

Oklahoma Law Review

Volume 74 | Number 4

A Life's Work: In Memory of Professor Jonathan B. Forman

2022

Taxation of Tort Damages

Patricia A. Cain

Follow this and additional works at: <https://digitalcommons.law.ou.edu/olr>



Part of the [Tax Law Commons](#), and the [Torts Commons](#)

Recommended Citation

Patricia A. Cain, *Taxation of Tort Damages*, 74 OKLA. L. REV. 587 (2022),
<https://digitalcommons.law.ou.edu/olr/vol74/iss4/4>

This Article is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact Law-LibraryDigitalCommons@ou.edu.

TAXATION OF TORT DAMAGES

PATRICIA A. CAIN*

I. Introduction

I have always thought the “go-to” rule for determining whether or not the receipt of damages should be taxable was to ask this key question: In lieu of what were the damages received? There are a number of influential cases on this topic. For example, in *Lyeth v. Hoey* the United States Supreme Court ruled that when a disappointed heir settles his undue influence claim against an estate, he should not have to report the settlement amount as taxable income because, after all, this settlement amount was paid in lieu of damages that he would have received if he had continued to press his lawsuit.¹ And, if he had received those damages instead of the settlement, the damages would have been in lieu of the inheritance he otherwise would have received.² Inheritances are excluded from gross income.³ Therefore, an amount received to replace that inheritance should similarly be excluded from income.

In contrast, if a taxpayer received damages or a settlement payment in lieu of lost profits, the amount received should be included in gross income just as the profits would have been if they had not been lost.⁴ On the other hand, if the damages received were to reimburse the taxpayer for her own capital, then the damages would not be taxable income.⁵ In “tax parlance” they would simply be a return of basis.⁶ Indeed, even if the damages were the result of a legal malpractice lawsuit against an attorney or accountant whose bad advice may have caused the taxpayer to pay more out of pocket on a tax bill, that damage payment would be perceived as returning that

* Professor of Law, Santa Clara University, Aliber Family Chair in Law, Emerita, University of Iowa. This Article is written in fond memory of Professor Jon Forman, a friend and my “go-to” person on issues relating to Social Security. I was very saddened to learn of his untimely death, and I am grateful that the law review is dedicating this issue to his memory.

1. 305 U.S. 188, 196 (1938).
2. *Id.*
3. I.R.C. § 102.
4. *See Swastika Oil & Gas Co. v. Comm’r*, 123 F.2d 382, 383–84 (6th Cir. 1941); *Raytheon Prod. Corp. v. Comm’r*, 144 F.2d 110, 113 (1st Cir. 1944).
5. *See Raytheon*, 144 F.2d at 113.
6. *See, e.g., Tribune Publ’g Co. v. United States*, 836 F.2d 1176, 1177 (9th Cir. 1988) (referring to the “balance of the cash as a non-taxable return of basis”). *See generally Topic No. 703: Basis of Assets*, IRS, <https://www.irs.gov/taxtopics/tc703> (Jan. 24, 2022) (“In most situations, the basis of an asset is its costs to you.”).

money to the taxpayer's pocket. It is not a taxable gain to retrieve what you would have been entitled to but for that malpractice.⁷

But how should we treat damages received in a tort claim intended to reimburse the taxpayer for personal injury losses? Here, we run into a different problem. The common law of taxation (for which there is very little) dealing with the notion of "in lieu of" damages is no longer where we turn. Instead, we must rely on a statute: § 104(a)(2) of the Internal Revenue Code.⁸ It is my position, however, that if § 104(a)(2) does not appear to apply, we must still consider the "in lieu of" doctrine.

II. A Short History of § 104(a)(2)

When the modern income tax law was enacted in 1913, the statute was silent on the question of whether tort damages for personal injuries should be included in income.⁹ There are arguments on both sides. To the extent that the damages are paid in cash, they produce a certain amount of liquidity that did not exist before. As to liquid cash, the taxpayer is clearly richer after the payment than before the payment. And receiving liquid cash that makes a taxpayer richer is normally a reason for taxing that increase in wealth, unless there is a statutory provision that says the receipt is not taxable.¹⁰ Damages might also be received in a personal injury tort lawsuit for items like lost wages, which should be included in income under the "in lieu of" theory.¹¹ At the same time, some people view these damages as restoring a person to the condition she enjoyed before the harm was inflicted.¹² One is not taxed on the ability to enjoy life free of pain and

7. See *Clark v. Comm'r*, 40 B.T.A. 333, 335 (1939), *acq.*, 1957-1 C.B. 4; see also Rev. Rul. 57-47, 1957-1 C.B. 23. The IRS has distinguished *Clark* (overstated tax on return due to preparer's error) from cases in which the taxpayer sought advice about taking steps to reduce taxes. In those cases, when the adviser has given bad advice regarding reduction of taxes, any malpractice recovery is treated as taxable income. See I.R.S. Priv. Ltr. Rul. 98-33-007 (Aug. 14, 1998). The Eleventh Circuit Court of Appeals seemed to embrace this distinction in *McKenny v. United States*, 973 F.3d 1291, 1299–1300 (11th Cir. 2020). *But see* Douglas A. Kahn & Jeffrey H. Kahn, *Recovery for Causing Tax Overpayment—Lyeth v. Hoey and Clark Revisited*, 74 TAX LAW. 437 (2021) (criticizing the distinction made by the IRS and the Eleventh Circuit's approach in *McKenny*).

8. I.R.C. § 104(a)(2).

9. See Revenue Act of 1913, Pub. L. No. 63-16, § 2, 38 Stat. 114, 167.

10. *E.g.*, I.R.C. § 102 (excluding the receipt of gifts from taxable gross income, even though a gift received certainly makes the taxpayer richer and therefore more able to pay taxes).

