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TAX TREATMENT OF EMPLOYMENT-RELATED PERSONAL INJURY AWARDS: THE NEED FOR LIMITS

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I. INTRODUCTION

Section 104(a)(2) of the Internal Revenue Code provides that "gross income does not include . . . the amount of any damages received (whether by suit or agreement . . .) on account of personal injuries or sickness."¹ The applicability, if not the wisdom, of this provision to physical injuries seems clear on its face, and its applicability to non-physical personal injuries has long been settled as well.

But in at least one specific area of some significance, the proper role of Section 104(a)(2) has become increasingly problematic. In recent years considerable litigation has centered on the applicability of Section 104(a)(2) to payments in settlement, or other resolution, of employment-related disputes—i.e., disputes arising out of an employment relationship and accompanied by charges of tortious conduct leveled at one or more of the parties.² Does the recipient of such a financial settlement have tax-free income because of the tortious aura in which the deal is struck? Or does the recipient have compensation income, or other taxable income, given the employment relationship that gave rise to the dispute and ultimately the payment? In *Byrne v. Commissioner*,³ the Tax Court recently answered both of these questions in the affirmative.

Christine Byrne's employer fired her in 1980 when the employer was under investigation by the Equal Employment Opportunity Commission [EEOC] for possible sex-based wage disparities in one of its departments. Although not employed in the depart-

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1. I.R.C. § 104(a)(2) (1987).

2. The article does not discuss the appropriate tax treatment of punitive damages received on account of personal injury, whether the injury arises out of an employment relationship or otherwise. The authors, however, have previously expressed the view that subjecting punitive damages to tax is an appropriate limitation on the Section 104(a)(2) exclusion. Burke & Friel, *Recent Developments in the Income Taxation of Individuals*, 9 REV. TAX'N INDIVS. 292, 304-05 (1985).

3. 90 T.C. 1000 (1988).

ment under investigation, Byrne had been singled out by company officials as a person who may have informed the EEOC of the wage disparity. After her termination, the EEOC filed suit against the company, alleging *inter alia* that the firing impeded its investigation under the Fair Labor Standards Act and also violated Section 215(a)(3) of that Act by discriminating against employees who participated in the investigation. The EEOC requested Byrne's reinstatement as relief, but did not seek the award of any back pay. The suit against the company was subsequently settled. As part of the settlement, the company paid Byrne \$20,000 in 1981 in lieu of reinstatement; Byrne in turn signed a release under which she released any claims "with respect to any matter relating to or arising out of the [EEOC] charges" and "any and all liability arising out of [the suit filed by the EEOC, her employment by the company and her] separation therefrom."⁴ Byrne did not include any of the \$20,000 as income on her 1981 tax return. The Internal Revenue Service took the position that the entire amount represented taxable income. Solomon-like, the Tax Court in turn held that Section 104(a)(2) excluded half of the \$20,000 payment from income, while the remaining \$10,000 fell outside Section 104(a)(2) and thus constituted taxable income. An understanding of how such a result came to pass—and quite logically at that—requires some history.

II. ORIGINS: AMOUNTS RECEIVED AS DAMAGES ON ACCOUNT OF NONPHYSICAL INJURIES

Section 104(a)(2) dates back to Section 213(b)(6) of the Revenue Act of 1918. The history of that original section suggests that Congress intended it to codify then-recent administrative decisions. Treasury regulations promulgated early in 1918 under the Revenue Acts of 1916 and 1917 provided specifically that damages were taxable, stating that an "[a]mount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be accounted for as income."⁵ However, in June 1918, in response to a Treasury inquiry, an Attorney General's opinion held that accident insurance proceeds were not taxable, based on the theory that the "human body is a kind of capital" and the insurance proceeds represented a "conversion of the capital lost through the injury."⁶ Shortly thereafter, based on that Attorney General's opinion, the Treasury deter-

4. *Id.* at 1004-05.

5. Treas. Reg. No. 33, Revised, Part I (1918).

6. 1 Op. Att'y Gen. 304 (1918).

mined "upon similar principles that an amount received . . . as a result of a suit or compromise for personal injuries sustained . . . through accident" was not taxable and revoked its prior regulation to the contrary.⁷ Against this background Congress enacted Section 213(b)(6) of the Revenue Act of 1918, which provided that the term "gross income" did not include: "(6) [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."⁸

Despite the obvious potential breadth of the damages provision, the earliest administrative interpretations were restrictive. In 1919, Solicitor's Memorandum 957, addressing the taxability of damages received by a lawyer for libel of his professional reputation, stated in its entirety that "[m]oney received as damages in libel proceedings is subject to income tax."⁹ In 1920, Solicitor's Memorandum 1384 held that damages received on account of alienation of a wife's affections were not within the exemption. This latter opinion conceded that alienation of a wife's affections constituted a personal injury, and that the statutory language "taken by itself, would seem to include any personal injury."¹⁰ Nonetheless, based on the 1918 background to Section 213(b)(6), as well as the statute's reference to accident and health insurance and workmen's compensation, the opinion concluded that it was "more probable . . . that the term 'personal injuries', as used therein means physical injuries only."¹¹ The opinion further stated:

Probably the provision of the Revenue Act of 1918 in question, so far as personal injuries are concerned, is merely declarative of the conclusions [contained in the 1918 Attorney General's opinion and in the Treasury decision in response to it] thus stated and intended to go no further. These 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.¹²

Thus the earliest administrative opinions rested the statute on

7. T.D. 2747 (1918).

8. Revenue Act of 1918, § 213(b)(6), 40 Stat. 1065-66 (1919).

9. Sol. Mem. 957, 1919-1 C.B. 65.

10. Sol. Mem. 1384, 1920-2 C.B. 71.

11. *Id.*

12. *Id.* at 72.

a loss-of-capital (or return-of-capital) notion, and suggested that only physical injuries gave rise to such lost capital. Whether judicial interpretations of the damages exclusion would have similarly limited it to physical injuries is unknown. Later in 1920, the Supreme Court, in *Eisner v. Macomber*,¹³ held that the stock dividend at issue there was not taxable as income under the Sixteenth Amendment, clearly reaffirming the proposition that income should be defined as the gain derived from capital, from labor, or from both combined. Of course, the Supreme Court subsequently developed a far more expansive view of what constitutes income, a view exemplified by the Court's decision in *Glenshaw Glass*.¹⁴ Nonetheless, with respect to personal injury damages, *Eisner v. Macomber* had a substantial impact.

In 1922, Solicitor's Opinion 132, on the basis of *Eisner v. Macomber*, modified Solicitor's Memorandum 957 (1919), revoked Solicitor's Memorandum 1384 (1920), and held that amounts received as damages for alienation of affections or "defamation of personal character" or in consideration of surrendering custody of a minor child did not constitute income.¹⁵ Opinion 132 noted that "both of these [earlier] rulings . . . were made prior to the decision of the Supreme Court in *Eisner v. Macomber*."¹⁶

In *Stratton's Independence v. Hobart*, and in *Eisner v. Macomber*, the Supreme Court defined income as 'the gain derived from capital, from labor, or from both combined . . .'

In the light of these decisions of the Supreme Court 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 . . . If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in . . . either damages or payment in compromise for an invasion of that right, it can not be held that

13. 252 U.S. 189 (1920).

14. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

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

16. *Id.* at 93. In commenting on the 1919 and the 1920 Memoranda, the Opinion added that:

Solicitor's Memorandum 1384 correctly held that the [statutory] exemption . . . does not include damages for alienation of affections, but the question is really more fundamental, namely, whether such damages are within the legal definition of income. Similarly, Solicitor's Memorandum 957 may have been correct in holding that damages received by a lawyer for libel of his professional reputation constitute income. Business libel may be distinguished from ordinary defamation of character and is not here under consideration. The ruling in Solicitor's Memorandum 957, however, was not limited but apparently applied to libel generally.

Id.

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. This also applies to money received in consideration of the surrender of the custody of a minor child.¹⁷

Solicitor's Opinion 132 thus revoked the distinction previously drawn between physical and nonphysical injuries, and conceded, not on the basis of statutory reinterpretation, but rather on the basis of the Supreme Court's evolving interpretation of income, that damages received on account of nonphysical personal injuries were nontaxable.

Judicial confirmation of the excludability of damages for non-physical injuries came in the seminal case of *Hawkins v. Commissioner*.¹⁸ The taxpayer in *Hawkins* was president of a corporation until removed from office by the directors. He subsequently sued the corporation and individual officers of the corporation for having published defamatory statements about him which were injurious to his personal reputation and to his health. That suit plus two other suits brought against the taxpayer by two corporate officers were thereafter settled and dismissed following payment of money damages to Hawkins. The Board of Tax Appeals held that the damages received for libel and slander to personal reputation were indeed nontaxable.¹⁹ It is striking that the court reached this result without any reference to the existing statutory exclusion. The taxpayer had argued for exclusion based on the Supreme Court's definition of income as gain from capital, labor, or both, and, in effect, the Board of Tax Appeals agreed:

This . . . is . . . a case, . . . which in no event involves income. So far as the evidence shows, the amount which petitioner received was wholly by way of general damages for the personal injury suffered It was compensation for injury to his personal reputation No suggestion is made that there was special damage paid . . . or . . . punitive or exemplary damages Even to the economist, character or reputation or other personal attributes are not capital They are not property or goods. Such compensation as general damages adds nothing to the individual It is an attempt to make the plaintiff whole as before the injury.²⁰

The Internal Revenue Service acquiesced in the *Hawkins* decision, and subsequent rulings and opinions echoed the *Hawkins* analysis of "income." For example, the Service concluded in I.T.

