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# Taxing Economic Loss Recovered in Personal Injury Actions: Toward a Capital Idea?

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# TAXING ECONOMIC LOSS RECOVERED IN PERSONAL INJURY ACTIONS: TOWARDS A CAPITAL IDEA?

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## I. INTRODUCTION**

"The tax base is eroding! The tax base is eroding!" Paul Revere or Chicken Little? Whichever, this was the original war cry of proponents of recent tax reform.[1] It then emerged as the watchword of the Tax Reform Act of 1986,[2]

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** Unless otherwise provided, all Code references herein are to the Internal Revenue Code of 1954. *See infra* note 2.

1. *See* 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 1 (Nov. 1984), *reprinted in* TAX IDEAS (P-H) § 2, 1 (Dec. 20, 1984) [hereinafter TREAS. II]; *see also* S. REP. No. 313, 99th Cong., 2d Sess. 4 (1986) ("The ability of some individuals to reduce their tax liability excessively leads to a direct erosion of the tax base, requiring higher tax rates.").

2. Tax reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter TRA '86]. TRA '86 so substantially modified the Internal Revenue Code of 1954 that Congress deemed it appropriate to redesignate the Code as the Internal Revenue Code of 1986 [hereinafter Int. Rev. Code of 1986]. *Id.* § 2(a).

when it became clear tax rates were to be lowered[3] but the federal fisc was to be preserved. Congress was forced to focus its attention on enlarging the tax base, as well as to restructure certain tax credits.[4] Base broadening can be achieved by either expanding gross income or reducing allowable deductions. Congress considered[5] and acted upon both.[6] One base broadening opportunity

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3. The most recent tax proposals continued the rate-reducing effort commenced by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) [hereinafter ERTA]. ERTA reduced the maximum tax rate from 70% to 50%. *Id.* § 101(a) (amending I.R.C. § 1). The new code reduces the maximum tax rate from 50% to 28%. TRA '86, § 101 (amending I.R.C. § 1). This reduction is subject to a one year phase-in period with marginal tax rates of 35% and 38.5% for tax year 1987. *Id.*; *see* 1 TREAS. II; 7, *supra* note 1, at viii (proposing a three-tiered flat tax system with the highest rate at 35%).

4. The original house bill proposed numerous changes. *See* H.R. 3838, 99th Cong., 2d Sess. § 111 (amending I.R.C. § 32(a)) (increase in earned income credit); *id.* § 112 (repealing I.R.C. § 24) (credit for political contributions); *id.* § 211 (adding Int. Rev. Code of 1986 § 49) (repealing the investment tax credit); *id.* (amending I.R.C. § 38(c)(1)) (reduction in value of general business credit); *id.* § 231 (amending I.R.C. § 30) (credit for increasing research activities); *id.* § 232 (amending I.R.C. § 28(e)) (extension of credit for clinical testing expenses for certain drugs); *id.* § 251 (amending I.R.C. § 46(b)(4)) (modifying the investment tax credit for rehabilitation expenditures); *id.* § 252 (adding Int. Rev. Code of 1986 § 42) (low-income housing credit); *id.* § 421 (amending I.R.C. § 46(b)(2)(A)) (extension of energy investment credit); *id.* § 501 (adding Int. Rev. Code of 1986 § 469) (disallowing credits arising from passive activities); *id.* § 1171 (repealing I.R.C. § 41) (employee stock ownership credit); *id.* § 1202 (amending I.R.C. § 902) (credit for corporate stockholder in foreign corporation); *id.* § 1275 (amending I.R.C. § 936(d)) (possession tax credit for Virgin Islands corporations); *id.* § 1701 (amending I.R.C. § 51(c)(3)) (extension and modification of targeted jobs credit).

5. *See, e.g.*, *id.* § 121 (including unemployment compensation in income); *id.* § 131 (repealing I.R.C. § 221) (deduction for two-earner married couples); *id.* § 132 (adding Int. Rev. Code of 1986 § 67) (placing a 2% floor on miscellaneous itemized deductions); *id.* § 134 (repealing I.R.C. § 164(a)) (deduction for state and local taxes); *id.* § 142 (amending I.R.C. § 274) (limiting deductions for business related meals, travel, and entertainment); *id.* § 144 (amending I.R.C. § 265) (deductions for mortgage interest and real property taxes allowable where parsonage allowance or military housing allowance received); *id.* § 302 (amending I.R.C. § 1) (reducing the net capital gain deduction); *id.* § 311 (amending I.R.C. 1201) (repealing preferential corporate net capital gains treatment); *id.* § 511 (amending I.R.C. § 163(d)) (limiting the deduction for nonbusiness interest); *id.* § 611 (reducing the deduction for dividends received by certain corporations); *id.* § 811 (adding Int. Rev. Code of 1986 § 453(c)) (recognizing gain on certain pledges and installment obligations); *id.* § 824 (amending I.R.C. § 118) (including contributions in aid of construction in gross income); *id.* § 1101 (amending I.R.C. § 219) (limiting the availability of IRA deductions); *id.* § 1102 (amending I.R.C. § 408) (limiting the excludable amount on individual retirement plan contributions); *id.* § 1106 (amending I.R.C. § 415(c)(1)(A)) (adjusting the limitations on contributions and benefits under qualified plans).

6. *Id.*; *see, e.g.*, Int. Rev. Code of 1986 § 67 (placing a 2% floor on the deductibility of miscellaneous itemized deductions); *id.* § 85 (including all unemployment compensation in gross income); *id.* § 118(b) (including in gross income contributions in aid of construction or any other contributions as a customer or potential customer); *id.* § 163(d) (limiting deductions for interest on investment indebtedness); *id.* §§ 219(g), 408(o) (eliminating IRA deductions for certain taxpayers based upon income levels or participation in pension plans, but continuing to defer tax accounting for all prior and future earnings from contributions to such an account); *id.* §§ 243(a)(1), 244(a)(3) & (b)(2), 246(b)(1), 246A(a)(1), & 805(a)(4)(B) (reducing the 85% dividends received deduction to 80%); *id.* § 265(a)(6) (disallowing deductions for interest on mortgages arising out of military

which Congress eschewed was repeal of the longstanding exclusion for payments received on account of personal injuries.[7] The current favorable tax treatment includes payments for economic losses[8] sustained by the recipient, even though such payments may represent little more than substitutes for what would otherwise have been includable in gross income.[9] Should such payments avoid taxation entirely? Perhaps — but the better view may be to tax them in a manner which recognizes their special nature. Consistent with this view, it is suggested that Congress adopt a tempered method for taxing the economic loss element of personal injury awards. The central thesis advanced would make these receipts either partially includable in income, considered as long-term capital gain, or taxed separately. By treating economic loss payments in any one of these ways, both base broadening and revenue preserving can be achieved without neglecting sound policy for tax fairness.

## II. The Liberal Interpretation of I.R.C. Section 104

### A. *The Rule Itself*

Currently, section 104(a)(2) excludes from income compensatory[10] payments (other than certain reimbursements)[11] received on account of personal injuries.[12]

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housing allowances or parsonage allowances); *id.* § 274(k)-(n) (limiting deductions for meals, travel and entertainment incurred during the ordinary course of business); *id.* § 402(g) (limiting the amount excludable on elective deferrals); *id.* § 1201 (changing the alternative tax for corporations); *see also id.* § 74 (limiting the exclusion for prizes and awards); *id.* § 117 (limiting the exclusion for scholarships); *id.* § 213(a) (increasing the floor on the medical expense deduction from 5% to 7.5%).

7. I.R.C. § 104(a)(2) (West 1985) (excluding personal injury awards which represent reimbursement for previously deducted medical expenses from gross income). *See generally* Int. Rev. Code of 1986 § 104(a)(2) (1986) (adopting § 104(a)(2) without change).

I.R.C. § 104 reads:

> (a) In general. — Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include —
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness . . . .

8. *Id.* The term "economic loss" has been in vogue of late and is subject to various definitions. For purposes herein, "economic loss" means compensatory payments that would have been included in gross income, I.R.C. § 61, by the recipient if such payments had not been received on account of personal injury and thus excludable from income under § 104(a)(2). For a discussion of "economic loss" in tort matters generally, see Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 Stan. L. Rev. 1513 (1985).

9. Section 104(a)(2) permits items which would have been included in income to escape taxation if received incident to a personal injury award. *See* Rev. Rul. 85-97, 1985-2 C.B. 50, 51 (where the amount allocable to claim for lost wages represented compensation for personal injuries, entire settlement amount excludable from gross income); *see also* sources cited *infra* notes 14 & 16.

10. "Compensatory" is used herein to mean that part of a recovery which is not punitive or exemplary in nature.

11. I.R.C. § 104(a) (1986) ("Except in the case of amounts attributable to . . . deductions allowed under section 213 (relative to medical, etc., expenses) . . . ."). This introductory language

As long as the underlying claim prompting the award is a personal tort,[13] the basis for computing any specific portion of the award is usually irrelevant for tax purposes.[14] The entire amount is excludable from gross income. Moreover, even the traditionally taxable interest element of such payments[15] can fall under this section's protective umbrella.[16] Reimbursements for previously deducted medical expenses are the exception to this generous rule.[17]

Not all compensatory awards can, however, navigate into the safe port of section 104(a)(2). Only those payments arising from personal injury actions are tax advantaged. Damages for injuries not arising out of a personal injury action

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provides that exclusions enumerated in subsections (1)-(4) do not apply to payments which reimburse the taxpayer for previously deducted medical expenses. *See* Rev. Rul. 75-230, 1975-1 C.B. 93 (where medical expenses were incurred and deducted in year prior to settlement of personal injury suit, presumption is that settlement amounts are first attributable to medical expenses deducted, and are thus includable in gross income in year of receipt to extent medical expense deductions were allowed in prior taxable year), *distinguishing* Rev. Rul. 58-418, 1958-2 C.B. 18. If recovery occurs before any medical expense deduction is taken, the receipt is excluded from income and the deduction not permitted. *See* Murray v. United States, 48 A.F.T.R.2d ¶ 81-5129 (S.D.N.Y. 1981).

12. It is essential that payment be made on account of personal injury or sickness; if not, the exclusion is inapplicable. I.R.C. § 104(a)(2) (1986); *see infra* notes 18-27 and accompanying text.

13. Treas. Reg. § 1.104-1(c) (West 1986) ("The term 'damages received (whether by suit or agreement)' means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution."). *See, e.g.*, Bent v. Commissioner, 87 T.C. 236 (1986) (damages received under settlement of § 1983 action for violations of first amendment rights are received for personal injuries and thus excludable under § 104(c)(2)).

