority, agreed with the test in part: "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. Respondents, for their part, agree that this is the appropriate inquiry, as does the dissent."[246]

In an effort to articulate the standards by which it can be determined whether an action brought under federal antidiscrimination statutes can be characterized as one attempting to vindicate "tort or tort-type" rights, the Supreme Court fashioned a new "scope of the remedies" analysis. The Supreme Court's analysis emphasized whether the statute in question incorporates sufficient hallmarks of traditional concepts of tort liability and recovery:

> A "tort" has been defined broadly as a "civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages." *Remedial principles thus figure prominently in the definition and conceptualization of torts.* Indeed, one of the hallmarks of traditional tort liability is *the availability of a broad range of damages* to compensate the plaintiff "fairly for injuries caused by the violation of his legal rights." Although these damages often are described in compensatory terms, in many cases they are larger than the amount necessary to reimburse actual monetary loss sustained or even anticipated by the plaintiff, and thus redress intangible elements of injury that are "deemed important, even though

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241. *Id.* (emphasis added).

242. The court was not convinced of
> any principled way to distinguish the injuries arising from a claim for invidious age discrimination, and the claim for invidious sex discrimination . . . except that these tort claims were brought under different federal statutes. In addition, the government was unable to demonstrate why injuries resulting from sex discrimination were not "personal" while other forms of nonphysical tort injuries were "personal" for the purposes of § 104(a)(2) exclusion.

Id. at 1123.

243. United States v. Burke, 112 S. Ct. 47 (1992).

244. United States v. Burke, 112 S. Ct. 1867 (1992).

245. Significantly, the Supreme Court cited with seeming approval the *Threlkeld* test: "The Court of Appeals concluded that exclusion under § 104(a)(2) turns on whether the injury and the claim are 'personal tort-like in nature.' 'If the answer is affirmative,' the court held, 'then that is the beginning and end of the inquiry.'"

Id. at 1869 (citations omitted).

246. *Id.* at 1872 (citations omitted).

> not pecuniary in [their] immediate consequence[s]."
>
> For example, the victim of a physical injury may be permitted, under the relevant state law, to recover damages not only for lost wages, medical expenses, and diminished future earning capacity on account of the injury, but also for emotional distress and pain and suffering. Similarly, the victim of a "dignitary" or non-physical tort such as defamation may recover not only for any actual pecuniary loss (e.g., loss of business or customers), but for "impairment of reputation and standing in the community, personal humiliation, and mental anguish and suffering." *Furthermore, punitive or exemplary damages are generally available in those instances where the defendant's misconduct was intentional or reckless. . . .* [247]
>
> In order to come within the § 104(a)(2) income exclusion, respondents therefore must show that Title VII, the legal basis for their recovery of backpay, redresses a tort-like personal injury in accord with the foregoing principles.[248]

According to Justice Blackmun, if a federal antidiscrimination statute reflects sufficient indicia of traditional tort concepts of recovery, it will be viewed as redressing a tort-like personal injury under § 104(a)(2). The main difference between this analysis and that employed by the Sixth Circuit, then, is in the manner in which an action involving "tort or tort-type" rights is to be identified. Under the Sixth Circuit's view and under the view of most of the courts that had taken up the matter, this determination involved an inquiry into whether the underlying injury was to the "individual rights and dignity of the person";[249] that is, whether there had been an "invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."[250] Justice Blackmun did not agree, however, that this was the appropriate test.[251] The Supreme Court's test, which focused on the scope of the remedies afforded under the particular antidiscrimination statute, led to a much different result when applied to Title VII cases:

> Indeed, in contrast to the tort remedies for physical and nonphysical injuries discussed above, Title VII does not allow awards for compensatory or punitive damages; instead, it limits available remedies to

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247. *Id.* at 1870-72 (emphasis added) (citations and footnote omitted). Justice Blackmun also pointed to the fact that no jury trial is available in a Title VII action as further indication that such an action does not bear the hallmarks of a traditional tort action. *Id.* at 1872.

248. *Id.* at 1872.

249. *See, e.g., Burke*, 929 F.2d at 1121.

250. *Threlkeld*, 87 T.C. at 1308.

251. The Court noted:

> It is beyond question that discrimination in employment on the basis of sex, race, or any of the other classifications protected by Title VII is, as respondents argue and this Court consistently has held, an invidious practice that causes grave harm to its victims. The fact that employment discrimination causes harm to individuals does not automatically imply, however, that there exists a tort-like "personal injury" for purposes of federal income tax law.

Burke, 112 S. Ct. at 1872-73 (citations omitted).

> backpay, injunctions, and other equitable relief. . . . An employee wrongfully discharged on the basis of sex thus may recover only an amount equal to the wages the employee would have earned from the date of discharge to the date of reinstatement, along with lost fringe benefits such as vacation pay and pension benefits; similarly, an employee wrongfully denied a promotion on the basis of sex, or, as in this case, wrongfully discriminated against in salary on the basis of sex, may recover only the differential between the appropriate pay and actual pay for services performed, as well as lost benefits.
>
> . . . Nothing in this remedial scheme purports to recompense a Title VII plaintiff for any of the other traditional harms associated with the personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages.[252]

While recognizing that other federal antidiscrimination statutes may be sufficiently "tort-like" under this standard,[253] this was not the case in a Title VII action:[254] "Thus, we cannot say that a statute such as Title VII, whose sole remedial focus is the award of backwages, redresses a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations."[255] Accordingly, the majority held that the backpay awards were taxable.[256]

4. Evaluation of *Burke*'s Law

As a practical matter, the specific holding of *Burke* will have a diminishing impact as time passes and pre-1991 Title VII controversies fall away.[257] Of more importance will be the utility and practicality of the approach articulated by the Supreme Court for determining whether recoveries under other federal antidiscrimination statutes are excludable.[258] It remains to be seen

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252. *Id.* at 1873 (citations omitted).

253. The court stated:

> No doubt discrimination could constitute a "personal injury" for purposes of § 104(a)(2) if the relevant cause of action evidenced a tort-like conception of injury and remedy. Indeed, the circumscribed remedies available Title VII stand in marked contrast not only to those available under traditional tort law, but under other federal antidiscrimination statutes, as well.

Id. at 1873 (citations and footnotes omitted).

254. The Court noted:

> Notwithstanding a common-law tradition of broad tort damages and the existence of other federal antidiscrimination statutes offering similarly broad remedies, Congress declined to recompense Title VII plaintiffs for anything beyond the wages properly due them — wages that, if paid in the ordinary course, would have been fully taxable.

Id. at 1874 (citation omitted).

255. *Id.* (footnote omitted).

256. In a concurring opinion that departed wholly from established law, Justice Scalia agreed that the back pay awards should be taxable, but on the surprising theory that only damages received for *physical* injuries should be eligible for exemption under § 104(a)(2). *Id.* at 1875. This long-discredited notion had not even been argued by the government.

257. In dissent, Justice O'Connor noted that "[b]y resting on the remedies available under Title VII and distinguishing the recently amended version of that law, the Court does make today's decision a narrow one." *Id.* at 1881 (O'Connor, J., dissenting).

258. As previously noted, the Civil Rights Act of 1991 significantly expanded the reme-

how the lower federal courts will apply the new "scope of the remedies" analysis laid down by the Supreme Court, and whether the new test will lead to heightened uniformity in judicial decisions in this area.

However, if experience in the first two years following the Supreme Court's decision in *Burke* is any indication, the courts appear confused. For example, several courts have attempted to apply the "scope of the remedies" analysis to back pay and liquidated damage recoveries under the ADEA, with wildly divergent results. After the Supreme Court's ruling in *Burke*, the Tax Court reexamined its decision in *Downey v. Commissioner*[259] at the government's request. The Tax Court affirmed that decision, holding that the "scope of the remedies" test is satisfied by the ADEA.[260] The Seventh Circuit reversed, however, and held that the ADEA does not provide remedies that are the hallmark of tort liability because liquidated damages—the only remedy available in an ADEA action that differentiates them from Title VII actions—do not compensate the victim for the intangible elements of a personal injury.[261] Thus, ADEA recoveries "lack an essential element of a tort-type claim"[262] and do "not even clear the low hurdle"[263] of being "tort-type" under the Regulations.[264] The Seventh Circuit therefore viewed ADEA recoveries as taxable.

The Seventh Circuit is in conflict with the Ninth Circuit over the treatment of ADEA recoveries. In *Schmitz v. Commissioner*,[265] the Ninth Circuit concluded that the ADEA does in fact "establish[] a tort-like cause of action within the meaning of *Burke*"[266] and held the taxpayer's back pay and liqui-

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dies available to a successful Title VII plaintiff. *See supra* note 177. As to post-1991 Title VII recoveries, the Service has concluded that recoveries for disparate treatment discrimination (the remedies for which include compensatory and punitive damages) are excludable (but specifically declining to rule as to whether a punitive damage recovery would be excludable), while back pay recoveries for disparate impact discrimination (the remedies for which do not include compensatory or punitive damages, and are more akin to those available under the ADEA) are not excludable. Rev. Rul. 93-88, 1993-2 C.B. 61.

259. 97 T.C. 150 (1991), *aff'd on reh'g*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994).

260. Downey v. Commissioner, 100 T.C. 634 (1993).

261. Downey v. Commissioner, 33 F.3d 836, 840 (7th Cir. 1994).

262. *Downey*, 33 F.3d at 840. The Tax Court continues to follow its decision in *Downey*. *See, e.g.*, Burns v. Commissioner, 67 T.C.M. (CCH) 3116 (1994); Cassino v. Commissioner, 67 T.C.M. (CCH) 2193 (1994); Fite v. Commissioner, 66 T.C.M. (CCH) 1588 (1993).

263. *Downey*, 33 F.3d at 838.

264. The Seventh Circuit gave no indication as to whether it endorsed the one-step *Threlkeld/Horton* test or the two-step *Hawkins/Miller* test, a controversy that is discussed in the text below. Interestingly, the Seventh Circuit stated in dicta its approval of the position taken by Justice Scalia in his concurrence in *Burke*, *see supra* note 256, that the plain language of I.R.C. § 104 excludes awards only for *physical* injury. Thus, even if the Seventh Circuit had concluded that ADEA claims are tort-type, the court would apparently have ruled Downey's award to be taxable. *Downey*, 33 F.3d at 838.

265. 34 F.3d 790 (9th Cir. 1994). Both *Schmitz* and *Downey* were argued on April 11, 1994, and decided on August 30, 1994.

266. *Id.* at 794. The government argued in *Schmitz* that liquidated damages under the ADEA represent only punitive damages, and therefore do not compensate the victim for

dated damage recoveries to be excludable. The other federal courts that have attempted to apply the "scope of the remedies" test to ADEA recoveries reflect hopeless confusion.[267]

The Supreme Court will soon step in to resolve the application of the "scope of the remedies" test to the ADEA. On August 31, 1993, in three related but unreported decisions, the Tax Court held recoveries under the ADEA to be excludable. One of these cases, *Schleier v. Commissioner*,[268] was subsequently appealed to the Fifth Circuit, which affirmed without opinion.[269] The other two cases have been appealed to the Tenth[270] and Eleventh[271] Cir-

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injuries such as emotional distress or pain and suffering. *See id.* at 793. The government's position was that, because liquidated damages serve no compensatory purpose and because the presence of compensatory damages is vital to a scheme of tort recovery, the scope of the remedies under the ADEA do not include a tort-like conception of remedy. The *Schmitz* majority disagreed, concluding that ADEA liquidated damages do in fact serve a compensatory purpose, at least in part, and this factor, taken together with the fact that the ADEA allows for jury trials, serves to distinguish the ADEA from pre-amendment Title VII as evaluated in the *Burke* decisions. *Id.* Whether or not liquidated damages under the ADEA are punitive, compensatory, or both, is a matter of controversy in the federal courts. *See infra* notes 267 and 509.

267. *See, e.g.*, Rice v. United States, 834 F. Supp. 1241 (E.D. Cal. 1993) (ruling that back pay and liquidated damages are not taxable). The court noted that the ADEA, in contrast with pre-amendment Title VII, provides for a jury trial and liquidated damages. Whether ADEA liquidated damages are viewed as serving a compensatory purpose or a punitive purpose is irrelevant. In either case, such damages are a "tort-type remedy which distinguishes the ADEA from pre-amendment Title VII." *Id.* at 1245. By concluding that the nature of liquidated damages is irrelevant, the court seemed to adopt a *Threlkeld* beginning-and-end-of-the-inquiry analysis that is inconsistent with the Ninth Circuit's later decision in *Schmitz*. Both *Downey* (award taxable) and *Rice* (award not taxable) involved United Airlines pilots who were plaintiffs in the same ADEA class action lawsuit.

The recovery of back pay was held taxable in Maleszewski v. United States, 827 F. Supp. 1553 (N.D. Fla. 1993). The only difference in remedies under pre-amendment Title VII and the ADEA is the availability of liquidated damages in cases involving willful violations. *Id.* at 1556. The purpose of liquidated damages is wholly punitive and noncompensatory and this single difference "does not convert every ADEA award into 'personal injury' damages for tax purposes." *Id.* at 1556-57. *Maleszewski* was criticized, and both back pay and liquidated damages were held non-taxable in Bennett v. United States, 30 Cl. Ct. 396 (1994). As in *Rice*, it is irrelevant whether liquidated damages are characterized as compensatory or punitive in nature. *Id.* at 400; *see also* Shaw v. United States, 853 F. Supp. 1378 (M.D. Ala. 1994) (adopting the reasoning of *Maleszewski* and holding back pay and liquidated damage recoveries taxable); Drase v. United States, 94-2 U.S. Tax Cas. (CCH) ¶ 50,463 (N.D. Ill. 1994) (following *Maleszewski* and *Shaw* and holding the recovery taxable and viewing liquidated damages as wholly punitive); *cf.* Wood, *supra* note 121, at 365 ("On balance . . . it would appear that ADEA recoveries stand an excellent chance of continuing to be excludable . . . .").

268. No. 22909-90 (T.C. 1990), *cited in* Burns v. Commissioner, 67 T.C.M.(CCH) 3116, 3118 (1994).

269. 26 F.3d 1119 (5th Cir. 1994) (table), *cert. granted*, 115 S. Ct. 507 (1994). The Fifth Circuit considers awards under the ADEA not taxable. *See* Purcell v. Sequin State Bank & Trust Co., 999 F.2d 950, 960-61 (5th Cir. 1993) (a non-tax case).

270. Gates v. Commissioner, No. 17889-90 (T.C. 1990), on appeal to the Tenth Circuit (Nov. 24, 1993), *cited in* Burns v. Commissioner, 67 T.C.M. (CCH) 3116, 3118 (1994).

271. Estate of Hillelson v. Commissioner, No. 11464-90 (T.C. 1990), on appeal to the Eleventh Circuit (Nov. 24, 1993), *cited in* Burns v. Commissioner, 67 T.C.M. (CCH) 3116,

cuits. In light of the conflict between the Fifth and Ninth Circuits on the one hand, and the Seventh Circuit on the other hand, the Supreme Court granted certiorari in *Schleier*[272] on November 14, 1994, to resolve the application of *Burke* to ADEA recoveries. In resolving *Schleier*, the Supreme Court may decide, either directly or indirectly, the issue of whether punitive damages are excludable under I.R.C. § 104(a)(2).[273]

Importantly, the Supreme Court's test in *Burke* exacerbates the confusion surrounding the taxation of punitive damages. It is unclear whether the Supreme Court validated the *Threlkeld* beginning-and-end-of-the-inquiry analysis, which had been applied by the Sixth Circuit. The Supreme Court cited that analysis, then subsequently noted that it "agree[d] with the Court of Appeals' analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents' damages award."[274] Was this enigmatic statement intended to place a stamp of approval on the *Threlkeld* analysis? Apparently, the Supreme Court did not have a problem with the notion that, so long as the injury and the claim are "personal and tort-like in nature," that is the "beginning and end of the inquiry." The Court seemed only to object to the manner in which the inquiry itself was to be undertaken and substituted its "scope of the remedies" analysis for the tests that had been applied by the lower courts in identifying a tort or tort-type action.

If the *Threlkeld* analysis survived the Supreme Court's scope-of-the-remedies test, it is arguable that as long as the underlying claim is tort or tort-type, that is the beginning and end of the inquiry and *all* damages—*including* punitive damages—are excludable from income.[275] The Supreme Court's analysis in *Burke* has crucial significance to the question of the federal income tax treatment of punitive damages.

On the other hand, it is also easy for a court to distinguish the Supreme Court's decision in *Burke* from any case involving punitive damages. *Burke* simply did not involve punitive damages and did not address that issue. Regardless of whether *Burke* is factually distinguishable, it can be argued that the Supreme Court did not *explicitly* approve the *Threlkeld* approach. Therefore, there is nothing in the *Burke* decision to preclude the conclusion that if an injury is found to be tort or tort-type under the scope-of-the-remedies test, there is also a second inquiry to be considered: whether the resulting recovery is received "on account of" that injury. If a second test indeed exists and requires the recovery to be received "on account of" a personal injury, it can be argued that punitive damages are not excludable under I.R.C. § 104(a)(2) on the theory that punitive damages are not received on account of personal injury at all, but because of the tortfeasor's malicious or wanton misconduct.

3118 (1994).

272. 115 S. Ct. 507 (1994).

273. *See infra* note 505 and accompanying text.

274. *See* United States v. Burke, 112 S. Ct. 1867, 1872 (1992).