17. *Id.* at 93-94 (citations omitted).

18. 6 B.T.A. 1023 (1927), *acq.*, VII-1 C.B. 14 (1928).

19. *Id.* at 1025.

20. *Id.* at 1024-25.

2420 that an award paid to a widow on account of the death of her husband was "compensation for the loss [of a life] and as such is not embraced in the general concept of the term 'income'."²¹ Similarly, the Tax Court held that damages for breach of contract to marry were not taxable as income, based on "[t]he [Supreme Court] decisions . . . and the principles . . . set forth . . . in *Hawkins v. Commissioner*."²² As late as 1954, in Revenue Ruling 54-19, holding that a wrongful death settlement was not taxable to the decedent's estate or to the dependents who were to receive the proceeds, the Service merely repeated the conclusion of I.T. 2420 that "[p]roceeds of this nature, that is compensation for loss of life, are not embraced in the general concept of the term 'income'."²³ Following *Hawkins*, it was clear that damages for nonphysical personal injuries were excludable from income, and that the exclusion rested on the judicial definition of "income" rather than any statutory analysis.

Although the Supreme Court reconsidered and expanded the definition of income in *Glenshaw Glass*, the *Hawkins* conclusion emerged unscathed. *Glenshaw Glass* involved two separate cases with a common question, namely, whether the punitive damages awarded constituted gross income. Neither case involved personal injuries; both centered on business disputes. The corporate taxpayers claimed that the punitive damage awards each had received did not fall within the statutory definition of gross income. Instead, they characterized the damages as nontaxable "windfalls" and urged the Court to apply the *Eisner v. Macomber* characterization of income as gain derived from capital, labor or both combined. That definition of income had been pivotal in the development of taxation of personal injury awards. However, the Court in *Glenshaw Glass* essentially relegated that definition to mere historical interest. According to *Glenshaw Glass*, the Court in *Eisner v. Macomber* had simply determined whether a corporate stock dividend constituted realized gain or only a change in the form of the taxpayer's investment.

In that context—distinguishing gain from capital—the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions Here 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 punish-

21. I.T. 2420, VII-2 C.B. 123 (1928).

22. *McDonald v. Commissioner*, 9 B.T.A. 1340, 1342 (1928).

23. Rev. Rul. 54-19, 1954-1 C.B. 179, 180.

ment for unlawful conduct cannot detract from their character as taxable income to the recipients.²⁴

Admittedly, the Supreme Court took care to distinguish the taxation of punitive damages from the taxation of personal injury damages. In a much-cited footnote, it commented in dictum that:

The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property . . . 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.²⁵

The Supreme Court thus did not question the Service's rulings on personal injury damages or, by extension, the *Hawkins* decision. Although *Glenshaw Glass* effectively rejected the *Eisner v. Macomber* formulation of income, it did not mandate a reexamination of the tax treatment of damages for nonphysical personal injuries and, indeed, no reexamination occurred.

The disinclination of the Internal Revenue Service to reconsider the tax treatment of nonphysical personal injury awards became clear in a series of rulings, issued from 1955 to 1958, on war-related damages. In Revenue Ruling 55-132, the Service held that U.S. payments made to World War II prisoners of war under the War Claims Act of 1948 on account of enemy violations of the Geneva Convention relating to provision of food, forced labor and inhumane treatment, were "in the nature of reimbursement for the loss of personal rights" and therefore did not constitute gross income.²⁶ No authority was cited for the holding, but the loss-of-personal-rights rationale clearly reflects the *Hawkins* emphasis on the nontaxability of compensation for damages to "strictly personal attributes." Revenue Ruling 56-462 held, solely on the authority of Revenue Ruling 55-132, that similar payments made under the War Claims Act to Korean War prisoners were "compensation for the loss of their personal rights" and, as such, not includable in gross income.²⁷ Revenue Ruling 56-518 dealt with the tax treatment of payments made by the Federal Republic of Germany to former German citizens, now U.S. citizens or residents, who were persecuted by the Nazi regime "because of anti-Nazi persuasion or

24. 348 U.S. 426, 431.

25. *Id.* at 432 n.8.

26. Rev. Rul. 55-132, 1955-1 C.B. 213.

27. Rev. Rul. 56-462, 1956-2 C.B. 20.

for reasons of race, faith, or philosophy of life.”²⁸ Citing Revenue Ruling 55-132 as its authority, Revenue Ruling 56-518 held that:

[T]he compensation paid . . . on account of such persecution which resulted in damage to life, body, health, liberty, or to professional or economic advancement, are [sic] in the nature of reimbursement for the deprivation of civil or personal rights and do not constitute taxable income²⁹

On similar facts and reasoning, the Service reached the same conclusions in Revenue Ruling 58-370 with respect to payments by Austria to former Austrian citizens persecuted by the Nazi regime.³⁰ The payments were held to be reimbursement for the loss of civil and personal rights and, accordingly, not taxable.

Further evidence of the Service’s disinclination to reexamine its historic view of nonphysical personal injury damages came almost twenty years after *Glenshaw Glass* in the promulgation of Revenue Ruling 74-77.³¹ The ruling revisited the tax status of damages received on account of alienation of affections or in consideration of the surrender of the custody of a minor child, two of the three issues considered by Solicitor’s Opinion 132 over fifty years earlier. After noting that alienation of affections and custody “relate to personal or family rights, not property rights, and may be treated together,” Revenue Ruling 74-77 simply stated that the amounts received as damages “are not income,” and then concluded that “Solicitor’s Opinion 132 . . . is hereby superseded since the position stated therein is set forth under the current statute and regulations in this Revenue Ruling.”³² The ruling thus effectively reaffirmed Solicitor’s Opinion 132 and, by analogy, *Hawkins v. Commissioner* as well.³³

There is a decided irony in this. The teaching of Solicitor’s Opinion 132, *Hawkins* and the war-claims rulings—that awards for nonphysical personal injuries such as damage to reputation or deprivation of personal or civil rights are not includable in income—ultimately becomes part of the fabric of Section 104(a)(2). But these authorities were based on the *Eisner v. Macomber* definition of gross income and not on interpretations of Section

28. Rev. Rul. 56-518, 1956-2 C.B. 25.

29. *Id.*

30. Rev. Rul. 58-370, 1958-2 C.B. 14.

31. Rev. Rul. 74-77, 1974-1 C.B. 33.

32. *Id.*

33. No statute or regulation was cited in the text of the ruling, but the heading of the ruling referred to both Sections 104 and 61, and regulations thereunder thusly: “Section 104.— Compensation for Injuries or Sickness. 26 C.F.R. 1.104-1: Compensation for injuries or sickness. (Also Section 61; 1.61-1).” *Id.*

104(a)(2) or its predecessors. Indeed, but for the *Eisner v. Macomber* decision, Solicitor's Opinion 132 and *Hawkins v. Commissioner* might never have been issued, and the early administrative determinations in the 1919 Solicitor's Memorandum 957 and the 1920 Solicitor's Memorandum 1384—that the predecessor of Section 104(a)(2) did not encompass nonphysical personal injuries—might have become the law. Solicitor's Opinion 132 suggested as much in stating that “Solicitor's Memorandum 1384 correctly held that the [statutory] exemption . . . does not include damages for alienation of affections”³⁴

It is curious that a line of authority based on a discredited theory of gross income which does not rely on or purport to interpret (and in most cases does not even acknowledge) an existing statutory exclusion should later be viewed as defining the scope of the statutory exclusion. Nonetheless, these authorities provide the basis for the unanimous view of the courts and the Service that the term “personal injury” as used in Section 104(a)(2) embraces non-physical as well as physical injuries.

While the nonstatutory exclusion theory of Solicitor's Opinion 132 and *Hawkins* remained viable after *Glenshaw Glass*, injured taxpayers, their counsel and the courts nevertheless began relying on Section 104(a)(2) as authority for the exclusion of personal injury awards. One can only speculate that this emphasis on Section 104(a)(2), a provision almost entirely ignored for over forty years, was prompted by taxpayers' desire for certainty in view of the significantly broadened scope of “gross income” announced by *Glenshaw Glass*. Section 104(a)(2) quickly emerged as the primary authority for the exclusion of personal injury awards.

