Florida Law Review

Volume 49 | Issue 5 Article 2

December 1997

Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress

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MAKING PEOPLE WHOLE AGAIN: THE CONSTITUTIONALITY OF TAXING COMPENSATORY TORT DAMAGES FOR MENTAL DISTRESS

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"If you hurt and cry, I'll tax your tears"**

Until recently, Congress generally excluded tort awards and settlements for personal injuries to individuals from "gross income" and thus exempted them from federal income taxation. The sole test for this exclusion under section 104(a) of the Internal Revenue Code was whether tort recovery for personal injury was involved.[1] Although this recovery could include items as diverse as mental distress and lost income, the nature of the specific elements of the damages award was irrelevant. As a result, this exclusion covered *all* the elements of tort recovery, including such otherwise taxable items as lost income.[2] Despite debate about the reasons for this approach, it was consistently followed for decades.[3] However, in 1989, Congress began limiting the exclusion. This process began with an amendment to section 104(a) to provide that punitive awards were taxable as income unless they were in connection with a case "involving physical injury or physical

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** THE BEATLES, *Taxman*, *on* REVOLVER (EMI Records 1966) (written by George Harrison). The lyrics to this song indicate that the "taxman" wants 95% of your goods, that if you complain about this rate he will take it all, that if you ask what will be done with it, he will take more, and that you should "declare the pennies on your eyes" when you die. The lyrics also contain the following:

> If you drive a car, I'll tax the street
> If you try to sit, I'll tax your seat
> If you get too cold, I'll tax the heat
> If you take a walk, I'll tax your feet
> . . .
> 'Cause I'm the taxman, yeah, I'm the taxman.

1. Section 104(a)(2) provides that "gross income does not include . . . the amount of any damages . . . received . . . on account of personal . . . injuries. . . ." 26 U.S.C.A. § 104(a)(2) (West 1997). This quotation provides the general framework and does not contain the references to punitive damages, physical injuries, and emotional distress. For discussion of these details, see *infra* notes 4-7, 103-11 and accompanying text.

2. *See infra* notes 74-79 and accompanying text.

3. *See infra* notes 4-7, 68-111 and accompanying text.

sickness."[4] In 1996, section 104(a) was again amended to subject *all* punitive damages to income taxation.[5] Congress made another fundamental change in 1996 by amending the Code to provide, for the first time, that some compensatory awards for personal injury must be included in income. More specifically, section 104(a) was amended to provide that the traditional exclusion from income of "damages received . . . on account of personal injuries as sickness" did not apply to a victim's claim for "emotional distress"[6] unless the claim had "its origin in a physical injury or physical sickness."[7] Because of this new treatment of damages for mental distress, victims of torts like assault must now pay income tax on any award or settlement that compensates for the psychic trauma from the fear and terror of being assaulted.

Though there may be merit in the new approach to punitive damages,[8] the change in the treatment of compensatory damages for mental distress raises serious constitutional questions. Compensatory damages are meant to "make the victim whole again" by restoring the victim to the status quo before the tort. Moreover, damages for mental trauma do not replace something, like lost wages, that would otherwise be income. Thus, it is questionable whether compensation for mental distress constitutes income in any ordinary sense of the term. If these damages are not income, is it constitutional to tax them as such? Addressing this issue requires an examination of the legal framework for taxation of income and of the nature and purpose of compensatory damages for mental trauma. The constitutional framework is addressed in Part I of this Article. Part II summarizes the statutory approach to the taxation of tort damages. The nature of tort damages for mental distress is discussed in Part III. Part IV argues that it is unconstitutional to treat awards for mental distress as income.

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4. 26 U.S.C. § 104(a) (1994).

5. 26 U.S.C.A. § 104(a) (West 1997).

6. *Id.* See *infra* notes 103-11 and accompanying text for further discussion of this legislative change.

7. H.R. CONF. REP. No. 104-737, at 3011 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793; *see* 26 U.S.C.A. § 104(a) (West 1997). Section 104(a) still allows the taxpayer to exempt from income "an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress." 26 U.S.C.A. § 104(a) (West 1997).