275. Note, however, that both the Tax Court and the Sixth Circuit in *Threlkeld* seemed to be addressing the tax treatment of compensatory damages only. *See supra* notes 155 and 159.

Whether the *Threlkeld* beginning-and-end-of-the-inquiry approach has survived *Burke* is a key question affecting the taxation of punitive damages. Courts attempting to apply the Supreme Court's test in *Burke* to the tax treatment of punitive damages have come to inconsistent conclusions.

C. *The Riddle of the Revenue Reconciliation Act of 1989 and its Amendment of I.R.C. § 104(a)*

In the midst of the battle being played out in the courts, described in the previous section, Congress moved to bring some certainty to the area. In 1989, as part of the Revenue Reconciliation Act of 1989, I.R.C. § 104(a) was amended to provide that the § 104(a)(2) exclusion "shall *not* apply to any punitive damages in connection with a case *not* involving *physical* injury or physical sickness."[276] This curious language, phrased as a double negative, has succeeded only in confounding those judges who have since attempted to divine congressional intent in adopting the amendment. Serious doubt and confusion continues to exist over the legislative purpose behind the amendment, and its impact on the proper tax treatment of punitive damages is extremely problematic.

That the amendment was adopted to address the emerging judicial trend extending § 104(a)(2) to recoveries for nonphysical injury seems clear. The House Conference Report[277] accompanying the Revenue Reconciliation Act of 1993 (RRA '93) acknowledges those judicial developments by stating that "[i]n some cases, courts have held that [the I.R.C. § 104(a)(2)] exclusion is available even though there is no physical injury, for example, in cases involving employment discrimination."[278] Concerned about this emerging trend,[279] the House version of the bill had provided that "the exclusion for damages

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276. *See supra* note 10 (emphasis added).

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

278. H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 622, *reprinted in* 1989 U.S.C.C.A.N. at 3225. The House Ways and Means Committee Report was even more specific, stating:

> Courts have interpreted [the I.R.C. § 104(a)(2)] exclusion broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving employment discrimination and injury to reputation where there is no physical injury or sickness.
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> . . . .
>
> Amounts received as damages for personal injury or sickness receive favorable tax treatment in that they are excludable from gross income. The committee believes that such treatment is inappropriate where no physical injury or sickness is involved.

H.R. CONF. REP. NO. 247, 101st Cong., 1st Sess. 1354-55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2824-25.

279. By 1989, compensatory damage recoveries for nonphysical injuries had been held excludable in Byrne v. Commissioner, 90 T.C. 1000 (1988), *rev'd*, 883 F.2d 211 (3d Cir. 1989); Threlkeld v. Commissioner, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 87 (6th Cir. 1988); Bent v. Commissioner, 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987); Roemer v. Commissioner, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983).

received for personal injury is *limited* to cases involving physical injury or sickness."[280] This provision would have withdrawn the exclusion for all damages recoveries (both compensatory and punitive) for nonphysical injuries and thus would have stemmed the tide of recent decisions. The Senate version of the bill had no corollary provision. In conference, the bill was amended to read as finally adopted; however, the legislative history gives no hint as to congressional intent. The final version of the bill therefore limited the reach of the provision to punitive damages and adopted the double negative phrasing.

Congressional intent behind the amendment as adopted is extremely difficult to discern. The question of congressional intent has two important aspects. First, what did Congress think existing law was *prior* to the amendment? This question has particular relevance to the recent case law developments concerning punitive damages that are the focus of this article, as those cases all arose under federal tax law as it existed prior to 1989. Therefore, if one determines that a particular interpretation of congressional intent is more attractive than another, one must also consider whether that interpretation is consistent with the conclusions already reached by the Fourth, Sixth, Ninth, and Federal Circuits in *Miller*, *Horton*, *Hawkins*, and *Reese*, respectively.[281]

A second aspect of this legislative history addresses how Congress intended to *change* existing law. That is, what did Congress intend the effect of the amendment to be on post-RRA '89 damage recoveries? Clearly, after the amendment, punitive damages for nonphysical injuries are taxable. Conversely, by implication it would seem relatively clear that punitive damages for physical injuries are to be excluded subsequent to RRA '89. This interpretation has received support from the commentators.[282] Significantly, the Supreme Court has apparently endorsed this view of post-RRA '89 law, stating in *Burke* that "Congress amended § 104(a) to allow the exclusion of *punitive* damages *only* in cases involving 'physical injury or physical sickness.'"[283]

With these questions in mind, several possibilities may explain congressional intent behind the 1989 amendment.

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280. H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 622, *reprinted in* 1989 U.S.C.C.A.N. at 3225 (emphasis added).

281. *See supra* notes 1 and 2.

282. *See, e.g.*, Mark W. Cochran, *1989 Tax Act Compounds Confusion Over Tax Status of Personal Injury Damages*, 49 TAX NOTES 1565, 1567 (1990); Jaeger, *supra* note 121, at 111-112; Andrews, *supra* note 121, at 766.

283. United States v. Burke, 112 S.Ct 1867, 1872 n.6 (1992) (emphasis added). This is essentially the same conclusion reached by Professor Chirelstein, who states:

> The result, as it seems, is that physical injury and nonphysical injury are now to be treated alike under § 104 *except* with respect to punitive damages, which are excluded by § 104(a)(2) if awarded in connection with physical injury but remain taxable under § 61 if awarded in connection with nonphysical injury.

CHIRELSTEIN, *supra* note 101, at 42; *see also* Matlow, *supra* note 121, at 390 ("[B]y implication punitive damages in physical injury actions will continue to qualify for exclusion under section 104(a)(2)."). The District Court for the District of Colorado has reached the same conclusion. In Brabson v. United States, 859 F. Supp. 1360 (D. Colo. 1994), the court stated that after RRA '89 "[p]unitive damage awards are excludable *only if* the underlying injury is physical." *Id.* at 1362 n.2 (emphasis added).

Interpretation #1. Congress believed that punitive damages awarded for both physical and nonphysical injuries were tax-exempt prior to 1989. Congress intended to change existing law by providing that punitive damages for nonphysical injuries are now taxable, but that punitive damages for physical injuries will remain tax-exempt.[284]

This reading of the 1989 amendment implies that Congress intended to narrow the scope of I.R.C. § 104(a)(2) in RRA '89.[285] This is a plausible explanation of congressional intent, and is the most immediately obvious result suggested by the wording of the amendment itself. It is also consistent with the legislative history, which shows that Congress initially sought to remove even *compensatory* damages for nonphysical injuries from the reach of I.R.C. § 104(a)(2). Limiting the change to just punitive damages can be seen as a slight retreat from this initial position, and merely a function of legislative compromise. By expressing a concern over the exclusion of recoveries for nonphysical injuries only, and by leaving the law unchanged regarding damages for physical injuries, Congress implicitly placed its stamp of approval on existing law.[286]

This interpretation of congressional intent, however, fails to explain satisfactorily the particular double negative phrasing employed. Why did Congress not simply state in positive terms that "the exclusion for punitive damages received for personal injury shall *only* apply in cases involving physical injury or sickness"? This would have made clear both the direct statement (that punitive damages recoveries for physical injury are tax-exempt) and the implied result (that punitive damages for nonphysical injury are taxable). Congress's intentional use of the double negative phrasing perhaps suggests the result that

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284. *See, e.g.*, Horton v. Commissioner, 33 F.3d 625, 631 n. 12 (6th Cir. 1994) (discussed *infra*); Hawkins v. United States, 30 F.3d 1077, 1086-87 (9th Cir. 1994) (Trott, J., dissenting) (discussed *infra*).

285. As relevant to *compensatory* damages, the Supreme Court has interpreted the legislative history to indicate that *subsequent* to RRA '89, "Congress assumed that [damages other than punitive damages, such as compensatory damages] would be excluded in cases of both physical *and* nonphysical injury." *Id.* The Supreme Court thus reads the 1989 amendment to § 104(a)(2) as finally resolving, if further resolution was necessary, and rejecting the Service's physical- vs.-nonphysical distinction, at least insofar as compensatory damages are concerned. The Court did not, however, view this as relevant to the larger threshold question in *Burke*: whether Burke's back pay award was on account of a tort or tort-type injury, and therefore whether I.R.C. § 104(a)(2) was even applicable to the recovery.

286. As to the relevance of the amendment to pre-RRA '89 law, see Rickel v. Commissioner, 900 F.2d 655, 664 (3rd Cir. 1990), concluding that the amendment placed a Congressional stamp of approval on the case law trend that had excluded compensatory damage awards for nonphysical injuries:

> In its final conference bill, Congress chose to implicitly endorse the courts' expansive interpretation of § 104(a)(2) to encompass nonphysical injuries and merely circumscribe the scope of the exemption as to only one type of remedy, i.e., punitive damages, and not other types of remedies typically available in employment discrimination cases, such as back pay.

Id. This conclusion is buttressed by the fact that the original House Ways and Means Conference Report specifically disapproved that expansive interpretation. *See supra* note 278. The House Conference Committee Report, however, dropped the disapproving language.

could have been more directly stated was not intended, and that Congress did not intend to make a definitive statement on the tax treatment of punitive damages for physical injuries.[287]

Interpretation #2. Congress believed that punitive damages awarded for both physical and nonphysical injuries were taxable prior to 1989. Congress intended to change existing law by providing that punitive damages for nonphysical injuries only will continue to be taxable. Therefore, by implication, damages for physical injuries are now tax-exempt.[288]

If this view of legislative history accurately represents Congress's assumptions in enacting the amendment, it means the effect of RRA '89 was to *expand* the scope of I.R.C. § 104(a)(2). This view is hardly consistent with the legislative history, which clearly evinces an intent to narrow that scope. Moreover, if Congress intended to expand the scope of § 104(a)(2), it would have made much more sense for the amendment to state simply and affirmatively that the exemption extends only to punitive damages received for physical injuries and not for nonphysical injuries. There is no good reason why Congress would use a double negative if it intended to expand the statute.

The implication of this interpretation is that, if the Fourth, Ninth, and Federal Circuits are correct in their apparent belief that *all* punitive damage recoveries prior to RRA '89 are taxable,[289] and if it is true (as the Supreme Court has indicated) that after RRA '89 only punitive damage recoveries for nonphysical injuries are taxable, then these Courts of Appeal *have* interpreted the RRA '89 amendment as expanding the scope of § 104(a)(2). Again, this is completely inconsistent with the tenor of the legislative history accompanying the amendment.

It perhaps can be argued that, by using the double negative phrasing, Congress did in fact imply that punitive damages for physical injuries are now exempt where they were not before, *but* that this implication was totally inadvertent and essentially represents a drafting error. However, this seems a very strained and unwarranted reading of Congressional intent.

Interpretation #3. Congress believed that punitive damages awarded for both physical and nonphysical injuries were taxable prior to 1989. After the amendment to I.R.C. § 104, punitive damages, whether for physical or nonphysical injuries, are still taxable; that is, Congress did not intend to change existing law.[290]

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287. *See* Dodge, *supra* note 70, at 143 ("The 1989 amendment seems to be based on the erroneous, or at least doubtful, assumption that punitive damages generally fall within the section 104 exclusion.").

288. *See, e.g., Hawkins*, 30 F.3d at 1087 (Trott, J., dissenting).

289. The analysis and rationale of the Fourth, Ninth, and Federal Circuits' opinions in *Miller*, *Hawkins*, and *Reese*, respectively, simply do not permit a distinction to be made between physical and nonphysical injuries. The implication of these decisions is that pre-RRA '89 punitive damage recoveries for both types of injury are taxable. If this is the case, then either Interpretation #2 is true—but that interpretation seems wholly unwarranted—or Interpretation #3 is true.

290. *See, e.g., Hawkins*, 30 F.3d at 1086-87 (Trott, J., dissenting).

This interpretation of congressional intent, which is most favorable to the Service, is the most strained of the several here discussed. Under this view, both categories of punitive damages are taxable both before and after the amendment. It is difficult to believe that this view accurately reflects congressional intent. If the law prior to RRA '89 was complete exclusion, and after the amendment the law continues to be full exclusion, then the amendment is completely superfluous and carries no import whatsoever—it does not even restate or codify existing law in a coherent fashion. Legitimate interpretation of congressional intent cannot lead to the conclusion that Congress intended to enact a meaningless statute.

One must consider this interpretation carefully because, if the implication of the Fourth, Ninth, and Federal Circuit opinions is that all punitive damages, whether for physical or nonphysical injury, are taxable both before and after the amendment, the net effect is that the courts have simply written the amendment out of the statute and have rendered it a complete nullity. This seems an unprincipled application of legislative history to interpret an amended statute.

Interpretation #4. Congress believed that punitive damages awarded for physical injuries were exempt prior to 1989, but punitive damages for nonphysical injuries were taxable. Congress intended to codify this position by specifically incorporating it into I.R.C. § 104(a)(2), and this remains the rule following RRA '89.[291]

Interpretation #4 implies that Congress was simply clarifying, restating, and codifying existing law, or at least Congress's understanding of existing law. While this is not an unreasonable reading of the legislative history, it is not entirely consistent with the tone of the legislative history, which suggests that Congress intended to narrow the scope of I.R.C. § 104(a)(2) and not merely restate existing law.

This interpretation has particular merit considering that by 1989, two courts[292] had held punitive damage recoveries for nonphysical injuries excludable. It is entirely plausible to assume that Congress was aware of these holdings and considered them inconsistent with its understanding of the law. RRA '89 can therefore be viewed as nothing more than a legslative reversal of those two cases.[293] Of course, these cases were later determined to be incorrectly decided,[294] and in that sense the amendment ultimately would be su-

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291. *See, e.g., Hawkins*, 30 F.3d at 1082.

292. Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983); Miller v. Commissioner, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990). The Tax Court decision in *Miller* was entered on September 13, 1989. The House Report is dated September 20, 1989, and the House Conference Committee Report is dated November 21, 1989, the same date that RRA '89 was passed by both houses of Congress.

293. The main problem with this analysis is that "[t]he legislative history clearly shows that Congress was rejecting the judicial decisions holding that section 104 covered damages received from nonphysical injuries rather than decisions that had found punitive damages to fall within the scope of the section 104 exclusion." Jaeger, *supra* note 121, at 111-12.

294. Subsequent to RRA '89, the Ninth Circuit disavowed its analysis of punitive damages from *Roemer* in Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994), and *Miller*

perfluous. However, that fact does not undermine this explanation of congressional intent. While it is true that this renders the 1989 amendment meaningless, this was certainly not known at the time, and only subsequent events created that result.

This interpretation also accurately explains the results in *Miller*, *Hawkins*, and *Reese* (all of which held punitive damages for nonphysical injuries taxable) and in *Horton* (which held punitive damages for a physical injury[295] taxable). However, as noted, the rationale of *Miller*, *Hawkins*, and *Reese* does not seem limited to nonphysical injury, and it seems clear that the Fourth, Ninth, and Federal Circuits would also hold punitive damages for nonphysical injuries includable if faced with that issue, a result inconsistent with Interpretation # 4.

Interpretation # 5. Congress did not have a clear idea how punitive damages for physical injuries were taxed under existing law, and perhaps it did not care one way or the other. However, Congress was concerned about the emerging trend of courts finding that damage awards, both compensatory and punitive, for nonphysical injuries fell within the scope of I.R.C. § 104(a)(2). Congress intended to express its disapproval of this trend and legislatively reverse those cases. Due to a compromise between the House and Senate, this reversal was effected only for punitive damages and not for compensatory damages. Therefore, after the amendment, compensatory damages for nonphysical injuries are still tax-exempt, but punitive damages for nonphysical injuries are now taxable. The proper tax treatment of punitive damages for physical injuries was simply not addressed by the amendment and was not intended to be.[296]

Under this interpretation, the taxation of punitive dmages remains an open question, except for post-RRA '89 punitive damages for nonphysical injuries, which are now explicitly taxable. Whether punitive damages for physical injuries both before and after the amendment are taxable, and whether pre-RRA '89 damages for nonphysical injuries are taxable, are left to the courts.[297]

In one sense, this interpretation of congressional intent can be viewed as a variation of Interpretation #4. Under this view, Congress was only concerned with legislatively overruling those cases that had held *punitive* damages for nonphysical injuries excludable. Moreover, Congress did address or consider the tax treatment of punitive damages for physical injuries, and it had formed no view as to whether these were taxable or excludable, preferring to let the law develop. It is therefore quite acceptable for the courts to have ultimately concluded that punitive damages for both physical and nonphysical injuries,

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was reversed by the Fourth Circuit in Miller v. Commissioner, 914 F.2d 586 (4th Cir. 1990). One therefore begins to suspect that, in one sense, Congress jumped the gun by amending I.R.C. § 104(a)(2) in 1989. Had the matter been left to the courts, they would have ultimately come to the correct conclusion—at least in the view of Congress—without the need for statutory tinkering and its resulting controversial effect.

295. *See infra* note 428.

296. *See, e.g.*, *Hawkins*, 30 F.3d at 1082 n.7.

297. *See* Dodge, *supra* note 70, at 143 & n.4.

recovered prior to RRA '89, are taxable. It is also not inconsistent with the legislative history to conclude that, after RRA '89, punitive damages for non-physical injuries are taxable but punitive damages for physical injuries are not, viewing post-RRA '89 law as consistent with the Supreme Court's apparent view. While this turn of events does *expand* the scope of I.R.C. § 104(a)(2), this is neither consistent nor inconsistent with the legislative history as so interpreted. It is merely a neutral consequence, neither compelled nor precluded by the amendment.