This is not to suggest that the specific holdings and theory of Solicitor's Opinion 132, *Hawkins* and the war-claims rulings did not remain important. Indeed, as suggested by Revenue Ruling 74-77, these nonstatutory authorities were incorporated as part of the fabric of Section 104(a)(2). Subsequent to *Glenshaw Glass*, the courts appear to have assumed that Section 104(a)(2) merely codified the nonstatutory exclusion theory of Solicitor's Opinion 132, *Hawkins* and the war-claims rulings. An early case reflecting this merger is *Starrels v. Commissioner*.³⁵ In *Starrels*, the taxpayer had been paid for consenting, in advance of the production of a motion picture, to release any right-of-privacy claims she might have based on the motion picture. The Tax Court held that the pay-

34. Sol. Op. 132, I-1 C.B. 92, 93.

35. 35 T.C. 646 (1961).

ment was taxable, finding no evidence of any actual invasion of privacy. Even had the taxpayer established an invasion of privacy based on the motion picture, the Tax Court expressed "considerable doubt" regarding the application of the "narrowly conceived" Section 104(a)(2) exclusion to such voluntary advance waivers of personal rights.³⁶ Affirming the Tax Court, the Ninth Circuit chose to opine on the "underlying purpose" of the statutory exclusion. In so doing, the court reinforced the loss-of-personal-rights analysis of the war-claims rulings and the early departmental rulings described previously:

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. See *Commissioner of Internal Revenue v. Glenshaw Glass Co.*, 342 U.S. 426, 432 n.8 . . . and, in addition to the department rulings there cited, [the war-claims rulings] Revenue Ruling 58-132; . . . Revenue Ruling 56-462; . . . Revenue Ruling 56-518; . . . Revenue Ruling 57-505; . . . Revenue Ruling 58-370; . . . and Revenue Ruling 58-500³⁷

After stating that this rationale does not apply to receipts that add to wealth instead of compensating for loss, the Ninth Circuit, quoting footnote eight of *Glenshaw Glass* in its entirety, concluded that the footnote's restoration-of-capital reasoning meant that Section 104(a)(2) did not apply to payments for injuries (as in *Starrels*) that never occurred.³⁸

While the *Starrels* result was entirely appropriate, the Ninth Circuit opinion reflected the continuing influence of *Hawkins* and Solicitor's Opinion 132, even though those authorities were not mentioned explicitly. As indicated, the Ninth Circuit's loss-of-personal-rights rationale for Section 104(a)(2) relied in part on the war-claims rulings and in part on footnote eight of *Glenshaw Glass*. The war-claims rulings, as noted, did not refer to any statute for authority but simply pronounced that compensation for deprivation of civil or personal rights was not taxable income. Footnote eight of *Glenshaw Glass* relied on the line of administra-

36. *Id.* at 648. The Tax Court commented in a footnote that the legal basis for the taxpayer's claim for exclusion was "not clearly articulated We think that the payment for surrender of the right of privacy consists of gross income under section 61, and no statutory provision other than section 104(a)(2) has been suggested as a basis for excluding the payment from gross income." Perhaps the lack of articulation was due in part to the historical treatment of personal injury damages as an income definition matter, rather than a matter of interpreting an exclusion provision. *Id.* at note 2.

37. 304 F.2d 574, 576 (9th Cir. 1962).

38. *Id.* at 576-77.

1989] APPLICATION OF DAMAGES

tive rulings based on Solicitor's Opinion 132.

Thus, as demonstrated by the decisions in *Starrels*, the courts, without examining the conceptual underpinnings of the early administrative rulings and cases like *Hawkins*, recognized the continuing viability of those authorities in the application of Section 104(a)(2). The merger of these authorities with Section 104(a)(2) set the stage for further decisions, including very recent decisions such as *Byrne* which broadly apply Section 104(a)(2).

III. THE APPLICATION OF SECTION 104(a)(2)

With the emergence of Section 104(a)(2) as the authority for the exclusion of personal injury awards and the determination that "personal injury" as used in that Section encompassed nonphysical personal injuries, most of the cases and rulings applying Section 104(a)(2) have focused on two issues.³⁹ The first issue (and by far the more important) is definitional: what nonphysical injuries are encompassed by the term "personal injury"? The second issue is evidentiary: whether a taxpayer has borne the burden of establishing that a settlement or an award was received on account of personal injuries. A review of the case law suggests the close interrelationship between these two issues. As discussed herein, the courts have often blurred the distinction between these issues.

A. Defining the Scope of "Personal Injury"

Given the merger described above of *Hawkins*, Solicitor's Opinion 132 and the war-claims rulings into Section 104(a)(2), the term "personal injury" as used in Section 104(a)(2) could be expected to encompass a broad range of nonphysical injuries. The Treasury did nothing to dispel that notion. Indeed, in promulgating regulations interpreting Section 104(a)(2), the Treasury did not attempt to define "personal injury" as used in Section 104(a)(2) and instead concentrated its efforts on the definition of the term "damages."⁴⁰ Presumably, the regulation's drafters were satisfied that the term "personal injury" was self-explanatory. Recently, the Tax Court in its decision in *Threlkeld v. Commissioner*,⁴¹ confirmed the enormous breadth of the term "personal injury" when it

39. A third issue, i.e., whether punitive damages constitute "damages" within the meaning of that term in Section 104(a)(2), has been commented on extensively in the literature, and the authors have suggested elsewhere their own views on this matter. See Burke & Friel, *Recent Developments in the Income Taxation of Individuals*, 9 REV. TAX'N INDIVS. 292, 304-05 (1985).

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

41. 87 T.C. 1294 (1986). See *infra*, text accompanying notes 54-61.

stated, "Exclusion 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."⁴²

Oddly enough, other than the arguably artificial limits the courts have occasionally created, the only limit on the term "personal injury" is in the definition of "damages" in the regulations interpreting Section 104(a)(2). In relevant part, those regulations provide:

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. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) . . . upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosection.⁴³

While defining "damages," this regulation essentially limits the meaning of "personal injury" in Section 104(a)(2) to injuries of a "tort or tort type" nature. Thus, a recovery on a contract theory will not be excludable under Section 104(a)(2). This regulation, rather than serving as a helpful limitation on the scope of Section 104(a)(2), has proven problematic in its application because of the significant overlap between contract and tort theory.

The specific parameters of the term "personal injury" in Section 104(a)(2) have been defined primarily through cases arising out of business and employment contexts. Employment disputes, especially those resulting from termination of employment or denial of promotion or tenure, often involve claims of discrimination, sexual harassment, libel or slander and bad faith in addition to breach of contract claims. Needless to say, the injured employee would prefer to characterize any settlement or award received as a result of such a dispute as an award to which Section 104(a)(2) applies. Consequently, the courts and the Service have had to analyze a variety of specific claims to determine as a threshold matter whether there has been a personal injury or whether an amount has been received "on account of personal injury." The recent case law and the rulings in the employment context reflect an acknowledgement by the courts and the Service of the broad range of non-physical personal injury awards potentially excludable under Section 104(a)(2). At the same time, these authorities demonstrate the

42. *Id.* at 1308.

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

uneasiness of the Service and the courts in permitting an exclusion for what otherwise appears to be taxable income in the nature of compensation or profit. Apparently as a result of that uneasiness, courts have occasionally used an analysis of personal injury inconsistent with the language of the statute and the regulations. An examination of recent decisions highlights the difficulties encountered in applying Section 104(a)(2) to amounts received as a result of employment-related disputes. This article categorizes and examines those authorities with reference to the nature of the award received: awards for injury to one's professional reputation, awards for injuries to one's constitutionally protected rights, and awards under Title VII of the Civil Rights Act and the Equal Pay Act.

1. *Injury to One's Business Reputation*

While allowing employees to exclude settlements for damage to personal reputation, the courts and the Service initially refused to permit taxpayers to exclude damages for injury to their professional reputation.⁴⁴ In *Roemer v. Commissioner*,⁴⁵ the Tax Court denied the application of Section 104(a)(2) to a compensatory damage award received by a taxpayer, an independent insurance broker, as a result of a "grossly defamatory" credit report. The credit report, done in conjunction with the taxpayer's application for a license to sell insurance on behalf of a particular insurance company, raised serious questions regarding the competency and honesty of the taxpayer. As a result of the report, the taxpayer was denied the license, lost business, and was injured in his relations with his friends, most of whom were also his clients. According to the Tax Court, the damages compensated the taxpayer primarily for injury to his business reputation.⁴⁶ As such, the injury was not a "personal injury" within the meaning of Section 104(a)(2).⁴⁷ In so characterizing the injury, the court emphasized that the taxpayer had relied on lost business income as evidence of the damage sustained as a result of the defamatory credit report.⁴⁸

The Ninth Circuit reversed the Tax Court in *Roemer*, noting that the Tax Court had confused "a personal injury with its consequences and illogically distinguish[ed] physical from nonphysical

44. While addressing the defamation of *personal* character and alienation of affection, Solicitor's Opinion 132 specifically acknowledged that "[b]usiness libel may be distinguished from ordinary defamation of character."

45. 79 T.C. 398 (1982).

46. *Id.* at 406.

47. *Id.* at 407.

48. *Id.* at 406.

personal injuries.”⁴⁹ Citing Solicitor’s Opinion 132 for the proposition that nonphysical injuries are personal injuries and that awards for nonphysical injuries are excludable from gross income, the court emphasized that “The relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries.”⁵⁰ In holding that the taxpayer had suffered a “personal injury” within the meaning of Section 104(a)(2), the Ninth Circuit stated:

[A]ll 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.⁵¹

However, the Service in Revenue Ruling 85-143⁵² announced that it would not follow the Ninth Circuit decision in *Roemer*. According to the Service:

In factual situations similar to *Roemer*, where the libelous statements were directed primarily to the individual in the individual’s business capacity, with the result that the primary harm suffered by the individual was loss of business income, the individual has not suffered a personal injury for purposes of Section 104(a)(2) of the Code.⁵³

In *Threlkeld v. Commissioner*,⁵⁴ however, the Tax Court recently conceded the error of its position in *Roemer*. The taxpayer in *Threlkeld* commenced and then settled (in return for payment to him of \$300,000) a state court civil suit alleging malicious prosecution. The settlement agreement specifically allocated \$75,000 of the total settlement to Threlkeld’s release of his claims for damage to his professional reputation. Considering the application of Section 104(a)(2) to the settlement, the Tax Court concluded first that despite its own longstanding recognition of a distinction between professional and personal reputation, the injury alleged was a “personal injury”; and second that the amounts received were “dam-

49. 716 F.2d 693, 697 (9th Cir. 1983).

50. *Id.*

51. *Id.* at 699.

52. 1985-2 C.B. 55.