14. Roemer v. Commissioner, 716 F.2d 693, 696-97 (9th Cir. 1983) (lump-sum damages award not allocated between personal aspects of injury and economic loss aspects of injury), *rev'g* 79 T.C. 398 (1982); Bent v. Commissioner, 87 T.C. 236 (1986) (element of lost wages not an independent basis for recovery but an evidentiary fact to determine amount of damages). If the origin of the claim prompting the recovery is embraced by § 104(a)(2), no further inquiry is necessary other than to determine if a reimbursement of a previously deducted medical expense is being made or punitive damages are involved. For instance, damages for injury to professional reputation, as opposed to personal reputation, while connected with a taxpayer's business pursuits, are classified as consequences of the personal tort of defamation and are therefore excludable from gross income. Threlkeld v. Commissioner, 87 T.C. No. 76 (1986). *See, e.g.*, Church v. Commissioner, 80 T.C. 1104, 1110 n.7 (1983); Rev. Rul. 75-45, 1975-1 C.B. 47 (punitive damages); Rev. Rul. 75-230, 1975-2 C.B. 93 (previously deducted medical expense), *superseding* Rev. Rul. 58-578, 1958-2 C.B. 38.

15. *See* Rev. Rul. 65-29, 1965-1 C.B. 59 (interest realized from investment of excludable lump-sum payment includable in gross income).

16. Section 104(a)(2) parenthetically includes "periodic payments" within its ambit. I.R.C. § 104(a)(2). Thus, what was once tax-includable interest income is now congressionally sanctioned as a tax-excludable receipt if incident to a structured settlement of a claim falling under § 104. For further discussion of structured settlements, see Burke, *Structured Settlements Revisited*, 59 FLA. B.J., March 1985, at 40-42; Cane, *How to Use and Benefit from Structured Settlements in Personal Injury Suits*, 59 J. TAX'N 330 (1983); McGown, *Structured Settlements: Deduct Now and Pay Later*, 60 TAXES 251 (1982); and Noel, *Tax Aspects of Settlements, Judgments, Antitrust Payments and Recoveries*, Tax Mgmt. (BNA) 5th Ser., § 121, at A-19 (1985).

17. *See supra* note 11 and accompanying text.

are cast in the same form as receipts for which they are a substitute, and generally constitute income.[18] It is well established that bifurcated analyses attempting to allocate losses among various aspects of tort claims are not permitted.[19] Nor is it appropriate to try to ascertain the predominate nature of an injury and then determine the applicability of section 104(a)(2).[20] An "all or nothing" approach has been adopted. If the underlying claim is personal, therefore, section 104(a)(2) excludes all compensation including economic losses.[21] Otherwise, recoveries are given the same tax character as items for which they are a substitute.

The "personal" versus "non-personal" origin of the claim becomes a crucial threshold determination in seeking tax relief. Although this type of distinction is not novel in tax law,[22] it has been particularly vexing in this area. Perhaps this is a result of the inherent nature of some tort actions. Consider, for example, the defamation action. Can injury to one's personal reputation be completely separated from harm to one's business reputation? Can any attempted allocation between the two be meaningful for the personal-service providing plaintiff? In response to this threshold problem, courts have generally relied on a "facts and circumstances" analysis of damage awards and settlements.[23] To

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18. *See* Rev. Rul. 85-44, 1985-1 C.B. 22 (back pay, unpaid lien and health insurance premiums resulting from illegal dismissal includable in income), *distinguishing* Rev. Rul. 61-146, 1961-2 C.B. 25; Rev. Rul. 75-64, 1975-1 C.B. 16 (back pay due to illegal discharge not paid in connection with personal injury tort-type claim not excludable from income); Rev. Rul. 72-341, 1972 C.B. 32 (settlement of employment discrimination action not excludable under § 104(a)(2)); *see also* Villaume v. United States, 616 F. Supp. 185 (D. Minn. 1985) (§ 104(a)(2) held inapplicable to recovery for unpaid real estate commissions); Applegate v. Commissioner, 50 T.C.M. (CCH) 1172 (1985) (§ 104(a)(2) held inapplicable to settlement agreement where signed releases indicated that payment was compensation for past services); *cf.* Hort v. Commissioner, 313 U.S. 28 (1941). In *Hort*, the Court used an origin-of-the-claim analysis to conclude that an amount received as a substitute for ordinary income (rent) retained its ordinary income character. *Id.* at 31.

19. *See* Roemer v. Commissioner, 716 F.2d 693, 697 (9th Cir. 1983) ("When an individual recovers damages for a physical personal injury, the lump-sum award is not allocated between the personal aspects of the injury and the economic loss occasioned by the personal injury . . . ."); *Threlkeld*, 87 T.C. No. 76 (settlement damages for malicious prosecution suit allocated among damage to professional credit reputation, indignity, humiliation, and inconvience, all held attributable to claim for personal injury and within scope of § 104(a)(2)).

20. Roemer v. Commissioner, 716 F.2d at 697. ("[N]or is the taxpayer precluded from use of § 104(a)(2) when the predominant result of the injury is a loss of income . . . . The relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries.").

21. *See supra* notes 9, 13-14, and accompanying text.

22. The "origin-of-the-claim" issue touches and concerns tax items too numerous to catalogue. Aside from the problem of retaining the ordinary income character for items such as the rent substitutes addressed in *Hort*, the Supreme Court thoroughly treated the issue in United States v. Gilmore, 372 U.S. 39 (1963). In *Gilmore*, the Court sorted out items of tax significance incident to a divorce and disallowed deductions for expenses which could be traced to the personal aspects of the action. *Id.* at 51-52.

23. *See, e.g.*, Woodward v. Commissioner, 397 U.S. 572 (1970); Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983); Villaume v. United States, 616 F. Supp. 185 (D. Minn. 1985); Bent v. Commissioner, 87 T.C. 236 (1986); Church v. Commissioner, 80 T.C. 1104 (1983); Whitehead v. Commissioner, 41 T.C.M. (CCH) 365 (1980).

this end, a variety of factors may be considered, such as the plaintiff's pleadings,[24] evidence presented at trial,[25] and the intent of the payor.[26] The government itself has approved and practices this "best evidence" approach.[27] Despite general agreement on how to tackle the problem, the procedure is not clear cut and, unfortunately, obtaining consistent results is not assured.

It is also necessary for tax purposes to distinguish compensatory from punitive damages awarded the recipient. The landmark case of *Commissioner v. Glenshaw Glass Co.*[28] clearly established the principle that punitive damages are includable in gross income.[29] There was no reason to believe the *Glenshaw Glass* holding inapplicable to punitive damages associated with personal injury awards. Nevertheless, Rev. Rul. 75-45,[30] a post-*Glenshaw Glass* ruling, brought punitive damages arising from personal injury actions safely back to the tax-excludable port of section 104(a)(2).[31] Subsequently, but not surprisingly, the government awoke at the helm. Finding itself in a tax-free harbor, it quickly withdrew punitive damages from the pier and placed them back in gross income waters.[32] This is the current tax status of punitive damages associated with personal injury awards, and one which is unlikely to change.

Although all personal injury compensatory damages are unquestionably section 104(a)(2) items, this was not always the case. Originally, there was room to argue that some portion of the award was includable in income. An early income tax ruling, interpreting the precursor to section 104(a)(2),[33] succinctly stated, "[m]oney recovered as damages in libel proceedings is subject to income

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24. *See* Villaume v. United States, 616 F. Supp. 185, 187 (D. Minn. 1985); Church v. Commissoner, 80 T.C. 1104, 1107 (1983).

25. *See* Church v. Commissioner, 80 T.C. 1104, 1107-08 (1983).

26. Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965); Agar v. Commissioner, 290 F.2d 283, 284 (2d Cir. 1961); Fono v. Commissioner, 79 T.C. 680, 694 (1982); Whitehead v. Commissioner, 41 T.C.M. (CCH) 365, 368 (1980). These cases attribute importance not only to the payor's intent, but also to the nature of the release or settlement agreement itself. *See, e.g.*, *Fono*, 79 T.C. at 692-700. *But see* Bent v. Commissioner, 87 T.C. 236 (1986) (basis of settlement agreement determinative regardless of payor's intent).

27. *See* Rev. Rul. 85-98, 1985-2 C.B. 51 (taxpayer's complaint as best evidence available to allocate taxable punitive from non-taxable compensatory damages received in settlement); Rev. Rul. 75-230, 1975-1 C.B. 93 (amount of previously paid medical expenses as best evidence for allocating settlement into taxable and non-taxable portions); Rev. Rul. 58-418, 1958-2 C.B. 18 (taxpayer's complaint as best evidence to allocate taxable and non-taxable portions of award).

28. 348 U.S. 426, *reh'g denied*, 349 U.S. 925 (1955).

29. *Id.* at 433 ("We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts constitutionally taxable were we to say that [punitive damages] are not gross income.").

30. Rev. Rul. 75-45, 1975-1 C.B. 47.

31. *Id.* ("[A]ny damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income.").

32. Rev. Rul. 84-108, 1984-2 C.B. 32, *revoking* Rev. Rul. 75-45, 1975-1 C.B. 47.

33. Revenue Act of 1918, Pub. L. No. 65-254, tit. II, ch. 18 § 213(b)(6), 40 Stat. 1057, 1065-66 ("[T]he term "gross income" . . . (b) [d]oes not include the following items, which shall be exempt from taxation under this title . . . (6) . . . the amount of any damages received whether by suit or agreement on account of [personal] injuries or sickness.").

tax."[34] Shortly thereafter, in another ruling,[35] the Solicitor of Internal Revenue concluded that damages awarded for alienation of affections do not constitute personal injuries entitled to exemption from taxation.[36] The opinion conceded that although alienation of affection is a personal injury,[37] it was not the type of personal injury contemplated by the statute. The Solicitor noted the exemption was intended for "physical injuries only."[38] In supporting this position, the Solicitor referred to legislative history, provided through Supreme Court interpretations[39] and two administrative determinations.[40] These decisions supported the conclusion the exemption applied only to personal injuries "resulting in the destruction or diminution in the value of a capital asset . . . ."[41] The opinion suggested that a receipt which constitutes a restoration of capital is not income, but a spouse's affections are not capital for tax purposes. Thus, the exclusion was inapplicable.

The picture changed quickly, however. On the heels of *Eisner v. Macomber*,[42] and reconsideration of *Stratton's Independence v. Howbert*,[43] the government shifted gears. Solicitor's Opinion 132[44] concluded that *Macomber* precluded personal injury awards for alienation of affections and libel from being considered gross income since neither gave rise to "gain."[45] Whether or not the opinion was a correct interpretation of *Macomber*, the position became entrenched in tax thinking[46] and remains the operative rule to date.[47] Moreover, exclusion for

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34. Solicitor's Memo 957, 1 C.B. 65 (1919).
35. Solicitor's Memo 1384, 2 C.B. 71 (1920).
36. *Id.* at 72.
37. *Id.* at 71.
38. *Id.*
39. The opinion relies on Doyle v. Mitchell Bros., 247 U.S. 179 (1918) (funds obtained by conversion of capital assets not taxable income).
40. 31 Op. Att'y Gen. 304 (1918) (human ability being a capital asset, proceeds of personal accident policy take the place of lost capital and are not income); T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) (amount received from judgment or settlement of personal injury lawsuit not income).
41. Solicitor's Memo 1384, 2 C.B. 71, 72 (1920). "Capital asset" is used here in an economic sense and not as defined in § 1221.
42. 252 U.S. 189 (1920).
43. 231 U.S. 399 (1913).
44. Solicitor's Opinion 132, I-1 C.B. 92 (1922), *superseded by* Rev. Rul. 74-77, 1974-1 C.B. 33.
45. *Id.* at 93.