In reviewing these alternative explanations of congressional intent, Interpretations #2 and #3—and therefore, any treatment of punitive damages under such interpretations — are the least defensible, for the reasons stated above. Among the remaining three alternatives, Interpretation #1 seems the most reasonable and requires the least rationalization. This interpretation would lead one to the conclusion that punitive damages received prior to RRA '89 should be within the scope of I.R.C. § 104(a)(2) and therefore nontaxable. Such a conclusion is inconsistent with the view taken by the Fourth, Ninth, and Federal Circuits and, as will be explored in Part VI below, will present those courts the formidable task of explaining away this interpretation of congressional intent.

V. RECENT CASE LAW DEVELOPMENTS INVOLVING PUNITIVE DAMAGES TAXATION

The following discussion examines the major cases addressing the taxation of punitive damages. These cases reflect severe disagreements among the courts as to the application of punitive damages under I.R.C. § 104(a)(2). Three of the cases discussed, *Reese*, *Hawkins*, and most recently *Horton*, proceeded through the courts on virtually parallel tracks and were decided within a few months of each other in 1994. Developments in this area have thus been rapid as well as controversial.

A. Roemer v. Commissioner[298]

The facts of *Roemer* have been discussed previously.[299] In addition to his compensatory damages of $40,000, Roemer had also recovered punitive damages of $250,000 in his libel and defamation suit against Retail Credit.[300] The Service sought to tax this component of the recovery, claiming that the damages were not paid on account of personal injury and therefore were not excludable under I.R.C. § 104(a)(2).

At the time of the Tax Court's decision in *Roemer*, Revenue Ruling 75-45[301] was still in effect, holding a punitive damage award eligible for exclu-

298. 716 F.2d 693 (9th Cir. 1983).
299. *See supra* text accompanying and following note 126.
300. *Roemer*, 79 T.C. at 403.
301. *See supra* note 105 and accompanying text.

sion under I.R.C. § 104(a)(2). In arguing Roemer's punitive damages taxable, the Service therefore advanced a litigation position inconsistent with its published ruling. The Tax Court's majority opinion, which had already concluded that Roemer's underlying compensatory damage recovery was taxable, held:

> It therefore follows that the punitive damages were [also] not awarded "on account of personal injuries" to the petitioner. This is inconsistent with the Supreme Court's decision in *Commissioner v. Glenshaw Glass Co.* and the Commissioner's ruling positions in Rev. Rul. 75-45. Accordingly, we hold that the punitive damages are includable in petitioner's gross income.[302]

This conclusion was consistent with the theory of Revenue Ruling 75-45: if the underlying compensatory award is not taxable, neither are any punitive damages received in the same action. Conversely, if the underlying compensatory damage component is taxable, so is the punitive damage component.[303]

The majority did not, however, give a ringing endorsement to the Commissioner's interpretation of I.R.C. § 104(a)(2) as reflected in Revenue Ruling 75-45:

> Since [the Commissioner's] interpretation *arguably* comes within the language of section 104(a)(2), the Commissioner, in his administrative discretion, has chosen to allow punitive damages to be excluded from gross income in the same manner as compensatory damages *provided they arise out of a personal injury.*[304]

In dissent, Judge Wilbur would have bifurcated the compensatory damage award from the punitive damage award. As we have seen, Judge Wilbur forcefully argued that Roemer's compensatory damages should have been excluded, using his "fingerless surgeon" example.[305] He then stated:

> However, the law is clear that punitive or exemplary damages must be included in gross income, and I would so hold. *Commissioner v. Glenshaw Glass Co.* . . . Punitive damages are certainly not intended to compensate petitioner for a loss within the purview of section 104. I realize respondent has a revenue ruling that suggests a contrary result. Rev. Rul. 75-45. Under appropriate circumstances, respondent may be precluded from taking one position in a ruling with respect to taxpayers in general, and a different position in regard to a taxpayer before the Court. Nevertheless, the facts in Rev. Rul. 75-45 are sufficiently different from those herein to permit the surprising but general language of the ruling to be disregarded for now.[306]

On appeal in *Roemer*, the Ninth Circuit reversed the Tax Court and held

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302. *Roemer*, 79 T.C. at 408 (citations ommitted).

303. Revenue Ruling 75-45 was therefore a largely "pro-taxpayer" ruling: it was inconsistent with the return of capital theory, to the taxpayer's benefit. On this basis, the Tax Court majority was willing to follow its approach.

304. *Roemer*, 79 T.C. at 408 (emphasis added) (footnote omitted).

305. *See id.* at 414 (Wilbur, J., dissenting).

306. *Id.* at 414-15 (citations omitted).

Roemer's entire award excludable. In doing so, the Court of Appeals held that I.R.C. § 104(a)(2) excluded punitive damages, as long as the underlying injury was personal in nature. The court noted:

> Normally, an amount awarded for punitive damages is includable in gross income as ordinary income. *Commissioner v. Glenshaw Glass Co.* Nevertheless, *the Commissioner liberally interprets § 104(a)(2)* to exclude punitive damages as well as all compensatory damages where there has been a personal injury. Rev. Rul. 75-45. Therefore, according to the Commissioner's own interpretation, the punitive damages received by Roemer on account of his § 104(a)(2) personal injury (the defamation(are excludable from gross income.[307]

The Ninth Circuit therefore held the Service to its own published ruling position on punitive damages, and found Roemer's recovery excludable.[308] Therefore, whatever the wisdom or correctness of Revenue Ruling 75-45, it contributed directly to the Ninth Circuit's conclusion that had little to do with whether punitive damages should be excludable as a matter of statutory construction. Just as the Service was faced with the hurdle of Revenue Ruling in arguing that punitive damages are taxable, so too would courts later be faced with the Ninth Circuit's decision in *Roemer* arriving at the opposite conclusion.

B. Commissioner v. Miller[309]

Bonnie Miller had brought defamation actions against her former employers, alleging they had accused her of embezzlement and other kinds of misconduct to conceal their own participation in schemes involving bribery of government officials.[310] Miller's first suit went to trial and a jury awarded her $500,000 in compensatory damages and $450,000 in punitive damages. She and the defendants then settled both actions for $900,000.[311] After payment of legal fees and costs from the settlement amount totaling $375,000, Miller received $525,000 in net settlement proceeds.[312] The Service took the view that the entire $525,000 was taxable,[313] and Miller petitioned the Tax

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307. Roemer v. Commissioner, 716 F.2d 693, 700 (9th Cir. 1983) (emphasis added) (citations omitted).

308. *Id.*; *see also* Church v. Commissioner, 80 T.C. 1104, 1110 (1983) (finding Church's compensatory damages, received in a libel action, excludable). In *Church*, the Service did not bother to

> argue that the punitive damages should be included in income regardless of the nature of the underlying compensatory damages. [R]espondent, in his adminstrative discretion, has chosen to allow punitive damages to be excluded from gross income in the same manner as the underlying compensatory damages, provided they arose out of a personal injury.

Church, 80 T.C. at 1110 n.7 (citation omitted). The Service therefore conceded that Church's punitive damages award was excludable. *Id.*

309. 914 F.2d 586 (4th Cir. 1990).

310. *Miller*, 93 T.C. 330, 331 (1989).

311. *Id.* at 333-34.

312. *Id.*

313. In *Miller*, as in previous cases, the Service argued that a distinction existed between

Court.

In *Miller*,[314] the Tax Court had no difficulty concluding that I.R.C. § 104(a)(2) excludes from gross income both compensatory and punitive damages received on account of personal injuries, essentially adopting the conclusion of Revenue Ruling 75-45:

> Section 104(a)(2) excludes from gross income "any damages received . . . on account of personal injuries." . . . Congress, aware of [the existence of punitive damages], could have excluded only "compensatory damages" or provided that only damages received "as compensation for" personal injuries be excluded . . . It did neither, and the plain meaning of the broad statutory language simply does not permit a distinction between punitive and compensatory damages . . . *Thus, we read "any damages" to mean "all" damages, including punitive damages.*[315]

By this time, of course, the Service had reversed its ruling position by issuing Revenue Ruling 84-108,[316] revoking Revenue Ruling 75-45. Addressing the history of the Service's ruling position on punitive damages, the court rejected the rationale and holding of Revenue Ruling 84-108, noting:

> At one time, the Commissioner also viewed the statute as free of ambiguity. Revenue Ruling 75-45 . . . .
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> . . . .
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> . . . In Revenue Ruling 84-108 the Commissioner reversed his position and stated that section 104(a)(2) does not exclude punitive damages from gross income. The Commissioner relied primarily on *Commissioner v. Glenshaw Glass Co.* [H]owever, *Glenshaw Glass* does not support respondent's position. *Glenshaw Glass* involved two-thirds of treble damages recoveries for violations of Federal antitrust laws and a punitive damages recovery for fraud. The taxpayers had not received any recoveries on account of personal inuries, and thus the predecessor of section 104(a)(2) was not in issue.[317]

Revenue Ruling 84-108 had concluded that punitive damages are not awarded "on account of" personal injury, because they are "determined with reference to the defendant's degree of fault."[318] The Tax Court viewed the Commissioner's construction of the phrase "on account of" as "strained and unnatural."[319] According to the Tax Court, the plain meaning of the

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the treatments of physical and nonphysical injuries under § 104(a)(2). This argument had been rejected in *Roemer* and by the Tax Court in *Threlkeld*. In *Miller*, the Tax Court followed *Threlkeld*, holding that the compensatory damage element of Miller's recovery was excludable under § 104(a)(2), even if the injury was nonphysical and was to the taxpayer's "professional" rather than "personal" reputation. *Id.* at 335-37.

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

315. *Id.* at 338 (emphasis added) (citations omitted).

316. *See supra* note 109 and accompanying text.

317. *Miller*, 93 T.C. at 339 (citations omitted).

318. *See supra* note 116.

319. *Miller*, 93 T.C. at 339.

statute[320] required a conclusion that the receipt of punitive damages is "on account of" the infliction of the tort due to a relationship suggesting causation:

> Webster's defines the phrase "on account of" as: "For the sake of," "by reason of," or "because of." These phrases suggest causation. Punitive damages result from both personal injury and a defendant's culpability. Without the "invasion of . . . rights" referred to in *Threlkeld*, punitive damages are unavailable, and most jurisdictions require some amount of actual damages before punitive damages may be awarded. Thus, punitive damages are received "on account of" personal injury, although personal injury alone may not justify an award of punitive damages.[321]

The type of causation described here by the Tax Court can best be described as "but for" causation. The Tax Court's view of causation boiled down to this: punitive damages are received "on account of" personal injury because the two are linked by a cause-and-effect relationship—*but for* the personal injury, there would simply be no punitive damages. In a concurring opinion, Judge Ruwe reinforced the "but for" causation argument of the majority:

> [P]unitive damages can only be awarded if there is a valid underlying cause of action. In this case, the underlying cause of action is clearly one for personal injury. The existence of a personal injury is the sine qua non for an award of any kind of damages, be they compensatory or punitive. While the primary purpose of punitive damages may well be to deter egregious conduct on the part of tortfeasor, egregious conduct standing alone will not entitle a claimant to punitive damages. Without an injury, there is simply no basis for awarding punitive damages, regardless of how much interest society might have in preventing a reoccurrence of egregious conduct.[322]

Judge Ruwe was unimpressed with the Service's argument that punitive damages are accessions to wealth and should therefore be taxed, noting that under this theory recoveries for lost wages should also be taxed but are not.[323] As previously discussed,[324] when placed in the context of the return

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320. Under the "plain meaning" rule of statutory construction, the plain meaning of a statute is not to be disregarded except to prevent an abusrd result or one that is contrary to legislative intent. *See, e.g.*, United States v. American Trucking Ass'ns, Inc., 310 U.S. 534, 543 (1940); Ables v. Commissioner, 91 T.C. 1019, 1028 (1988); *see also Miller*, 93 T.C. at 340-41. *But see* Harrison v. Northern Trust Co., 317 U.S. 476, 479 (1943) ("But words are inexact tools at best, and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how clear the words may appear on 'superficial examination'."); United States v. The Heirs of Boisdore', 49 U.S. (8 How.) 113, 122 (1849) ("In expounding a statute, we must not be guided by a single sentence or members of a sentence, but look to the provisions of the whole law, and to its object and policy.").

321. *Miller*, 93 T.C. at 339-40 (citations omitted).

322. *Id.* at 342 (citations omitted).

323. Judge Ruwe noted:

> The very purpose of section 104(a)(2) is to exclude from income amounts which would otherwise have been taxed. The fact that punitive damages represent an accession to wealth and therefore would normally be included in gross income is no reason to preclude the application of section 104(a)(2). Indeed, even certain

of capital theory, this is a telling observation. The Tax Court majority thus concluded that I.R.C. § 104(a)(2) applied to both compensatory *and* punitive damages equally, without regard as to whether punitive damages served a compensatory purpose. The majority therefore found it unnecessary to analyze Maryland law to determine the nature of punitive damages in that state.

Judge Whalen dissented, criticizing the majority's expansive reading of the phrase "any damages," suggesting that an *additional* inquiry was required: whether the punitive damages were actually received "on account of" personal injuries at all.[325] Judge Whalen argued that under this reading of the statute, one is requierd to examine underlying state law to determine "on account of" what the punitive damages in question are awarded. Reviewing Maryland law,[326] Judge Whalen determined that Maryland followed the majority view characterizing punitive damages as a form of civil punishment.[327] The dissent concluded that in Maryland punitive damages are not recovered "on account of" a personal injury at all but are instead awarded on account of the wrongdoer's outrageous conduct as a form of private fine levied by the jury.[328] The dissent would have given effect to the phrase "on account of" as

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> compensatory damages would seem to be includable in taxable income as an accession to wealth were it not for the existence of section 104(a)(2). For example, compensatory damages for personal injury are frequently measured by the injured party's lost future earnings. Such future earnings would have been accessions to wealth and would clearly have been taxable. Even respondent agrees that compensatory damages, that are determined by reference to lost future income, are excludable under section 104(a)(2).

Id. at 342-43 (citation omitted).

324. *See supra* text accompanying note 90.

325. Judge Whalen stated:

> I do not believe [the majority's] approach is justified by the fact that section 104(a)(2) uses the words "any damages" and does not expressly distinguish between compensatory and punitive damages. Rather, it seems to me that the majority's analysis on that point begs the question of whether the payment, by whatever name it is described, qualifies under section 104(a)(2) as an amount "paid on account of personal injuries."

Id. at 348 (Whalen, J., dissenting) (citations ommitted).

326. *See, e.g.*, Nast v. Lockett, 539 A.2d 1113, 1116 (Md. 1988) (stating that punitive or exemplary damages are damages on an increased scale, awarded not as the measure of actual loss suffered but "as punishment for outrageous conduct and to deter future transgressions.") (citing BLACK'S LAW DICTIONARY 352 (5th ed. 1979)). *See also* Exxon Corp. v. Yarema, 516 A.2d 990, 997 (Md. 1986):

> Punitive damages are inherently different from compensatory damages and the reasons for the award of each differ sharply . . . [T]he award of punitive damages does not attempt to compensate the plaintiff for harm suffered by him but rather is exemplary in nature and is over and above any award of compensatory damages. The fundamental purpose of a punitive damages award is to punish the wrongdoer for misconduct and to deter future egregious conduct by others.

327. *Miller*, 93 T.C. at 346 (Whalen, J., dissenting).

328. *Id.* at 344-46. Judge Whalen noted that:

> the amount paid to satisfy petitioner's claims for punitive damages was paid "on account of" the tort-feasor's culpable conduct, not petitioner's personal injuries. Accordingly, it should be included in petitioner's income under section 61(a) as an accession to her wealth, rather than excluded as compensation which makes her personal injuries whole.

used in the statute, holding that punitive damages awarded in Maryland are not received "on account of" a personal injury nor intended to compensate the victim for such an injury, but instead are received "on account of" the tortfeasor's conduct and intended to punish the wrongdoer. Such damages, therefore, would not fall within the statutory exclusion.

The Fourth Circuit, which had previously failed to adopt the *Threlkeld* beginning-and-end-of-the-inquiry analysis in holding for the government in *Thompson*,[329] reversed.[330] The court immediately took issue with the Tax Court's conclusion that the "plain meaning" rule clearly required application of a "but for" test of causation:

> We do not quarrel with the [tax] court's observation that "on account of" suggests "causation." However, in our view, that observation blithely smooths over the distinction between "but-for" causation and "sufficient" causation. . . . [U]nder a sufficient causation approach, the fact that personal injury is a prerequisite to punitive damages does not lead to the conclusion that the punitive damages were "on account of" the plaintiff's injuries because, even if the other elements of the tort are present, personal injury alone does not sustain a punitive damage award. The fact that a plaintiff seeking punitive damages has to show egregious conduct by the defendant indicates that the plaintiff's injury was not a sufficient cause of the punitive damages.[331]

The Court of Appeals concluded that I.R.C. § 104(a)(2) was inherently ambiguous.[332] The court therefore resorted to "extrinsic aids to interpretation."[333] The court relied upon two factors in construing the statute. First, the court noted the "well-recognized, even venerable, principle that exclusions to income are to be construed narrowly."[334] This mitigated against extending the § 104(a)(2) exemption to punitive damages.

Second, the court invoked the return of capital theory, discussed in Part III, *supra*, concluded that this theory persuasively provided a rationale for I.R.C. § 104(a)(2) and therefore assisted in construing the scope of the exclusion.[335] The court found it worth noting that I.R.C. § 104 is entitled "*Com-*

Id. at 344.