53. *Id.* at 56.

54. 87 T.C. 1294.

ages" under Treasury Regulation Section 1.104-1(c).⁵⁵

Examining its lengthy history of support for the distinction between professional and personal reputation, the Tax Court found that only in *Roemer* had it relied solely on the distinction in deciding a case, that two appellate courts had questioned or invalidated the distinction, and that the distinction simply lacked a "firm foundation" in its own case law and was ultimately unpersuasive.⁵⁶ By way of example, the Tax Court considered the hypothetical case of a surgeon's loss of a finger as a result of another's tort. In that case, evidence of loss of future income would be a major component in determining damages, and those damages would be excluded.⁵⁷ The court in *Threlkeld* concluded that since Section 104(a)(2) is not limited to physical injuries, the rule could be no different when amounts received on account of a nonphysical injury include compensation for the loss of future income.

With regard to whether the taxpayer's suit for malicious prosecution satisfied the "tort or tort type" standard of the regulations, the Tax Court noted that state law classifications should generally be relied upon, except where the state law classifications are insufficient because the claim is unclear or when there are several claims, both personal and nonpersonal.⁵⁸ The Tax Court reviewed the law of Tennessee, the state in which the action arose, and concluded that Tennessee would treat the malicious prosecution as similar to an action for defamation. The court therefore held the "tort or tort type" standard of the regulation satisfied.⁵⁹

The Sixth Circuit recently affirmed the Tax Court decision in *Threlkeld* and agreed with the Tax Court and the Ninth Circuit in *Roemer* that injury to one's reputation is personal regardless of whether the primary effect of such injury is on one's professional pursuits.⁶⁰ In this respect the court specifically rejected Revenue Ruling 85-143 as establishing an unreasonable standard.⁶¹

While affirming the broad scope of the term "personal injury" in Section 104(a)(2), the Ninth Circuit decision in *Roemer* and the Tax Court and Sixth Circuit decisions in *Threlkeld* opinions are perhaps most significant in their refusal to permit the consequences of an injury, for example, lost income, to define the character of the injury. As illustrated by the Tax Court decision in

55. *Id.* at 1307-08.

56. *Id.* at 1304.

57. *Id.* at 1300.

58. *Id.* at 1305-06.

59. *Id.* at 1307-08.

60. 848 F.2d 81 (6th Cir. 1988).

61. *Id.* at 84.

Roemer, the temptation exists to analyze the application of Section 104(a)(2) in light of the nature of the award given. That is not what the statute requires. Rather, as emphasized by the Ninth Circuit in *Roemer*, the key question is whether the injury complained of is a personal injury. If so, "any damages" received are excludable.

2. Violation of Constitutional Rights

The broad definition of "personal injury" suggested by the Tax Court in the war-claims rulings and most recently articulated in *Threlkeld* is reflected in the recent decisions in *Bent v. Commissioner*⁶² and *Metzger v. Commissioner*,⁶³ addressing the tax treatment of awards for violations of an individual's civil rights. In *Bent v. Commissioner*, a teacher at a public high school criticized the school administration, and the school board subsequently decided not to rehire him. One of the stated reasons for his termination was his display of "unprofessional behavior by consistently downgrading the school, the staff, and the administration."⁶⁴ Bent ultimately filed a state court action against the board, alleging both contract violations and various violations of his rights under the United States Constitution, including a constitutional tort claim under 42 U.S.C. Section 1983.⁶⁵ After a trial on the issue of liability only, the state court concluded that Bent's reemployment had been denied for reasons which, in part, abridged his First Amendment rights to freedom of speech regarding his views of his public employer and administrators. The state court rejected Bent's other claims and continued the case on the matter of damages. The parties subsequently settled the case for \$24,000 and the court dismissed Bent's complaint with prejudice. Neither the general release he signed nor the \$24,000 check from the school board's insurance carrier made any allocation of the settlement.⁶⁶ Although there was some evidence to the contrary, the Tax Court found that

62. 87 T.C. 236 (1986).

63. 88 T.C. 834 (1987).

64. 87 T.C. at 239.

65. 42 U.S.C. § 1983 (1982) provides in relevant part:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

66. Bent paid \$8,000 of the settlement to his state education association on account of the legal representation it had provided in the matter. 87 T.C. at 242.

the board paid Bent the \$24,000 settlement entirely on the basis of the state court decision that Bent's free speech rights under the First Amendment had been violated.⁶⁷

In concluding that the settlement was excludable under Section 104(a)(2), the Tax Court relied on the Supreme Court decision in *Wilson v. Garcia*⁶⁸ which, in a different context, held that all Section 1983 claims are best characterized as involving claims for personal injuries.⁶⁹ The Tax Court noted that Congress would have considered the remedies provided in the original Section 1983 "to be more analogous to tort claims for personal injury than, for example, to claims for damages to property or breach of contract."⁷⁰ Thus, the \$24,000 settlement award satisfied both the "personal injury" and "tort or tort type" standards of Section 104(a)(2) and the regulations thereunder.⁷¹ While *Bent* addressed only a settlement payment in a Section 1983 action for denial of the taxpayer's freedom of speech, given its determination that the "personal injury" language of Section 104(a)(2) reaches those rights most analogous to tort type rights, and given the Supreme Court's determination that Section 1983 actions involve precisely that type of right, it seems apparent that the Tax Court would have excluded damages received on account of any Section 1983 claim.

The Third Circuit recently affirmed the Tax Court decision in

67. *Id.* at 243. The Tax Court, however, noted that in a post-trial brief in state court, prior to settlement, Bent stated that "the parties have conferred and agreed that for purposes of briefing, the special damages . . . shall be viewed" as "wage loss differential" of \$12,000, attorney's fees of \$12,000, and \$6,150 in various other costs. *Id.* at 241. Moreover, the insurance company's own "Notice of Close-Out" stated that the \$24,000 settlement represented \$12,000 for "[r]einstatement of wage loss" and \$12,000 for attorney's fees, and its representative testified in the Tax Court that such was his belief. *Id.* at 242. The Commissioner thus argued that the settlement was taxable compensation plus a negotiated attorney's fee, but given the state court's rejection of all claims except the First Amendment claim, and the absence of any allocation in the release or on the check, the Tax Court held to the contrary. "[W]e view the instant case as being equivalent to a situation where the settlement agreement provided the basis upon which the settlement payment was made. Accordingly in this situation, we need not engage in an analysis of the 'intent of the payor' to establish the nature of the payment." *Id.* at 246. Furthermore, "Consideration of a taxpayer's lost wages is appropriate in disposing of a sec. 1983 claim . . . as well as . . . an employment contract claim. It follows that this evidence is consistent with petitioner's case as well as with respondent's case." *Id.* at 250.

68. 471 U.S. 261 (1985).

69. *Id.* at 280.

70. *Id.* at 277.

71. The remaining issue in *Bent* involved the deductibility of the \$8,000 in legal fees paid to the state education association. Since Section 265(1) of the Code denies a deduction for expenses allocable to tax-exempt income, and since the legal fees were allocable to the \$24,000 settlement excluded from income, the Tax Court held the fees nondeductible. 87 T.C. at 251.

Bent.⁷² In its decision, the circuit court relied on the analysis of *Roemer* to reject the Commissioner's argument that the amounts received were essentially nothing more than lost compensation and should therefore be subject to tax. Echoing the Ninth Circuit's analysis in *Roemer*, the Third Circuit emphasized that the consequences of an injury, for example, lost compensation, did not define the nature of the injury.⁷³

Following *Bent*, the Tax Court had occasion to consider again the meaning of "personal injury" as used in Section 104(a)(2). In *Metzger v. Commissioner*,⁷⁴ the taxpayer, an associate professor of Spanish at Muhlenberg College in Pennsylvania, complained to the Pennsylvania Human Relations Commission and the United States Equal Employment Opportunity Commission that the college, in denying her tenure, had discriminated against her on the basis of sex and national origin. Prior to filing her complaints with the state and federal commissions, the taxpayer sued the college for breach of contract in a Pennsylvania state court. She did not assert any personal injury claims in state court.⁷⁵

After the United States Equal Employment Opportunity Commission found reasonable cause for her complaint, the taxpayer commenced an action in federal court alleging that the college had violated her Thirteenth and Fourteenth Amendment rights as well as various sections of the Civil Rights Act of 1964. When the Pennsylvania Human Relations Commission scheduled public hearings, the parties commenced settlement negotiations. As a result of the negotiations, the taxpayer received \$75,000.

An indemnification agreement signed by the college and the taxpayer recited that \$37,500 of the settlement represented satisfaction of the taxpayer's wage claims and that the remainder of the settlement was in satisfaction of all of her other claims. The agreement specifically provided: "[T]his division of payment is made for tax purposes only in order to satisfy Internal Revenue Rulings dealing with discrimination claim settlement"⁷⁶ The general release and indemnification agreement executed by the taxpayer recited that the college did not admit any of the taxpayer's allegations and also that the college agreed to the settlement only to avoid litigation. Furthermore, the college conditioned its payment

72. 835 F.2d 67 (3d Cir. 1987).

73. *Id.* at 70.

74. 88 T.C. 834.

75. The taxpayer voluntarily discontinued her Pennsylvania state court proceeding prior to negotiating a settlement with the college. *Id.* at 841 n.7.