11. See *Pistillo v. Comm'r*, 912 F.2d 145, 148–49 (6th Cir. 1990).

12. See *id.* at 149–50.

suffering. So, if a tort injury deprives a person of a pain-free existence, and that person is able to collect some cash to make her whole again (or at least as close as possible to whole), then taxing that person seems to be taxing her restoration to what she used to be (i.e., pain free). If the payment is viewed as something akin to payment for destroyed human capital (the ability to live pain free), then just like the restoration of capital costs in lost property, the payment should not be considered taxable income.

However, in 1915, the Treasury issued a Treasury Decision concluding that “[a]n amount received as a result of a suit or compromise for ‘pain and suffering’ is . . . income . . . taxable under the provision of law that includes ‘gains or profits and income derived from any source whatever.’”¹³ In other words, the broad language in the tax law defining gross income meant that damages for pain and suffering looked like a taxable gain. The Attorney General then opined that such damages were in essence a return of lost human capital and therefore did not constitute taxable gains.¹⁴ The Treasury subsequently reversed its position.¹⁵

In 1918, Congress enacted a statutory provision specifically excluding from income the amount of any damages received, whether by suit or agreement, “on account of such [personal] injuries or sickness.”¹⁶ That 1918 provision, effective in 1919, remained virtually unchanged in the Revenue Codes of 1939, 1954, and 1986.¹⁷

During this period, a number of important glosses were added to the statutory meaning of “on account of personal injuries.” The damages had to be received by a plaintiff making a tort-like claim.¹⁸ This requirement was set forth in the regulations promulgated under § 104(a)(2).¹⁹ There were not many tax cases involving damages received for nonphysical tort injuries,

13. T.D. 2135, 17 Treas. Dec. Int. Rev. 39, 42 (1915).

14. Income Tax—Proceeds of Accident Ins. Pol’y, 31 Op. Att’y Gen. 304, 308 (1918).

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

16. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919). For further discussion of this history, see Douglas A. Kahn, *The Constitutionality of Taxing Compensatory Damages for Mental Distress When There Was No Accompanying Physical Injury*, 4 FLA. TAX REV. 128 (1999); Douglas K. Chapman, *No Pain – No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407 (1987); and Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical but Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51 (1997).

17. The provision was amended in 1984 to provide an exemption for any damages that were paid out periodically as a “structured settlement.” Tax Reform Act of 1986, Pub. L. No. 99-514, § 1002, 100 Stat 2085, 2388.

18. See I.R.C. § 104(a)(2).

19. *Id.*

such as invasion of privacy or defamation. However, in 1983, the Ninth Circuit Court of Appeals in *Roemer v. Commissioner* held that damage to reputation was a personal injury.²⁰ The Tax Court had ruled the damages taxable because they were primarily to compensate the taxpayer for damage to his business reputation rather than his personal reputation.²¹ The Ninth Circuit viewed all damage to reputation as primarily personal under California law, even though that damage might result in loss of income or damage to business reputation.²² It concluded that this approach accorded with the IRS practice of excluding punitive damages under § 104, even though punitive damages otherwise appeared to be taxable under *Commissioner v. Glenshaw Glass*.²³ As to excluding damages paid for nonphysical harm, the court cited a 1922 Solicitor's Opinion holding that "damages for alienation of affections, defamation of personal character, and surrender of child custody rights are damages for invasion of personal rights and not income."²⁴ In the Tax Court, the taxpayer had also cited a 1972 Tax Court opinion holding that so long as the injury was personal, the damages paid could be excluded, even in the absence of physical injury.²⁵

The IRS responded to the *Roemer* decision by issuing a revenue ruling that held damages received in a wrongful death case, if punitive in nature, were not paid as compensation for the injury and therefore should be taxable.²⁶ The IRS also responded to *Roemer* by indicating that it would not follow the decision and that it would continue to take the position that the § 104(a)(2) exemption from taxation applied only to physical personal injuries.²⁷

The House of Representatives took notice of the IRS's position in 1989. The House proposed an amendment to § 104(a)(2) that would have codified the IRS position by limiting the exclusion to all damages received for

20. 716 F.2d 693, 700-01 (9th Cir. 1983).

21. *Roemer v. Comm'r*, 79 T.C. 398, 408 (1982).

22. *Roemer*, 716 F.2d at 700.

23. *Id.*; see also *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 432-33 (1955) (holding that punitive damages constitute gross income and should be taxed). But in 1975, the IRS had issued a revenue ruling that concluded punitive damages received in a wrongful death claim were excluded from income. Rev. Rul. 75-45, 1975-1 C.B. 47, *revoked by* Rev. Rul. 84-108, 1984-2 C.B. 34.

24. *Roemer*, 716 F.2d at 697 (paraphrasing Sol. Op. 132, I-1 C.B. 92, 93 (1922)).

25. *Roemer*, 79 T.C. at 405-06 (citing *Seay v. Comm'r*, 58 T.C. 32 (1972)).

26. See Rev. Rul. 84-108, 1984-2 C.B. 32, 34 (revoking Rev. Rul. 75-45, 1975-1 C.B. 47).

27. Rev. Rul. 85-143, 1985-2 C.B. 55, 56.

physical personal injuries or sickness.²⁸ However, the Senate rejected the House proposal, and ultimately the Conference Committee elected to restrict only the exclusion of punitive damages in cases without physical injury or sickness.²⁹ This action implicitly gave congressional approval to the exclusion of compensatory damages for nonphysical injuries.