329. Thompson v. Commissioner, 866 F.2d 709 (4th Cir. 1989).

330. Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990).

331. *Id.* at 589-90.

332. *Id.* at 590.

333. *Id.*

334. *Id.*; *see* Commissioner v. Jacobson, 336 U.S. 28, 49 (1949).

335. *Miller*, 914 F.2d at 590. The court stated:

In discussing the section, the Ninth Circuit has observed 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." In so commenting, the Ninth Circuit aptly relied upon the Supreme Court's comment, in another context, that "[p]unitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes."

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

pensation for injuries or sickness."[336] The court concluded that "[t]he Tax Court's interpretation of § 104(a)(2) extends the section to situations in which a plaintiff's damages do not serve to make a plaintiff whole and thus runs afoul of the section's purpose."[337] The analysis of the Fourth Circuit thus dovetailed with that of Judge Whalen's dissent in the tax court and required the Fourth Circuit to consider the nature of punitive damages in Maryland to determine whether or not Bonnie Miller's punitive damages served a compensatory purpose. Consistent with Judge Whalen, the court of appeals concluded that, under Maryland law, punitive damages punish the wrongdoer and do not compensate the victim.[338] As a result, Miller's punitive damage award could not be excluded from her taxable income.

The court then addressed the Service's inconsistent ruling position, which once held punitive damages to be excludable:

> It is of little moment that the Commissioner at one time construed § 104(a)(2) to exclude from income punitive damages and that the Ninth Circuit [in *Roemer*] held (relying on Rev. Rul. 75-45) the then Commissioner's "liberal" interpretation to control. The Ninth Circuit was merely presenting proof that when in Rome one should do as the Romans do. However, in the first place, the Commissioner's subsequent shift in position calls for Roemer, as a Roman, to shift also. . . . [T]he making of an error does not recommend, let alone, necessitate, its repetition. The Commissioner does not, in circumstances such as those in the present case, adhere to a dubious construction such as was applicable in *Roemer*. Rev. Rul. 84-108.[339]

Glenshaw Glass Co., 348 U.S. 426, 432 (1955)).

336. *Miller*, 914 F.2d at 590.

337. *Id.*

338. *Id.* at 589. The court stated:

> To determine whether Miller's settlement award may be excluded pursuant to § 104(a)(2), "the nature of the cause of action and the injury to be remedied must be identified." That inquiry requires consideration of the Maryland law that created Miller's entitlement to relief.
>
> Under Maryland law, a defamation action such as Miller's is an action for personal injuries. However, it must also be recognized that, under Maryland law, "[p]unitive damages are inherently different from compensatory damages and the reasons for the award of each differ sharply." A punitive damages award "does not attempt to compensate the plaintiff for harm suffered by him, but rather is exemplary in nature and is over and above any award of compensatory damages." In the context of a defamation action, the Maryland Court of Special Appeals has commented that "[e]xemplary or punitive damages, as the name connotes, are rather a punishment for and deterrent to wrongdoing than a means of recompensing the victim. To the victim they are a windfall not necessarily related to the injury he has suffered."

Id. (citations omitted) (footnote omitted).

339. *Id.* at 591 (citations omitted). Miller had argued that it was "unfair to apply the Commissioner's 'new' rule to her case because she detrimentally relied upon the Commissioner's 'old' rule when she negotiated her settlement." *Id.* The court noted:

> While Miller's argument evokes some sympathy, "the Supreme Court has upheld the retroactive application of revenue rulings on the grounds that the I.R.S. should not be estopped from correcting a 'mistake of law,' even though a taxpayer may

The court concluded that Miller's settlement representing punitive damages fell outside the scope of § 104(a)(2) and was therefore includable in income. Such damages were a "'windfall,'. . ., being 'over and above any award of compensatory damages'. . . ."[340]

The Tax Court in *Miller* took a position analytically indistinguishable from its *Threlkeld* beginning-and-end-of-the-inquiry test, essentially holding that if the underlying injury is personal and if the claim seeks to vindicate tort or tort-type rights, then all damages arising out of the action, including punitive damages, are excludable under I.R.C. § 104(a)(2). The Fourth Circuit's opinion can be taken as a direct rejection of the beginning-and-end-of-the-inquiry analysis and requiring that a further question be asked: whether the recovery is truly "on account of" that personal injury. In the case of punitive damages, this was held not to be the case.

C. Reese v. United States[341]

In *Reese*, both the Court of Federal Claims and the Court of Appeals for the Federal Circuit adopted reasoning similar to the Fourth Circuit's analysis in *Miller*, holding a punitive damage award to be taxable.

The taxpayer in *Reese* filed suit under the District of Columbia Human Rights Act[342] against her former employer asserting gender discrimination, sexual harassment, intentional infliction of emotional distress, and breach of contract.[343] Following a jury trial, she was awarded $100,000 in punitive damages as part of a larger award. At the time of her award, the law was unsettled as to whether punitive damages were in fact available under the DCHRA.[344] When the Service included the punitive damages award in her taxable income, Reese paid the tax and sued for a refund in the Court of Federal Claims. Noting the inconsistent historical treatment of punitive damages by the Service in its rulings[345] and the current split developing in the courts,[346] the Court of Federal Claims in *Reese*[347] sided with the Fourth

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have relied to his detriment on a prior agency ruling.". . . There is nothing about Miller's alleged detrimental reliance that distinguishes it from any other taxpayer's detrimental reliance. Hence, the retroactive change in the Commissioner's position here was permissible.

Id. at 591-92 (citations omitted).

340. *Id.* at 591 (citations omitted).

341. 24 F.3d 228 (Fed. Cir. 1994).

342. D.C. CODE ANN. § 1-2501 (1981) (hereinafter DCHRA). The jury verdict was reflected in a subsequent settlement agreement that also addressed Reese's additional claim for attorneys' fees and costs.

343. Reese v. United States, 28 Cl. Ct. 702, 703 (1993).

344. *Compare* Green v. American Broadcasting Co., 647 F. Supp. 1359 (D.D.C. 1986) *with* Thompson v. International Ass'n of Machinists & Aerospace Workers, 614 F. Supp. 1002 (D.D.C. 1985).

345. *Reese*, 28 Cl. Ct. at 703-04.

346. *Id.* at 704-05. By this time, the Tax Court's decision in Horton v. Commissioner, 100 T.C. 93 (1993), had been issued, creating a conflict with the Fourth Circuit's decision in

Circuit and adopted the *Miller* analysis, taxing Reese on her punitive damage recovery.

The Court of Federal Claims rejected the Tax Court's "plain meaning" construction of § 104(a)(2) in *Miller* and agreed with the Fourth Circuit that the statute was ambiguous.[348] The court resorted to "alternative bases" for construing § 104(a)(2).[349] Similar to the Fourth Circuit, the court noted that "income" is to be broadly defined, while exemptions from income are to be narrowly construed.[350]

Second, following the Fourth Circuit in *Miller*, the court pointed to the title of I.R.C. § 104, which is entitled "*Compensation* for injuries or sickness." Consistent with its title, § 104 sets out various categories of exclusions which "generally are received as compensation for financial loss" resulting from injury or sickness such as worker's compensation, accident or health insurance, and disability.[351] This indicated to the court that the section was not intended to apply to noncompensatory payments or recoveries, and that taxing punitive damages would be consistent with this perceived purpose.

Relying on authority supporting the view that punitive damages were not recoverable under the DCHRA, Reese claimed that her award must necessarily be compensatory in nature. The Court of Federal Claims disagreed with this position, first pointing out that there was authority in the District of Columbia for allowing punitive damages under the DCHRA.[352] The Court of Federal Claims then quoted at length the jury instructions relating to Reese's claims,[353] which clearly demonstrated that the award received by Reese had no compensatory purpose but was founded on theories of punishment and deterrence.

Finally, unlike the Fourth Circuit, the Court of Federal Claims examined the legislative history of the 1918 enactment of the predecessor of I.R.C. § 104(a)(2)[354] and concluded that Congress did not have the tax consequences of punitive damages in mind when it enacted the provision; rather, it was codifying, or was at least cognizant of, some of the old "return of capital" opinions, such as Attorney General Opinion 304, discussed in Part II above.[355] However, the court concluded that those old administrative opinions, even if valid, do not support an exclusion of *punitive* damages: "Noncompensatory punitive damages are not in any sense a return of capital and hence, under the Attorney General's analysis, would constitute "income" subject to taxation."[356]

Miller.

347. *Reese*, 28 Cl. Ct. at 702.
348. *Id.* at 705.
349. *Id.* at 706.
350. *Id.*
351. *Id.* at 707.
352. *See supra* note 344.
353. Reese v. United States, 24 F.3d 228, 232 (Fed. Cir. 1994).
354. *Reese*, 28 Cl. Ct. at 707-08.
355. *Id.* at 708.
356. *Reese*, 28 Cl. Ct. at 708.

By this time, the Supreme Court had announced its decision in *Burke*, and so the Court of Federal Claims turned to the question of *Burke*'s effect on the application of I.R.C. § 104(a)(2) to punitive damages. The court determined that taxing punitive damages was not inconsistent with *Burke*. The court concluded that the *Burke* "scope of the remedies" test only discussed the threshold determination of whether a particular injury is tort or tort-like, and not to the additional question whether the recovery in question was "on account of" that personal injury:

> The question before the Supreme Court was not whether the damages were received "on account of" the violation of the statute and the resulting injuries, but rather whether the "injuries" suffered as a result of the violation of Title VII constituted "personal injuries" within the scope of I.R.C. § 104(a)(2).[357]

Thus, the Court of Federal Claims implicitly concluded that the Supreme court neither adopted nor approved the *Threlkeld* analysis in *Burke*. Rather, once it is determined whether the underlying claim was personal in nature (i.e., whether it is tort or tort-type) under a scope-of-the-remedies analysis, the Court of Federal Claims added a second question, neither considered nor precluded by the Supreme Court in *Burke*: whether the resulting recovery was "on account of" that personal injury.[358] Examining the nature of the punitive damages recovered in this case,[359] and concluding that they served no compensatory purpose but were intended only to deter and punish,[360] the court held the damage award was not "on account of" a personal injury and was therefore taxable.[361]

Reese appealed,[362] and the Court of Appeals for the Federal Circuit affirmed. The Court adopted much of the reasoning of the Court of Federal Claims below, thus siding with the Fourth Circuit and against the Tax Court.

On appeal, Reese argued that the causation implied by the phrase "on account of" is a "but for" causation;[363] the government, on the other hand, argued for a stricter causal link ("sufficient" causation).[364] Noting that both interpretations "are plausible,"[365] the Federal Circuit followed the lead of the Fourth Circuit in *Miller*, stating that it was not possible to conclude that the

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357. *Id.* at 710.

358. *Id.*

359. *Id.* at 710-11.

360. *Id.* at 711. The Court of Federal Claims placed significant emphasis on the District Court's jury instructions, which so stated.

361. *Id.* Subsequent to *Reese*, punitive damages recovered in an insurance bad faith case were held fully taxable in Estate of Wesson, 843 F. Supp. 1119, 1123 (S.D. Miss. 1994). After noting that "[a] consensus on this issue within the federal judiciary is nonexistent", *Wesson*, 843 F. Supp. at 1121, the District Court adopted the principles of *Miller*, 914 F.2d 586, and *Reese*, 28 Cl. Ct. 702, declining to follow the Tax Court's *Horton* decision. *Wesson*, 843 F. Supp. at 1121-22.

362. Reese v. United States, 24 F.3d 228 (Fed. Cir. 1994).

363. *Id.* at 230.

364. *Id.* at 230-231.

365. *Id.* at 231.

"plain meaning" of the statute clearly supported one interpretation to the exclusion of the other.[366] Similar to the Fourth Circuit in *Miller* and the Court of Federal Claims, below, the Court of Appeals resorted to extrinsic aids to construe the statute. The court first noted that the title of I.R.C. § 104 is "*Compensation* for personal injuries or sickness," and consistent with its title, § 104 sets out various categories of exclusions which consistently "encompass only the replacement of loss resulting from injury or sickness" such as worker's compensation and accident or health insurance.[367] Second, the court acknowledged "an abiding principle of federal tax law" that exemptions from income are to be narrowly construed.[368]

The Court of Appeals, like the lower court, also drew support for its conclusion from two other sources. After examining the legislative history of the 1918 amendment to the predecessor of I.R.C. § 104 in a manner similar to the Court of Federal Claims, the Court of Appeals concluded that the legislative history "support[s] the conclusion that punitive damages are not excludable from gross income."[369] The legislative history and its foundations in the return of capital theory led the court to conclude:

> [I]t would be inconsistent with the legislative history to treat punitive damages as excludable from income, since punitive damages in no way resemble a *return* of capital. . . . [P]unitive damages represent a pure accession to a taxpayer's wealth and cannot be excluded as compensation for personal injury.[370]

The taxpayer argued, as she had in the court below, that the DCHRA did not even allow for the recovery of punitive damages. The Court of Appeals, however, held that subsequent to the lower court's decision in *Reese*, the District of Columbia Court of Appeals had determined that punitive damages are available under the DCHRA,[371] thus "blunting the force of Reese's argument."[372] As the Court of Federal Claims had done, the Court of Appeals examined the jury instructions and concluded that Reese's punitive damage recovery did not exhibit any compensatory characteristics. Thus, the return of capital theory as reflected in the legislative history weighed against excluding Reese's punitive damage recovery.

The court also explained that the Supreme Court's opinion in *Burke* did not call for a different result. Like the court below, the Federal Circuit concluded that *Burke* only addressed the question of whether damages are awarded for a tort or tort-like action. Punitive damages were not present in *Burke*, and the case did not present the Supreme Court with the opportunity to consider whether there is an additional question whether punitive damages are awarded "on account of" personal injury:

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366. *Id.*
367. *Id.*
368. *Id.*
369. *Id.* at 232 (citations omitted).
370. *Id.* at 233.
371. Arthur Young & Co. v. Sutherland, 631 A.2d 354 (D.C. 1993).
372. *Reese*, 24 F.3d at 232.

> The *Burke* case, however, did not present facts requiring the Court to determine whether punitive damages awarded in a personal injury action are received "on account of" personal injury so as to be excludable from gross income by virtue of section 104(a)(2). The case did not involve punitive damages; thus, we do not regard *Burke* as controlling or even relevant to our interpretation of the statute on this point.[373]

Interestingly, Reese had argued that because the Supreme Court in *Burke* had relied upon the presence of punitive or exemplary damages in articulating the hallmarks of traditional concepts of tort liability and recovery,[374] and because the presence of such damages may therefore be helpful in reaching the threshold conclusion that a claim or injury is "tort or tort-type" for purposes of I.R.C. § 104(a)(2), it would be inconsistent and illogical to conclude that such damages do not fall within the scope of I.R.C. § 104(a)(2).[375] The Court of Appeals rejected this argument, stating that the Supreme Court's reference to punitive damages "was merely part of a broad definition of tort liability rather than a holding that" punitive damages should be excludable.[376]

The Court of Appeals thus held Reese's punitive damage award to be taxable. Interestingly, while relying largely on the Fourth Circuit's opinion in *Miller*, the court made no mention of the Tax Court's contrary holding in *Horton*.

Like *Miller*, *Reese* may be read as a rejection of the *Threlkeld* beginning-and-end-of-the-inquiry analysis, and another vote in favor of the approach that asks a second question: are the punitive damages really received "on account of" a personal injury? As did *Miller*, *Reese* answered that question in the negative. *Reese* adds to this analysis its view that *Burke* does not preclude this second question—that Supreme Court in *Burke* did not implicitly approve the beginning-and-end-of-the-inquiry analysis used by the Sixth Circuit.[377]

D. Hawkins v. United States[378]

The taxpayer in *Hawkins* totalled her $8,000 automobile.[379] Her insurer, Allstate Insurance Company, pressured her into buying an inferior, less expen-

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373. *Id.* at 234.

374. *See supra* note 247 and accompanying text.

375. *Reese*, 24 F.3d at 234.

376. *Id.*

377. The two-step analysis employed in Reese v. United States, 24 F.3d 228 (Fed. Cir. 1994) was followed in Bennett v. United States, 30 Cl. Ct. 396 (1994). After concluding that ADEA claims are "tort-type" under the *Burke* "scope of the remedies" test, the court went on to consider whether the liquidated damages portion of the award should nevertheless be taxable, as asserted by the government, because it served merely a punitive purpose and was not awarded "on account of" personal injury. However, the court concluded that liquidated damages under the ADEA do in fact serve a compensatory purpose, and are therefore excludable.

378. 30 F.3d 1077 (9th Cir. 1994).

379. *Id.* at 1078.

sive replacement car, and failed to equip it properly.[380] Hawkins sued Allstate for insurance bad faith (breach of good faith and fair dealing, and bad faith litigation), and she recovered $15,000 in compensatory damages and $3.5 million in punitive damages.[381] Hawkins's state court action ultimately reached the Arizona Supreme Court,[382] which affirmed the punitive damages award.[383] After the Service included the punitive damages award in her taxable income, Hawkins paid the deficiency and initiated a refund suit in the District Court for the District of Arizona.

In a brief Memorandum and Order, the District Court concluded that the plain language of § 104(a)(2) extends to both compensatory and punitive dames, and held that the punitive damages received were on account of personal injuries Hawkins suffered (arising out of insurance bad faith) and were therefore excludable. The Ninth Circuit, which had previously held punitive damages to be excludable in *Roemer*,[384] reversed in a split decision, holding Hawkins's punitive damage award to be taxable. Much of the Ninth Circuit's majority opinion is set over to addressing arguments advanced by Judge Trott's vigorous dissent.