76. *Id.* at 843 (court's emphasis deleted).

to the taxpayer on her release of all claims against the college arising out of the employment relationship.⁷⁷

Relying on Section 104(a)(2), the taxpayer excluded one half of the \$75,000 settlement from her gross income and also deducted her entire \$7,750 legal fee. In assessing a deficiency against the taxpayer, the Service claimed that the entire \$75,000 was includable in the taxpayer's gross income.⁷⁸

As in *Bent*, the Tax Court concluded that both the "personal injury" and the "tort or tort type" requirements of Section 104(a)(2) had been satisfied.⁷⁹ Considering first the taxpayer's federal court action, the Tax Court noted that the taxpayer had grounded her action against the college on the Thirteenth and Fourteenth Amendments and *inter alia* on Section 1981. With respect to whether the taxpayer's federal court action was based on "tort or tort type rights," the Tax Court, relying on *Bent*, emphasized that Section 104(a)(2) extends to damages on account of legal rights that are more analogous to tort type rights than to any other legal category of rights.⁸⁰ Separately analyzing each of the federal statutory provisions cited, the Tax Court concluded that the taxpayer's action based on, *inter alia*, Section 1981 was an action based on "tort or tort type rights."⁸¹ In addition, the court concluded that the taxpayer's action under the statutory provisions was in the nature of a "personal injury" action as required for exclusion under Section 104(a)(2).⁸² In this regard, the Tax Court, as in *Bent*, relied on a number of federal cases⁸³ in which courts found that state statutes of limitation relating to personal injuries were applicable to actions under, *inter alia*, Section 1981 because those actions could properly be viewed "as tort claims brought to redress personal injuries."⁸⁴ In essence, the Tax Court position is that these Civil Rights Act provisions address rights that are guar-

77. *Id.* at 844.

78. *Id.* at 846. Alternatively, the Service contended that if any of the settlement were excludable, a proportionate part of the \$7,750 legal fee would not be deductible. In holding that the taxpayer was entitled to exclude part of the settlement, the Tax Court nevertheless agreed with the Service that the fees would have to be allocated between the excludable and the includable portions of the award. *Id.* at 860. Section 265(1) disallows a deduction for those fees allocable to the excludable portion of the award.

79. *Id.* at 850-58.

80. *Id.* at 851.

81. *Id.*

82. *Id.* at 851-56.

83. See *Runyon v. McCrary*, 427 U.S. 160 (1976); *Goodman v. Lukens Steel Co.*, 777 F.2d 113 (3d Cir. 1985); *McCausland v. Mason County Bd. of Educ.*, 649 F.2d 278 (4th Cir. 1981); and *Meyers v. Pennypack Woods Home Ownership Ass'n*, 559 F.2d 894 (3d Cir. 1977).

84. 88 T.C. at 853.

anted to the person and that denial of these rights constitutes a personal injury.

The Tax Court next considered the taxpayer's complaint to the Federal Commission wherein the taxpayer had relied on Title VII of the Civil Rights Act of 1964. While the relief afforded under Title VII of the Act may be different from the relief accorded under 42 U.S.C. Section 1981, the Tax Court concluded that the injuries the taxpayer complained of under Title VII were essentially the same as the injuries she asserted under 42 U.S.C. Section 1981 and, therefore, the taxpayer's Title VII claims, like her Section 1981 claims, were tort type personal injury claims.⁸⁵ Having concluded that all of taxpayer's legal actions (other than the state court action) were personal injury "tort or tort type" actions, the court held that no less than \$37,500 of the settlement amount was excludable under Section 104(a)(2).⁸⁶ Because the taxpayer did not assert that any more than \$37,500 of the settlement should be excluded, the Tax Court held that it would not consider whether any greater amount was excludable.⁸⁷

Bent and *Metzger* not only reaffirm the breadth of the term "personal injury" but also suggest the importance to the courts of the regulation requirement that the award arise out of "tort or tort type" activity of the payor. As suggested by *Bent*, courts will be required to analyze applicable state law as well as relevant federal precedent to determine whether an action is a tort or tort type rather than a contract or property action. Considering the fact that claims arising in the employment context almost invariably can be characterized as being based partly on contract theory and partly on tort theory, courts will find the analysis used in both *Bent* and *Metzger* difficult to apply. Furthermore, given the variations in state law, the same set of facts may yield a different result under Section 104(a)(2), depending on the state in which an action is brought.

85. *Id.* at 856. The taxpayer complained to the Pennsylvania Human Relations Commission that the college had discriminated against her in violation of the Pennsylvania Human Relations Act. *Id.* at 839. The Tax Court noted that the Act was essentially a codification of Title VII of the 1964 Civil Rights Act and that damages for a violation of the Act were excludable under Section 104(a)(2). *Id.* at 858.

86. *Id.* at 858.

87. *Id.* In view of its conclusions regarding the nature of the claims asserted, and in view of *Threlkeld*, the taxpayer might have been successful in arguing that the entire amount of the award was excludable.

3. *Back Pay under Title VII of the Civil Rights Act of 1964 and the Equal Pay Act*

As *Threlkeld*, *Bent* and *Metzger* demonstrate, the courts have been willing to acknowledge the broad scope of nonphysical personal injuries occurring in the employment context which may trigger the benefits of Section 104(a)(2). Nevertheless, the courts and the Service have likewise demonstrated their concern that awards which closely resemble compensation not be excluded from gross income. A comparison of two cases, *Hodge v. Commissioner*,⁸⁸ and *Thompson v. Commissioner*,⁸⁹ suggests the difficulties which confront the courts in the employment context.

In *Hodge*, the taxpayer sought to exclude from income an amount he had received in settlement of a job discrimination suit brought by certain employees of a trucking concern against their employer. Relying on Title VII of the Civil Rights Act of 1964, the employees complained that the trucking firm had denied them a transfer to higher paying routes because of their race. The Tax Court, characterizing the complaint, noted:

[T]he complaint did not allege that the [employer's] discriminatory acts personally injured the plaintiffs. In their prayer for relief, plaintiffs' only claim for a monetary award was for back pay based on the difference between the salary for a line driver and the salary for a city driver from the time of discrimination to the date of judgment. The prayer did not contain a plea for personal injury damages.⁹⁰

The taxpayer and other similarly situated employees received cash settlements which the district court had characterized as "back pay and damages."⁹¹ The taxpayer contended that the entire amount was excludable under Section 104(a)(2). The Tax Court rejected the taxpayer's argument that job discrimination causes personal injury and that any amount recovered for such discrimination must be considered damages received on account of personal injury. Noting that the Civil Rights Act empowers a court to order payment of back pay and that back pay is normally an item of gross income, the court refused to find that any part of the settlement was excludable:

88. 64 T.C. 616 (1975).

89. 89 T.C. 632 (1987).

90. *Hodge*, 64 T.C. at 617. Note that at one point in the proceedings, an attorney for the plaintiffs threatened to amend the complaint to include allegations of personal injuries but never did so.

91. *Id.* at 620.

Had there been no discrimination against the petitioner, he would have received a better job without a lawsuit and would have paid more taxes on increased pay as received. Because of discrimination, he received increased pay later than he should have, but this is no reason to exclude that pay from gross income. Use of the adjective "back" in the phrase "back pay" indicates a recovery of wages which should have been paid but were not.⁹²

The court explained in a footnote that its holding was limited to a determination that an award of back pay under the Civil Rights Act of 1964 is taxable.⁹³ The court specifically stated that it did not have to reach the issue of whether, as a matter of law, amounts recovered under the Civil Rights Act of 1964 may constitute personal injury damages within the meaning of Section 104(a)(2).⁹⁴

In *Thompson v. Commissioner*, the taxpayer, an employee of the Government Printing Office, was awarded back pay under Title VII and the Equal Pay Act. The taxpayer and other female employees had filed a sex discrimination claim against their employer contending that they did not receive the same wages as male employees even though they performed work requiring the same skill, effort and responsibility as that of male workers. In addition to the back pay, the taxpayer also received liquidated damages under the Equal Pay Act. The taxpayer contended that both the backpay and the liquidated damages were excludable under Section 104(a)(2). Relying on *Threlkeld*, the taxpayer argued that the amounts she received were for the "invasions of the rights granted to her by virtue of being a person."⁹⁵ The taxpayer argued that her action was not premised on any contractual violation, but rather on the tortious conduct of her employer in sexually discriminating against her.

Rejecting the taxpayer's claim, the Tax Court concluded that an award of back pay under the Equal Pay Act "is more in the nature of a payment for a contract violation than for a tort type right."⁹⁶ The employer under the Act was required to pay an equal

92. *Id.* at 619.

93. *Id.* at n.7.

94. *Id.* at 619. In Revenue Ruling 72-341, 1972-2 C.B. 32, the Service considered the case of employees who had received settlement awards for employment discrimination under Title VII of the Civil Rights Act of 1964. The settlement amounts represented the difference between what the employees would have earned had there been no discrimination and the amount that they actually earned. The Revenue Ruling provides that the settlement awards constitute taxable income.

95. *Thompson*, 89 T.C. at 643.

96. *Id.* at 646.

amount for equal work regardless of sex.⁹⁷ In this case, the employer “owed” the taxpayer the difference between what she was paid and what similarly-situated males were paid. Payment of that which was “owed” did not constitute payment of damages for the personal injury of sex discrimination. Rather, it was payment for work performed.⁹⁸

By contrast, the court concluded that the liquidated damages received by the taxpayer were excludable as damages received on account of a personal injury, that is sex discrimination.⁹⁹ Although the liquidated damages were measured by the amount of back pay awarded, the court emphasized that they were intended to compensate the taxpayer for intangible losses sustained by the taxpayer as a result of the sex discrimination.¹⁰⁰ Consequently, the taxpayer in *Thompson* was entitled to exclude part of the award received under the Equal Pay Act.