8. Punitive awards were held to fall within the statutory definition of income where the award did not involve personal injury. *See, e.g.*, Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). For criticisms of the exclusion of punitive awards. see *infra* note 74.

I. CONSTITUTIONAL FRAMEWORK

A. *The Apportionment Requirement for Capitation or Other Direct Taxes*

The Constitution grants Congress extensive powers of taxation. Article I provides Congress with the "Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States. . . ."[9] This power is subject to a number of limits, however.[10] In terms of income taxation, the most important limit is that "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[11]

The precise scope of this limit is uncertain because, when one moves beyond certain easy examples, the meaning of the phrase "Capitation, or other direct, Tax" is not clear. A capitation tax is a direct tax imposed on a person, *as a person*, rather than imposed on an activity or on real or personal property.[12] The poll tax is clearly a capitation tax

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9. U.S. CONST. art. I, § 8, cl. 1.

10. In addition to the limit on direct taxation discussed in the text, the Constitution also limits the congressional power to tax in several ways. First, "all Duties, Imposts and Excises shall be uniform throughout the United States. . . ." U.S. CONST. art. I, § 8, cl. 1. Second, "[n]o Tax or Duty shall be laid on Articles exported from any State." *Id.* § 9, cl. 5. Third, "[n]o Preference shall be given by any Regulation of Commerce or Revenue to the Ports of one State over those of another: nor shall Vessels bound to, or from, one State be obliged to enter, clear, or pay Duties in another." *Id.* cl. 6. Fourth, the exercise of the taxation power, like other congressional powers, is subject to general provisions like the due process clause of the Fifth Amendment and the establishment clause of the First Amendment. *See* Hernandez v. Commissioner, 490 U.S. 680, 693 (1989) (holding that deduction limitations on charitable contributions to churches did not offend First Amendment); Brushaber v. Union Pacific R.R., 240 U.S. 1, 24-25 (1916) (recognizing in principle that Fifth Amendment limits power to tax); 1 BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶¶ 1.2.5, 1.2.6 (1989) (reviewing authorities and concluding that Congress is subject to due process limits, but has not been held to violate them in income taxation). Other general limits include the restriction on diminishment of judges' salaries, the need to respect federalism in terms of taxing state and municipal governments or income from their bonds, and the restrictions implicit in the treatment of Indian tribes as sovereign entities. *Id.* ¶¶ 1.2.7, 1.2.8, 1.2.9.

11. U.S. CONST. art. I, § 9, cl. 4, *amended by* U.S. CONST. amend XVI. This apportionment requirement is also contained in Article I, Section 2, clause 3, which provides:

> Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons.

12. *See* Scholey v. Rew, 90 U.S. (23 Wall.) 331, 343 (1874).

because it is levied upon each person regardless of activity or property (or lack of property).[13] However, it is not clear what, if any, other tax would be a capitation tax. The phrase "other direct tax" presents similar difficulties. Taxes on real property appear to have been definitely included in the term,[14] but there was arguably no certainty among the drafters as to other inclusions.[15] The Supreme Court has interpreted the term "direct tax" to include a tax on property, whether real or personal, or a tax on the income from property, but not to include "taxation on business, privileges, or employment," which is indirect taxation.[16]

The reason for the limitation on direct taxation is the subject of debate. Two reasons have been suggested. First, the limit is viewed as based on concerns of federalism and the need to limit the taxation powers of the central government. Second, the limitation has been characterized as a politically necessary restriction on the federal taxation of slaves. Because such a tax would obviously fall mostly on the southern states, these states would be reluctant to ratify the Constitution without the limitation.

From the perspective that the limitation is based on federalism, the provision is viewed as a compromise "intended to guard against . . . the exercise by the general government of the power of directly taxing persons and property within any State through a majority made up from the other States."[17] Thus, the provision is "one of the bulwarks of private rights and private property."[18] It is important to note that the concern is *not* to protect property within a particular state from taxation imposed by a majority of that particular state's population; each state is free to impose direct taxation on its citizens and on property within the state. Instead, the concern is to ensure that this power is not exercised by the central federal government except in "extraordinary emergencies," in which case the tax must be apportioned.[19] The concern for

13. *See* Breedlove v. Suttles, 302 U.S. 277, 281 (1937); Pacific Ins. Co. v. Soule, 74 U.S. 433, 444 (1868).