In the 1990s, the U.S. Supreme Court heard three § 104(a)(2) cases in fairly rapid succession. First, in 1992, was the *Burke* decision.³⁰ In *United States v. Burke*, the Court adopted the test from the regulations that in order for the exclusion to apply, a claim had to be sufficiently tort-like.³¹ In the Court's view, the respondent's claim for sex discrimination under Title VII did not meet that test since damages under Title VII did not at the time embrace the broad range of compensatory damages that are generally available for tort claims.³² Next, in 1995, the Court decided *Commissioner v. Schleier*, ruling that damages to compensate for age discrimination could not meet the test of being tort-like.³³ One year later, in *O'Gilvie v. United States*, the Supreme Court determined that the language "on account of" necessitated a somewhat direct connection between the damages and their cause, meaning that punitive damages could not be excluded.³⁴ *O'Gilvie* involved a physical injury, so the language removing punitive damages from the exclusion in absence of a physical injury was not applicable.³⁵ The Court found that, generally, punitive damages are caused more by the tortfeasor's bad behavior rather than "on account of" the personal injuries.³⁶ Congress has now codified the taxation of punitive damages in § 104(a)(2).³⁷

In 1996, just seven years after rejecting the House bill to restrict the § 104(a)(2) exclusion to cases involving physical injuries,³⁸ Congress

28. H.R. REP. NO. 101-247, at 1354–55 (1989) (Conf. Rep.), as reprinted in 1989 U.S.C.C.A.N. 1906, 2824–25 (describing the reason for the change to the § 104(a)(2) exclusion proposed in H.R. 3299, 101st Cong. § 11641 (1989)).

29. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379.

30. *United States v. Burke*, 504 U.S. 229 (1992).

31. *Id.* at 237.

32. *Id.* at 241–42.

33. 515 U.S. 323, 336–37 (1995).

34. 519 U.S. 79, 83 (1996).

35. *See id.* at 82–83, 90.

36. *Id.* at 83.

37. I.R.C. § 104(a)(2) (“[F]or any prior taxable year, gross income does not include . . . the amount of any damages (other than punitive damages) received . . .”).

38. *See supra* text accompanying notes 28–29.

reversed itself and amended the provision to provide an income tax exclusion only if the damages were paid “on account of *physical* injuries or *physical* sickness.”³⁹ The amendment’s legislative history is somewhat sparse and provides no theoretical foundation for why damages for one sort of personal injury (physical) should be excluded but damages for another sort of personal injury (nonphysical) should be taxed.⁴⁰ The Conference report referred to the abovementioned Supreme Court cases:

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held [in *Schleier v. Commissioner*] that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income. In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.⁴¹

So, in part, Congress agreed with the Supreme Court cases on employment discrimination, especially when the damage award seemed to be in lieu of lost wages. But the Supreme Court had never dealt with other forms of nonphysical harm, especially any case in which the damages were for pain and suffering.

The Committee Report does provide some guidance for how the language excluding damages for nonphysical harms should be construed. Often, of course, a single claim involves both physical harm and nonphysical harm. The House Conference Report explains that

39. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (emphasis added).

40. See H.R. REP. NO. 104-737, at 300–02 (1996) (Conf. Rep.), as reprinted in 1996 U.S.C.C.A.N. 1677, 1792–94.

41. *Id.* at 300.

[t]he House bill provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.

The House bill also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.⁴²

The most logical explanation for *why* Congress made this change is that it was estimated to raise significant revenue. The amendment was part of the Small Business Job Protection Act of 1996,⁴³ which was intended to stimulate the economy by providing numerous tax cuts to small businesses. And, of course, whenever tax cuts are made available, the bill must be revenue neutral and so must include tax increases as well. But the need to raise revenue is not a sufficient reason to explain why a provision is fair or in line with larger goals of tax policy.

42. *Id.* at 301.

43. Small Business Job Protection Act § 1605, 110 Stat. at 1838.

Numerous commentators have complained about the lack of justification for this change.⁴⁴ Some have suggested that while it would be okay to make all damages taxable, there is no justification for taxing some damages and exempting others.⁴⁵ Others have argued that taxing damages received in lieu of lost wages may make sense, but not all damages for nonphysical harm are made to replace lost wages.⁴⁶ It is the taxation of damages for emotional distress that needs an explanation, but Congress has yet to provide one. After all, given the construction that Congress gives to the statute in the legislative history, some emotional distress damages will still be excluded, provided they are connected to a prior physical injury.⁴⁷ To me, this rule, excluding emotional distress damages from statutory coverage unless accompanied by a physical injury, sounds eerily similar to the rules that existed in tort law 100 years ago.⁴⁸ This early tort law history may also help to explain why the IRS resisted extending § 104(a)(2)'s coverage to nonphysical harms. Emotional distress damages for nonphysical harms did not become common until the mid-twentieth century.

III. A Short History of Tort Law's Physical Injury Requirement

In the 1800s and early 1900s, countless courts refused to award tort damages for purely emotional distress in the absence of a physical injury.⁴⁹ Although there were early exceptions to this rule that required physical injury before a plaintiff could win emotional distress damages, this course changed in the 1950s when the California Supreme Court recognized an independent cause of action for intentional infliction of emotional distress (“IIED”).⁵⁰

44. See, e.g., Ronald H. Jensen, *When Are Damages Tax Free?: The Elusive Meaning of “Physical Injury”*, 10 *PITT. TAX REV.* 87 (2013); Kurt A. Leeper, *Arguably Arbitrary: Taxation and the Physical Injury Requirement of I.R.C. Section 104(a)(2)*, 55 *CASE W. RESV. L. REV.* 1039 (2005).