Judge Goodwin, writing for the majority, first noted that both parties were in agreement that Hawkins's bad faith lawsuit was a tort-type action under Arizona law.[385] This was not disputed by Judge Trott's dissent. Moreover, both the majority and dissent agreed that the Tax Court had held consistently that punitive damages were excludable, while the position of the Service had been less consistent.[386] Beyond this, the majority opinion and the dissent found little common ground. The two opinions highlight the major arguments

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380. *Id.* at 1079.

381. *Id.*

382. Hawkins v. Allstate Insurance Co., 733 P.2d 1073 (Ariz. 1987).

383. In affirming, the Arizona Supreme Court stated that in Arizona it was clear that "[t]he purpose of punitive damages is not to compensate the plaintiff, but to express society's disapproval of outrageous conduct and to deter such conduct by the defendant and others in the future." *Hawkins*, 733 P.2d at 1080 (citations omitted). Given this background, in the Hawkinses' ensuing federal tax refund case the taxpayers did not even attempt to argue that their punitive damages award served a compensatory purpose. *Hawkins*, 30 F.3d at 1079. Thus, the nature and purpose of the taxpayers' punitive damage award was not an issue in *Hawkins*.

384. The Ninth Circuit ultimately distinguished its *Roemer* opinion on the grounds that it relied on Revenue Ruling 75-45, a ruling that contradicted the government's own position in *Roemer*. But, as Revenue Ruling 75-45 has since been overruled, the court no longer felt constrained to follow *Roemer*'s lead. *Hawkins*, 30 F.3d at 1081-82; *see also* Rice v. United States, 834 F. Supp. 1241 (E.D. Cal. 1993), in which a district court located in the Ninth Circuit declined to follow *Roemer* for essentially the same reasons, and held a punitive damages award to be taxable:

> But *Roemer* relied solely (and perhaps reluctantly) on the 1975 Revenue Ruling that was subsequently revoked. Before that ruling, it was well-settled that punitive amages were taxable income because they represented an accession to wealth rather that restoration of capital. Because the Ruling has been revoked, punitive damages are again taxable income.

Rice, 834 F.Supp. at 1246 (citations omitted) (footnotes omitted).

385. *Hawkins*, 30 F.3d at 1079.

386. *Hawkins*, 30 F.3d at 1080 & n.2.

in favor of and against extending the § 104(a)(2) exclusion to punitive damages.

Judge Trott first asserted that the plain meaning of I.R.C. § 104(a)(2), particularly as evidenced by its use of the phrase "any damages," "simply does not permit a distinction between compensatory and punitive damages."[387] Had Congress intended that I.R.C. § 104(a)(2) extend only to compensatory damages, Judge Trott wrote, "it certainly could have made that distinction explicit."[388] The majority, on the other hand, was "not convinced that the 'plain meaning' of § 104(a)(2) compels exclusion of punitive damages."[389] The majority concluded:

> [T]he phrase "on account of" does not necessarily mean "but for causation." . . . Rather, 'on account of' could mean what the *Miller* court called "sufficient causation"— i.e. all damages to which a litigant is entitled because of her injuries, but not those which serve solely to punish the wrongdoer.[390]

Turning to the impact of the Supreme Court's decision in *Burke* on the punitive damages question, the majority simply distinguished *Burke* by stating that the taxpayers in that case "had not received punitive damages, and the Court did not address the excludability of punitive damages."[391] According to the majority, the phrase "on account of" qualifies the remainder of I.R.C. § 104(a)(2) and establishes an independent test for exclusion, contrary to the *Threlkeld* analysis.[392] Judge Trott's dissent pointed out that the Supreme Court had "agree[d] with the [Sixth Circuit] Court of Appeals' analysis insofar as it focused . . . on the nature of the claim" underlying the damages award.[393] Judge Trott interpreted this to mean that the Supreme Court had approved implicitly the *Threlkeld* beginning-and-end-of-the-inquiry analysis as employed by the Sixth Circuit in *Burke*: "the import of the Court's analysis is clear. The focus should be on the nature of the underlying claim. The *Burke* Court did not mention any additional requirements for exclusion under § 104(a)(2)."[394]

The majority did not agree:

> [T]he Court did *not* state that courts should look exclusively at the nature of the claim underlying the damage award. The Court's alleged failure to "mention any additional requirements for exclusion under § 104(a)(2)" means little, given that the Court concluded that the

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387. *Id.* at 1084 (Trott, J., dissenting).

388. *Id.*

389. *Id.* at 1080.

390. *Id.* at 1080 n.3 (citations omitted).

391. *Id.* at 1081.

392. As the dissent summarized, "[t]he majority believes § 104(a)(2) requires the taxpayer to proves *both* (1) the damages were recovered in a tort-like suit [under the Supreme Court's scope-of-the-remedies test] *and* (2) the damages were received *on account of* personal injury." *Id.* at 1085 (Trott, J., dissenting) (emphasis added).

393. *Id.*; *see supra* note 246 and accompanying text.

394. *Hawkins*, 30 F.3d at 1085 (Trott, J., dissenting) (footnote omitted).

> taxpayers' underlying cause of action was not "tort-like." The Court had no occasion to discuss any such additional requirements.[395]

As in *Reese*, the taxpayers in *Hawkins* argued that the Supreme Court in *Burke* "described the availability of punitive damages as one of the indicia of traditional tort liability" and relied, in part, on the unavailability of punitive damages in a Title VII case in holding that Burke's recovery was taxable.[396] Given that the Supreme Court viewed the concept of traditional tort liability as "inextricably bound up with remedies,"[397] including punitive damages, Hawkins argued that "it follows that punitive damages are received 'on account of personal injury.'"[398] Judge Trott agreed with this analysis.[399]

The majority acknowledged that punitive damages were certainly one of the hallmarks of traditional tort concepts of liability and recovery.[400] However, the majority was unable to reach the same conclusion as the dissent, noting that "[p]unitive damages may be an indicia of a tort-like cause of action without themselves being damages received on account of personal injury."[401]

In *Hawkins*, for the first time, the question of congressional intent in amending I.R.C. § 104(a)(2) as part of RRA '89[402] came to the fore. Predictably, this added to the confusion surrounding the taxation of punitive damages. Judge Trott construed the legislative history to RRA '89 in a manner that, to him, "offer[ed] a consistent explanation of both the pre-1989 and post-1989 law."[403] According to Judge Trott, the reasonable implication of amending § 104(a)(2) to explicitly tax punitive damages received *after* RRA '89 on account of nonphysical injuries is that not all punitive damages received *prior* to RRA '89 are taxable. In light of the obvious legislative purpose to narrow the scope of § 104(a)(2), this suggests:

> Before 1989, all punitive damages received in personal injury cases were excludable from gross income. After Congress's narrowing of the exclusion in 1989, only punitive damages received in personal injury cases involving physical injury or sickness were excludable.[404]

Judge Goodwin likewise reviewed the legislative history to the RRA '89

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395. *Id.* at 1081 (emphasis added).

396. *Id.* at 1085-86.

397. United States v. Burke, 112 S.Ct. 1867, 1872 n.7 (1992).

398. *Hawkins*, 30 F.3d at 1086 (Trott, J., dissenting) (citation omitted).

399. Judge Trott declared that "[t]o conclude otherwise, as the majority does, is to say that although the availability of punitive damages makes the claim tort-like, . . . the punitive damages themselves are unrelated to the personal injury and should be taxable. I am reluctant to reach such an illogical conclusion." *Id.*

400. *Id.* at 1081.

401. *Id.*

402. *See supra* note 10.

403. *Hawkins*, 30 F.3d at 1086 (Trott, J., dissenting). Judge Trott's interpretation of the legislative history of RRA '89 is consistent with Interpretation #1 described *supra* note 284 and accompanying text.

404. *Hawkins*, 30 F.3d at 1086 (Trott, J., dissenting).

amendment to § 104(a)(2),[405] and concluded that there were several possible interpretations of congressional intent underlying the amendment. For example, Congress could have been restating existing law (that is, both before and after the amendment, punitive damages are understood by Congress to be taxable if awarded for a nonphysical injury, but not taxable if they arise out of a physical injury).[406] Alternatively, Congress may have been aware of the cases that had recently held excludable punitive damages for nonphysical injury,[407] and believing these cases to be inconsistent with its understanding of the law and incorrectly decided, it amended the statute to make its disapproval clear. While the majority admitted the weaknesses of these interpretations, the dissent's view of the legislative history is not the only plausible interpretation.

The majority was therefore unwilling to admit that the effect of the RRA '89 amendment to § 104(a)(2) was anything other than its one stated effect: that punitive damages for nonphysical injuries after 1989 are now clearly taxable. Significantly, the majority would not even concede that the implied post-1989 effect of RRA '89 makes punitive damages for physical injury excludable. Judge Goodwin noted that if in fact this is the implication of the 1989 amendment, "this implication could be inadvertent."[408] Alternatively, Congress could have declined to consider the question of the taxation of damages for physical injury at all, since the legislative history "indicates that Congress was not concerned with punitive damages, but with non-physical injury cases."[409] Thus, the question would remain open for decision by the courts.[410]

Judge Trott found this result unacceptable. If in fact the courts ultimately do determine that pre-1989 punitive damages for both physical and nonphysical injuries to be taxable, as the majority opinion holds, and if the effect of RRA '89 is to make punitive damages for physical injury excludable as the Supreme Court has seemingly held,[411] then RRA '89 *expanded* the scope of I.R.C. § 104(a)(2),[412] a result that Judge Trott found untenable.[413] According to Judge Trott, the only reading of congressional intent that satisfactorily explains the majority's view was that prior to and after RRA '89, all punitive damage awards, both for physical and nonphysical injuries, are taxable.[414] This, however, means that the amendment was completely without effect, an indefensible position.[415] Judge Trott concluded:

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405. *Id.* at 1082.

406. This interpretation is suggested by Interpretation #4. *See supra* note 291 and accompanying text.

407. *See supra* note 292.

408. *Hawkins*, 30 F.3d at 1082 n.7.

409. *Id.* at 1082 n.6.

410. This interpretation is consistent with Interpretation #5. *See supra* note 296 and accompanying text.

411. *See supra* note 285.

412. This result is discussed as Interpretation #2. *See supra* note 288 and accompanying text.

413. *Hawkins*, 30 F.3d at 1087 (Trott, J., dissenting).

414. This is discussed as Interpretation #3. *See supra* note 290 and accompanying text.

415. *Hawkins*, 30 F.3d at 1086-87 (Trott, J., dissenting).

> The rule the majority announces—damages representing a windfall are taxable—will undoubtedly be cited in support of the proposition that *all* punitive damages are taxable. This court will then have to chose between rendering the 1989 amendment meaningless or improperly construing the amendment as expanding the § 104 exclusion. My interpretation of § 104(a)(2) avoids that dilemma.[416]

The final area of contention over which the majority and dissent differed concerned the application of the return of capital theory. According to the majority, I.R.C. § 104(a)(2) "was enacted to exclude damages which compensate a taxpayer for injuries."[417] The court emphasized that the underlying rationale of I.R.C. § 104 is that "damages 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."[418] This was not the case with Hawkins: the punitive damages were awarded on account of Allstate's misconduct and the potential harm to other insureds.[419] Hawkins never contended that the punitive award had any compensatory purpose. The court concluded: "[t]he $3.5 million does not compensate the Hawkinses for any injury, economic, intangible, or otherwise. It is a pure windfall, as much an accession to wealth as a successful lottery ticket or a game show winnings. The Hawkinses have not been made whole; they have won the litigation lottery."[420] Under these circumstances, stated the majority, "the restoration of capital rationale is simply inapplicable."[421]

Judge Trott, on the other hand, found the majority's invocation of the return of capital theory troubling and unpersuasive, pointing out some of the defects of the theory when applied to the Code's treatment of other transactions, such as the recovery of lost wages.[422] Given the weaknesses of the return of capital theory, Judge Trott concluded: "[a]though I agree that the majority's restoration of capital rule may make sense as a matter of policy, I don't think the text of § 104(a)(2), its legislative history, or the case law can be squared with the majority's interpretation."[423]

As noted, the Ninth Circuit majority opinion and dissent in *Hawkins* highlight the various factors and corresponding arguments that affect the determination whether I.R.C. § 104(a)(2) acts to exclude punitive damage awards.

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416. *Id.* at 1087.
417. *Id.* at 1083.
418. *Id.* (quoting Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962)).
419. *Hawkins*, 30 F.3d at 1083.
420. *Id.* at 1083-84.
421. *Id.* at 1084.
422. *Id.* at 1087. *See supra* note 90 and accompanying text.
423. *Hawkins*, 30 F.3d at 1084.

E. Horton v. Commissioner[424]

In *Horton*,[425] the Tax Court addressed whether to abandon its holding in *Miller* or to stand by its earlier conclusion, maintaining that punitive damages are excludable under I.R.C. § 104(a)(2).[426]

The Horton's house had exploded in the early morning after the gas company failed to detect a leak.[427] The Hortons, home at the time, suffered physical injuries[428] and sued the power company under tort theories of negligence and gross negligence. The Hortons were awarded $103,552 in compensatory damages and $520,000 in punitive damages.[429] The Kentucky Supreme Court ultimately upheld the award, affirming the punitive damages award over the gas company's objections that (i) the awarding of punitive damages is an outdated concept and should be abandoned in Kentucky and (ii) in any case, the gas company's conduct did not warrant the imposition of punitive damages.[430] In justifying the award of punitive damages in Kentucky, the Kentucky Supreme Court noted that "[t]he concept of permitting punitive damages *in addition to* compensatory damages is one of longstanding in Kentucky"[431] and that many of the older Kentucky cases "recognize and approve the award of punitive damages *in addition to* compensatory damages."[432]

The foregoing description of punitive damages by the Kentucky Supreme Court appears consistent with a notion that punitive damages do not serve a compensatory purpose under Kentucky law but are purely penal. Such a view was also expressed in early Kentucky decisions, which had noted that punitive damages "are allowed as a punishment of the defendant and to discourage the defendant and others from similar conduct in the future."[433] Under Kentucky law, it is said: "[p]unitive damages represent a sum over and above the amount a claimant is entitled to receive as compensation for a loss suffered by him. In theory, they are allowed as a punishment of a defendant for outrageous conduct or to deter such conduct in the future."[434]

These statements would seem to indicate that Kentucky follows the major-

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424. 33 F.3d 625 (6th Cir. 1994).

425. *Horton*, 100 T.C. 93 (1993).

426. At the time the Tax Court considered *Horton*, the Ninth and Federal Circuits' decisions in *Hawkins* and *Reese* had not yet been issued.

427. *Horton*, 100 T.C. at 93.

428. While the nature of the Hortons' injuries are not described in detail in the reported decisions, it can be inferred from the description of the facts that they were physical injuries. *See* Horton v. Union Light, Heat & Power Co., 690 S.W.2d 382, 386 (Ky. 1985); *see also Horton*, 33 F.3d at 631 ("Here, the underlying claim is one for personal, physical injury.").

429. *Horton*, 690 S.W.2d at 384.

430. *Id.* at 390.

431. *Id.* at 388 (emphasis added).

432. *Id.* (emphasis added).

433. Harrod v. Fraley, 289 S.W.2d 203, 205 (Ky. 1956) (citations omitted); *see also* Ashland Dry Goods Co. v. Wages, 195 S.W.2d 312, 315 (Ky. 1946).

434. Federal Kemper Ins. Co. v. Hornback, 711 S.W.2d 844, 846 (Ky. 1986) (Vance, J., concurring).

ity view concerning the purpose and nature of punitive damages. However, in *Horton*, the Kentucky Supreme Court went on to note:

> There is a reason for paying the punitive damages to the injured party. It is because "the *injury* has been *increased* by the *manner* in [which it] was inflicted. In *Louisville & N.R. Co. v. Roth*, 130 Ky. 759, 114 S.W. 264, 266 (1908), we explained that although "punitive damages are awarded as a civil punishment upon the wrongdoer, rather than as indemnity to the injured party . . . it might with much propriety be said that they are allowed by way of remuneration for the aggravated wrong done." Thus there are sound legal reasons of longstanding supporting *both* the award of punitive damages *and* their payment to the injured party in addition to compensatory damages.[435]

Under this theory, punitive damages serve, at least in part, a compensatory purpose as "remuneration" for the increased injury suffered from the tortfeasor's egregious act. This theory would place Kentucky in the minority view, under which punitive damages are not solely penal in nature. This theory also distinguishes the nature of the punitive damages received by the taxpayers in *Horton* from those recovered by the taxpayers in *Miller*, *Reese*, and *Hawkins*.

The Hortons received their award in 1985. After the IRS sought to include the punitive damage element in the Hortons' gross income, the taxpayers petitioned the Tax Court.

Acknowledging that the Fourth Circuit had reversed the Tax Court in *Miller*, the Tax Court nevertheless concluded that its original decision in *Miller* was correct and declined to follow the Fourth Circuit. In a relatively brief opinion, the Tax Court majority held that the punitive damages were excludable from gross income:

> After careful consideration of the views of the Fourth Circuit, we reaffirm our holding in *Miller* that punitive damages received as a result of a personal injury claim are excludable under section 104(a)(2). The *beginning and end of the inquiry* should be whether the damages were paid on account of "personal injuries." This inquiry is answered by determining the nature of the underlying claim. Once the nature of the underlying claim is established as one for personal injury, *any damages* received on account of that claim, *including punitive damages*, are excludable.[436]

Similar to Judge Trott's dissent in *Hawkins*, the Tax Court concluded that its decision was supported by the Supreme Court's opinion in *Burke*, which allegedly embraced the beginning-and-end-of-the-inquiry approach applied by the Tax Court in *Threlkeld* and followed by the Sixth Circuit in *Burke*. The Supreme Court's opinion in *Burke* was thus seen as quarrelling only with the

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435. *Horton*, 690 S.W.2d at 390 (citations omitted).