> [T]here 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 relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it cannot be held that he thereby derives any *gain* or profit.

*Id.* (emphasis supplied).

46. *See, e.g.*, Huddell v. Levin, 395 F. Supp. 64, 87 & n.27 (D.N.J. 1975) (citing 31 Op. Att'y Gen. 304, 308 (1918)), *vacated on other grounds*, 537 F.2d 726 (3d Cir. 1976). Because *Glenshaw Glass* provides a broader definition of gross income, reliance on *Macomber* to support the exclusion

awards arising from loss of personal rights has been expanded to include payments for economic losses as well, provided such losses flow from the personal injury.[48] This treatment of economic loss seems incongruent given the historical rationale for applying the section.

### B. *A Non-Mechanical Review*

There are a variety of reasons for excluding from income economic loss recoveries incident to personal injuries. These can be grouped into three main headings: avoiding administrative inconvenience, non-tax considerations, and tax fairness. Supporters of the first category posit that ascertaining pure "lost profit" or economic loss elements of the award is too difficult if not impossible to determine. Juries are not usually required to declare how much is being awarded for each count in the pleadings.[49] Additionally, settlement agreements may represent waivers of all claims against the payor without specifying what is actually being compensated, or in what amount.[50] Finally, an injury such as defamation may, by its inherent nature, give rise to damages which are difficult to attribute to economic loss resulting from impaired reputation rather than the purely personal harm aspect of the tort.[51]

Non-tax consideration arguments which motivate the exclusion stem from emotional concerns questioning the propriety of taxing "pain and suffering."[52] It has been suggested that media headlines trumpeting the government's share of some unfortunate tort victim's recovery are not the kind of publicity the

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of personal injury damages is misplaced. *See* Roemer v. Commissioner, 716 F. Supp. 121, 126-27 (E.D. Pa. 1983).

For brief historical sketches of subsequent judicial developments, see Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 703-06 (1977); Note, Roemer v. Commissioner: *The Excludability of Nonphysical Tort Damages from Gross Income Under Internal Revenue Code Section 104(a)(2)*, 1985 UTAH L. REV. 477, 477-82.

47. Section 104(a)(2) not only affirms Solicitor's Opinion 132 but, as interpreted by Treasury Regulation § 1.104-1(c), also expands it. Whereas the Solicitor in 1922 viewed *Macomber* as precluding taxation of recoveries for injuries to personal rights, the current view also excludes economic losses — items clearly not contemplated by *Macomber*. *See* Rev. Rul. 61-1, 1961-1 C.B. 14, *amplified by* Rev. Rul. 85-97, 1985-2 C.B. 50.

48. *Id.*

49. General verdicts by their nature do not require an itemization of amounts awarded for any specific count in the pleadings. *See* FED. R. CIV. P. 49(b) (General Verdict Accompanied by Answer to Interrogatories); *see also* Kalavity v. United States, 584 F.2d 809, 811 (6th Cir. 1978) (rejecting argument that any award over and above actual loss is "punitive," on grounds that traditional tort law mixes theories of compensation and deterrence together when awarding ordinary damages).

50. As with general verdicts, non-itemized settlements can be drafted. For a discussion of the specific problems this creates in allocating damages and how to solve it, see *infra* notes 140-46 and accompanying text.

51. *See* Note, *supra* note 46, at 478 n.7 (citing L. ELDRIDGE, THE LAW OF DEFAMATION § 2 (1978)).

52. *See* Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614, 626 (1952); Yorio, *supra* note 46, at 706-07; Note, *Taxation of Damage Recoveries from Litigation*, 40 CORNELL L.Q. 345, 346 (1955), *cited with approval in* Roemer v. Commissioner, 716 F.2d 693, 696 (9th Cir. 1983).

Treasury Department wants or needs.[53] Also, there are various concerns over the impact taxing such receipts would have on the size of jury awards. Insurers and other indemnifiers may fear that eliminating section 104(a)(2) will lead to higher awards and, in turn, greater exposure.[54]

The third group has two lines of thought that challenge the tax fairness of including personal injury awards in gross income. The first concern focuses on whether a taxpayer should include, what may be considered, "unwanted" receipts in income. Unlike the case with most other receipts which are includable in income, the activity giving rise to a personal tort recovery is not one voluntarily entered into by the victim.[55] The other tax fairness argument speaks to the periodicity issue. Tort awards, especially jury verdicts, telescope into one payment and consequently one tax year the payment representing economic losses which would otherwise have been received and reported over a number of tax years.[56] This distortion of income violates the general tenet that tax items be reported in the tax periods to which they are properly allocable.[57] While well established exceptions to this rule exist,[58] few approach the degree of unfairness that taxing a lump sum award in one year would create.

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53. Frolik, *The Convergence of I.R.C. § 104(a)(2),* Norfolk and Western Railway Co. v. Liepelt *and Structured Tort Settlements: Tax Policy "Derailed,"* 51 FORDHAM L. REV. 565, 591 (1983).

54. The Supreme Court addressed the issue permitting juries to consider the federal tax factor in Norfolk & W. Ry. v. Liepelt, 444 U.S. 490 (1980). For detailed discussion of this holding and its possible impact, see Frolik, *supra* note 53; Note, *Jury Review of Tax Consequences of FELA Damage Awards Now Considered Appropriate,* 26 LOY. L. REV. 409 (1980); Comment, *Damages — A Jury Should Receive Evidence and Instructions Concerning the Impact of Federal Income Taxation on an Award of Damages* — Norfolk & Western Railway Co. v. Liepelt, 444 U.S. 490 (1980), 21 SANTA CLARA L. REV. 873 (1981).

55. Although bringing a tort lawsuit is a voluntary act, the essence of the suit is to make whole an involuntarily-harmed victim. Additionally, settlement offers may be made without any action on the part of the victim. Accepting a settlement award is not a "voluntary act" in the true sense of the term because settlement only places the victim in the same position he had prior to the payor's tortious conduct.

56. This "income bunching" problem is "double-barreled." The recovery may include an amount for lost compensation prior to the receipt of the award, as well as for prospective economic losses. Thus, the taxpayer would have to account for what would have been income includable in prior years, in the year of receipt, as well as the prepayment which would have been reportable over future tax periods. The deferral of past economic loss in tandem with the acceleration of future economic loss into one tax period does indeed present a fulsome possibility.

57. I.R.C. § 451(a) (West 1985) ("The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period."). *See generally* Int. Rev. Code of 1986 § 451(a) (1986) (adopting I.R.C. § 451(a) without change).

58. Most of the exceptions are taxpayer-oriented and designed to provide tax relief. *See* I.R.C. §§ 451(b)-(d), 455, 456 (1985); *see also* Treas. Reg. § 1.461-1(a)(2) (West 1985) (accrual method of accounting); Rev. Proc. 71-21, 1971-2 C.B. 549 (permissible procedures for accrual method taxpayers), *superseding* Rev. Proc. 70-21, 1970-2 C.B. 501. Generally, tax accounting is done in the period of receipt. Thus, the cash basis taxpayer reports income unearned yet received in the taxable year prior to the required rendition of services. Similarly, the income may be earned (services rendered) in a year prior to the one in which it is received. In both instances, distortion of income

Although the economic loss element of personal injury recoveries is excludable from income,[59] there is no official reason why this is allowed.[60] The above noted justifications are theories which have been hypothesized as afterthoughts to this favorable tax *fait accompli.* But trying to understand or find a suitable rationale for the tax treatment is not equivalent to accepting it. Many have criticized the tax protection given economic loss under section 104(a)(2).[61] It is easy to see why. Each of the suggested reasons for permitting exclusion can be neutralized with a minimum of effort.

Perhaps the easiest rationale to overcome is administrative inconvenience. There are numerous instances where taxpayers and the government make difficult allocations for tax purposes.[62] The addition of one more would not cause the system to collapse. Moreover, this allocation problem already exists. First, determining how much, if any, of a settlement is a section 104(a)(2) item (the threshold question discussed earlier)[63] may require a similar type of analysis. Second, when punitive damages are present, it is necessary to allocate expenses attributable to the includable punitive damages portion of the award so corresponding deductions may be taken.[64] As previously discussed,[65] the government has found a way to hurdle these obstacles with a "facts and circumstances" approach. It is problematic whether overcoming the economic loss allocation problem would be any more burdensome, or any less amenable to resolution under a similar approach.

The emotion-based rationale for the existence of section 104(a)(2) is equally susceptible to attack. First, and foremost, there are other receipts which are similarly hardship-oriented but nonetheless taxed.[66] Second, the government's concern about unwanted publicity probably has no place in sound tax policy.

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is possible. Similar results can occur with an accrual taxpayer. *See generally* B. BITTKER, FUNDAMENTALS OF FEDERAL INCOME TAXATION ¶¶ 35.2(1)-(2), .3(4) (1983). Neither situation, however, is likely to generate the degree of distortion which would occur with the reporting of a tort award.

59. *See* Yorio, *supra* note 46, at 706 n.40 (citing two commentators espousing this view).

60. *See id.* at 707 (questioning application of § 104(a)(2) specifically to economic loss). The *Roemer* court suggested that the exclusion was compassion motivated, but its only authority for this proposition is Note, *supra* note 52.

61. *See, e.g.*, Yorio, *supra* note 46, at 706-08. Several courts have explained away § 104's analytical deficiencies on evidence of jury confusion grounds. *See, e.g.*, Combs v. Chicago, S.P.M.&O. Ry., 135 F. Supp. 750, 757 (N.D. Iowa 1955); Pfister v. City of Cleveland, 113 N.E.2d 366, 368 (Ohio Ct. App. 1953).

62. *See* Yorio, *supra* note 46, at 708 & n.51 ("Yet taxpayers and courts frequently confront the problem in allocating damages for a business injury."). One need go no further than Treasury Regulations which address the deductibility of traveling expenses having both business and personal characteristics to see the persuasiveness of this argument. Treas. Reg. § 1.162-2(b)(1)-(2) (1960).

63. *See supra* notes 22-27 and accompanying text.

64. *See* Rev. Rul. 85-98, 1985-2 C.B. 51; *infra* notes 93-97 and accompanying text. The limitations placed upon these deductions by the new Code are reviewed *infra* note 89.

65. *See supra* note 23.