45. See Jensen, *supra* note 44, at 134.

46. See Leeper, *supra* note 44, at 1057.

47. *Id.*

48. A handful of other commentators have pointed out this similarity as well. See, e.g., Jensen, *supra* note 44, at 103.

49. See *RESTATEMENT (SECOND) OF TORTS* § 436A cmt. b (AM. L. INST. 1965); see also W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* § 54, at 360–61 (5th ed. 1984); Martha Chamallas & Linda K. Kerber, *Women, Mothers, and the Law of Fright: A History*, 88 *MICH. L. REV.* 814 (1990). But see *Watson v. Diltz*, 89 N.W. 1068, 1068–69 (Iowa 1902) (supporting a wife’s claim for emotional distress damages based on the fright she experienced when she saw an intruder attack her husband).

50. See *State Rubbish Collectors Ass’n v. Siliznoff*, 240 P.2d 282, 286 (Cal. 1952).

Today, to win a claim on the basis of IIED, the plaintiff must prove two key elements: (1) the defendant's conduct must be extreme and outrageous, and (2) the plaintiff must have suffered severe emotional distress.⁵¹ The difficulty in satisfying these elements⁵² effectively limits the number of successful IIED claims. It is a mystery why tax law was not willing to follow tort law's lead in this regard. If a plaintiff has recovered for IIED, that plaintiff has jumped over hurdles put in place by tort law. In my view, that limitation should be honored by tax law.

Tort law recognized negligent infliction of emotional distress claims even later than the 1950s.⁵³ And like IIED claims, tort law has placed meaningful parameters around those causes of action as well. There are two types of claims for negligent infliction of emotional distress. One is for the direct plaintiff.⁵⁴ There are two types of negligent conduct that can result in damages solely for emotional distress. One type is conduct that places the plaintiff in fear of bodily harm despite the fact that no bodily harm occurs, but rather, only a fear of such harm.⁵⁵ The Third Restatement provides an example for this type of claim: a passenger on an airplane fears crashing and almost certain death due to negligence by the airline. But, at the last minute, the flight is prevented from crashing. Nonetheless, the passenger's emotional distress is a recoverable harm.⁵⁶ Tax law would tax those damages because there was no resulting physical injury, only the fear of its imminence.

Under the Restatement, the other type of direct plaintiff can recover for emotional distress only on the basis of conduct that "occurs in the course of specified categories of activities, undertakings, or relationships in which

51. 2 RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 46 cmt. h (AM. L. INST. 2012); *id.* at cmt. j.

52. *See id.* § 46 cmt. j ("The law intervenes only where the distress inflicted is so severe that no reasonable [person] could be expected to endure it." (alteration in original)).

53. California courts have led in the move toward awarding tort damages for emotional distress, even in the absence of physical injury. But still, it was not until 1980 that the California Supreme Court recognized such a claim. *See Molien v. Kaiser Found. Hosps.*, 616 P.2d 813 (Cal. 1980) (awarding emotional distress damages to a husband whose wife had been misdiagnosed with syphilis and had been advised to have himself tested; he suffered no physical injury). Some states continue to require proof of physical harm before emotional distress damages can be awarded in a negligence cause of action. *See, e.g., Ware v. ANW Special Educ. Coop.* No. 603, 180 P.3d 610 (Kan. Ct. App. 2008).

54. 2 RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 47(a).

55. *Id.* § 48 cmt. a.

56. *Id.* § 47 cmt. e, illus. 1.

negligent conduct is especially likely to cause serious emotional harm.”⁵⁷ This rule is an attempt to limit the availability of pure emotional harm damages.⁵⁸ The rule is often met in instances involving patients and physicians.⁵⁹ The other limiting principle is that the harm must be “serious.”⁶⁰

The second type of claim for negligent infliction of emotional distress involves a bystander, i.e., someone who witnesses the physical injury of someone close to them, typically a family member.⁶¹ In early cases of this sort, the plaintiff was required to prove some type of physical impact to recover emotional distress damages.⁶² This requirement, however, was eroded by the “zone of danger” limitation.⁶³ While some states still apply that limitation,⁶⁴ California became a leader in developing the parameters of this tort by moving away from the “zone of danger” requirement. Under *Dillon v. Legg*, which many states have followed, if the plaintiff was “present” at the time of the tort (usually a car accident in which there was a physical injury), then the plaintiff can recover (so long as the plaintiff is closely related to the accident victim).⁶⁵ This “bystander” version of negligent infliction of emotional distress would seem to satisfy the IRS’s current understanding that damages can be excluded so long as someone is physically injured. After all, the IRS agrees that wrongful death (physical harm to someone other than the taxpayer) and loss of consortium (also

57. *Id.* §47(b).

58. *Id.* §47 cmt. b.

59. *Id.* §47 cmt. f.

60. *Id.* § 47(b).

61. *Id.* § 48 cmt. a.

62. *Id.*

63. *Id.* Nonetheless many of these “zone of danger” cases did not result from actual physical injury to the plaintiff who was claiming emotional distress. *See, e.g.,* *Gonzalez v. N.Y.C. Hous. Auth.*, 181 A.D.2d 440, 440 (N.Y. App. Div. 1992) (denying plaintiff’s IIED claim because she had not faced “imminent danger of physical harm”). They did, however, result from physical injury to the victim, typically the victim in a car accident. *See, e.g.,* *Tobin v. Grossman*, 249 N.E.2d 419, 419, 423 (N.Y. 1969) (evaluating a mother’s IIED claim when her two-year-old child was injured in an automobile accident). Professor John Diamond provides an excellent review of these negligent infliction of emotional distress cases and their connection to the physical harm requirement at John Diamond, *Rethinking Compensation for Mental Distress: A Critique of the Restatement (Third) §§ 45–47*, 16 VA. J. SOC. POL’Y & L. 141, 145–48 (2008).