The result in *Hodge* appears to be inconsistent with the Service’s position in Revenue Ruling 85-97¹⁰¹ that the exclusion of Section 104(a)(2) extends to personal injury damages allocable to lost wages. If a personal injury has occurred, Section 104(a)(2) authorizes the exclusion of “any damages” received. No difference exists between wages lost because a taxpayer is unable to work as a result of a physical injury and the back pay awarded in *Hodge* because the tortious conduct of an employer prevented the taxpayer from working on a more lucrative trucking route. Likewise, *Hodge* appears to conflict with both *Threlkeld* and *Thompson*. As noted by the *Thompson* court, the taxpayer in that case had a clearer wage claim than in *Hodge*. In *Thompson*, the taxpayer actually performed the work but was not compensated properly for the work; whereas in *Hodge*, the taxpayer never had the opportunity to perform the work. *Threlkeld* and *Thompson* both teach that the consequences of the injury are not determinative of the nature of the injury. Yet, even though the court in *Hodge* indicated that it did not decide whether there was a personal injury, it nonetheless seems that the *Hodge* court did define the injury by the nature of the damages sought. *Thompson* itself is troubling in that the admittedly tortious conduct of the employer gave rise to an award which in part was taxable and in part excludable. In view of the Section 104(a)(2) language “any damages,” the court seems to have

97. *Id.*

98. *Id.* at 648.

99. *Id.* at 650.

100. *Id.* at 649-60.

101. 1985-2 C.B. 50.

used a hypertechnical analysis in reaching its conclusion.¹⁰²

Both *Hodge* and *Thompson* indicate the concern of the courts and the Service in permitting the exclusion of awards with a strong compensation flavoring. That concern seems well founded in view of the general notion that compensation is taxable as gross income.¹⁰³ Nonetheless, the specific language of Section 104(a)(2) excluding "any damages on account of personal injury," Revenue Ruling 85-97 authorizing the exclusion of lost wages, and the courts' interpretation of "personal injury," seem at odds with the analysis in *Hodge* and to some extent the analysis in *Thompson*.

Given the foregoing review of the history of judicial treatment of personal injury awards, the result in *Byrne v. Commissioner*¹⁰⁴ is not surprising. However, *Byrne* does illustrate the difficulties facing courts in applying the "tort or tort type" standard of the regulations. In *Byrne*, as part of the settlement agreement between the EEOC and Grammer, *Byrne's* employer, the petitioner released Grammer from any liability for "any matter relating to or arising out of the [EEOC] charges" and any liability arising out of the cause of action filed in district court by the EEOC against Grammer.¹⁰⁵ In determining whether the settlement was intended to

102. In Private Letter Ruling 8833014 (May 20, 1988) the Service followed *Hodge* in denying an exclusion under Section 104(a)(2) for amounts received by a taxpayer in settlement of a sex discrimination action brought by the taxpayer under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e. The taxpayer sought back pay in an amount sufficient to negate the economic loss caused her by the employer's discriminatory actions. As in *Hodge*, the Service concluded that neither the complaint nor the settlement agreement suggested that plaintiff sought to recover for personal injury. The result in this Letter Ruling, like the result in *Hodge*, is questionable. The Service appears to focus primarily on the results of the sex discrimination, i.e., reduced compensation, rather than on the fact that discrimination occurred.

The Service reached a similar result in Private Letter Ruling 8836034 (June 14, 1988). There the taxpayer filed a complaint with the Ohio Civil Rights Commission claiming that his former employer had eliminated his position in violation of state laws prohibiting age discrimination. In addition, the taxpayer was preparing to file a federal action against his former employer for violations of the Age Discrimination in Employment Act of 1967 (ADEA), 29 U.S.C. §§ 621 to 634 (1982). The former employer negotiated a lump sum settlement with the taxpayer. Rejecting the application of Section 104(a)(2) to the settlement award, the Service noted that both the Ohio statutory scheme and the federal Act cited above were intended "to restore victims of age discrimination to the economic position they would have occupied but for the employer's illegal conduct." The claims that the taxpayer released against his former employer were therefore economic claims rather than claims for personal injury. The Service also noted that while ADEA provides for liquidated damages where there has been a willful violation, the liquidated damages were based on back pay and therefore should be treated as nonexcludable under Section 104(a)(2). That conclusion by the Service is inconsistent with the Tax Court's treatment of liquidated damages in *Thompson*.

103. I.R.C. § 61(a)(1) (1986).

104. 90 T.C. 1000.

105. 90 T.C. at 1004-05.

compensate Byrne for personal injuries, the court had to consider the nature of the EEOC claims. Because the claims were based on an alleged violation of the Fair Labor Standards Act,¹⁰⁶ the court considered whether such a violation was tort or tort-like. Byrne argued that the EEOC claims were similar to “personal injury torts” under New Jersey law, “i.e. ‘abusive, wrongful, and retaliatory discharge and defamation of character.’”¹⁰⁷ Byrne relied on “the recently developed New Jersey ‘tort cause of action for employees discharged in violation of public policy.’”¹⁰⁸

Although the court approved of Byrne’s analogy to state law, the court noted that the New Jersey court had acknowledged in *Pierce* that such cases might also raise contract claims.¹⁰⁹ In other words, a state contract analogy was equally possible. Furthermore, the court noted that claims in addition to those under the Fair Labor Standards Act, including state tort and contract claims, might be covered by the broad language of the release executed by Byrne.¹¹⁰

Byrne argued that the EEOC’s failure in its complaint to seek back pay indicated that “no part of the settlement payment was made to compensate for contractual damages, i.e., lost wages.”¹¹¹ The Tax Court also rejected this argument, emphasizing that the language of the release was more probative of Grammer’s intent in making the settlement.¹¹² Given the breadth of the release language, the court concluded that a range of claims, including claims based on Byrne’s employment contract, were resolved. Under these circumstances, the court concluded that only part of the settlement amount was excludable under Section 104(a)(2).¹¹³

Byrne thus provides an excellent example of the difficulties courts confront in attempting to determine whether a personal injury has occurred. Given the ongoing development of state contract and tort theories and the merger of those theories in certain cases, the Tax Court and other federal courts will continually find themselves analyzing state law and attempting to determine whether an action is more analogous to a tort action than to a contract action.

106. Fair Labor Standards Act of 1938, § 15(a)(3), 52 Stat. 1068 (current version at 29 U.S.C. § 215(a)(3) (1982)).

107. 90 T.C. at 1008.

108. *Id.* at 1008-09 (citing *Pierce v. Ortho Pharmaceutical Corp.*, 84 N.J. 58, 417 A.2d 505 (1980)).

109. *Id.* at 1009.

110. *Id.* at 1010.

111. *Id.*

112. *Id.*

113. *Id.* at 1011.

As in *Byrne*, no clear determination may be possible.

The attempt by the Tax Court in *Byrne* and *Thompson* to allocate an award between personal injury claims and contract claims is equally problematic. In each instance, the employer took action against the employee which was deemed to cause personal injury to the employee. The Tax Court, however, seems to say that if the injury can be viewed as either a contract injury or a personal injury, then there must be some bifurcation of the award or settlement for purposes of applying Section 104(a)(2). That is not a reasonable standard. Arguably, *Byrne* would have recovered \$20,000 under either theory. The reliance of the Tax Court on the general nature of the release does not resolve the problem. Releases are always general. A better rule in a case like *Byrne* would be that if the injury can be characterized as a "personal injury," then any damages received, including damages for alleged contract violations, should be excluded.

B. Taxpayer Efforts to Characterize Payments as "Damages on Account of Personal Injury"

As illustrated by *Byrne*, the majority of reported Section 104(a)(2) decisions reflect taxpayers' efforts to characterize awards or settlements which they have received as compensation for injury to their personal reputations. In the earliest of such post-*Glenshaw Glass* cases, *Agar v. Commissioner*,¹¹⁴ the taxpayer was unsuccessful in his effort to exclude amounts received from his employer upon his resignation from the company. While there was evidence that the taxpayer had resigned because of accusations and criticism levelled against him, the settlement agreement made no reference to these matters, and indicated only that the taxpayer was leaving his employment because of a desire to return to public accounting. Furthermore, the record reflected that the employer intended its payments to the taxpayer to be a form of severance pay rather than a settlement for any possible defamation claims which the taxpayer may have had.¹¹⁵

The Tax Court subsequently encountered a similar defamation argument in *Knuckles v. Commissioner*.¹¹⁶ There the tax-

114. 290 F.2d 283 (2d Cir. 1961), *aff'g* T.C. Memo 1960-21.

115. 290 F.2d at 284. In addition, the Tax Court opinion noted that even assuming that the taxpayer had established that the amounts received were in compensation for the injury he suffered as a result of the accusations and criticism, the amounts would still not be excludable because the injury complained of would have been one to his business reputation and not one to his personal reputation. T.C. Memo 1960-21.

116. T.C. Memo 1964-33, *aff'd* 349 F.2d 610 (10th Cir. 1965).

payer, an employee of a life insurance company, was fired for allegedly mismanaging the company. The taxpayer sued to recover for breach of contract. Only after a settlement had been reached as to the amount of damages did the taxpayer introduce a theory of recovery based on personal injury, specifically, injury to his personal reputation and his health. The company, however, refused to acknowledge any tort liability or any liability whatsoever. On the basis of these facts, the Tax Court held and the Tenth Circuit Court of Appeals agreed that the amount received by the taxpayer was intended only as compensation for breach of contract. As such, the settlement was not excludable.