66. *See, e.g.*, Int. Rev. Code of 1986 § 71 (taxation of alimony payments); *id.* § 85 (unemployment compensation included in gross income); *see also* Social Security Amendments of 1983, Pub. L. No. 98-21, § 122(b), 97 Stat. 65, 87 (1983) (repealing I.R.C. § 105(d) which excluded sick pay benefits from gross income).

It is highly unlikely the source of disenchantment with the government's revenue raising activities can be traced to section 104(a)(2). Moreover, the enforcement procedures of the revenue laws are a greater source of controversy than the specific laws themselves. In any event, emotionalism seems a weak argument for section 104(a)(2),[67] and surely loses force when economic loss absent pain and suffering is the sole item of tax concern.

Undoubtedly, the most compelling arguments supporting section 104(a)(2) come under the rubric of tax fairness. It is hard to justify taxing unwanted receipts, especially since similarly received items are excludable from income.[68] This argument, however, has a sophistic ring. While it is true the tort victim may not have willingly entered into the situation which gave rise to the recovery, it is also true he can to some degree control or at least limit the amount received. No rule forces the tort plaintiff to seek damages for economic loss, although it is probably unrealistic to believe he would not.[69] To the extent recovery of economic loss is necessary to make the victim whole, he should be made whole. Any other view is just outright unfair. There is, however, no sound tax reason for putting him in a better position than if he had "earned" rather than "recovered" the economic loss element of the award. Such a view has emerged with respect to unemployment compensation benefits,[70] which can be likened to the economic loss element of a tort recovery.[71] Similarly, employer-paid amounts for sickness or illness are includable in income,[72] with an exclusion carved out only for amounts not associated with the economic loss incurred by the employee.[73] It seems inappropriate to make the source of payment, *i.e.*, employer versus unrelated third party, a pivotal factor in determining taxability.

67. One commentator suggests that even if "emotionalism" is a valid justification for § 104(a)(2), it ought not protect all personal injuries since some suits (for example, fraud and deceit actions) probably do not involve personal anguish. Yorio, *supra* note 46, at 707. The same author questions whether the exclusion "goes far enough" if in fact sympathy motivates its existence. Specifically, the author questions whether injury to one's business reputation is less traumatic than injury to one's personal reputation. *Id.*

68. *See, e.g.*, I.R.C. § 102 (1982) (excluding from income gifts and inheritances); Int. Rev. Code of 1986 § 74(b)(1) (excluding from income only prizes or awards which the recipient did not actively pursue).

69. Because personal injury damages are designed to make the victim whole, and a major element of the loss may well be economic loss, such loss will invariably be recovered. *See* Slagle, *The Role of Profits in Personal Injury Actions*, 19 OHIO ST. L.J. 179, 180-81 (1958).

70. Int. Rev. Code of 1986 § 85 includes these receipts in income in their entirety.

71. To the extent economic loss damages represent lost wages, the damages resemble unemployment compensation. The latter also replaces "lost" pay. Economic loss damages probably are more closely akin to workmen's compensation payments. Both can represent recoveries of wages lost because of injury. Workmen's compensation payments, however, are excludable from income. I.R.C. § 104(a)(1) (1982). Although a recent attempt to include these payments in income failed, the exclusion may well be on the endangered species list. *See* 2 TREAS. II, *supra* note 1, at 51-57.

72. *See* Estate of Kaufman v. Commissioner, 35 T.C. 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962).

73. I.R.C. § 105(c) (1982) (compensating amounts for permanent loss or disfigurement which are computed with reference to the nature of the injury and without regard to the period the employee is absent from work are not included in gross income).

Clearly, upon close scrutiny, this aspect of the fairness issue loses much of its force.

The periodicity argument is the most difficult to refute, but it too can be overcome. There is no denying that a lump sum award telescopes perhaps years of income into one taxable period. Moreover, some relief previously available through income averaging can no longer be had.[74] Although the periodicity problem is not unique to personal injury awards,[75] and can to a large degree be avoided through structured settlements,[76] it nonetheless raises a legitimate concern.

Despite some unwanted tax exposure, taxpayers have survived the periodicity aberration for other transactions. Consequently, to merit tax exclusion on this count requires that the personal injury award be so different from other taxable events as to require completely different treatment. Such an argument will probably not be overly convincing. The periodicity rationale may be the hardest argument to defeat, but it is not totally free from challenge. This is now especially true since the spread between the highest and lowest marginal tax rates has been greatly reduced, and the number of rates pared down to only two. Thus, it might make little tax difference whether the recovery was received all in one year or over a number of years. At worst, the taxpayer will suffer the loss of some or all of the use of the lower rate.[77] Furthermore, to the extent even this concern can legislatively be qualmed, the periodicity issue should not be viewed as an insurmountable barrier to taxing personal injury related economic loss.

74. I.R.C. § 1303 (West 1985) (permitting certain taxpayers to reduce tax liability by computing the current year's liability with reference to prior years' incomes), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141(a), 100 Stat. 2085.

75. Numerous instances exist where taxpayers have a disproportionately higher gross income in one year than in others. Some examples include large bonuses, recognition of gain accrued over a number of tax periods, and windfalls in general.

76. Structured settlements can reduce tax liability by excluding the "interest" element of an award from income when personal injury awards are involved. *See* sources cited *supra* note 16. Structured settlements can also be beneficial when taxable receipts are at issue. By spreading the payments out over a number of years, each receipt can be offset by that year's standard deduction and personal exemption(s). *See* Int. Rev. Code of 1986 §§ 63(c), 151-153. Additionally, by spreading income over a number of years, the marginal, and thus, effective tax rate will be lowered, thereby reducing the tax liability. Even though only two actual and three effective rates now exist, the benefit is nonetheless available. *See infra* note 77.

77. Although the new Code establishes only two tax rates, 28% and 15%, the new Code deprives taxpayers with incomes over statutorily imposed limits of the use of the otherwise applicable 15% rate and personal exemptions. Int. Rev. Code of 1986 § 1(a)-(e), (g). The effective result is an increase in the true marginal rate of up to 33%. The true marginal rate could, of course, be anywhere between 28% and 33%, depending upon the taxpayer's income and the amount of benefits lost. In any event, telescoping a taxable receipt into one tax year could trigger the operation of § 1(g) and create a greater tax liability than would have arisen had the recovery been over a number of tax periods. Thus, "income bunching" still carries with it potentially adverse tax exposure.

## III. A Proposed "Settlement"

### A. *Statutory Revision*

Once it is accepted that the economic loss element of personal injury damages ought to be included in gross income, the chief concern becomes constructing a statutory scheme which best implements that goal. In doing so, the arguments raised against taxing these receipts cannot be blindly cast aside. To the extent possible, those concerns should be integrated into the legislative process to fairly balance the competing interests. Of course, not all of the objections can be given full, if any, weight. To do so would result in maintaining the status quo, *viz.*, total exclusion of the economic loss element of personal injury recoveries. The periodicity and fairness issues are, however, sufficiently compelling to warrant specific statutory treatment tailored to meet the objections they raise.

In all, three alternative statutory revisions are proposed. They are presented and discussed below. Some salient features are common to each of the proposals and need be analyzed only once. The differences receive more detailed attention. The first proposal provides a set percentage exclusion from gross income for personal injury economic loss. The second treats the economic loss as a long-term capital asset. The third segregates the economic loss from other gross income items and taxes it separately, albeit at a modified rate. Only changes to the current version of section 104(a)(2) are provided.

### B. *The Exclusion Model*

#### 1. The Statute

PROPOSED SECTION 104 COMPENSATION FOR INJURIES OR SICKNESS

(a) Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year, gross income does not include —

(2) The amount of A) any non-economic damages and B) one-half of economic loss damages (net of any expenses properly allocable thereto), received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

(c) For the purposes of this section

(1) non-economic damages means payments for A) medical expenses or treatments, or B) the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement of the taxpayer, or C) pain and suffering; and

(d) '(c)' is relettered '(d).'

### 2. "Non-Economic" Damages

Damages awarded for most personal injuries can be grouped into three categories:[78] (1) medical expenses; (2) pain and suffering; and 3) economic loss. The last category can be further divided into two subgroups: the value of time lost because of injury prior to resolution of the action and the value of the decrease in future earning capacity.[79] The value of time lost can usually be equated to a "lost pay" or "past profits" element; that is, the amount of earnings or profits not received because injury prevented the victim from pursuing gainful employment or other profit-making activities. Undoubtedly, a statute could include the entire amount of a personal injury award (all three categories) in income.[80] The proposed statute, however, seeks to tax only category 3-type damages — economic losses. The exclusion for category 1- and 2-type damages has been retained, even though they can still precipitate other taxing issues. These issues, as well as the rationale for continued exclusion, merit mention.

Medical expenses raise a number of vexing tax problems. Sometimes these costs are paid by the victim who, in turn, is reimbursed by the tortfeasor. Other times the tortfeasor pays the providers of medical goods and services directly, on behalf of the victim. In the former instance, there is always the possibility that "recovery of tax benefit"[81] type income has been received. The predicate to both the current and proposed versions of section 104(a)(2) permit special tax treatment only to the extent receipts do not constitute a reimbursement for amounts which the taxpayer previously deducted as medical expenses.[82] This is necessary to prevent a double benefit, *viz.*, both an exclusion and a deduction from income for the same item. The introductory language effectively locks the taxpayer into obtaining only one benefit and forces a tax cost by

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78. *See* Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 215-16 (1958) (four categories).

79. *Id.* at 216.

80. *See* sources cited *supra* note 46.

81. If a deduction reduced tax liability, its subsequent recovery constitutes gross income. *See* Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 298 (1946); Estate of Black v. Commissioner, 39 B.T.A. 1231 (1939) (disposed of on stipulation as to deficiency due), *aff'd sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60, 61 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940); *see also* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129 (1943); I.R.C. § 1119(a) (1986) ("Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."). *See generally*, Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. REV. 265 (1978); Note, *The Tax Benefit Rule, Claim of Right Restorations, and Annual Accounting: A Cure of the Inconsistences*, 21 VAND. L. REV. 995 (1968).

82. *See* Int. Rev. Code of 1986 § 213(a) ("There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse or a dependent . . . to the extent that such expenses exceed 7.5 percent of adjusted gross income.").

denying the other. Thus, if the taxpayer pays medical costs and deducts them, any part of the personal injury settlement or award which is a reimbursement of already deducted costs is income. This result is fair and consistent with section 213 which permits deductions only for medical expenses "not compensated for by insurance or otherwise . . . ."[83] If payment of costs and receipt of award occur in the same year, there is a "tax wash," i.e., no deduction for the expenses nor income for the receipt.[84]

The easy application of this rule can be complicated by an allocation problem. How much of the recovery is for medical costs reimbursement and how much for tax-excludable items? Given that medical expenses can in most instances be reasonably estimated, even if they have not already been actually incurred, the problem is not of great moment. Of course, the entire problem is obviated when the tortfeasor makes medical payments directly to health service providers. It might not be possible, however, to defer these payments until a settlement is reached or an award made. Notwithstanding the potential allocation problem, it is notable that the proposed statute would not confer preferential tax treatment upon this type of receipt. The access to special tax treatment would be available only to the "non-economic" and half of the "economic loss" receipts. Technically, such amounts could never be taken as medical expense deductions anyway, but the proposed language leaves nothing to doubt.[85] To the extent the proposal does not alter current law, further discussion is not warranted.