64. For example, New York still considers the “zone of danger” rule. *See Gonzalez*, 181 A.D.2d at 440; *Graber v. Bachman*, 27 A.D.3d 986, 988 (N.Y. App. Div. 2006).

65. 441 P.2d 912, 920 (Cal. 1968).

physical harm to someone other than the taxpayer) both produce damages that are excluded from income.⁶⁶

IV. Trying to Reconcile Tax and Torts

Here's what we know so far. Tax law excludes damages, even damages to compensate for emotional distress, so long as the taxpayer can show that a physical injury preceded the emotional distress damages.⁶⁷ This conclusion is based (in my view) on the infamous private letter ruling that is often called the ruling on the "First Pain Incident" and sometimes known as the "bruise ruling."⁶⁸ This ruling addressed the very difficult dividing line between, on the one hand, physical pain caused by sexual harassment involving physical injury (bruises or cuts) and, on the other hand, physical pain that results from the very serious emotional distress that often accompanies sexual harassment rather than from a physical injury.⁶⁹ If the emotional pain occurs before a bruise, it is taxable.⁷⁰ If it occurs after a bruise, it is not.⁷¹ The IRS explained as follows:

The term "personal physical injuries" is not defined in either § 104(a)(2) or the legislative history of the 1996 Act. However, we believe that direct unwanted or uninvited physical contacts resulting in *observable bodily harms* such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a)(2). See Black's Law Dictionary 1304 (Rev. 4th ed. 1968) which defines the term "physical injury" as "bodily harm or hurt, excluding mental distress, fright, or emotional disturbance."⁷²

66. This result was made clear by the Conference Report. See H.R. REP. 104-737, at 301 (1996) (Conf. Rep.), as reprinted in 1996 U.S.C.C.A.N. 1677, 1793. And the IRS has indicated that it will follow the guidance from the Report. See I.R.S. Priv. Ltr. Rul. 2001-21-031 (May 25, 2001) (loss of consortium); I.R.S. Priv. Ltr. Rul. 2000-29-020 (July 21, 2000) (wrongful death).

67. See I.R.C. § 104(a)(2).

68. See I.R.S. Priv. Ltr. Rul. 2000-41-022 (Oct. 13, 2000); Jensen, *supra* note 44, at 100 (referring to this private letter as the "bruise ruling").

69. *Id.*

70. See *id.*

71. See *id.* Personally, I think this is a trivialization of anyone who has suffered serious emotional distress and resulting physical injury from sexual harassment, but it is the rule followed by the IRS to date.

72. *Id.* (emphasis added).

This seems to mean that mere unwanted touching or fondling is insufficient to qualify as “personal physical injury,” since there is no observable harm. Battery is the invasion of one’s personal integrity, but if one receives damages for that invasion, including emotional distress damages, then the damages are taxable if the invasion left no bruise.⁷³ Assaults in tort law are similarly viewed as invasions of one’s personal integrity, but there is not necessarily a touching.⁷⁴ The IRS rule means that any recovery of compensatory damages for an assault is taxable.

Both battery and assault are traditional trespassory torts.⁷⁵ These are the very sort of compensable invasions that were thought to be worthy of tax-free recoveries from the very early days of our modern income tax.⁷⁶ False imprisonment is another traditional trespassory tort.⁷⁷ Yet, compensatory damages received for that tort are taxable since no touching or physical harm is required to establish false imprisonment.⁷⁸ The 1996 amendment to § 104(a)(2) separated tax and tort law in ways that it is doubtful the legislators understood at the time. They appeared to embrace the traditional tort law and its accompanying damages while distancing claims based on such things as sex and age discrimination in employment.

V. *The Bright-Line Justification: Problem Cases*

The amendment adding the word “physical” to the “personal injury” requirement in § 104(a)(2) is often defended on the basis that it provided a “bright line” for those damages that were taxable or nontaxable.⁷⁹ By providing clarity the new rule should have reduced litigation over the issue of taxability of damages. That does not appear to have happened. Taxpayers who suffer physical pain, injury, or sickness understandably think they are covered by the exemption language in the statute. But, as we’ve seen, if that

73. *See id.*; *Battery*, BLACK’S LAW DICTIONARY (11th ed. 2019).

74. *See Assault*, BLACK’S LAW DICTIONARY (11th ed. 2019) (noting that assault may occur based on a threat).

75. *See* Joi T. Christoff, *Tax Free Damages: Trespassory Torts and Emotional Harms*, 53 AKRON L. REV. 71, 93 (2019).

76. *See* Jensen, *supra* note 44, at 89.

77. *See* Christoff, *supra* note 75, at 93.

78. *See* *Stadnyk v. Comm’r*, 96 T.C.M. (CCH) 475, 2008 WL 5330828, at *6 (Dec. 22, 2008), *aff’d* 367 F. App’x 586 (6th Cir. 2010).

79. *See* Jensen, *supra* note 44, at 92 (asserting that the amendment “made it clear that punitive damages awarded in personal injury cases, with one very narrow exception, were always taxable” (emphasis added)).

physical pain, injury, or sickness stems from emotional distress, compensatory damages are taxable.