436. Horton v. Commissioner, 100 T.C. 93, 96 (1993) (emphasis added) (footnote omitted), *aff'd*, 33 F.3d 625 (6th Cir. 1994).

manner in which the Sixth Circuit went about identifying "tort-type" injuries,[437] an interpretation of *Burke* arguably adopted in *O'Gilvie v. United States*.[438]

The Tax Court also argued (as did Judge Trott) that because the Supreme Court had singled out punitive damages as one of the hallmarks of a tort-type action—according to the Supreme Court, punitive damages are "inextricably bound up" with the concept of tort rights and one of the prime determinants of whether a claim reflects traditional concepts of tort liability[439]—it was "logical to conclude that punitive damages are received 'on account of' such claims."[440]

The Tax Court finally noted that the Fourth Circuit's approach in *Miller* can prove unworkable.[441] Under *Miller*, a court is required to analyze the nature of punitive damages as awarded in the particular case to determine if they are intended to compensate the victim or merely to punish the actor. This involves resorting to state law where the recovery was obtained under a state law claim. Here, after examining Kentucky law, including the very Kentucky Supreme Court opinion affirming the Hortons' award,[442] the Tax Court concluded that "in Kentucky, punitive damages serve *both* to compensate the injured party *and* punish the wrongdoer."[443] The Tax Court professed itself in a complete quandary as to how the *Miller* test ought to be applied in such a circumstance.[444] In any case, under the Tax Court's beginning-and-end-of-the-inquiry test, the fact that Kentucky might follow the minority rule as to the nature of punitive damages was not relevant to the outcome.

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437. *Id.* at 97-98.

438. *Id.* at 98. In O'Gilvie v. United States, U.S. Tax Cas. ¶ 50,567 (D. Kan. 1992), the district court had originally held a punitive damage award in a wrongful death case to be taxable. O'Gilvie's wife died of toxic shock syndrome in 1983, and O'Gilvie obtained a large punitive damage award against Playtex. *See* O'Gilvie v. International Playtex, Inc., 609 F. Supp. 817 (D. Kan. 1985). Subsequent to the Supreme Court's decision in *Burke*, O'Gilvie filed a motion for reconsideration. In August, the District Court issued its opinion on reconsideration, and reversed itself, holding for the taxpayer. In its brief opinion, the court noted:

> In our previous order, this court focused on the nature of the punitive damage award itself, rather than the nature of the underlying claim. In light of *Burke*, we believe our focus was misplaced. The Supreme Court's opinion makes it clear that the proper inquiry for purposes of § 104(a)(2) is on the nature of the claim underlying the taxpayer's damages award. As we recognized in our previous order, the underlying suit giving rise to O'Gilvie's recovery of punitive damages is indisputedly tort-like in nature. Accordingly, the court believes its previous order is contrary to *Burke* and must be reversed.

O'Gilvie, 92-2 U.S. Tax Cas. at 50,568 (citations omitted). *O'Gilvie* did not conclude that a separate question, whether the recovery was "on account of" the identified tort-like injury, must also be asked, and therefore apparently views the *Threlkeld* beginning-and-end-of-the-inquiry analysis as having survived *Burke*.

439. *See supra* note 397.

440. *Horton*, 100 T.C. at 99.

441. *Id.* at 99-101.

442. *See supra* note 428.

443. *Horton*, 100 T.C. at 100 (emphasis added).

444. *Id.* at 101.

In a lengthy dissent joined by two other judges, Judge Whalen (who had dissented in the Tax Court's opinion in *Miller*) concluded that the punitive damages award should be taxable.[445] Similar to the courts of appeals' majority opinions in *Reese* and *Hawkins*, Judge Whalen argued that the Supreme Court in *Burke* had not necessarily approved the Tax Court's beginning-and-end-of-the-inquiry approach to § 104(a)(2). Judge Whalen argued that the Supreme Court had merely provided a test for the *threshold* question of whether a particular claim is tort or tort-like. If that question is answered in the negative, as in *Burke*, the taxpayer cannot rely on § 104(a)(2). But the Supreme Court did not give any definitive clue as to what it would do if the question is answered in the affirmative.[446] The Tax Court majority would cling to its approach that an affirmative answer is the *beginning and end of the inquiry*, and *all* resulting damages, including punitive damages, are excludable. Judge Whalen found no express support for this approach in *Burke* and concluded that, in fact, there *is* an additional inquiry: whether the particular award was paid "*on account of*" the tort claim.[447] Judge Whalen found the Fourth Circuit's approach in *Miller* to be the correct one. Moreover, determining whether an award is "on account of" a tort-like claim requires one to examine what the recovery was intended to accomplish. This in turn necessitates a review of applicable state law.[448] If the recovery is intended to compensate the victim, then it is excludable. But if the recovery is intended merely to punish and deter, then the award is not "on account of" of the tort claim at all, but instead is "on account of" the egregious acts of the tortfeasor. Looking to Kentucky law, Judge Whalen concluded—despite the statements of the Kentucky Supreme Court in *Horton* itself—that in Kentucky an award of punitive damages has only punishment and deterrence as its purpose.[449] Thus, Judge Whalen would have taxed the $500,000 punitive damages award in its entirety.[450]

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445. *Id.* at 104-14.

446. *Id.* at 111.

447. *Id.* at 108. Judge Whalen continued:

> [T]he statute imposes at least two requirements for eligibility to exclude an amount from gross income. First, the amount must have been received through prosecution of a "tort-like personal injury." Second, the amount at issue must have been paid "on account of" that injury. Petitioners must meet both requirements to qualify for the exclusion.

Id. (citations omitted).

448. *Id.* at 107-08.

449. *Id.* at 105-107. Judge Whalen therefore would not have experienced the same difficulty as the majority professed to face in applying the Fourth Circuit's *Miller* analysis to the punitive damages recovery in *Horton*. *See supra* note 444 and accompanying text.

450. In maintaining that the *Threlkeld* beginning-and-end-of-the-inquiry analysis did not survive *Burke*, Judge Whalen is supported by Judge Halpern, who joined Judge Whalen's dissents in *Miller* and *Horton*, and who separately dissented (joined by Judge Whalen) in Kovacs v. Commissioner, 100 T.C. 124, *aff'd*, 25 F.3d 1048 (6th Cir.), *cert. denied*, 115 S. Ct. 424 (1994), stating: "I do not think the sole condition for exclusion contained in section 104(a)(2) is that an amount constitute damages received in a suit involving such tortlike personal injury. Another necessary condition contained in section 104(a)(2) is that the damages be received '*on account of* personal injuries or sickness.'" *Kovacs*, 100 T.C. at 139

Notwithstanding the recent pro-government decisions in *Reese* and *Hawkins*, the Sixth Circuit affirmed the Tax Court in *Horton*.[451] Siding with the Tax Court in a split decision, the Sixth Circuit broke with the Fourth, Ninth, and Federal Circuits, thus deepening the division among the courts. The Sixth Circuit's opinion in *Horton* reflects the court's strong belief in the *Threlkeld* beginning-and-end-of-the-inquiry analysis, on which it had previously relied in *Burke*.

After summarizing the arguments and conclusion in *Miller*, *Reese*, and *Hawkins*,[452] the Sixth Circuit turned to the Supreme Court's holding in *Burke*, which had reversed the Sixth Circuit in 1992. Using this as a starting point, the Sixth Circuit interpreted that reversal as nonetheless *approving* the Sixth Circuit's approach to analyzing § 104(a)(2), that is, the *Threlkeld* beginning-and-end-of-the-inquiry approach.[453]

The Sixth Circuit thus viewed *Burke* as simply establishing a new threshold test, the scope-of-the-remedies test, for determining whether a claim is tort-like, but *not* otherwise altering the resulting beginning-and-end-of-the-inquiry analysis to applying § 104(a)(2). Applying this approach, and finding it mandated by the "plain meaning" of the statute,[454] the Sixth Circuit concluded: "Here, the underlying claim is one for a personal, physical injury; therefore, the taxpayers' entire recovery is excludable. The Hortons' damages—both compensatory and punitive—were received "on account of their" personal injuries from the explosion."[455]

As support for its conclusion, the Sixth Circuit reviewed the 1989 amendment to I.R.C. § 104(a), noting that the Supreme Court in *Burke* had viewed the amendment as establishing that, subsequent to 1989, punitive damage recoveries for physical injuries are excludable:[456]

> Since punitive damages in a case not involving physical injury or physical sickness are singled out as being includable in gross income, the clear implication of Congress' phraseology is that punitive damages in a case involving physical injury or physical sickness are excludable, *and were* excludable even before the amendment.[457]

The Sixth Circuit also noted that, under Kentucky law—in fact, as stated

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(Halpern, J., dissenting) (emphasis added).

451. Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994). To summarize the Sixth Circuit's holding:

> They meant what they said
> and said what they meant.
> The Tax Court's correct:
> One hundred percent!

With apologies to DR. SEUSS, HORTON HATCHES THE EGG (1940).

452. *Horton*, 33 F.3d at 628-29.

453. *Id.* at 630.

454. *Id.* at 631.

455. *Id.*

456. *See supra* note 285.

457. *Horton*, 33 F.3d at 631 n.12 (emphasis added). This position is reflected in Interpretation #1. *See supra* note 284 and accompanying text.

by the Kentucky Supreme Court in upholding the damage award in this very case[458]—punitive damages serve both a compensatory and a punitive purpose. The Kentucky Supreme Court had stated that "although 'punitive damages are awarded as a civil punishment upon the wrongdoer, rather than an as indemnity to the injured party . . . it might with much propriety be said that they are allowed by way of remuneration for the aggravated wrong done.'"[459] This served to distinguish *Miller* and *Hawkins*, where it was determined that under Maryland and Arizona law, respectively, punitive damages serve no compensatory purpose.

The Sixth Circuit's reliance on the dual nature of punitive damages under Kentucky law, while buttressing the majority's ultimate holding, is unfortunate in that any court disinclined to follow *Horton* may seek to distinguish it in cases where the punitive damage recovery in question served no compensatory purpose. *Horton* thus arguably becomes a less compelling precedent. On the other hand, *Horton*'s resort to the dual nature of punitive damages under Kentucky law seems unnecessary to the holding: even if the award served a solely punitive purpose, the beginning-and-end-of-the-inquiry analysis would still lead to the same result. Thus, even in cases where the punitive damages serve no compensatory purpose whatsoever, the Sixth Circuit would still presumably hold the damages to be excludable.

Finally, the court was "not persuaded" by the Commissioner's "return of capital" theory, under which only damages which serve to make the taxpayer "whole" should be excludable, and those that are accession to wealth should not.[460] The court viewed this as

> a false dichotomy. For example, a plaintiff in a personal injury suit who is permanently maimed is really not "made whole" by compensatory money damages. That money damages make the injured person whole in merely a legal fiction. Those money damages do not make the physical injury disappear; the money is therefore arguable an "accession to wealth." There is really no bright-line distinction, then, as the Commissioner contends, between damages which make plaintiffs whole and damages which are accessions to wealth.[461]

This statement, too, is unfortunate. It is certainly true that money damages can never fully compensate the victim of a crippling or disfiguring injury, at least in a nonmonetary sense. However, it is a hallmark of our system of civil justice that juries are presumed to attempt to do just that; that is, measure the immeasurable and place a dollar value on a tort victim's suffering, humiliation, and anguish. Whether or not this is merely a "legal fiction" is of no moment, and the Sixth Circuit's statements in this regard are not persuasive. Judge Trott's dissent in *Hawkins* more tellingly criticizes the return of capital theory.[462] The Sixth Circuit's criticisms, on the other hand, simply miss the

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458. Horton v. Union Light, Heat, & Power Co., 690 S.W.2d 382, 390 (Ky. 1985).
459. *Id.* (quoting Louisville & N.R. Co. v. Roth, 114 S.W. 264, 266 (Ky. 1908).
460. *Horton*, 33 F.3d at 632.
461. *Id.* (footnote omitted).
462. *See supra* note 422 and accompanying text.

mark.

In a brief dissent, Judge Kennedy found the conclusions reached by the Fourth, Ninth, and Federal Circuits more persuasive—particularly Judge Goodwin's majority opinion for the Ninth Circuit in *Hawkins*—and would have held the Hortons' punitive damage award to be taxable as income.[463]

The Tax Court now seems deeply committed to the analysis it articulated in *Miller* and *Horton*.[464] The Tax Court's approach after *Horton* and *Burke* is to determine if the taxpayer's claim sought to vindicate "tort or tort-type" rights by focusing on the remedies available to the taxpayer in respect of the claim pursued. If those remedies are sufficiently broad so as to reflect traditional concepts of tort liability and recovery, the claim will be seen as tort or tort-type: that will be the "beginning and end of the inquiry"[465] and *all components* of any award or settlement will be excludable under I.R.C. § 104(a)(2), *including* punitive damages. The Sixth Circuit seems committed to a similar approach, founded on the *Threlkeld* beginning-and-end-of-the-inquiry analysis the Sixth Circuit embraced in *Burke*.

VI. SUMMARY AND CONCLUSIONS

The federal courts stand hopelessly divided on an important question: whether I.R.C. § 104(a)(2) applies to exclude punitive damage recoveries from gross income. The Tax Court[466] and the Sixth Circuit[467] have concluded

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463. *Horton*, 33 F.3d at 632; *see also* Kemp v. Commissioner, 771 F. Supp. 357 (N.D. Ga. 1991). The taxpayer in *Kemp* had received certain amounts in 1986 after successfully prosecuting a § 1983 action. The recovery included a punitive damages element. The District Court held the punitive damages to be taxable, basically accepting the government's position in full:

> Although the court agrees that plaintiff's damages derived from violation of a tortious injury, punitive damages are not awarded "on account of" such personal injury within the meaning of section 104(a)(2). The Supreme Court has recognized that punitive damages in a section 1983 action "are awarded in the jury's discretion 'to punish [the defendant] for his outrageous conduct and to deter him and others like him from similar conduct in the future.'" Thus, punitive damages are awarded when the "tortfeasor's conduct . . . calls for deterrence and punishment over and above that provided by compensatory awards."
>
> Punitive damages awarded under section 1983 clearly serve no "compensatory" purpose. The court therefore agrees with the Fourth Circuit's recent decision in [*Miller*]. The court in *Miller* held that the portion of the plaintiff's settlement that represented punitive damages was "a 'windfall,' . . . being 'over and above any award of compensatory damages,' . . . and therefore, f[e]ll beyond § 104(a)(2)'s reach." Punitive damages therefore constitute gross income pursuant to I.R.C. § 61(a).

Id. at 359 (citations omitted).

464. *See, e.g.*, Estate of Moore v. Commissioner, 67 T.C.M. (CCH) 1925 (1994) (holding pre-RRA '89 punitive damages received in a malicious prosecution and invasion of privacy lawsuit to be excludable from gross income).

465. As previously noted, the underlying injury must of course be personal in nature. *See supra* note 160; *supra* note 212 and accompanying text.

466. The Tax Court is, of course, a court of national jurisdiction, and taxpayers from all parts of the United States may bring their case there. However, in cases appealable to the Fourth and Ninth Circuits, the Tax Court will find itself constrained to rule against the tax-

that such damages are excludable, while the Fourth, Ninth, and Federal[468] Circuits have held that punitive damages are taxable. Resolution of the punitive damages controversy turns on one's view of the outcome of several contributing considerations: Has the *Threlkeld* beginning-and-end-of-the-inquiry test survived the Supreme Court's decision in *Burke*? Does the return of capital theory point to a clear answer? What was Congress' intent in amending I.R.C. § 104(a)(2) as part of RRA '89?

It is impossible to declare a clear "winner" among the courts' various positions. However, it is submitted that on balance—and a very delicate balance it is—*Horton* seems more correctly decided. First, while the return of capital theory would provide a compelling model if the courts were writing on a clean slate, it must be acknowledged that they are not. The manner in which the Internal Revenue Code operates in the area of personal injury damages simply does not admit of an argument that the return of capital theory has in any way been incorporated into the Code or has unambiguously influenced past administrative and judicial interpretations of I.R.C. § 104(a)(2) and its predecessor.[469] The decisions in *Miller*, *Reese*, and *Hawkins* rely greatly on the return of capital theory, and it is difficult to deny its underlying validity. However, reliance on the return of capital theory at this late stage of the law's development surrounding personal injury damages taxation seems hazardous and unconvincing.

Second, the least strained and most reasonable interpretation of congressional intent in amending I.R.C. § 104(a)(2) is that, subsequent to RRA '89, punitive damages recovered for nonphysical personal injuries are now taxable, and that punitive damages recovered for physical injuries are excluded. This is the view expressed by the Supreme Court.[470] Given that Congress fairly clearly intended to narrow the scope of I.R.C. § 104(a)(2) in RRA '89, it follows that pre-RRA '89 punitive damage recoveries for *both* physical and nonphysical injuries are excludable.[471] While there may be other plausible explanations of congressional intent, this interpretation is the most defensible of the alternatives.