14. *See* Scholey v. Rew, 90 U.S. (23 Wall.) 331, 343 (1874); Hylton v. United States, 3 U.S. (3 Dall.) 171, 175 (1796); THE FEDERALIST NO. 35, at 215 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

15. *See infra* notes 25-34 and accompanying text.

16. *See infra* notes 32-34 and accompanying text. The Supreme Court also has determined that the term does not include an excise type tax on income from "transactions" involving the property. *See infra* notes 32, 186-92 and accompanying text.

17. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 582 (1895) [hereinafter *Pollock I*]; *see Hylton*, 3 U.S. (3 Dall.) at 177 (Patterson, J.) (concern of southern states to prevent extensive holdings in slaves and real property from being taxed by majority vote of other states); BITTKER & LOKKEN, *supra* note 10, ¶ 1.2.2, at 1-15.

18. *Pollock I*, 157 U.S. at 583.

19. *Id.*

relating taxation to representation was central to the drafters of the Constitution[20] and continues to be a concern to state supreme courts in interpreting their state constitutions.[21] In more modern terms, the concern was that only the legislators in one's own state could impose a direct tax, not the distant congressional legislators "inside the beltway" in Washington, D.C. The legislators in one's own state are closer and more easily influenced by local concerns and viewpoints. Moreover, it is easier to move to a different state with a different taxing scheme than it is to leave the country. The limitation also protects the ability of state and local governments to raise revenues by limiting the central government's ability to use certain types of taxes.

The other view is that the limitation was related to the issue of slavery. Under this view, slave states agreed to accept congressional representation based upon a system that counted a slave as three-fifths of a person so long as direct taxation was similarly apportioned.[22] Moreover, since slaves were a unique form of property owned mostly in the southern states, any direct tax on slaves would be felt disproportionately by the southern states.[23]

It is not clear whether the limitation was adopted for one or the other or both reasons. From a modern perspective, the limitation on direct taxation is now meaningless surplusage if one assumes that taxation of slaves is the only concern. However, if one takes the view that the limitation is concerned with allocating taxation powers between the federal and state levels and with protecting private rights from the actions of a majority acting through the federal government, then the limitation is still important in modern times. The Supreme Court has adopted this view because it has determined that the limitation is still viable despite the abolition of slavery by the adoption of the Thirteenth Amendment.[24]

For decades, neither the meaning of nor the reason for the limitation on direct taxation was relevant in terms of income taxation because Congress did not use its taxing powers to impose an income tax until

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20. *See* Edward J. McCaffery, *Tax's Empire*, 85 GEO. L.J. 71, 73 (1996) ("The American Revolution was, after all, partly a tax revolt."). One might view the apportionment requirement as a measure of insuring that there would be no "taxation without [meaningful] representation."

21. *See* Weaver v. Recreation District, 492 S.E.2d 79 (S.C. 1997) (relying on state "constitutional restriction against taxation without representation" and holding that unelected special "boards" could not impose taxes). The author is thankful to his colleague, James L. Underwood, for this point. Sometimes law faculty lounge conversation can be scholarly.

22. *See* BITTKER & LOKKEN, *supra* note 10, ¶ 1.2.2, at 1-15 to 1-16.

23. *See Hylton*, 3 U.S. (3 Dall.) at 177.

24. *See infra* notes 29-31 and accompanying text.

additional sources of revenue were needed to finance the Civil War.[25] The income tax scheme adopted to fund the war was upheld in *Springer v. United States,*[26] in which the Supreme Court rejected a challenge that this tax was a "direct" tax and, therefore, unconstitutional since it was not apportioned by census.[27] After the war, the tax was repealed; and customs and excise taxes were, once again, the main sources of federal tax revenues.[28]

In 1894, a new income tax scheme was adopted. This statute was held to be an unconstitutional direct tax in *Pollock v. Farmers' Loan & Trust Co.*[29] Though *Pollock* provides limited conceptual guidance on the distinction between direct and indirect taxes, its holding is reasonably clear. The *Pollock* Court held that the fact that a tax on real estate is a direct tax meant that a tax on the income from real estate is also a direct tax.[30] Similarly, a tax on personal property or on the income from personal property is also direct tax.[31] However, the *Pollock* opinion suggests that taxation of income in the form of salary, wages, or profits is not direct because the Court notes:

> We have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on

25. *See, e.g.*, BITTKER & LOKKEN, *supra* note 10, ¶ 1.1.2, at 1-4.