In many cases it is difficult to tell which came first: the physical injury or the emotional distress. In real life, these things happen fairly spontaneously.⁸⁰ For example, in *Parkinson v. Commissioner*, the taxpayer claimed that his employer's bad treatment of him at work, especially the stress it put him under, caused him to have a heart attack.⁸¹ He sued his employer and recovered via a settlement agreement.⁸² While a heart attack is a physical injury, the question was whether he recovered for emotional distress that caused him to have a heart attack (all damages would be taxable) or whether he recovered for having a heart attack that caused him emotional distress (all damages would be nontaxable).⁸³ In a decision that defies my sense of understanding, the Tax Court concluded that half of the damages were attributable to pure emotional distress and were therefore taxable, but the other half were attributable to the heart attack and therefore excludable.⁸⁴ Under the "bruise ruling," it seems that it should all depend on which came first.

A similar case is *Collins v. Commissioner*.⁸⁵ The taxpayer in *Collins* alleged that he experienced racial discrimination by his employer and that a physician diagnosed his harm as "depression, general anxiety disorder, hypertension, blood clots, and muscle spasms."⁸⁶ He also alleged the discrimination resulted in high blood pressure.⁸⁷ One might think that high blood pressure, hypertension, blood clots, and muscle spasms are physical sicknesses like a heart attack. But the Tax Court distinguished *Parkinson v. Commissioner* by saying that taxpayer Collins signed a settlement agreement that allocated the contested damage award to emotional

80. *See id.* at 126 (explaining this connection) ("As the Diagnostic and Statistical Manual of Mental Disorders, the leading guide to the clinical practice of psychiatry, points out, a 'compelling literature documents that there is much "physical" in "mental" disorders and much "mental" in "physical" disorders.') (quoting AM. PSYCHIATRIC ASS'N, DIAGNOSTIC AND STATISTICAL MANUAL OF MENTAL DISORDERS: DSM-IV-TR, at xxx (4th ed. 2000)).

81. T.C.M. (RIA) 2010-142, 2010 WL 2595005, at *1 (T.C. June 28, 2010).

82. *Id.* at *2.

83. *Id.* at *3.

84. *Id.* at *6-7.

85. T.C. Summ. Op. 2017-74, 2017 WL 4015039.

86. *Id.* at *1.

87. *Id.*

distress.⁸⁸ In other words, the settlement agreement trumped the factual allegations in the complaint.

Currently, there are no reported cases holding that negligent infliction of emotional distress damages in “bystander” claims are excluded from tax. But surely exclusion is the correct result, given the tax treatment of wrongful death and loss of consortium claims. At the same time, it does make one wonder why, if all that the plaintiff is experiencing is emotional distress, a “bystander” plaintiff should be entitled to exclude damages from taxation when other plaintiffs who suffer only emotional distress damages, but not on account of another’s physical injury, cannot exclude their recoveries. Why, as a matter of tax policy, should the cause of the emotional distress affect the tax consequences of the recovery of damages? But that’s where we are: emotional distress damages stemming from one’s own physical injury are excludable, and emotional distress damages stemming from another person’s physical injury are also excludable.⁸⁹ On the other hand, damages for severe emotional distress with resulting physical injury and sickness are taxable.⁹⁰

There are other “close call” cases that become problematic under the 1996 amendment’s requirement of “personal physical injury.” For example, in 1955 and 1956, the IRS issued rulings that damages received as compensation for loss of freedom as a prisoner of war were tax-exempt because they compensated for the loss of personal rights.⁹¹ The IRS rulings did not require that the prisoner suffer physical injury or sickness, although

88. *Id.* at *4. Tax law practitioner Robert W. Wood suggests that bad wording in settlement agreements is often the primary reason these “close call” cases go against the taxpayer. Robert W. Wood, *Bad Settlement Agreement Wording Spells Taxes — Again*, 173 TAX NOTES FED. 965, 966 (2021). Wood notes that personal injury lawyers are often not sufficiently attuned to the tax consequences of the words they use in their complaints and their settlement agreements. *Id.* at 966–67.

89. *See supra* text accompanying notes 42, 54–55, 57.

90. *See supra* text accompanying note 42. And what about emotional distress damages stemming from physical injury to a treasured pet? While in most states such damages are not awarded because the damage to the pet is mere damage to property and therefore measured by the loss of the pet’s fair market value, there are a handful of cases that have awarded emotional distress damages to the pet’s owner. *See, e.g.,* Campbell v. Animal Quarantine Station, 632 P.2d 1066, 1071 (Haw. 1981) (death of pet dog). For an overall summary of the law on damages for injury to pets, see Victor E. Schwartz & Emily J. Laird, *Non-Economic Damages in Pet Litigation: The Serious Need to Preserve a Rational Rule*, 33 PEPP. L. REV. 227 (2006). Presumably any such compensatory damages would be taxable as physical injury to an animal is not a physical injury to a person.

91. Rev. Rul. 55-132, 1955-1 C.B. 213; Rev. Rul. 56-462, 1956-2 C.B. 20.

that is often the case for such prisoners.⁹² The rulings also covered those damages received on account of inhumane treatment.⁹³ Those rulings appear to have remained in effect until they were declared obsolete in 2007.⁹⁴ Now such damages would be covered by § 104(a)(2). But the ruling declaring the former positions obsolete did nothing to answer whether inhumane treatment damages, which do not necessarily cause physical injury or sickness, are taxable. And if damages are paid in a lump sum, must they be allocated between those damages attributable to physical injury and other injuries such as emotional distress and pain and suffering, which are likely attributable to the imprisonment rather than the physical injury?