The proposal recommends that the exclusion for "pain and suffering" and recovery for physical personal injury continue.[86] This position gives proponents of emotionalism their due. Clearly, if any part of an award represents "unwanted" income that ought to be free of governmental sharing, it is the pain and suffering and physical injury elements. Some argue that this part of the award cannot be taxed. In *Starrels v. Commissioner*[87] the court held that pain and suffering constituted a restoration of basis. As such there was no gain capable of being included in income.[88] Whether this analysis could withstand a direct application of *Glenshaw Glass* need not be debated.[89] The proposed statute conforms with the current view that such receipts should not be taxed, and to the extent the decision fosters tax fairness, all the better. Unfortunately, a thorny allocation problem surfaces when one tries to separate the pain and suffering element from the balance of the award. Although more difficult to resolve than

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83. *Id.*

84. *See* Murray v. United States, 48 A.F.T.R.2d (P-H) ¶ 81-5129 (S.D.N.Y. 1981).

85. Section 213 applies solely to the payment of medical expenses. The statute does not authorize a deduction for payments for non-medical expenses. Int. Rev. Code of 1986 § 213 (1986).

86. Recoveries for all damages, other than those payments made as reimbursement for medical expenses, fall within the purview of § 104. *See* Treas. Reg. § 1.104-1(c) (West 1986). No rule exists barring the exclusion for payments made to compensate for pain and suffering.

87. 304 F.2d 574 (9th Cir. 1962), *aff'g* 35 T.C. 646 (1961).

88. *Id.* at 576-77.

89. Absent statutory exception, pain and suffering arguably would not qualify for special tax treatment. *See supra* note 46.

its medical expense counterpart, this problem does not raise an insurmountable obstacle.

The heart of the proposed legislation is to tax the economic loss element of personal injury awards. Instead of providing a precise definition of what is to be taxed, the proposal identifies more specifically that portion of the award which would not be taxed. This is consistent with its objective since section 104 is primarily an exclusion section, and consequently should define what is "excludable." The proposal specifically identifies "non-economic" receipts for that purpose. Additionally, by providing a definition of what is excludable, arguably all else is subject to tax. In this way, the section should not easily be emasculated. Courts tend to strictly construe statutory language which is intended to limit access to preferential tax treatment, especially when the appropriate legislative history is present.[90]

What then are economic losses to be included in gross income? They are the receipts for lost profits or past earnings and for the diminution of potential future profits or earnings. The next logical question is, "How are they measured?" The tax response is that the question is improper. For tax purposes the damages need not be measured, but merely allocated. The tax treatment for these damages presupposes an award or settlement has already been made, otherwise there would be nothing to include in or exclude from income. Although computing the value of any of the elements of pure economic loss is difficult, sophisticated theories designed for this purpose have been advanced.[91] But such theories may not be needed for proper tax administration. All that is required is a relatively fair and simple way to allocate those parts of the damage awards to the various items which they compensate. The "facts and circumstances" approach presently used for resolving other section 104(a)(2) allocation problems[92] seems equally applicable to the instant problem. It is suggested, however, that a procedure more closely akin to that employed in Rev. Rul. 85-98[93] be adopted.

In Rev. Rul. 85-98, the government addressed the issue of deducting attorneys' fees paid in connection with the receipt of an award containing both taxable punitive damages and non-taxable (section 104(a) type) damages.[94] Rather than try to determine the merit of each claim and allocate the award accordingly,

90. *See, e.g.*, First Nat'l Bank & Trust Co. v. United States, 115 F.2d 194, 195 (5th Cir. 1940) (deductions are matter of legislative grace and permissible only to extent statute allows); *see also* Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) ("The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in light of the same policy.").

91. *See* Bell, Bodenhorn & Taub, *Taxes and Compensation for Lost Earnings*, 12 J. LEGAL STUD. 181 (1983); Bruce, *An Efficient Technique for Determining the Compensation of Lost Earnings*, 13 J. LEGAL STUD. 375 (1984); Burke & Rosen, *Taxes and Compensation for Lost Earnings: A Comment*, 12 J. LEGAL STUD. 375 (1984).

92. *See supra* notes 19-27 and accompanying text.

93. Rev. Rul. 85-98, 1985-2 C.B. 51, *superseding* Rev. Rul. 58-418, 1958-2 C.B. 18.

94. *Id.* at 51-52.

the government looked to the pleadings of the underlying action for guidance.[95] The award was then allocated pursuant to the ratio of each prayer for damages as it related to the entire amount requested.[96] Although not necessarily accurate as to what was actually paid for each pleaded item, it was at least consistent with what the victim felt his undivided damages should be.

Undeniably, the procedure is rife with objectionable features and can be easily abused.[97] Nonetheless the overall administrative ease in applying it seems to justify its use. In order to achieve fair results, the "pleadings percentage" procedure would have to be modified to take into account medical expenses actually incurred or reasonably calculable. These items would be deducted from the recovery before allocating the balance of the recovery to economic and other non-economic elements. This is consistent with the current practice set out in Rev. Rul. 75-230.[98] Of course, in any settlement made prior to the bringing of suit, no pleadings exist to guide the allocation. Such instances will force recourse to "facts and circumstances." Given that the taxpayer will make the initial determination as to the appropriate allocation when the tax return is filed, it would seem that the statute would require little more than reasonable support for the tax position taken. The burden will be on the taxpayer to make a good faith allocation effort. Failure to do so would leave the door open for audit level redetermination by the government. Then, if the taxpayer decides to move forward for a judicial determination, he will carry with him the burden of overcoming the presumption of correctness accorded the Commissioner.[99] Although perhaps insufficient in itself to dissuade the taxpayer from initially taking an unsupportable position, it may be amply chilling to prompt reasonable agreements as to damage allocations at the administrative level.

Closely related to the problem of computing "economic loss" for purposes of the proposed statute is determining the correlative expenses. The parenthetical language of proposed section 104(a)(2)(B) permits the taxpayer to offset those expenses incurred in connection with recovering the economic loss against what is ultimately the includable portion. Although section 212 is equipped to do the job,[100] because of the recently imposed two percent (2%) floor on miscel-

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95. *Id.* at 52.

96. *Id.*

97. The biggest fear lies in the ability to amend pleadings. Exercising this right could distort the true nature of the judgment or settlement. *See infra* text accompanying notes 137-53. Pleadings may also have disproportionately large prayers for items which would remain excludable from gross income. Such practices would prevent the pleadings from providing any meaningful allocation of damages, and force one to look elsewhere for resolution of the issue. It is questionable whether such activities can be curbed. For a general discussion of restraints on frivolous pleadings, see Parness, *Groundless Pleadings and Certifying Attorneys in the Federal Courts*, 1985 UTAH L. REV., 325, 333-52.

98. *See supra* note 11.

99. *See* Helvering v. Taylor, 293 U.S. 507, 513-16 (1935); T.C. RULE 142.

100. I.R.C. § 212(1) (1982) (allowing miscellaneous deductions for all ordinary and necessary expenses paid or incurred for production or collection of income). Section 265, however, denies deductibility for expenses incurred relating to tax-exempt income. I.R.C. § 265(a)(1) (1982). Thus,

laneous itemized deductions,[101] the full tax benefit of these expenses cannot be assured. The parenthetical language of proposed subsection "(a)(2)(B)" makes clear that those expenses "properly allocable" to the economic loss element can reduce what would be the includable amount. Perhaps more importantly, the parenthetical language prevents a taxpayer from reaping the benefit of a possible dollar-for-dollar itemized deduction for expenses incurred, while the corresponding receipt giving rise to the deduction will be added to the tax base on only a fifty-cents-on-the-dollar basis. Whereas section 212 could permit that result, proposed subsection "(a)(2)(B)" prevents it. The parenthetical language also implicitly prevents an immediate deduction for all of the expenses even though the inclusion of income could be deferred over a period of time. The "properly allocable" language speaks to both the taxable amount and its timing. In this way potential abuse from "frontloading" expense deductions is eliminated.[102] The tax treatment of these expenses cannot be lightly cast aside as personal injury actions are wont to be cost intensive. Failure to devote proper attention to them could easily undermine the express purpose of the statute.

### 3. Exclusion Treatment

To ameliorate the negative impact attendant taxing economic loss arising from personal injuries, the proposed statute includes only one-half of the otherwise taxable portion of the recovery in income. Preferential treatment for economic loss is justifiable. First, from a fairness perspective, to the extent an item which arguably ought not to be taxed is included in income, consideration should be given to minimizing the resulting tax consequences. Second, given the periodicity problem, i.e., bunching income into one tax year, it is appropriate to try to soften the blow of one-year tax accounting. The proposed treatment addresses both concerns. The fifty percent exclusion creates a tax posture which is neither unfair nor unduly harsh. To the extent tax rates have been "flattened,"[103] periodicity problems become less onerous.[104] The exclusion

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so long as the receipt giving rise to the expense is includable in income (as would be the economic loss damages under the proposal), all ordinary and necessary expenses incurred to obtain the recovery are deductible.

101. Int. Rev. Code of 1986 § 67(a) (permitting miscellaneous itemized deductions only to the extent such deductions exceed 2% of adjusted gross income). Because § 212 items are not excepted, they are considered miscellaneous itemized deductions subject to the limitation. *Id.* § 67(b).

102. If an agreement is reached whereby the recovery is to be paid over a number of tax periods, a taxable portion of the recovery would be reported in each of the periods of receipt. The full tax exposure is thus spread over a number of tax periods. The costs, however, would probably be paid in full in the year of recovery or from the first payment. To permit a deduction expense in the first year for costs properly allocable to other taxable receipts would unnecessarily distort income. The language of the proposal in effect amortizes the costs attributable to the recovery to match an appropriate corresponding expense with each year's taxable amount.

103. TRA '86 § 101 (replacing multiple tax brackets with two-tiered system imposing 15% and 28% tax rates). Although not a true one-rate flat tax, the new two-tiered system creates a

is sufficiently generous to offset much of the residual periodicity objection. In all, the proposal, though perhaps not ideal, is an easy-to-apply, workable model for taxing economic loss.

### C. *The Capital Asset Model*

#### 1. The Statute

The "capital asset" proposal provides a different approach to achieve the same goal of its "exclusion" counterpart. Although proposed subsection "(a)(2)(A)" is substantially identical, subsection "(a)(1)(B)" is eliminated and replaced by a new subsection, subsection (c), which provides the mechanism for incorporating the economic loss recovery into tax base. (Subsections (c) and (d) of the exclusion model proposal are relettered to subsection (d) and (e), respectively.) The proposal is as follows:

PROPOSED SECTION 104 COMPENSATION FOR INJURIES OR SICKNESS

(a) Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year, or as provided in subsection (c), gross income does not include. . . .