Undaunted by the taxpayers' failures in *Agar* and *Knuckles*, Southern Illinois University faculty members whose positions were cut as a result of budget reductions sought to exclude settlements they received from the University by characterizing them as amounts received on account of personal injuries including defamation.¹¹⁷ In rejecting the faculty members' exclusion arguments, the Tax Court noted that the faculty members failed to establish that the University, in making the settlement payments, intended to compensate the faculty members for possible defamation or other personal injury claims which the faculty members might have pursued. The University's settlement guidelines did not indicate that the settlements were intended to compensate faculty members for "tort or tort type" damages but rather merely provided that each faculty member whose position was terminated was to receive one year's salary.¹¹⁸

The taxpayer in *Seay v. Commissioner*,¹¹⁹ however, was successful in convincing the Tax Court that part of a settlement he received from his former employer constituted compensation for injury to his personal reputation. In *Seay*, the taxpayer's position as president of a corporation was terminated when a dispute arose between the taxpayer and the owners of the corporation. The taxpayer refused to vacate his position and the owners of the corporation instituted a trespass action against him which received wide publicity. Personally embarrassed by the publicity, the taxpayer believed that his personal reputation had been damaged. A settlement reached between the taxpayer and the owners provided for the payment to the taxpayer of one year's salary plus \$45,000 for any damages caused by the newspaper publicity. A letter agreement specifically stated that the \$45,000 was "compensation for

117. *Whitehead v. Commissioner*, T.C. Memo 1980-508.

118. *Id.*

119. 58 T.C. 32 (1972).

such personal embarrassment, mental and physical strain and injury to health and personal reputation in the community" the taxpayer had suffered.¹²⁰ Emphasizing that the nature of the claim settled is determinative for Section 104(a)(2) purposes, the Tax Court concluded that the evidence indicated the payor paid \$45,000 to the taxpayer to compensate him for any personal injuries suffered.¹²¹ Therefore, the \$45,000 was excludable by the taxpayer under Section 104(a)(2).

Recently, in *Madson v. Commissioner*,¹²² the taxpayer succeeded in arguing for the exclusion of the entire amount he received in settlement of his action against the City of Green Bay, Wisconsin for forcing him to retire as police chief at age sixty. Following a trial on the merits, the state court determined that Green Bay had violated the taxpayer's right to equal protection and had also breached its employment contract with the taxpayer. The court awarded the taxpayer damages computed with reference to his lost earnings and loss of state retirement and social security benefits. The court also concluded that the amount of damages awarded to the taxpayer would have been the same under either the contract or equal protection theory of recovery.¹²³ Green Bay appealed the trial court decision. During the appeal the parties agreed to settle the dispute for \$41,000. While the settlement agreement was silent regarding the reason for the payment, the Tax Court concluded that the payment was for the violation of the taxpayer's equal protection rights. The Tax Court reasoned that because Green Bay relied on its insurer to pay the \$41,000 and because the insurer was not obligated to pay for breach of contract, Green Bay must have intended to pay the taxpayer for the violation of taxpayer's equal protection rights, a tort type claim. Exclusion was therefore appropriate.¹²⁴

These employment-dispute cases, combined with the recent decisions in *Byrne*, *Thompson*, *Metzger*, and *Bent*, reflect the post-*Glenshaw Glass* pattern of taxpayers' constant and sometimes creative efforts to bring their settlements or awards within the scope of Section 104(a)(2) or, as in *Agar*, the *Hawkins* exclusion.¹²⁵ In addition, they emphasize the failure of the courts since

120. *Id.* at 35.

121. *Id.* at 37.

122. T.C. Memo 1988-325.

123. *Id.*

124. *Id.*

125. In Private Letter Ruling 8829016 (April 15, 1988) the Service considered whether Section 104(a)(2) was applicable to amounts received by taxpayers in settlement of a suit brought against a brokerage firm for its involvement in an investment fraud in which the

Glenshaw Glass to reconsider whether amounts received for non-physical personal injuries such as defamation or violation of civil rights should be excluded from gross income. Nor is there any effort to develop a consistent and reasoned policy which would at least limit the extent to which taxpayers could exclude employment awards and settlements from gross income. Rather, the courts, and even the Service, have seemed content to accept that if an employee could establish that amounts paid him by his employer were intended to settle any potential claims that the employee had against the employer for injury to the employee's personal reputation or civil rights, then the employee could exclude the amount from gross income. Having uncritically adopted that position, the courts' analysis in these cases is necessarily limited to a sterile examination of the pleadings and the settlement agreement to determine whether the taxpayer-employee proved his case. The taxpayers in *Agar*, *Knuckles*, and other cases would presumably have been entitled to exclude all or part of the settlements they received from their employers had they simply done a better job in either pleading their action or in drafting their settlement agreements. The case law is disturbing in its emphasis on pleading and on drafting the settlement agreements and releases. The case law is even more troubling, however, in its failure to address the threshold issue of permitting an exclusion for nonphysical personal injury awards.

IV. CONCLUSION: A POLICY BASED LIMITATION FOR SECTION 104 (a)(2)

The early history of the tax treatment of damages strongly suggests that the original statutory exclusion was based on return-

taxpayers lost a large sum of money. In their complaint, the taxpayers alleged:

[V]iolations of federal and state securities laws, federal commodity trading laws, federal and state racketeering laws, mail-fraud, wire-fraud, common law fraud and breach of fiduciary duty. In addition, the [taxpayers] claimed that the enormous monetary losses suffered in connection with the investment was [sic] the proximate cause of severe emotional distress.

The taxpayers did not, however, elaborate on the extent of personal injuries suffered or request damages for personal injury. The settlement documents indicated that all claims, including personal injury claims, were being settled, but made no allocation of the settlement amount to personal injury claims. Rather, the taxpayers were advised by their attorneys that they could make whatever allocation they believed proper. The taxpayers allocated a significant amount of the settlement to their personal injury claims. The Service rejected the applicability of Section 104(a)(2) noting that there was no indication that the brokerage firm intended to compensate the taxpayers for personal injury. Citing *Agar*, the Service emphasized that the intention of the payor was important in determining the nature of the damage award. The Letter Ruling provides yet another example of the importance of pleadings and the language of settlement agreements.

of-capital notions that had been formulated primarily in consideration of proceeds received for accidental physical injuries. This theoretical foundation was not carefully considered after the enactment of the statute, because of the emerging definition of "income." During the reign of *Eisner v. Macomber*, the Service and the courts agreed that damages received on account of personal injury simply did not constitute income; the statutory exclusion, in effect, was superfluous. Under the influence of the narrow definition of income, the Service reasoned that damages for non-physical injuries were nontaxable. The Tax Court decision in *Hawkins v. Commissioner* applied that reasoning to such injuries in the employment context where, as detailed previously, the statutory exclusion today has growing significance.

Following the rejection of the *Eisner v. Macomber* definition of income in *Glenshaw Glass*, the *Hawkins* line of authority should have been similarly rejected, leaving only the original statutory return-of-capital concept as the basis for exclusion. Instead, the Service and courts failed to reconsider *Hawkins* and its progeny and uncritically merged the *Hawkins* line of authority and return-of-capital concept into post-*Glenshaw Glass* Section 104(a)(2) cases.

Given the history of Section 104(a)(2), only the return-of-capital concept should have any validity today, and even that concept suffers from severe limitations. Under traditional tax principles, application of the return-of-capital theory requires that the taxpayer establish an investment of capital in the asset in question, recognized by the tax code as basis. In the case of a person's corporal and noncorporal attributes—one's body, reputation, mental health, and the like—one presumes that the tax code, ordinarily at least, recognizes no investment of capital, and so no basis. Perhaps money spent over time on food, clothing, shelter, and education, as well as other expenditures necessary for survival or development, might arguably provide a tax basis in one's body and personal rights or attributes. The code, however, has never acknowledged such an investment as constituting basis, and the practical and administrative difficulties inherent in doing so in the general case seem insurmountable. It seems clear that a taxpayer realizes gain on receipt of a personal injury award.¹²⁶

126. Of course, one may conjure up circumstances in which considerations of equity might argue that a specific nondeductible expense has given the taxpayer a basis in some bodily part or personal attribute. But this is surely the aberration, not the norm, and even in the aberrational case, the basis is neither infinite nor elastic; it would have to be established by the taxpayer, not presumed to encompass whatever award is rendered. Assume, for example, that a taxpayer incurs nondeductible expenses for elective cosmetic surgery. If the taxpayer thereafter sustains disfiguring injuries, which essentially undo the cosmetic sur-

If the receipt of a personal injury award constitutes realization of gain—which, by traditional tax standards, it must—the exclusion of the gain from income can be justified only by substantial policy considerations. One might presume that the involuntariness of the injury sustained is a factor underlying the exclusion, for the taxpayer who consents in advance to the “injury” apparently removes the compensation received from the protection of Section 104(a)(2).¹²⁷ Commentators and courts have suggested that personal injury awards are excluded for humanitarian reasons. One writer states that taxing the compensation received “by persons who have been blinded or crippled by accident would no doubt be regarded as heartless, unless their recoveries from tortfeasors were correspondingly increased,” but notes that the exclusion extends to “less emotionally charged receipts” as well.¹²⁸ Indeed, the Ninth Circuit has suggested that the Commissioner’s willingness to exclude personal injury lump-sum awards in their entirety was based on “a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components.”¹²⁹

But if humanitarian concerns underlie the exclusion of damages from income, the obvious objection is that not all damages on account of involuntary personal injuries—and perhaps relatively few—warrant such tender treatment. It may, for example, be “heartless” to tax damage awards received on account of severe physical injuries, such as brain damage, paralysis, loss of sight or numerous other terrible injuries. But few conceivable humanitarian reasons exist to exclude damages received for a sprained ankle or a bruised arm; for defamation of personal or business reputation; for violation of free speech rights; for violation of open meeting laws; or for all manner of claims that can plausibly be shoe-horned into a personal injury mold. Moreover, why is it only the compensated victim to whom humanitarian tax relief is extended? The uncompensated victim is presumably even more deserving of compassion, and surely administrative burdens could be satisfactorily taken into account in fashioning some tax relief program—an

gery, and for which damages are awarded, it may not seriously offend one’s tax principles to exclude the damages from income to the extent of the nondeductible expenses, or at least to the extent of some prorated (“unused”) portion thereof. Of course, if one spies a slippery slope in the vicinity of this example, all bets are off.