26. 102 U.S. 586 (1880).

27. *See id.* at 602.

28. *See* United States v. James Daniel Good Real Property, 510 U.S. 43, 60 (1993) ("[B]efore passage of the Sixteenth Amendment, the Federal Government relied heavily on liquor, customs, and tobacco taxes to generate operating revenues."); BITTKER & LOKKEN, *supra* note 10, ¶ 1.1.2, at 1-4. The sale and lease of public lands also played a role in the raising of revenues. *See generally* PAUL W. GATES, HISTORY OF PUBLIC LAND LAW DEVELOPMENT (1968).

29. There are two *Pollock* decisions. The initial decision addressed only the issues of taxation of the income from real property and from municipal bonds. *See Pollock I*, 157 U.S. at 429. Following this decision, a petition for rehearing was filed requesting the Court to address issues such as the taxability of personal property and the severability of unconstitutional provisions. These issues were addressed in the second decision. *See* Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895) [hereinafter *Pollock II*]; BITTKER & LOKKEN, *supra* note 10, ¶ 1.2.2, at 1-18; JAMES W. ELY, JR., THE CHIEF JUSTICESHIP OF MELVILLE W. FULLER 119-21 (1995).

30. *See Pollock I*, 157 U.S. at 579-83.

31. *See Pollock II*, 158 U.S. at 628, 634. This part of the opinion in *Pollock* was addressing a point that had been regarded as uncertain in early cases. *See* Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533, 540-47 (1869) (In upholding a tax on bank-circulated notes as akin to a duty, the Court noted the uncertainty concerning the scope of the term "direct taxes" and concerning whether taxation of personal property is encompassed in the term.).

> business, privileges, or employments has assumed the guise of an excise tax and been sustained as such.[32]

The Court also noted that such taxes on "business, privileges, or employments" were at issue in *Springer v. United States*,[33] and that this was the reason the income tax scheme involved in *Springer* had been upheld.[34]

B. *The Sixteenth Amendment and the Definition of "Income"*

The Sixteenth Amendment was adopted in 1913 to provide a basis for a widely-based income tax scheme. The amendment provides that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."[35] The effect of the amendment was *not* to grant Congress the power to adopt income taxes; this power already existed.[36] Instead, the amendment simply eliminated the need for apportionment of any income taxes that might be viewed as direct taxes.[37] However, the amendment does not eliminate the apportionment requirement for direct taxes that do not involve income. Thus, for example, because a property tax as such is a direct tax, apportionment would be still necessary if Congress attempted to tax the property itself, as opposed to income from that property.[38]

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32. *Pollock II*, 158 U.S. at 635. The Court struck down the entire income tax scheme, including the taxation of "employments," because it did not feel that Congress intended to adopt such a narrow scheme. *See id.* at 636-37.

33. 102 U.S. 586 (1880); *see supra* notes 25-26 and accompanying text.

34. *See Pollock I*, 157 U.S. at 578-79; *supra* note 29 and accompanying text. It has been argued that it is not likely that the *Springer* Court would view this distinction as important. *See* BITTKER & LOKKEN, *supra* note 10, ¶ 1.2.2, at 1-17. For a defense of *Pollock* on this point, see ELY, *supra* note 29, at 122-24. A corporate income tax was upheld as indirect on the basis of this distinction in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 150 (1911).

35. U.S. CONST. amend. XVI.

36. *See, e.g.*, Evans v. Gore, 253 U.S. 245, 261-62 (1920); *Brushaber*, 240 U.S. at 17-18; *Pollock II*, 158 U.S. at 632-33.

37. *E.g.*, *Evans*, 253 U.S. at 261-62.

38. *See, e.g.*, Helvering v. Independent Life Ins. Co., 292 U.S. 371, 378 (1934) (tax on "rental value" of building by owner a direct tax since income not involved); Taft v. Bowers, 278 U.S. 470, 481 (1929) ("[T]he Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which heretofore could not have been properly regarded as income."); Eisner v. Macomber, 252 U.S. 189 (1920).