A similar question arises in cases involving damages received for being wrongfully imprisoned or being wrongfully convicted by a governmental entity. Even if the wrongful imprisonment resulted in physical harm, damages are typically awarded for emotional distress as well as the physical harm.⁹⁵ The emotional distress in those cases usually stems from the wrongful imprisonment, not from the physical harm. In that case, to apply § 104(a)(2), one would have to apportion the damages between the physical injury and the emotional distress. This problem has been resolved for wrongful imprisonment that results from a wrongful conviction by the passage of § 139F, added to the Internal Revenue Code in 2015.⁹⁶ Under § 139F, all damages received are excluded.⁹⁷

But problems remain for wrongful imprisonments that are not the result of wrongful convictions. For example, in *Stadnyk v. Commissioner*, the taxpayer was wrongfully arrested for writing a bad check.⁹⁸ Her bank had wrongfully dishonored a check that she had written when she had asked the bank to stop payment on the check because the goods purchased with the

92. See *supra* note 91.

93. See *supra* note 91.

94. See Rev. Rul. 2007-14, 2007-1 C.B. 747.

95. See I.R.S. Chief Couns. Advice 201045023 (Nov. 12, 2010) (concluding that a wrongfully incarcerated person who is physically injured while incarcerated can exclude damages received for the wrongful incarceration to the extent the damages are attributable to the physical injury, but providing no guidance on how to make that determination); see also Robert W. Wood, *Wrongful Conviction Settlements Are Retroactively Tax Free*, 150 TAX NOTES 1595 (Mar. 28, 2016) (discussing this ruling and the problem of allocation).

96. For a discussion of this provision and an analysis of its coverage, see Robert W. Wood, *Dollars and Sense*, 80 TEX. B.J. 432 (2017).

97. *Id.* at 433.

98. 96 T.C.M. (CCH) 475, 2008 WL 5330828, at *1 (T.C. Dec. 22, 2008), *aff'd* 367 F. App'x 586 (6th Cir. 2010).

check were inferior.⁹⁹ She was not injured when she was arrested and jailed.¹⁰⁰ As a result, the damages were fully taxable, although some might view a wrongful confinement as a form of physical injury, even if there are no observable bruises or cuts.¹⁰¹ If she had been physically injured, the damage award would have been allocated between the physical injury and the emotional distress.¹⁰² Section 139F does not help a taxpayer like Stadnyk; she was not wrongfully convicted, but only wrongfully arrested.

Finally, some cases involve physical conditions that do not necessarily involve physical injuries or sickness. For example, a court held that a tort victim had a triable claim to recover compensatory damages where he had suffered harm from a clinic misdiagnosing him as having HIV.¹⁰³ The clinic tested and treated him, but he was not physically injured.¹⁰⁴ Nor is it clear how § 104(a)(2) would apply to wrongful birth or wrongful pregnancy cases. Wrongful birth cases involve some form of negligence by a physician that causes a woman to decide to give birth when, but for the negligence, she would have decided otherwise. Wrongful pregnancy cases typically involve a botched sterilization that the woman (and man) believed would prevent pregnancy.¹⁰⁵ These cases all involve a physical condition (pregnancy and birth), but is pregnancy a sickness or a physical injury?

While *Parkinson* held that a heart attack was a physical sickness,¹⁰⁶ lesser physical reactions to fright or fear are not clearly recognizable as

99. *Id.*

100. *Id.* at *2.

101. Apparently, the taxpayer's attorney as well as the bank had concluded that the damages were sufficiently connected with a physical injury that they should not be taxable. See David M. Higgins and Janet Guzman, *Fixing the Definition of Physical Personal Injury*, 174 TAX NOTES FED. 221 (Jan. 10, 2022). A number of commentators take this position as well, most notably Robert W. Wood, who has written more articles than anyone else on the question of what damages should be excluded under §104. In his view, "the loss of liberty and physical confinement is itself a physical injury within the meaning of section 104." See Robert W. Wood, *Tax-Free Wrongful Imprisonment Recoveries*, 130 TAX NOTES 961 (Feb. 21, 2011).

102. Before the enactment of § 139F, the IRS took this position regarding damages received for being wrongfully convicted. See I.R.S. Chief Couns. Advisory Mem. 2010-45-023.

103. *Hedgepeth v. Whitman Walker Clinic*, 22 A.3d 789, 820 (D.C. 2011).

104. See *id.* at 819.

105. See Katherine A. Gehring, Casenote, *Ohio's Approach to Prenatal Torts—A Different Strand of DNA: Schirmer v. Mt. Auburn Obstetrics & Gynecologic Associates, Inc.*, 844 N.E.2d 1160 (*Ohio* 2006), 76 U. CIN. L. REV. 235, 238 (2007).

106. *Parkinson v. Comm'r, T.C.M. (RIA) 2010-142*, 2010 WL 2595005, at *5 (T.C. June 28, 2010).

such. People often faint in reaction to something they see.¹⁰⁷ Fainting can result in additional physical injuries such as concussions and broken teeth. If the defendant did not touch the plaintiff but only caused the plaintiff fear (e.g., by holding a gun to the plaintiff's head), is any recovery possible from the defendant for assault attributable to a physical sickness (fainting) or physical injuries, i.e., those that resulted from the fainting that initially resulted from the fear? If a plaintiff is so upset by a defendant's actions that she vomits, is that sufficient to satisfy § 104(a)(2)? Or is the physical manifestation merely a result of the initial emotional distress? If the latter, then § 104(a)(2) does not apply to exclude the damages.