127. See, e.g., *United States v. Garber*, 589 F.2d 843 (5th Cir. 1979).

128. B. BITTKER, 1 *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* 13-2 (1982).

129. *Roemer*, 716 F.2d at 696. Subsequently, the Service issued Revenue Ruling 85-97, which explicitly confirms that the lost wages component of a personal injury award is not taxable. Rev. Rul. 85-97, 1985-2 C.B. 50.

allowance of certain personal injury losses, perhaps—for the uncompensated. The conclusion one is finally driven to is that humanitarian reasons supply a woefully inadequate justification for the breadth of injuries encompassed by Section 104(a)(2).

Of course, in some instances there may be other strong social policy reasons advanced to justify use of the tax code to encourage the victim of injury to pursue and, through the legal system, penalize the tortfeasor. Racial discrimination, for example, might be deemed so abhorrent that some might argue that private action against it ought to receive tax-favored treatment. Nonetheless, Section 104(a)(2) is scarcely limited to personal injuries that strike at a society's fundamental values, nor have the pro-taxpayer results in discrimination cases been justified in those terms. In sum, it seems clear that no policy justifies the breadth of the existing exclusion. Accordingly, it is not surprising that courts, faced with the broad language of Section 104(a)(2) and the absence of any policy moorings, have been willing to permit exclusion to an ever-expanding array of personal injury awards. But the exclusions grow increasingly problematic as Section 104(a)(2) encompasses more and more employment-related awards where traditional tax analysis would lead to the conclusion that taxable compensation was paid.

May the compensation element in such awards be identified and taxed? First, consider the position and role of the courts. As noted, the language of the Section 104(a)(2) is broad; the exclusion extends literally to "any damages received on account of personal injury." Given the return-of-capital concept that prompted enactment of the original statute, it might be argued that the exclusion should apply only where the taxpayer can identify some property interest that has been damaged and is being restored by the award. Such an approach, for example, would clearly eliminate any exclusion for lost wages and punitive damages, and perhaps for pain and suffering as well. But the return-of-capital concept was flawed to begin with. Why overturn settled law in favor of a fundamentally unworkable concept?

Alternatively, the courts might seek to limit the exclusion to physical injuries, consistent with the probable intention of the drafters of the original statute.¹³⁰ Such an approach rewrites a statute that Congress has clearly chosen to leave as is. It also draws a line that may frequently be difficult to justify, but it is a line that

130. See text accompanying footnotes 11 and 12.

Congress has chosen to draw in Section 130.¹³¹ Congress's treatment of Section 130 is all the more reason to insist that such line-drawing in Section 104(a)(2) be done only by Congress. As a half-way measure, the statutory language might be interpreted so as to exclude, as damages "on account of" personal injury, those damages that rest on employment-based factors such as the victim's occupation or salary level. The Service has made an analogous argument with respect to damages based on the tortfeasor's malice or recklessness, and its belated efforts to subject punitive damages to taxation might yet be rewarded with success. But, the Service has conceded the exclusion with respect to lost wages. Urging the Service or the courts to rethink the treatment of employment-related awards simply comes too late in the day. The courts cannot create the policy that Congress failed to provide, nor revive and reexamine long-settled concepts the Congress has not challenged. It is for Congress to establish tax policy, and thus it is Congress that must address the burgeoning of the Section 104(a)(2) exclusion.¹³²

The Code is replete with provisions that carve out exceptions to general tax rules. There would likely be little quarrel with a Congressional decision to exclude from income for humanitarian reasons a limited category of personal injury awards.¹³³ Whether such awards were also employment-related would then become less significant, and also, given the nature of the limited excludable-injury categories that might be drawn, less likely to occur and less

131. Congress has limited the special exclusion available to structured settlement companies (i.e., third parties who assume the obligation to pay damages owed by another) to obligations involving payment of damages on account of physical injury or sickness. I.R.C. § 130(c).

132. A number of articles have examined the Section 104(a)(2) exclusion in recent years. See, for example: Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 LA. L. REV. 875 (1988); Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43 (1987); Morris, *Taxing Economic Loss Recovered In Personal Injury Actions: Toward a Capital Idea?*, 38 U. FLA. L. REV. 735 (1986); Frolik, *Personal Injury Compensation As a Tax Preference*, 37 ME. L. REV. 1 (1985); Morrison, *Getting a Rule Right and Writing a Wrong Rule: The IRS Demands a Return on All Punitive Damages*, 17 CONN. L. REV. 39 (1984).

133. Even among its related provisions in Sections 104 and 105, Section 104(a)(2) is noteworthy in its breadth. Section 104(a)(1) is limited to workers' compensation awards. Section 104(a)(3) excludes employee-financed accident or health insurance. Exclusions under Section 105 for employer-financed insurance are limited to medical expenses incurred by the employee and to certain permanent disability or disfigurement payments. Whatever the merits of such exclusions—and they are admittedly debatable—embedding them in the context of workers' compensation, or accident or health insurance, surely restrains their expansion and the ease with which they may be manipulated. Section 104(a)(4), as limited by Section 104(b), and Section 104(a)(5) provide exclusions only for certain military disability pensions and certain victims of terrorist attacks, and are clearly quite narrow in their application.

disruptive to general tax principles. Any special treatment provided must be seen as equitable, must be administratively feasible, and must be drafted so that clear guidance is given to taxpayers and the Service as to the specific circumstances that give rise to the favored treatment. The design of the special provisions should also hew as closely as possible to general tax principles underlying the income tax code. For example, increased personal exemptions could be granted to persons with objectively verifiable disabilities; the exemption could vary depending on the degree of disability, and could be phased out beyond certain income levels. Consistent with existing preferences for the blind and elderly, such an approach would have the further advantage of treating disabled persons equally for tax purposes, regardless of the cause of the disability (tortious injury, birth defect, etc.) and regardless of whether compensation had been received for the disability. Under such an approach, all recoveries for personal injuries would be taxable, except reimbursement of nondeductible medical expenses. As an alternative approach, the lost wages component of a damage award could be specifically subject to tax, along with any amount of punitive damages awarded. Such an approach would be consistent with the general tax principle that substitutes for ordinary income shall be taxed as ordinary income, and also with the *Glenshaw Glass* view of income. Where an award compensated for lost wages over a number of years, an income-averaging rule could be adopted to mitigate the bunching effect. As another alternative, an exclusion could be patterned on Section 105(c) and limited to what are presumably the most serious injuries—those that cause permanent disability or disfigurement.

The final suggestion might offer the most promise of a policy-based tax treatment of damages for personal injuries or sickness. The fundamental difficulty with Section 104(a)(2) is that it is not grounded in any sound tax policy. One solution would be to simply eliminate Section 104(a)(2), so that all such damages are taxed in full, as ordinary income in the year received. Such a solution may lack political appeal; it definitely lacks consistency with companion provisions in Section 104 and 105. The major problems with Section 104(a)(2) can successfully be addressed by narrowing its scope in a manner generally consistent with Sections 104 and 105. The Section 104(a)(2) exclusion for personal injuries or sickness should be no greater than that provided by other provisions of Section 104 and Section 105. Section 104(a)(3) and Section 105 distinguish between the tax treatment of proceeds of health and accident insurance based on whether the insurance is employer-provided or em-

ployee-provided. As between the two, the damages received by a tort victim may be better analogized to employer-provided insurance, since in both instances the recipient has no after-tax “investment” attributable to the amounts received. If the analogy is accepted, then consistent with Section 104(a)(3) and 105, the damages received under Section 104(a)(2) should be includable in income—except to the extent they are attributable to amounts expended for medical care in a manner similar to Section 105(b), and except to the extent they are attributable to permanent disability or disfigurement in a manner similar to Section 105(c). Such an approach would end the exclusion for non-physical injuries and for physical injuries that are not serious ones, yet would maintain a compassionate response for recoveries on account of the most serious physical injuries. It remains true, of course, that Section 104(a)(1) would continue to exclude amounts received under workers’ compensation acts without limitations such as those contained in Section 105, and workers’ compensation may be viewed as employer-provided insurance. Nonetheless, the tax treatment of workers’ compensation may reflect its historic concern for employment conditions in or related to the workplace, and the favorable tax treatment is circumscribed by the requirement that compensation be under a workers’ compensation act. Whether the distinction warrants different tax treatment may be debatable, but the distinction itself is apparent. The Section 104(a)(2) exclusion may thus be limited in a fashion consistent with Section 104(a)(3) and Section 105, and as a result may achieve a consistency, rationality, and policy basis that it sorely lacks now.