1. Constitutional Interpretation

The Supreme Court took the view that just such direct, non-income taxation of property was involved in *Eisner v. Macomber*.[39] At issue in *Macomber* was the Revenue Act of 1916, which treated a stock dividend as income.[40] The taxpayer argued that this treatment was unconstitutional since the additional shares simply evidenced her continuing ownership of the same proportion of the corporation.[41] Thus, though she had more shares, she had no additional property and therefore had received no "income." The Supreme Court agreed and held that the stock dividends were not income and therefore were not taxable under the Sixteenth Amendment.[42] Congress could impose a tax based on the value of the shares; however, "this would be taxation of property because of ownership, and hence would require apportionment" since the taxation would be a direct tax not authorized by the Sixteenth Amendment.[43]

As *Macomber* indicates, the definition of "income" is crucial to determining the scope of the power granted under the Sixteenth Amendment. If the tax is imposed on property rather than on income, the amendment does not apply; and, since a direct tax is involved, the tax must be apportioned by census. *Macomber* attempted to guide the drawing of this distinction by providing a general framework for defining income.[44] The Court defined income as " 'the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets. . . ."[45] As indicated above,[46] the Court held that shareholders received no income from a stock dividend because the dividend did not constitute a "gain." Instead, the dividend affected only the "form" of the ownership interest and did not "increase the intrinsic value" of the stockholdings.[47]

The approach adopted by *Macomber* of using gain to define income[48] has been followed in other contexts.[49] For example, the

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39. 252 U.S. 189 (1920).

40. *See id.* at 199.

41. *See id.* at 201.

42. *See id.* at 212.

43. *See id.* at 217.

44. *See id.* at 206-08.

45. *Id.* at 207 (quoting from Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)).

46. *See supra* notes 39-43 and accompanying text.

47. *See Macomber*, 252 U.S. at 210; *see* Helvering v. Sprouse, 318 U.S. 604, 607 (1943) (no gain to shareholders where dividend to shareholder did not change shareholder's proportional share of ownership of cooperation).

48. In addition to using gain as the measure of income, *Macomber* also requires a

Court held in *Edwards v. Cuba Railroad Co.*[50] that payments "to reimburse plaintiff for capital expenditures . . . do not constitute income within the meaning of the Sixteenth Amendment."[51] In contrast, where a gain was realized, then income was held to be involved.[52] For example, "a gain from capital investment which, when realized, by conversion into money or other property, constitutes profit which has consistently been regarded as income within the meaning of the Sixteenth Amendment and taxable as such. . . ."[53]

The Supreme Court's reliance on gain as a standard for determining whether income is involved is consistent with the Court's general approach to the interpretation of the Sixteenth Amendment. The language of the amendment must be the "starting point of any inquiry

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realization of that gain—*i.e.*, a "capturing" of the gain through a severance of the gain from capital by a change in the form or nature of the property. *See Macomber*, 252 U.S. at 208-19; *see generally* BITTKER & LOKKEN, *supra* note 10, ¶ 5.2 (general discussion of realization). This aspect of *Macomber* has been criticized. *See, e.g.*, Helvering v. Griffiths, 318 U.S. 371, 405, 409 (1943) (Douglas, J., dissenting); Charles L.B. Lowndes, *Current Conceptions of Taxable Income*, 25 OHIO ST. L.J. 151, 171-82 (1964). However, this aspect of *Macomber* has not been overruled and has been consistently recognized as a matter of constitutional interpretation. *See, e.g.*, Helvering v. Sprouse, 318 U.S. 604 (1943). *But see* Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 19-20 (1992) (arguing that realization is now treated as a matter of administrative convenience); Paul B. Stephan III, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357, 1360 n.3 (1984) (arguing that it is "reasonably certain that the Court no longer views realization as a constitutional requirement"). The requirement has also been recognized as a matter of statutory interpretation. *See, e.g.*, Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991); James v. United States, 366 U.S. 213, 219 (1961); *Griffiths*, 318 U.S. at 392-94, 404. Regardless of the approach taken concerning realization of a gain, the Supreme Court consistently has held, as a matter of constitutional and statutory interpretation, that a gain of some sort is required in order for income to be involved. *See infra* notes 49-53, 60-62 and accompanying text.