VI. Blum v. Commissioner, T.C. Memo. 2021-18

I began this Article with what I consider the paramount common law inquiry for determining whether or not damages are taxable income: in lieu of what were the damages awarded?¹⁰⁸ And I will end with the recently decided, problematic case of *Blum v. Commissioner*.¹⁰⁹ *Blum* involves a malpractice claim against the taxpayer's lawyer.¹¹⁰ One would think the most relevant question is, why were the damages paid? If they were to reimburse the taxpayer for an out-of-pocket loss, then, as recognized in *Clark v. Commissioner*, the damages are not income.¹¹¹

In *Blum*, the taxpayer sued her lawyer for mishandling her personal injury lawsuit.¹¹² She had been personally injured by a hospital's negligence when she was a patient at the hospital.¹¹³ There is no question that her

107. See Marc D. Ginsberg & Tricia E. McVicker, *Not for the Faint of Heart: Does a Hospital Owe a Duty to Warn a Squeamish Visitor?*, 41 J. MARSHALL L. REV. 473 (2008), for discussion of an array of tort cases in which the plaintiffs claimed damages for fainting, which, in most cases, caused themselves further physical injury. In most of these cases the plaintiff was unable to obtain compensatory damages because the hospital or emergency facility did not have a duty to this plaintiff, but only to the patient. *Id.*

108. See *supra* Part I.

109. 121 T.C.M. (CCH) 1147, 2021 WL 632330 (T.C. Feb. 18, 2021), *aff'd* No. 21-71113, 2022 WL 1797334 (9th Cir. June 2, 2022).

110. *Id.*, 2021 WL 632330, at *1.

111. *Clark v. Comm'r*, 40 B.T.A. 333 (1939), *acq.*, 1957-1 C.B. 4. In *Clark*, a lawyer gave taxpayer Clark bad advice about how to file his tax return, and Clark ended up paying more in tax than he rightfully should have paid. *Id.* at 333-34. The damages were to reimburse him for that extra cash that he paid out of his own pocket; Clark was merely getting his own money back. *Id.* at 335.

112. *Blum*, 2021 WL 632330, at *1.

113. *Id.*

lawsuit against the hospital was for personal physical injury damages.¹¹⁴ She did not allege any emotional distress damages.¹¹⁵ However, she did incur pain and suffering as a result of her injury from the use of a broken wheelchair provided to her by the hospital.¹¹⁶ After losing her case against the hospital, she sued her lawyers, claiming that but for their negligence she would have recovered her physical injury damages.¹¹⁷ The lawyers readily agreed to pay her \$125,000 to settle her claim.¹¹⁸ The settlement agreement provided that the payment was to settle her malpractice claim against them in full.¹¹⁹ The settlement agreement also provided that her lawyers' negligence had not resulted in any physical injury to her.¹²⁰ The only physical injuries she suffered were due to the hospital's negligence.¹²¹ The Tax Court latched onto this language in the settlement agreement and ruled that since the damages were paid for malpractice negligence, which did not result in any physical injuries, the exclusion under § 104(a)(2) could not apply.¹²²

This can't be correct. But for the lawyers' negligence she would have received damages from the hospital that would not have been taxable under § 104(a)(2). The malpractice damages were intended to make her whole. Paying taxable damages of \$125,000 is not the same as obtaining nontaxable damages of \$125,000 from the hospital. That settlement was paid in lieu of the personal physical injury award that she otherwise would have received. That makes the malpractice settlement damages nontaxable. That *should* be the result in this case. However, the Ninth Circuit has recently affirmed the Tax Court.¹²³ It did so in a memorandum opinion that is a mere five paragraphs long, deemed unsuitable for publication.¹²⁴ The opinion fails to grapple at all with the taxpayer's argument that the settlement with her attorneys was a direct result of her claim against the hospital for the physical injuries she sustained while a patient there. The court merely notes that she cannot prove any such causal link because her settlement agreement with the law firm stated that the law firm had not

114. *Id.*

115. *See id.*

116. *See id.*

117. *Id.*

118. *Id.*

119. *Id.* at *2.

120. *Id.*

121. *Id.*

122. *Id.* at *3.

123. *Blum v. Comm'r*, No. 21-71113, 2022 WL 1797334 (9th Cir. June 2, 2022).

124. *See id.*

caused her any physical injuries.¹²⁵ True enough. But the inquiry should not stop there. The question still remains as to why she had a valid cause of action against her attorneys. In my view, it is because they failed to obtain for her the physical injury award that she was entitled to receive but for their negligence. That makes her similar to the taxpayer in *Lyeth v. Hoey*.¹²⁶ And, as noted in the Introduction, even if § 104(a)(2) appears inapplicable to the damages paid, we must still consider the “in lieu of” doctrine.¹²⁷

VII. Conclusion

The purpose of this Article has been to question the wisdom of the 1996 amendment to § 104(a)(2). It is difficult to identify a strong policy justification for only excluding damages for physical injuries or sickness from taxation. That dividing line is not only questionable as a policy matter, but it also turns out to be difficult to apply. Thus, it is not the “bright line” that some imagined it to be. Tort law has moved away from requiring physical injury or impact before emotional distress damages can be awarded. Tort law has recognized that the harm of emotional distress is just as worthy of compensation as physical injury is. Tax law should follow in that direction: it should either exclude all personal tort damages or none. Drawing an unjustifiable line is bad tax policy.

125. *Id.* at *1.

126. 305 U.S. 188, 196 (1938) (ruling that an heir should not have to report a settlement amount as taxable income where this settlement was paid in lieu of damages that he would have been entitled to receive from his undue influence claim against the estate).

127. As this Article was “in press,” a request for rehearing en banc was pending before the Ninth Circuit in the *Blum* case. I hope the court does reconsider. But even if arguments I make in this Article turn out to moot in this case, I hope they will be considered in any similar case going forward.