(b) The amount of any non-economic damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injury or sickness.

(c) Nothwithstanding any other provision in this part, the amount (net of any expenses properly allocable thereto) of any economic loss damages shall be treated as a gain from the sale of a capital asset held for more than six months.

#### 2. Capital Gains: Gone But Not Forgotten

At first blush the proposal seems to make little sense. Why make a tax item capital gain when such gain no longer receives preferential treatment? Why not just include the item directly in gross income? The answer is that capital transactions still have a role to play, albeit a limited one, in the tax theater. Although favorable treatment accorded net capital gain[105] has been

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sufficiently regressive system deserving of the "flat tax" title. *See generally* Int. Rev. Code of 1986 § 1.

104. In light of the "flattening" of rates, the amount of the award or the length of time over which the receipts are spread may become immaterial. Income could be taxed at the same rate regardless. The amount or timing of the receipt could still make a difference. *See supra* note 77.

105. I.R.C. § 1222 (1982) (defining net capital gain as the excess of net long-term capital gain (§ 1222(7)) for the taxable year over the net short-term capital loss (§1222(6)) for such year).

eliminated,[106] an unfavorable aspect of capital losses remains. Specifically, while capital losses can offset capital gains without limitation, they cannot be used to offset more than $3000 of ordinary income[107] in any year.[108] Any unused capital loss may be carried over into future tax years.[109] By treating the economic loss recovery as long-term capital gain, the capital loss limitation is effectively increased by the amount of any "subsection (c)" additions to the tax base. Essentially, taxpayers could ameliorate some of the adverse effects of taxing the economic loss recovery to the extent deferred capital losses can immediately be used.

Although this model offers some special treatment for the "subsection (c)" amount, concededly it is limited, if not illusory. First, there is no guarantee the taxpayer would have any losses to offset at all, let alone losses in excess of capital gains. Second, even if otherwise immediately unusable losses exist, the proposal serves only to accelerate their tax accounting. Without the proposed change the losses would still be available to provide tax benefits in future years.[110] The proposal is worth consideration not for its immediate effect, but rather for its possible future impact.

Although net capital gain has lost its favorable tax treatment, Congress left the capital gain structure intact. Since the new tax rules treat all income equally,[111] why distinguish ordinary from capital gain income? In part, the answer lies in future plans Congress may have. If tax rates increase, even if done uniformly to maintain the new two-tiered[112] system, Congress may reinstate preferential treatment for net capital gains.[113] If this comes to pass, the capital gain model

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106. TRA '86 § 301(a) (repealing I.R.C. § 1202). By eliminating the 60% net capital gain deduction, Congress ended preferential tax treatment formerly accorded transactions of this kind. Capital assets have retained their character for tax purposes as net long-term capital losses and subject to deduction limitations. Int. Rev. Code of 1986 §§ 1211(b), 1222(8). Additionally, for 1987 (a transition year with respect to implementing the two-rate system) and *any other year* in which the rates provided in § 1(a)-(e) exceed 28%, net capital gain receives special tax treatment. *Id.* § 1(j).

107. *See* I.R.C. § 64 (1982) (defining ordinary income as any gain from the sale or exchange of property which is neither a capital asset nor property described in § 1231(b) (property used in the trade or business)).

108. Int. Rev. Code of 1986 § 1211(b) (losses incurred from sale or exchange of capital assets allowed only to extent of gains from such transactions plus (if losses exceed gains) the lower of $3,000 ($1,500 in cases of married individuals filing separately) or the excess of such losses over such gains).

109. *Id.* § 1212(b)(1).

110. This is the essence of the I.R.C. § 1212(b)(1) carryover rules. Capital losses which exceed capital gains by more than $3,000 cannot be immediately deducted, but must be used as losses in future periods. *Id.*

111. With the repeal of the net capital gain deduction, all income will be treated in a sense as ordinary income and subject to the two-tiered rate structure. *See supra* note 106. The new Code, however, provides a transition rule for 1987, to assure that net capital gains will not be taxed at a rate in excess of 28%, notwithstanding the fact that both a 35% and 38.5% rate is in effect for that year, and a standing rule for any subsequent year in which the highest rate of tax would exceed 28%. Int. Rev. Code of 1986 § 1(j).

112. *See supra* note 103.

113. *See* 2 H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. 106, *reprinted in* 1986 U.S. CODE

becomes an attractive method for taxing the economic loss recovery. Economic loss damages would first be used to generate additional income only after all capital losses[114] had been offset. When a "subsection (c)" amount exceeded such losses, it could then generate a net capital gain deduction.[115] Essentially, this mixing and matching of capital transactions would result in only partial inclusion of the economic loss recovery in adjusted gross income.[116]

Until preferential treatment for net capital gains is restored, the current proposal could be modified so that only forty percent[117] of the economic damages would be long-term capital gain. This would soften the blow of potential full inclusion of the recovery. The percent limitation would in turn be lifted if preferential capital gain treatment returned. The possible return of such treatment makes this proposal preferable to the pure "exclusion" model.

Aside from general concerns raised by the capital asset model, some basic technical criticism also arises. Specifically, the statutory sale or exchange requirement[118] for capital transactions is absent. Even more troubling, however, is that economic loss probably is not a capital asset.[119] The former objection lacks substantial merit. True, a sale or exchange is a statutorily imposed barrier restricting access to capital gain treatment,[120] but because it was legislatively erected it can also be overcome with some legislative assistance. The absence of a *bona fide* sale or exchange has not impeded qualification of other events as capital transactions.[121] There is no reason Congress cannot create similar exceptions for the taxation of economic loss.

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CONG. & ADMIN. NEWS vol. 9B, at II-106 ("The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."). Also, there has already been some movement to restore some preference to net capital gain. A bill for the Tax Reform Act of 1987 (S.670) would ensure that net capital gain would be taxed at a maximum rate of 28%, even though the taxpayer's other income might be subjected to an effective 33% rate because of the phase-out of certain benefits provided by § 1(g).

114. By definition, long-term capital gain can become net capital gain only to the extent it exceeds all net long-term capital gains and all net short-term capital losses. I.R.C. § 1222(11) (1982).

115. This scenario presupposes that reinstatement of preferential capital gains treatment would come in the form of reinstitution of the net capital gain deduction. The preference possibly could be provided through a rate adjustment, i.e., net capital gains not to be taxed at a rate in excess of 28%, as has been used in the current transition period. *See supra* note 111.

116. If the net capital gain deduction is reinstated, presumably it would resume its standing as a § 62 item. *See* TRA '86 § 301(b)(1) (striking out I.R.C. § 62(a)(3)).

117. Before its repeal, the net capital gain deduction was 60% of the otherwise includable amount. I.R.C. § 1202(a) (West 1985). This resulted in an effective inclusion of only 40% of the gain. Because present law does not distinguish ordinary gain from net capital gain, a 40% inclusion would effectively re-establish the 60% net capital gain deduction for economic loss damages.

118. *See* I.R.C. § 1222(1)-(4) (1982) (requiring a "sale or exchange" in order for transaction to be governed by capital gains and losses rules).

119. An economic loss recovery clearly is not "property" as required by § 1221 and, thus, cannot be a "capital asset."

120. *See supra* note 118.

121. *See, e.g.*, I.R.C. § 165(g)(1) (1982) (treating losses from worthless securities as if they arose from a sale or exchange).

The other objection can also be questioned. Essentially, capital gain treatment was to provide a tax benefit to income which does not arise from the taxpayer's ordinary day-to-day activities.[122] This is underscored by the fact that non-capital type income is, by definition, ordinary income.[123] This distinction remains today,[124] despite elimination of preferential treatment. Except for a handful of limited instances,[125] economic loss represents recovery of ordinary income. Thus, to confer capital gain tax status on economic loss seems to run counter to the *raison d'etre* for formerly favorable capital gains treatment itself. Now, however, given the repeal of the net capital gain benefit, from a broader perspective the distinction is not as vital.[126] Thus, to the extent the capital asset model takes some of the edge off of including personal injury economic loss recovery in the tax base, all the better.

Another justification for capital gain treatment, however, is one which invites economic loss to partake in possible future favorable tax treatment, and to a limited extent provides some benefit not accorded ordinary income. Specifically, it has been suggested that preferential treatment for capital gains was required to maintain the integrity of tax year system.[127] Unrealized gain accumulated over a number of years which is "bunched" for tax purposes into one accounting period unfairly distorts gross income. A deduction for net capital gain was thought to ameliorate the harsh effects of the "bunching" problem.[128] Recent rate reductions and installation of a two rate system has sharply curtailed this need.[129] But if rates were to rise, a net capital gain deduction would again

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122. Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955) ("Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss."); *see* 4 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, ¶ 22.02 (1980); Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 1003-04 (1956).

123. I.R.C. § 64 (1982).

124. Although preferential treatment is gone, the capital asset infrastructure survived TRA '86. *See supra* notes 106, 108-09.

125. If economic loss is, by definition, damages for lost past or future profits, a recovery of ordinary income is the rule. *See supra* notes 78-79 and accompanying text. Of course, peculiarities exist — the exceptions that prove the rule. Consider, for example, a cause of action whereby injuries prevent the victim from performing services which would have resulted in additions to basis rather than immediate gain.

126. While it is true capital and non-capital transactions will now be treated substantially equally, differences still exist. *See supra* notes 106, 108-09. Whether the remaining distinctions will have any tax impact will depend upon the individual taxpayer's particular circumstances.

127. *See supra* note 122.

128. *See* STAFF OF THE JOINT ECONOMIC COMM., 88th Cong., 2d Sess., at 80 ("It is also argued that capital gains typically accrue over more than one income-tax accounting period. It is obviously unfair, therefore, to tax gains at progressive rates in the year of realization. To do so might often result in a greater total tax liability than if the gains had been subject to tax each year as they accrued.").

129. *See* THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 166 (May 1985) ("With the reduction in the maximum marginal tax rate . . . a reduction in the exclusion rate applied to net capital gain is appropriate."). The proposal sought only to reduce the net capital gain deduction from 60% to 50%. *Id.* at 168. TRA '86 eliminated the deduction entirely. TRA '86 § 301(a) (repealing I.R.C. § 1202).

be an appropriate response to the bunching problem whether its source is accumulated unrealized gain or the telescoping of economic loss into one year.

Even though economic loss may not be a capital asset and its recovery not a sale or exchange, capital gain treatment would not be inconsistent with traditional tax theory. Given that the economic loss sought to be taxed would probably have been included in income over a number of tax periods, it makes sense to differentiate it from other income not telescoped into one year. Under the new tax rules, the "pure" capital asset model provides little or no benefit to the inclusion of the economic loss recovery. The modified version of treating only a percentage of the recovery as long-term capital gain is perhaps a better approach until such time as a net capital gain preference is reinstated. Moreover, because such treatment provides more tax benefits than a simple exclusion model,[130] it might better balance the scales towards fairness if the recovery is to be taxed.