Finally, it is reasonable to conclude that the Supreme Court did in fact leave intact the *Threlkeld* beginning-and-end-of-the-inquiry test: the Supreme Court took pains to state that it agreed with the Sixth Circuit's analysis "inso-

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payer, under the so-called "*Golsen* doctrine." *See* Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *cert denied*, 404 U.S. 940 (1971).

467. It is submitted that the Third Circuit, which so completely embraced the *Threlkeld* beginning-and-end-of-the-inquiry analysis in Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990), would be compelled to follow *Horton* if the question were raised in that Circuit.

468. Like the Tax Court, the Court of Federal Claims is also a court of national jurisdiction. Given the pro-government position of the Court of Appeals for the Federal Circuit, however, forum shoppers are unlikely to turn to the Court of Federal Claims if the tax treatment of punitive damages is at issue.

469. *See supra* note 86 and accompanying and following text.

470. *See supra* note 283 and accompanying text.

471. *See supra* note 284 and accompanying and following text.

far as it focused . . . on the nature of the claim,"[472] did not explicitly or implicitly criticize the test, and did not indicate that the approach of any other appellate court was more attractive. There is no hint in *Burke* of a two-part test under I.R.C. § 104(a)(2); in other words, that after determining whether a particular injury is "tort or tort-type," it must also be determined whether the resulting recovery is "on account of" that personal injury. Moreover, the majority opinion in *Burke* seems to assume that if the dissent was correct and the underlying claim had been found to be tort or tort-type, the back pay award would have been excludable. The only disagreement between the majority and the dissent related to the manner in which a tort or tort-type injury is identified. If the majority felt that the dissent was only addressing the first half of a two-part test, and that even if the dissent was correct the question of whether the recovery was "on account of" that injury would remain, it would have been logical for the majority to say so. Fairly read, the *Burke* analysis simply seems more consistent with the *Threlkeld* approach.

When applied to punitive damage recoveries, utilization of a two-part test after *Burke* also creates the undesirable result that the income tax consequences of such a recovery may vary from state to state, depending upon whether state law applicable to the particular tort action views punitive damages as wholly penal in nature, or conversely, as encompassing a compensatory element. As the Fourth Circuit's opinion in *Miller* teaches, application of the second prong of the two-part test requires one to examine whether or not punitive damages have a compensatory element.[473] If so, the recovery will be excludable to that extent,[474] but if the recovery serves no compensatory purpose it will be taxable. The two-part test would therefore require a case-by-case analysis of the purpose of the punitive damages award in question, potentially resulting in a patchwork treatment of such awards depending upon relevant state law and undercutting a uniform application of federal income tax law.

Moreover, use of a two-part test may result in inconsistent treatment of awards received under the federal antidiscrimination statutes described in Part IV.B.2. above. For example, in evaluating the tax treatment of ADEA recoveries, the question arises whether an award of liquidated damages under ADEA is in the nature of punitive damages—that is, wholly penal in nature—or whether such an award serves a compensatory purpose. As has been noted,[475] the treatment of ADEA recoveries since *Burke* has been inconsistent and unpredictable. One of the major points of contention in this debate is whether a two-part analysis is warranted after *Burke*, or whether the *Threlkeld* beginning-and-end-of-the-inquiry analysis has continuing vitality. Assuming for the moment that a two-part test is employed, and that the first test, whether the claim

472. *See supra* note 246.

473. *See supra* note 338 and accompanying text.

474. Where state law indicates that punitive damages have a mixed nature, serving *both* a compensatory and penal purpose, it is unclear how a punitive damage recovery is to be allocated between such purposes, if at all. *See supra* notes 441-44 and accompanying text.

475. *See supra* notes 259-71 and accompanying text.

is "tort-type," is satisfied, the next question becomes, on account of *what* are liquidated damages under ADEA awarded? That is, what *is* the nature and purpose of ADEA liquidated damages? If such damages are punitive and are awarded on account of the employer's egregious actions,[476] then they should be taxable. On the other hand, if ADEA liquidated damages serve a compensatory purpose, they should be excludable.

This problem was at the center of the recent *Schmitz*[477] case, in which the Ninth Circuit held, as in *Hawkins*, that a two-part test should be applied in evaluating ADEA recoveries. Once again, Judge Goodwin's and Judge Trott's differing views on the matter highlighted the issues at stake. In holding excludable both the back pay and liquidated damage awards, Judge Goodwin, writing for the majority, first determined that an ADEA claim is indeed tort or tort-type, thus satisfying the first prong of the two-part test.[478] Addressing the second part of the two-part analysis, the government had argued that liquidated damages are awarded "on account of" the employer's willful misconduct, rather than "on account of" the taxpayer's personal injury, and therefore have no compensatory purpose. Judge Goodwin concluded, however, that a liquidated damages award recovered in a successful ADEA lawsuit serves, at least in part, to compensate for nonpecuniary losses.[479] Thus, Judge Goodwin concluded that liquidated damages under ADEA serve both a compensatory as well as punitive purpose. On this basis, Judge Goodwin held the liquidated damages award excludable.

Judge Trott's concurring opinion in *Schmitz*, consistent with his dissent in *Hawkins*, argued once again that under *Burke*, once the ADEA claim is found to be tort or tort-type, the inquiry is complete and all damages, including liquidated damages, are excludable. Under Judge Trott's view, the *Threlkeld* analysis has survived *Burke*—in fact was specifically approved in *Burke*—and as in *Horton*, no second test is required. Because Judge Trott agreed with the majority that an ADEA claim is tort or tort-type, Judge Trott concurred in Judge Goodwin's conclusion that *both* the back pay and liquidated damages component of the taxpayer's award were excludable. However, the *Threlkeld/Horton* test used by Judge Trott to reach this result remains at odds with the Ninth Circuit majority's two-part test. Criticizing the majority in *Schmitz*, Judge Trott stated that ADEA liquidated damages are indistinguishable from punitive damages, and therefore are not awarded "on account of" personal injury. Thus, according to Judge Trott, under the majority's own two-part test Schmitz's liquidated damage award should have failed the second test and have been declared taxable.[480] Judge Trott stated that the *Schmitz* court's

476. *See supra* note 175 (award of liquidated damages under ADEA requires a showing that the employer's violation of ADEA was willful).

477. Schmitz v. Commissioner, 34 F.3d 790, 792 (9th Cir. 1994).

478. *Id.* at 794; *see also supra* note 266 and accompanying text.

479. Judge Goodwin concluded that liquidated damages under ADEA differ from common law punitive damages in "significant ways." *Schmitz*, 34 F.3d at 795. Moreover, such damages, being equal in amount to the underlying back pay award, are "proportionate to the personal injury suffered"; they are not computed in a manner specifically designed to punish the employer. *Id.*

480. Judge Trott noted:

division on the purpose of liquidated damages under ADEA was ample evidence of the basic unworkability of the two-part test, which requires case-by-case determinations and leads to inconsistent and conflicting results.

A further criticism of the two-part test is reflected in its treatment of back pay awards under the ADEA. Again, if one is to engage in an analysis of the true nature and purpose of each element of recovery under an ADEA action to determine "on account of" what the damages are awarded, it is difficult to see why a back pay recovery should be excludable. Such an award is merely a wage or salary substitute and should be taxed as such. Back pay recoveries do not compensate for any personal injury suffered; they merely replace wages that should have been paid. *Burke* teaches, however, that the focus of the analysis should always be on the nature of the claim, not the consequences of the injury. The two-step analysis is inconsistent with that teaching.

Concededly, reasonable minds may differ—and have differed—over these various conclusions. It is impossible to be overly critical of any of the outcomes reached by the various courts that have recently wrestled with this issue. The courts are constrained to apply the law as they find it, and in this area the law is in hopeless confusion: the courts find themselves, as it is said, in a Syrtis bog, not knowing whether they stand on dry land.[481] Seemingly every important factor impacting the resolution of the controversy is susceptible of alternate interpretations, and no compelling answers are to be found. In attempting to unravel these factors and impose order from the punitive damages chaos, the courts are simply "at sea without rudder or compass."[482]

Horton is correctly decided as a statement of the law as it now stands. However, it must be acknowledged that current law is largely indefensible as a matter of sound tax policy. Although the courts should align themselves with the *Horton* analysis, current law as reflected in *Horton* is in need of change.[483] Legislative action is now required to provide the rudder and the compass so desperately needed. As Judge Trott has implored, "Congress should straighten out this mess."[484] However, if Congress was to revisit the

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> Because the majority held in *Hawkins* that punitive damages are taxable, a logical application of that rule suggests that ADEA liquidated damages are also taxable. ADEA liquidated damages, like punitive damages, are only awarded in cases of willful violation. ADEA liquidated damages, like punitive damages, are intended to punish and deter.
>
> The majority tries to distinguish ADEA liquidated damages by claiming they "have both a compensatory and a punitive purpose." What compensatory purpose? Under the law of this circuit, ADEA liquidated damages do not compensate for the loss of the use of the money, emotional distress, or pain and suffering. Realistically, what's left to compensate?

Id. at 798 (Trott, J., dissenting) (citations omitted).

481. *See* JOHN MILTON, PARADISE LOST, Book II, *reprinted in* 4 HARVARD CLASSICS, THE COMPLETE POEMS OF JOHN MILTON (1909).

482. MCCULLOCH, TAXATION AND THE FUNDING SYSTEM (1845).

483. *See* remarks of Ulysses S. Grant in his inaugural address on March 4, 1869: "I know of no method to secure the repeal of bad or obnoxious laws so effective as their stringent execution."

484. Hawkins v. United States, 30 F.3d 1077, 1087 (9th Cir. 1994) (Trott, J., dissenting).

question, the question becomes: what *is* the appropriate federal income tax treatment of punitive damages?

If defensible and internally consistent conclusions are to be reached in this area, one must have reference to a theory by which the results obtained can be evaluated, and perhaps criticized.[485] Such guidance can be—and has been—found in the return of capital theory. The decisions of the Fourth, Ninth, and Federal Circuits are all greatly influenced by the return of capital theory. This is understandable, because the theory goes a long way toward explaining how personal injury recoveries, and particularly punitive damages, should be treated for income tax purposes.

Imperfections in the return of capital theory have been previously discussed,[486] and it is certainly acknowledged that the theory is not without its defects. The most damaging criticisms state that the theory does not adequately or accurately describe certain outcomes under today's Internal Revenue Code. For example, under the return of capital theory, it can be argued that recoveries for lost wages should always be taxable, yet this is not the result that the Service and the courts have reached. The post-RRA '89 treatment of punitive damages for physical injury, which now appear excludable from gross income, is also inconsistent with the theory. While these are serious flaws, they can be rectified, were Congress to address those issues in a top-to-bottom revision of I.R.C. § 104(a)(2).

The current confusion over the taxation of personal injury punitive damage recoveries presents Congress with the opportunity to revisit I.R.C. § 104(a)(2) in its entirety and amend the statute, not only to address that confusion, but also to resolve the federal income tax treatment afforded other components of a personal injury recovery, providing the internally consistent rules that are so urgently needed. With this in mind, the following rules[487] are submitted for consideration.[488]

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485. The "aim of theory is to lay down clear and consistent general principles . . . on the basis of which the popular use of concepts can be criticized." NICHOLAS KALDOR, AN EXPENDITURE TAX (1955).

486. *See supra* Part III.B.

487. For an argument that I.R.C. § 104(a)(2) should simply be repealed *in toto*, see Matlow, *supra* note 121, at 391-94. Burke and Friel counter by observing that such a result would be inconsistent with companion provisions in I.R.C. §§ 104 and 105, which exclude a broad range of recoveries for injury and sickness. Burke and Friel, *supra* note 70, at 46-47.

488. The following discussion assumes that a damage award can be rationally broken down into its various components. This may be a hopeful assumption. For example, the typical employment discrimination claim will usually be accompanied by state law claims of wrongful termination, age, race, or gender discrimination, sexual harassment, mental anguish, defamation, pain and suffering, etc. It can be extremely difficult to identify the components of a lawsuit and more difficult to allocate any resulting recovery among them, especially where the matter is settled prior to trial, and even more especially where the plaintiff delivers a blanket release of all claims. *See* Henry, *supra* note 70, at 730-34; Morgan, *supra* note 121, at 888-95; Wood, *supra* note 121, at 366-67; Yorio, *supra* note 70, at 707-09. For a recent case involving a blanket release and a failure by the taxpayer to carry his burden of proof as to the allocation of his recovery among his purported claims, see Taggi v. United States, 835 F. Supp. 744 (S.D.N.Y. 1993) (where taxpayer cannot carry his burden as to the proper allocation, the court will not make an allocation for him; entire recovery held tax-

1. Punitive damages should be fully taxable. Under the generally accepted view, they do not compensate the victim for any monetary or nonmonetary loss and serve only to punish the wrongdoer for malicious or egregious conduct and deter similar conduct by others. Under no reading of the return of capital theory can punitive damages be viewed as excludable.[489] For the sake of uniformity,[490] equity,[491] and practicality, punitive damages should be taxed in full, regardless of whether such damages arguably serve a compensatory purpose under state law concepts. Thus, the Fourth Circuit's approach in *Miller*, under which a review of state law is required to determine if a punitive damages award is actually compensatory in some fashion, would be rejected.

2. Recoveries for past lost income should also be fully taxable.[492] To

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able).

489. This is consistent with the overwhelming view of the commentators. *See, e.g.*, Brooks, *supra* note 70, at 785-86:

> Punitive damages do not compensate the plaintiff. Instead, they penalize the defendant for wrongful conduct. A damage award should be includable if it replaces something taxable that the taxpayer had and lost before it could be taxed, or if it substitutes for ordinary income not previously taxed. Punitive damages do not replace something the taxpayer had and lost; they arise from the lawsuit and are intended to punish the defendant for wrongful conduct. . . . A punitive damage award . . . does not represent recovery of a nonincludable value, and can be regarded as a windfall that is ordinary income under the *Glenshaw* test. Income theory supports the taxation of punitive damages.

See also Blackburn, *supra* note 70, at 690; Chapman, *supra* note 21, at 408; Dodge, *supra* note 70, at 180:

> As a matter of tax policy, there is little doubt that punitive damages should be included in gross income. Such damages represent an economic windfall, and do not compensate for any loss whatsoever. Punitive damages represent a pure accretion to wealth. . . . Punitive damages . . . as opposed to recoveries for human capital, should not be excluded from income. Such an exclusion is an unwise tax expenditure with no sound basis in either tax theory or general policy.

Id.; *see also* CHIRELSTEIN, supra note 101, at 42; J. Martin Burke & Joseph M. Friel, *Recent Developments in the Income Taxation of Individuals*, 9 REV. TAX'N INDIVS. 292, 304-305 (1985); Henry, *supra* note 70, at 741 n.247, 742; Yorio, *supra* note 70, at 735-36; *cf.* Morgan, *supra* note 121, at 930 (arguing that punitive damages should be excludable, but only on the basis of the current wording of the statute referring to "*all* damages").

490. While state law may create legal interests, relationships, and rights, federal law determines how and when they are to be taxed. Morgan v. Commissioner, 309 U.S. 78, 80 (1940); Burnet v. Harmel, 287 U.S. 103, 110 (1932) (goal is to "give a uniform application to a nation wide scheme of taxation").

491. It is commonly asserted that taxpayers with equal ability to pay taxes should pay equal amounts of tax and, correspondingly, in comparing any two taxpayers with different levels of ability to pay, the taxpayer with a greater ability to pay should pay more tax than the other. This concept is sometimes called "horizontal equity." *See, e.g.*, J. PECHMAN, FEDERAL TAX POLICY (5th ed. 1987). It has been stated that "horizontal equity in the treatment of taxpayers requires that the determination [of the underlying character of punitive damages] be a federal one" so that persons with equal abilities to pay tax are not treated unequally. Brooks, *supra* note 70, at 762.

492. *See, e.g.*, Chapman, *supra* note 21, at 408. Complications arise when the jury computes the lost wages award on an after-tax basis, thus effectively imposing the tax on the plaintiff and under-penalizing the defendant. As discussed *infra* note 496, juries should be allowed to consider the tax effects of an award, although the states have been slow to adopt this view. The most logical approach to recoveries for lost wages is that (i) they should be

alleviate the harsh tax result that arises under progressive tax rates from "bunching" the recovery in one taxable period, relief from the progressive rates should be provided.[493] For example, the recovery could be subjected to a maximum 28% tax rate, and treated in a manner similar to that afforded net capital gains under current law.[494] As a related matter, juries should be allowed, and therefore instructed, to consider the tax treatment of lost income recoveries in establishing the damage award.[495]

3. Recoveries for reduced future earning capacity should likewise be taxed, although the arguments are not one-sided.[496]

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subject to income tax, thus placing the victim in exactly the same position she would have been in had she never been injured (and coincidentally penalizing the wrongdoer for the appropriate amount), and (ii) the jury should compute the award on a before-tax basis, having been informed that the award will be taxed when paid.

493. On the "bunching" issue, see Cochran, *supra* note 70, at 49; Yorio, *supra* note 70, at 714-19, 734-35.

494. *See* I.R.C. § 1(h) (1994).