49. *See, e.g.*, Lowndes, *supra* note 48, at 162-71; L. Hart Wright, *The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts: A Chronological Study*, 8 STAN. L. REV. 164, 173-75 (1956) (historical treatment of income and gain as equivalent concepts). *But see* Kornhauser, *supra* note 48, at 19 (arguing that treatment of nonrecourse debt indicates an abandonment of need for a gain).

50. 268 U.S. 628 (1925).

51. *Id.* at 632-33.

52. *See* Helvering v. Bruun, 309 U.S. 461 (1940) (Improvement to real property by lessee constituted a gain, and therefore income for lessor.); Koshland v. Helvering, 298 U.S. 441, 445-46 (1936) ("[W]here a stock dividend gives the shareholder an interest different from that which his former stock holding represented he receives income."); *cf.* James v. United States, 366 U.S. 213 (1961) (embezzled funds held to be a gain, and therefore income within meaning of statutory scheme despite argument by dissent that no income within meaning of Sixteenth Amendment involved); *infra* notes 58-62 and accompanying text (definition of income in tax code).

53. MacLaughlin v. Alliance Ins. Co., 286 U.S. 244, 249 (1932).

as to what constitutes taxable income. . . ."[54] In dealing with this language, the Court has used the common understanding of the term "income." "Income within the meaning of the Sixteenth Amendment is . . . [w]ith few exceptions, if any, . . . income as the word is known in the common speech of men."[55]

> In determining the definition of the word "income" . . . , this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved . . . what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."[56]

Because income in ordinary speech involves a gain,[57] the Court's emphasis on gain is consistent with ordinary common usage.

2. Interpretation of Income as Used in the Tax Code

The interpretation of the term "income" in the tax code provides guidance in interpreting the Sixteenth Amendment because Congress consistently has expressed its intention to utilize its power under the Sixteenth Amendment to the fullest extent. As a result, "[t]he starting point in all cases dealing with the question of the scope of what is included in 'gross income' begins with the basic premise that the purpose of Congress was 'to use the full measure of its taxing power.' "[58] Though the statutory interpretation cases often avoid general definitions in favor of an *ad hoc* approach focusing on the facts of

54. James v. United States, 366 U.S. 213, 248 (1961) (Whittaker, J., concurring in part and dissenting in part).

55. United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 99 (1936).

56. Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 519 (1921).

57. *See, e.g.*, WEBSTER'S NEW COLLEGIATE DICTIONARY 581 (1977) ("income" defined as "a gain or recurrent benefit usu. measured in money . . . [that] derives from capital . . . [or] labor"). Though the Court has rejected the "*refinements* of lexicographers," *see* Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 519 (1921) (emphasis added), and found them to have "little to add" to case definitions, *see Macomber*, 252 U.S. at 207, simple straightforward dictionary definitions should provide guidance on common usage.

58. *James*, 366 U.S. at 218 (quoting from Helvering v. Clifford, 309 U.S. 331, 334 (1940)); *see also, e.g.*, Commissioner v. Schleier, 515 U.S. 323, 327-28 (1995); United States v. Burke, 504 U.S. 229, 233 (1992).

individual cases,[59] there is agreement that income involves a *gain* that adds to the capital already owned by a person.[60]

> The language of § 22(a) of the 1939 Code, "gains or profits and income derived from any source whatever," and the more simplified language of § 61(a) of the 1954 Code, "all income from whatever source derived," have been held to encompass all "accessions to wealth clearly realized, and over which the taxpayers have complete dominion."[61]

Though this emphasis on "accessions to wealth" as central to defining the term "income" has been utilized within a context of statutory interpretation, it provides further reason to view gain as a part of the "commonly understood meaning of the term."[62]

C. *Conclusion—Constitutional Issues Involved*

The constitutional requirement of apportionment only applies to capitation or other direct taxes; apportionment is not required if an indirect tax is involved. *Pollock* indicates that taxes on gains or profits from "business, privileges, or employments" are not direct taxes because they are not imposed on income from property.[63] Therefore, such taxes