### D. *The Separate Tax Model*

#### 1. The Statute

Rather than broadening the tax base by including personal injury economic loss in gross income, the taxable portion can be dealt with separately. Such an approach is not unique in tax law[131] and provides certain advantages over the exclusion and capital asset models. In order to insure that the separate tax does not generate a greater tax exposure than would result had the economic loss recovery been treated as ordinary income in the year of receipt, this approach provides an election for choosing the more advantageous tax method.[132] In analyzing the proposal, only the "taxing" provisions, subsections (d), (e) and (f), need be reviewed. The remainder of the proposed section mirrors the other proposals where appropriate.

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130. To the extent treating an economic loss recovery as a capital asset permits a mixing with other capital transactions, otherwise deferrable losses can be immediately utilized. The presence of capital losses will reduce, if not eliminate, the addition of the economic damages from adjusted gross income. *See* Int. Rev. Code of 1986 § 62. This, in turn, will increase the deductibility of expenses (to the extent they exist) which are limited by floors tied into adjusted gross income. *See, e.g.*, *id.* § 67 (permitting miscellaneous itemized deductions to the extent they exceed 2% of adjusted gross income); *id.* § 213 (permitting medical expense deductions to the extent they exceed 7.5% of adjusted gross income).

131. *See* I.R.C. § 402(e)(1) (permitting recipients of lump sum distributions from certain employee benefit plans to elect separate tax treatment).

132. Only rarely will the election to treat the economic loss recovery as ordinary income be made. Except in unusual circumstances, the "averaging" election should subject the recovery to a lower tax rate (and a lower tax liability) than would including the entire amount in income in the year of receipt. But peculiar circumstances do exist, such as where deductions exceed income because of a large deductible loss in any given year, or where the benefit of some credit is available only for the year of receipt. Therefore, the election is provided. But the election itself is not critical to the overall efficacy of the proposal, and could be eliminated without generating severe adverse ramifications.

PROPOSED SECTION 104 COMPENSATION FOR INJURIES OR SICKNESS

(d) The amount (net of any expenses properly allocable thereto) of any economic loss damages received (whether by suit or agreement and whether as lump sum or periodic payments) on account of such personal injury or sickness shall be includable in gross income, or at the election of the taxpayer, be treated separately as provided in subsection (e).

(e)(1) Notwithstanding any other provision in this title, there is hereby imposed a tax (in an amount determined under subparagraph (2)) on the amount described in subparagraph (d) which the taxpayer elects to exclude from income and be taxed pursuant to this subsection.

(2) The amount of tax imposed by subparagraph (1) for any taxable year shall be equal to five times the tax which would be imposed by section one on one-fifth of the amount described in subsection (d) in excess of the standard deduction.

(3) In the case of amounts received in any one year arising from more than one injury or sickness, for the purposes of this subsection, each such receipt shall be treated independently of any other receipt(s).

(f) The election permitted by subsection (d) shall apply to all payments attributable to a particular injury or sickness and shall be irrevocable.

In assessing the merits of the proposed section, it is worth noting that the economic loss recovery would be taxed in its entirety. Thus, this proposal is immediately distinguishable from the other two which would, in the worst case scenario, tax only a portion of statutory economic loss damages. The instant proposal provides possible beneficial treatment only if the taxpayer makes the appropriate election. Absent such election, the economic loss recovery (net of any expenses incurred incident to its receipt) is includable in income like any other section 61 receipt, and thus fully taxable. The essence of the proposal is to isolate the economic loss and minimize tax exposure by providing the recipient access to extra tax benefits.[133] As with the other proposals, the chief objective is to tax the economic loss recovery, but in a manner that ameliorates the harshness of taxing in one year an item which is comprised of amounts properly allocable to more than one tax period.

2. Five Year Averaging Treatment

If the subsection (e)(1) election is made, the proposed statute forces an accounting for that year's receipt of economic loss recovery as if it had been

133. Under the averaging procedure, the recipient in these circumstances is entitled to five additional standard deductions. *See* Int. Rev. Code of 1986 § 63(c). Additionally, to the extent the amount received and exceeding the standard deduction is small enough, the entire taxable portion of the recovery is subjected only to the lower 15% tax rate.

received over a period of years. As noted,[134] this procedure potentially provides exposure at lower tax rates and permits the taxpayer to take advantage of additional standard deductions. The proposal borrows from lump sum distribution rules for retirement plans,[135] and adopts a five (5) year averaging mode. Although not scientifically derived, this multiple attempts to strike a reasonable balance between single year, lump sum taxation and a spreading pattern which would eliminate any tax exposure. The former alternative is, of course, available at the taxpayer's election, but the latter would undermine the purpose of the proposal itself. Too many standard deductions would simply erase any possible tax liability.[136] Such an approach would emasculate the proposal to the point where the status quo is maintained and amendment is unnecessary.

The operative taxing section, (e)(1), is self-executing. The computation paragraph, (e)(2), requires recourse to section 1 which establishes the income tax rates. By using section 1, the proposal permits the taxpayer to maintain his or her filing status for separate tax accounting on the economic loss recovery. Similarly, the taxpayer's standard deduction[137] is preserved. Thus, before any tax is incurred, the taxpayer's economic loss recovery would essentially have to exceed the value of at least five standard deductions. This amounts to a substantial exclusion from income for the economic loss recovery and serves to silence critics who would argue the proposal is too harsh.

After one-fifth of economic loss received in any one year is converted into taxable income, section 1 rates are applied to produce a tax, which is then multiplied by five to arrive at the total separate tax liability. Despite its seemingly complicated structure, the proposal is a relatively simple procedure for taxing the economic loss element of personal injury awards.

The proposal has some built-in safeguards to prevent abuse, and some flexibility for the benefit of taxpayers. With regard to the former, "subsection (f)"

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134. *See supra* note 133.

135. *See supra* note 131; *see also* TRA '86 § 1122(a)(2) (amending I.R.C. § 402(e)(1)(c)) (reducing the averaging mode from ten years to five years).

136. This point is easily illustrated. Take as an example a single taxpayer whose economic loss damages (the proposed I.R.C. § 104(d) amount) are $25,000. If a ten year averaging mode were adopted, the taxpayer would shield the entire recovery from tax. In such a case the "(e)(2)" tax would be computed on the excess of 1/10 of the recovery over the standard deduction. But 1/10 of 25,000, 2,500, is less than the $3,000 standard deduction permitted a single taxpayer. *See infra* note 137. Thus, § 1 rates could not apply to any income amount.

The larger the averaging mode, the greater the number of available standard deductions and the lower the amount actually taxed. Under the proposed plan and standard deduction amounts, a married taxpayer could shield $25,000 of economic loss from tax exposure; a married taxpayer filing separately, $12,500; a head of household, $22,000; and a single taxpayer, $15,000. See *infra* note 137 for rules regarding the phase-in to the scheduled standard deduction amounts.

137. TRA '86 § 102 (repealing I.R.C. § 63(d) (the "zero bracket amount") and reinstituting the use of the standard deduction). Section 63 defines taxable income for non-itemizers as adjusted gross income minus the standard deduction and any available personal exemptions provided in § 151. Int. Rev. Code of 1986 § 63(b). The standard deduction is $5,000 in the case of a joint return; $4,400 in the case of a head of household; $3,000 in the case of an individual who is not married or who is not a surviving spouse or head of household; and $2,500 in the case of married individuals filing separate returns. *Id.* § 63(c)(2).

makes the averaging election irrevocable and applicable to all payments arising from the same source. For example, a taxpayer who structures a recovery settlement to receive "subsection (d)" payments over an eight year period and elects "subsection (e)" separate tax treatment in year one, cannot in any subsequent year decide to include any portion of that year's payment in gross income. Indeed the separate tax must also be imposed on that year's entire receipt. To permit taxpayers to choose which tax year the election will operate would dilute an already mild taxing provision. On the other hand, although the election cannot be made on a year-by-year basis, "subsection (e)(3)" makes clear it can be done on an injury-by-injury basis. Thus a taxpayer receiving "subsection (d)" payments and reporting on the election-basis is not required to elect separate taxation for other "subsection (d)" receipts arising from a different cause of action. Moreover, "subsection (e)(3)" provides that each "subsection (d)" receipt from unrelated causes of action is entitled to its own separate tax computation. In this way access to lower rates and extra standard deductions are guaranteed for each injury.

The separate treatment proposal is not without its faults. Notably, permitting a taxpayer to retain his or her own tax status raises certain equitable considerations. Also, similar criticism awaits permitting the taxpayer to use the standard deduction in computing separate tax. For instance, why should a married tort victim be able to reduce tax exposure on economic loss recovery more than single taxpayers? This concern is broader than its application to the averaging model. The issue of different deductions based on personal status belongs in the debate concerning the overall tax system. To the extent that these benefits currently supplement "regular" tax liability, it seems unfair to "cry foul" when these benefits are used to compute a separate tax. These criticisms properly aside, the five year averaging model emerges as a satisfactory response to the taxation of economic loss recovery problems.

## IV. Effect and Evaluation

Incorporating the economic loss element of personal injury awards into the tax base should produce benefits which outweigh any corresponding negatives. It seems improper to exclude from income an economic benefit which would have been included had it not been received incident to a personal tort action.[138] Current favorable treatment has been attributed primarily to the administrative difficulty in trying to distinguish economic loss from the balance of the tort victim's recovery.[139] True, this is an onerous chore. No doubt, isolating eco-

138. The proposed legislation only seeks to include economic loss recoveries in income. These receipts largely substitute for lost past or future earnings — items which would have been included in income had they been earned in the normal course of events.

139. *See* Roemer v. Commissioner, 716 F.2d 693, 696 (9th Cir. 1983) ("The rationale behind the exclusion of the entire award is apparently a feeling that the injured party, who has suffered enough, should not be further *burdened with the practical difficulty of sorting out taxable and nontaxable components of a lump-sum award.*") (emphasis added).

nomic loss represents the greatest obstacle and major weakness in the suggested proposals. But defining what is to be taxed can be accomplished, although the results are not always as exacting as one would like them to be.

Determining economic loss by pleadings may be somewhat arbitrary, but the tax neutrality of pleadings makes the procedure acceptable. Specifically, plaintiffs are unlikely to reduce damage requests solely because victory would trigger tax exposure. This reality minimizes the likelihood of tax motivated pleadings manipulation. Add the government's seeming willingness to accept such a method, and a viable solution to the thorniest problem is at hand.