495. This important question is beyond the scope of this article. In general, however, the problem is that if the jury ignores the tax treatment of the award, the recovery awarded can over-compensate or under-compensate the victim. The problem is especially acute under current law, where lost income recoveries are in many cases tax-exempt. Even if the jury were to take the tax-free nature of an award of lost income into account and appropriately set the award at an after-tax (i.e., "net") level, this can be seen as under-penalizing the tortfeasor, who need only pay the after-tax value of the victim's claim, thus shifting to the wrongdoer the subsidy effect of I.R.C. § 104(a)(2). On the other hand, if the award is set at pre-tax (i.e., "gross") levels, under current law the excludability of lost income recoveries provides an artificial incentive for plaintiffs to pursuant doubtful or meritless claims, because the gross award will not in fact be subject to tax. This inappropriately distorts the behavior of both the tort plaintiff and her attorney. The Supreme Court has held that in the context of certain *federal* actions, the jury may in fact be instructed as to the tax treatment of a particular damage award. Norfolk and Western Ry. Co. v. Liepelt, 444 U.S. 490 (1980). However, the majority of the states appear to have concluded otherwise. *See generally* Robert E. Burns, *A Compensation Award for Personal Injury or Wrongful Death is Tax Exempt: Should We Tell the Jury?*, 14 DEPAUL L. REV. 320 (1964-65); Chapman, *supra* note 21, at 417-423; Cochran, *supra* note 70, at 61-62; Lawrence A. Frolik, *The Convergence of I.R.C. Sec. 104(a)(2),* Norfolk & Western Railway Co. v. Liepelt *and Structured Tort Settlements: Tax Policy "Derailed"*, 51 FORDHAM L. REV. 565, 587-88 (1982-83) (surveying state law); Matlow, *supra* note 121, at 380-82; Robert J. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212 (1958); Steven T. Potts, Comment, *Income Tax Issues in Personal Injury Litigation*, 46 MONT. L. REV. 59, 72 (1985); Annotation, *Propriety of Taking Income Tax Into Consideration in Fixing Damages in Personal Injury or Death Actions*, 63 A.L.R. 2d 1393 (1959) and 16 A.L.R. 4th 589 (1982 & 1994 Supp.).

496. Reduced to its essentials, the argument *against* taxing lost future earning capacity goes something like this. Assume Taxpayer M owns ten life annuities, each of which is to pay her an annual amount of $10,000 for the rest of her life. The value of each annuity today is merely a function of the present value of the annual payments anticipated to be received in the future, discounted at prevailing interest rates. Assume this value is $100,000 per annuity. If Taxpayer M suffers a loss of three of those annuities, she will be fully compensated if she recovers $300,000, which she can use to replace the annuities. This $300,000, of course, merely represents the present value of the future income stream anticipated to be earned on the annuities. Despite this fact, no one would characterize the $300,000 recovery as a recovery of lost future income and thereby taxed. To the contrary, it is simply assumed that Taxpayer M will invest the $300,000 recovery in new annuities. The $300,000 recovery is treated as a return of capital, not income, and is so considered for

4. Recoveries for general compensatory damages, such as pain and suffering, mental anguish, embarrassment, humiliation, and the like, should be excludable, largely on the strength of the return of capital theory and the Haig-Simons definition of taxable income. Such recoveries actually do compensate the taxpayer for difficult-to-measure losses of human capital and should rightfully be excluded from gross income under the return of capital theory.[497]

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income tax purposes. The income later earned off the replacement annuities will be taxed when received.

Imported into the personal injury arena, this argument has important implications. If Taxpayer N, a tort victim, receives a $300,000 recovery for loss of future earning capacity, this recovery is analytically equivalent to the loss and recovery of the future annuity payments described above: the recovery merely represents the present value of lost earnings suffered by Taxpayer N as a result of his injury. Just as the amount recovered by Taxpayer M for the lost annuity payments represents a return of capital in respect of the annuity contracts, Taxpayer N's recovery for lost income merely replaces the human capital he enjoyed and utilized to produce income each year in the conduct of his trade or profession. The $300,000 is, therefore, merely return of capital to Taxpayer N, and should be excluded. Should Taxpayer N invest the $300,000 so as to produce investment income to replace his lost future earnings, such investment income would be taxed as received.

The problem with this theory is that, by analogizing Taxpayer N's future income stream to an annuity, he is essentially treated as a investor in a wasting asset, rather than a wage earner. As a wage earner, Taxpayer N is simply utilizing his human capital to throw off income each year. Although Taxpayer N can be seen as having an unacknowledged "basis" in his human capital derived from expenditures for items such as food, routine medical care, and the like, he receives neither a current deduction nor an amortization write-off for those items. Thus, from a tax standpoint, his human capital is not a wasting asset: his "basis" remains intact until his death (unless, of course, he is tortiously injured).

This view of Taxpayer N does have implications for those who insist on treating Taxpayer N as an investor rather than a wage earner. While it is possible to prove that the annuity analogy can place Taxpayer N in the same position, on a present value basis (as if he had never been injured), *see* Dodge, *supra* note 70, at 155-167, the annuity analogy never exactly duplicates the overall economic consequences to both Taxpayer N and the tax-collecting government that would have obtained had Taxpayer N never been injured, unless one assumes that the *entire* annual annuity payment is taxable. While such an assumption would be consistent with the treatment of Taxpayer N's ignored basis in his human capital, it does run counter to the existing tax rules governing annuities. These problems can be resolved if Taxpayer N is viewed as replacing his lost human capital not with an annuity but with a non-level payment (i.e., non-amortizing) bond. Such a bond pays an annual amount of interest, analogous to Taxpayer N's annual wage, with no principal reductions until the bond "balloons" at maturity. The principal of this non-amortizing bond is much more analogous to one's non-wasting human capital than is an annuity, at least insofar as such investments are treated for federal income tax purposes. By substituting such a corporate bond for the annuity in the foregoing discussion, the proper result is reached: Taxpayer N's recovery for lost future income is still excludable, and moreover, assuming Taxpayer N is analogized to an investor who purchases corporate bonds to make up for the lost income, the income generated each year exactly replicates (before and after taxes) the result that would have obtained had he never been injured. In a sense, Taxpayer N is treated *like* a bond, rather than as an *investor in* a bond. The fact that Taxpayer N, if he were to replace his lost human capital with a bond, has something to pass to his heirs when he dies—something he cannot do with human capital itself—merely underscores the inappropriateness of analogizing him to an investor rather than an income producer in the first place.

For other views on this debate, *see* Brooks, *supra* note 70, at 776-777.

497. It is not suggested that the Code be amended to allow hypothetical Taxpayer C (described in *supra* note 86 and accompanying text) a deduction for the value of her loss in

5. As under present law, recoveries for medical expenses should be excludable, subject to inclusion in the event the expenses have been previously deducted under I.R.C. § 213 and a tax benefit thereby derived.

6. Recoveries for statutory interest on a judgment merely represent compensation for the time value of money, and should be taxable accordingly.[498]

7. The current statutory rule under which a "structured settlement" providing for deferred payments[499] is fully excludable should be amended to tax the interest element, imputed or stated, in the deferred payments.[500]

8. No distinction between physical injury and nonphysical injury should be observed in applying these rules. Therefore, so long as the nature of the underlying claim sounds in tort[501] and is "personal" in nature,[502] exclusion

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human capital. Such a provision would simply be impractical to administer and would run counter to the pervasive principles reflected in I.R.C. § 262(a), which generally denies a deduction for personal, living, or family expenses. Closely allied to this concept is the notion of a person developing a "basis" in her human capital. *See supra* note 101 and accompanying and following text. If a taxpayer is in some fashion contributing to this basis with after-tax dollars because her everyday consumption expenditures such as food, vitamins, shelter, clothing, and education are not deductible, it seems unwise and inconsistent, as well as unfair, to require her to later prove those costs in showing that a subsequent personal injury recovery in respect of human capital does not exceed that basis. This "no deduction, no inclusion" approach is consistent with the Code's treatment of other transactions, most notably its treatment of life insurance (no deduction for life insurance premiums by virtue of I.R.C. § 262(a), no inclusion of life insurance proceeds by virtue of I.R.C. § 101(a)). *See* Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1611-1612 (1979) (describing the "yield exemption" treatment of life insurance and its relationship to an expenditure tax).

498. This rule would codify the result reached by the Tax Court in *Kovacs*, 100 T.C. 124 (1993). In *Kovacs*, the Tax Court held that prejudgment interest awarded to the taxpayers under Michigan law as a component of recovery in a wrongful death action was "interest" and not "damages" for purposes of I.R.C. § 104(a)(2), and was therefore taxable. *Kovacs* was followed in *Rice v. United States*, 834 F. Supp. 1241 (E.D. Cal. 1993).

Judge Beghe filed a lengthy dissent in *Kovacs*, arguing that (i) although statutory interest does carry the label of "interest," nevertheless it is simply a component of the damages awarded to the taxpayers, and therefore falls within the scope of I.R.C. § 104(a)(2), and (ii) under the *Threlkeld* beginning-and-end-of-the-inquiry analysis, such interest is excludable under I.R.C. § 104(a)(2) since the underlying wrongful death action is concededly tort or tort-type. *Kovacs*, 100 T.C. at 139 (Beghe, J., dissenting).

The District Court for the District of Colorado has declined to follow *Kovacs*, holding that mandatory prejudgment interest awarded under COLO. REV. STAT. § 13-21-101(1) (1982) in a tort case falls within the phrase "any damages received on account of personal injury" and is therefore excludable under I.R.C. § 104(a)(2). Brabson v. United States, 859 F. Supp. 1360 (D. Colo. 1994). The District Court's opinion specifically adopted the views expressed by Judge Beghe in his dissent in *Kovacs*.

499. *See generally* DANIEL W. HINDERT, ET. AL., STRUCTURED SETTLEMENTS AND PERIODIC PAYMENT JUDGMENTS (1994).

500. Under I.R.C. § 104(a)(2), recoveries otherwise falling within the scope of the statute are excludable no matter how received, "whether as lump sums or as periodic payments." Under this rule, added to the Code by the Periodic Payment Settlement Act of 1982, Pub. L. No. 97-473, 96 Stat. 2605 (1982), the interest element in a deferred "structured settlement" arrangement is excluded along with the principal amount of the award. This result cannot be defended on sound tax policy grounds, and should be repealed. *See generally* Frolik, *supra* note 496. *See also* Blackburn, *supra* note 70, at 683-686.

501. The "scope of the remedies" test as fashioned by the Supreme Court in *Burke*

would be appropriate if called for under the enumerated rules.

These rules would effectively abandon the *Threlkeld* beginning-and-end-of-the-inquiry analysis, and give separate meaning and import to the phrase "on account of" as now set forth in I.R.C. § 104(a)(2).

Absent congressional action, the tax treatment of punitive damages, as well as other components of personal injury damage recoveries, likely will remain uncertain and contentious,[503] leaving taxpayers and their advisors in the dark, inappropriately affecting the behavior of tort litigants, and encouraging further disputes between taxpayers and the government.

Notwithstanding the need for legislative action, the United States Supreme Court may soon provide further guidance in this area. In November 1994, the Court granted certiorari in *Commissioner v. Schleier*, an unreported Fifth Circuit case involving the application of the Court's decision in *Burke* to ADEA recoveries of back pay and liquidated damages.[504] This action may clarify the

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would control this determination, although its importance would be greatly mitigated if the enumerated rules were followed.

502. *See supra* note 160.

503. It is not entirely clear how the Tenth Circuit Court of Appeals would rule on the question whether punitive damages are excludable under I.R.C. § 104(a)(2), if presented with the issue. Two District Courts in the Tenth Circuit have adopted analyses consistent with the *Threlkeld* beginning-and-end-of-the-inquiry test, one specifically in the area of punitive damages, *see* O'Gilvie v. United States, 92-2 USTC ¶ 50,567 (D. Kan. 1990) and one in the area of statutory interest, *see* Brabson v. United States, 859 F. Supp. 1360 (D. Colo. 1994). The emerging law in the Tenth Circuit, therefore, is consistent with *Horton* and *Threlkeld*.

In the only recent Tenth Circuit Court of Appeals decision relevant to the question, Wulf v. City of Wichita, 883 F.2d 842 (10th Cir. 1989), the court held that an award of damages specifically allocated to back pay as a result of a wrongful discharge was nontaxable under I.R.C. § 104(a)(2). *Wulf* was not a federal tax case. Wulf had recovered $160,000 against his employer in the underlying cause of action, a § 1983 case. The trial court added $80,000 to the award as a 50% "enhancement" to cover presumed federal and state taxes payable on the award. The defendant objected to the tax enhancement, claiming that the award was not subject to income tax. The Tenth Circuit agreed, and remanded for a redetermination of the award. In its brief discussion of the issue, the court weighed the contrary authorities of Bent v. Commissioner, 835 F.2d 67 (3rd Cir. 1987) and Thompson v. Commissoner, 866 F.2d 709 (4th Cir. 1989), and sided with the *Bent* analysis. However, although the Tax Court had decided *Threlkeld* by this time, the Tenth Circuit made no mention of *Threlkeld*. *Bent* itself was a pre-*Threlkeld* case, so it is not accurate to assume that the *Threlkeld* analysis is subsumed or reflected in *Bent* and therefore in *Wulf*. On the other hand, *Bent* was decided by the Third Circuit, which has clearly adopted the *Threlkeld* approach in subsequent opinions. *See supra* note 467.

In *Brabson*, Judge Kane of the District Court for the District of Colorado unequivocally adopted the *Threlkeld* test, stating that "excludability under § 104(a)(2) . . . turns *solely* on the nature of the underlying claim. . . . If the underlying claim sounds in tort, that is the beginning and the end of the inquiry." *Brabson*, 859 F. Supp. at 1362 (emphasis added). Judge Kane viewed *Wulf* as entirely consistent with this analysis, *id.* at 1363, and specifically approved Judge Beghe's approval of the *Threlkeld* test in his dissent in *Kovacs*. *See supra* note 499.

Whether the Tenth Circuit would be compelled to follow *Horton* and therefore remain consistent with the Third Circuit is problematic, although the developing view in the Tenth Circuit, particularly as reflected in *Brabson*, is decidedly consistent with *Horton*.

504. Tax Court docket no. 22909-90; *see supra* note 268 and accompanying text.

tax treatment of punitive damages, either directly or indirectly, by allowing the Court to address the larger questions: (a) whether the *Threlkeld* beginning-and-end-of-the-inquiry test, as employed in cases like *Horton*, *Rickel*, and *Burke*, was in fact explicitly or implicitly approved by the Supreme Court in *Burke*, or whether the two-part analysis used in cases like *Miller*, *Reese*, *Hawkins*, and *Schmitz* is the proper one (or whether the Court has some other test in mind), and (b) whether ADEA liquidated damages are punitive in nature, and if so, how punitive damages should be taxed.

Several outcomes are possible under *Schleier*, including the following:

1. The Supreme Court may skirt the larger issues by following *Downey v. Commissioner*,[505] holding that the ADEA recovery scheme is analogous to pre-amendment Title VII and does not afford the broad range of remedies necessary to satisfy the "scope of the remedies" test. In this case, ADEA claims would not be "tort or tort-type," and the Court would hold both back pay and liquidated damages awards under the ADEA to be taxable. This would leave the taxation of punitive damages in limbo.

2. The Court may hold that the "scope of the remedies" test is in fact satisfied by the ADEA recovery scheme, *and* that under *Threlkeld*, this constitutes the "beginning and end of the inquiry." Therefore, both back pay and liquidated damages under the ADEA would be excludable, without reference to their underlying purposes (and as to liquidated damages, irrespective of whether they are compensatory, punitive, or both). This outcome would establish *Horton* as the law governing punitive damages.

3. The Court may conclude, with the majority view in *Schmitz*, that the "scope of the remedies" test is satisfied by the ADEA recovery scheme, *and* that under cases like *Miller*, *Reese*, and *Hawkins*, a second inquiry must be undertaken—on account of *what* are the damages awarded? In that case, the back pay award would be excluded.[506] However, as the debate between Judges Goodwin and Trott in *Schmitz* indicates,[507] the courts are divided over whether liquidated damages under ADEA are punitive or compensatory.[508] Two outcomes may be reached:

a. The Court may conclude, as did the majority in *Schmitz*, that liquidated damages serve (at least in part) a compensatory purpose, are not wholly penal, and are therefore excludable. This would establish that *Horton* is not the law, although it would not necessarily clarify the taxation of true punitive damages awarded in non-ADEA contexts.

b. The Court may alternatively conclude that liquidated damages under the ADEA are entirely punitive and are taxable, according to their non-compensatory nature.[509]

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505. 33 F.3d 836 (7th Cir. 1994); *see also* Shaw v. United States, 853 F. Supp. 1378 (M.D. Ala. 1994); Maleszewski v. United States, 827 F. Supp. 1553 (N.D. Fla. 1993); Drase v. United States, 94-2 U.S. Tax Cas. ¶ 50,463 (N.D. Ill. 1994).

506. As discussed in Part IV, *supra*, this result runs counter to a strict application of the "on account of" test, but is compelled by existing rulings and case law.

507. *See supra* note 478 and accompanying text.

508. *See Downey*, 33 F.3d at 839, and cases cited therein.

509. As of this writing, no reported post-*Burke* opinion has held back pay excludable

Outcome # 3 would essentially bring closure to the debate, at least regarding punitive damages received prior to RRA '89. However, it would not answer whether RRA '89's amendment of I.R.C. § 104(a) means that *post*-RRA '89 punitive damage recoveries are excludable if awarded in respect of a *physical* injury, discussed in Part V.C. above.

Depending on the course taken by the Supreme Court, *Schleier* may ultimately answer the question of the taxation of punitive damages. Irrespective of the outcome in *Schleier*, however, a congressional overhaul of I.R.C. § 104(a)(2) is greatly needed.

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while at the same time taxing liquidated damages.