Pleadings allocation is not without drawbacks. Since the lion's share of tort cases are settled without trial, pleadings are not always available. This is not to say a settlement means pleadings will never be filed. Numerous cases are settled after suit has been brought. In such situations pleadings could still control allocation. Pleadings should not be discounted merely because a disinterested third party did not act upon them. In fact, it is possible pleadings actually set the framework for the agreement ultimately reached. In those situations pleadings will probably be the best evidence as to actual allocation.

There will, however, be instances where settlement is reached prior to any formal drafting of pleadings. These cases necessitate a different procedure for allocating the various elements of the recovery. Recourse to "facts and circumstances"[140] looms as an alternate solution. The settlement agreement itself probably would not serve as an acceptable substitute for pleadings, and for good reason. Unlike pleadings, which serve to influence and inform judges and juries regarding the victim's appropriate damages, settlement agreements are designed to release rights and preclude further action. The payor is only interested in securing freedom from liability in exchange for monetary payment. It is the payee who would seek an agreement worded in a tax-advantaged manner. Only the payee's tax exposure could fluctuate according to different allocations within the agreement. What difference would it make to the payor if only one dollar of the recovery was attributed to the plaintiff's economic loss, and the remainder to other claims, e.g., pain and suffering or medical reimbursements? The payor's "bottom line" is unaffected by allocations within the agreement.[141] The payee's net receipt, however, will not be calculable until tax effects are taken into account.[142] Thus, the payee may bargain for specific tax saving language to the point of taking a lower pre-tax amount to create a larger after-tax recovery. Moreover, the payor, in an act of self-interest, may be the

140. *See supra* notes 23-27 and accompanying text.

141. The only tax benefit the payor could obtain is a deduction for the amount paid. Absent statutory authority, taxpayers cannot deduct expenses incurred. Torts arising from the tortfeasor's personal activities are clearly not deductible. Those arising in the tortfeasor's trade or business or income producing activity could possibly fall within the ambit of some deduction section.

142. If the economic loss element of the recovery is somehow included in the tax base, the payee's net receipt cannot be determined until after the recovery has been factored in his tax calculus. Each proposal creates potential tax liability, and until the payee "runs through the numbers," the actual in-pocket dollars cannot be determined.

one to suggest the idea to the payee. The tax consequences could become a major bargaining chip. Because of such possibilities a settlement agreement should not bind the government on the economic loss damages determination. Consequently, the government must use other procedures. This is not to say the agreement is totally without effect. The government may conclude the agreement, if it makes an allocation at all,[143] is reasonable, and accept it. The critical point is that such agreements ought not to bind the government because there are no countervailing interests to assure that a fair allocation has been made. This approach is consistent with the treatment given agreements in other tax settings.[144]

Another less likely problem with pleadings allocation is the ability of plaintiffs to amend their pleadings.[145] With a settlement near and a general release *sans* allocation secured, amended pleadings could shift the recovery to non-economic, tax advantaged elements. To permit amended pleadings to govern tax consequences in such instances would undermine the *raison d'etre* for the allocation procedure, *viz.*, obtaining non-tax motivated assessments of the value attributable to injuries sustained. To prevent abuse, amended pleadings would have to be scrutinized for the purposes of determining their "tax legitimacy." The pivotal question would be whether the new pleadings were independent of any anticipated settlement or filed primarily to achieve certain tax results. The former could be given effect, the latter should not. This is little more than an application of a "substance over form" analysis,[146] a test which is commonplace in tax administration.

To the extent the tax proposals require the economic loss portion of a personal injury recovery to be identified, the game rules for tort plaintiffs and their attorneys might be changed. What impact would taxing the economic loss recovery have at trial? Should juries or judges be permitted to consider the tax effect on the award, or the value of the damages? If so, to what extent and at what price? After all, jurors are not tax experts, and could be confused by the tax ramifications. Would litigators be forced to request judges to instruct juries for special verdicts that identify the economic loss element?[147] Would such

143. An agreement need not contain award allocations, or even state the reason for which it is being made. *See, e.g.*, Applegate v. Commissioner, 50 T.C.M. (CCH) 1172 (1985) (release signed by the parties indicated that compensation was for past services and not a personal tort claim).

144. *See, e.g.*, Harolds Club v. Commissioner, 340 F.2d 861 (9th Cir. 1965) (Commissioner not bound by compensation agreement because degree of control one party was presumed to have over the other deprived agreement of "free bargain" requirement of Treas. Reg. § 1.162-7(b)); *see also* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION § 4.02(3)(g) (4th ed. 1978) (discussing ability of taxpayer "buy-sell" agreements to peg closely held stock valuations for estate and gift tax purposes); Rev. Rul. 75-230, 1975-1 C.B. 93 (indicating the government's willingness to accept allocations made by the parties in their agreements if not unreasonable).

145. *See* FED. R. CIV. P. 15(a) (authorizing amendments to pleadings).

146. For a discussion of the "substance over form" doctrine, see 1 B. BITTKER, FUNDAMENTALS OF FEDERAL INCOME TAXATION § 1.3(3) (1983).

147. If the verdict is not itemized, the plaintiff-taxpayer is just delaying the day of reckoning.

verdicts eliminate future tax allocation problems?[148] Is the system ready for this?

The specter of having a portion of recovery taxed raises these questions. Undoubtedly, a departure from current tax treatment will prompt some changes. This is not to be unexpected. But it does not follow that change is for the worse. Take for example non-general or itemized verdicts. In an environment where jury awards are considered excessive, the public might be hospitable to a process which requires juries to specify the harm being compensated. Such verdicts are already available,[149] and sometimes required.[150] Would it matter that the final push in that direction comes indirectly from a tax statute rather than directly from legislation addressing the problem?

Perhaps the better inquiry is whether a change in tax rules would wreak such havoc. Given the limited number of jury verdicts in the overall welter of tort actions, is it appropriate to emphasize the possible impact tax change would have on trial practice? Settlements will no doubt remain the order of the day. A tax change will not alter this fact. To the contrary, more settlements might result.[151] Thus, the crucial concern is whether the tax benefits to the federal fisc will be worth any administrative costs that will be generated. It is suggested they will, principally because it is believed the proposals will not create new administrative burdens but merely shift the focus of existing ones. The prominent issue of section 104 cases will become "how much" is income, rather than "is it income." Concededly, the practical application of this shift is easier noted than accomplished. But it is nonetheless manageable, especially because, in some instances, disinterested third parties will allocate awards prior to the time any tax return need be filed.[152] In sum, this major objection to taxing

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Under the proposals, at some point an allocation of award between the economic and non-economic damages must be made.

148. The question is really whether the jury's itemization binds the government. Common sense dictates it be answered in the affirmative. As disinterested parties, who better than the jury that actually decided the merits of the case to make the allocation? Consider the alternative. The government does not accept the jury's allocation and assesses a deficiency against the taxpayer, the taxpayer in turn contests the government's determination, and the issue is ultimately resolved by another jury. It seems clear the government would not only accept, but probably welcome an itemization of the award.

149. FED. R. CIV. P. 49(b) (permitting request for special verdicts in which verdict may be itemized into the various injuries compensated). *See generally* M. GREENE, BASIC CIVIL PROCEDURE 208-10 (2d ed. 1979).

150. *See, e.g.*, ILL. REV. STAT. ch. 110, ¶ 2-1109 (1986) ("In every case where damages for injury to the person are assessed by the jury the verdict shall be itemized so as to reflect the monetary distribution among economic loss and non-economic loss, if any."). The Illinois courts have been more than willing to enforce the statute. *See* Powers v. Illinois Cent. Gulf R.R., 91 Ill. 2d 375, 438 N.E.2d 152 (1982); Henderson v. Hudson, 121 Ill. App. 3d 780, 460 N.E.2d 10 (Ill. App. Ct. 1984).

151. Conceivably, the tort victim might want the settlement and the chance to structure the payout to minimize tax exposure by allocating receipts to different tax periods. Additionally, to the extent the government is inclined to be bound by it, the agreement can allocate the recovery between taxable economic and non-taxable, non-economic elements.

152. *See supra* notes 148-50.

economic loss awarded in personal injury awards is not the impediment to implementing a fair tax policy.

Beyond administrative problems lies the inherent nature of the proposals themselves. The "exclusion" model is the simplest and easiest to integrate into the tax system. For this reason it merits high marks. The features of the "separate tax" model offer some opportunities which earn it praise. The ability to spread tax inclusion over several periods and profit from annual benefits has special appeal. The "capital asset" model is the least acceptable. There is no reason to add to the capital gains muddle, especially since there are no major counterbalancing tax advantages. Even if the proposal were modified to treat only a percent of economic loss damage as a capital asset, there is insufficient reason to choose this approach over the pure "exclusion" model. If, however, preferential capital gain treatment is reinstated, it is suggested the "capital asset" proposal provides the best method for taxing economic loss damages. This method gains favor over the simple "exclusion" approach because the special tax treatment only becomes available, but is not guaranteed. By forcing economic loss damages to be mixed with capital transactions, it is possible that the "taxable" recovery will serve only to offset capital losses.[153] Any of a number of other scenarios are also possible.[154] Although the existence of these possibilities may cause the proposal to violate a basic tax principle,[155] it seems worth the risk given the nature of the creature sought to be taxed. If tax rates are returned to a more progressive posture and the net capital gains of deduction reinstated, then, for tax purposes, economic loss damages are best treated as long-term capital gains.

## V. Conclusion

Now that Congress has revised the current tax system, how long will it be before it seeks new sources of revenue? Soon Congress may consider taxing personal injury awards. Basic tax and non-tax policy considerations should preserve current exclusions for certain aspects of such receipts. Exclusion for the economic loss element recovered cannot, however, be satisfactorily justified, and

153. *See supra* note 108.

154. The retention of the capital gain structure carries with it different net capital transaction results. If the economic damages represent the only capital transaction, a net capital gain will result. (The long-term capital gain would become net long-term capital gain because there are no long-term capital losses to offset, and this in turn would become net capital gain because there are no short-term capital losses to offset.) The economic damages would offset the long-term capital losses, if any, and become net capital gain only to the extent the excess exceeded any net short-term capital losses. Absent long-term capital losses, the economic damages would be applied directly against net short-term losses and become net capital gain to the extent of any excess over such losses. Of course, if other long-term capital gains were present, the economic damage would be added to them without regard to source, and matched against losses as noted above.

155. One commentator has stated that a tax system ought to be practical. Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567, 568, 572-74 (1965). To this end, tax provisions should be relatively simple and easy to administer. Clearly, adding to the capital gains menagerie does little to meet this criterion for sound tax policy.

ought to be taxed. Other considerations dictate that economic loss should not be treated similarly to ordinary income even though it may be no more than a substitute for it. It has therefore been suggested that economic loss awarded in a personal injury action be incorporated into a tax base in a preferential manner. Three alternatives have been advanced, and each would provide an additional source of revenue, but in a manner consistent with sound tax policy. Although the proposals are not without potential problems, those concerns are not insurmountable and have been adequately addressed. In the near future, may the Capitol capitalize on one of these ideas.