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59. *See, e.g., Glenshaw Glass Co.*, 348 U.S. at 431 (In the context of distinguishing gain from capital, "the definition [in *Eisner v. Macomber*] served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions."); Commissioner v. Wilcox, 327 U.S. 404, 407 (1946), ("[N]o single conclusive criterion has yet been found to determine in all situations what is a sufficient gain to support the imposition of an income tax. No more can be said in general than that all relevant facts and circumstances must be considered."); United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (Since facts indicated that income was involved, there was "nothing to be gained by the discussion of judicial definitions" of income.).

60. *See* Bernard Berkowitz & Andrew M. Greenstein, Note, *Taxation of Damage Recoveries from Litigation*, 40 CORNELL L. REV. 345, 345-46 (1955) (compensatory tort awards that returned a person to *status quo* not income since no gain); Lowndes, *supra* note 48, at 162; *cf.* Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918) (In interpreting the Corporation Excise Tax Act of 1909, which imposed tax on corporate income, the Court noted that " '[i]ncome may be defined as the gain derived from capital, from labor, or from both combined' " and that "[i]n order to determine whether there has been gain or loss, and the amount of the gain, if any, [from the sale of capital] we must withdraw from the gross proceeds an amount sufficient to restore the capital value. . . ." (quoting from Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913)).

61. *James*, 366 U.S. at 219 (quoting *Glenshaw Glass Co.*, 348 U.S. at 431); *see also* United States v. Burke, 504 U.S. 229, 233 (1952); BITTKER & LOKKEN, *supra* note 10, ¶ 5.4 (right to tax free recovery of capital before computation of "gain"). The requirement that the gain or accession be realized is discussed *supra* at note 48.

62. *See supra* notes 55-56 and accompanying text.

63. *See supra* notes 32-34 and accompanying text.

may be imposed by Congress without apportionment and without regard to the requirements of the Sixteenth Amendment.[64] Thus, one issue to be considered herein is whether the tax on compensatory damages for mental distress is an indirect tax on income relating to "business, privileges, or employments." If the tax on compensatory tort damages is not an indirect tax, then it must be apportioned by census among the states unless it is an income tax authorized by the Sixteenth Amendment.[65] Thus, a second constitutional issue is presented: Is the tax on compensatory damages a tax on "income" under the Sixteenth Amendment? An essential aspect of income is a gain or accession to capital.[66] Consequently, the constitutionality of taxing compensation for mental distress as income depends upon whether the compensation is a "gain." The following parts of this Article address these two constitutional questions by reviewing the historical treatment of tort and tort-like awards, analyzing the nature and role of compensatory damages for mental distress, and considering how to interpret the Constitution and apply it to these tort awards.

II. THE HISTORY OF THE TAXATION OF TORT DAMAGES

The taxation of damages awards and settlements has been treated in two different ways. First, Congress consistently has excluded such payments from income so long as the award or settlement constituted an award for "personal injuries." Under this approach, taxability is determined solely by the issue of whether the injury is "personal;" the nature of the damages award is irrelevant. Second, where other, nonpersonal injuries are involved, the courts have developed an "in lieu of what test" to determine taxability. Under this test, the focus is on damages, not the nature of the injury or claim. Any part of an award or settlement is taxable as income if, and only if, it compensates for otherwise taxable income.

A. *Personal Injuries—The Total Statutory Exclusion*

Initially, Congress decided to use its power under the Sixteenth Amendment to tax compensatory payments.[67] However, beginning in 1918, Congress adopted a pattern of excluding all recoveries for

64. *See* Flint v. Stone Tracy Co., 220 U.S. 107 (1911) (upholding tax on corporate income).

65. *See supra* notes 36-38 and accompanying text.

66. *See supra* notes 39-53 and accompanying text.

67. *See* J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13, 14-15 (1989).

"personal injuries" from income.[68] Because this approach focussed on whether the nature of the injury was "personal," rather than on the nature of the damages awarded, all recovery for personal injuries, including recovery for lost income and for punitive damages, was not taxable.[69]

1. Reasons for the Statutory Exclusion

Though Congress has not given an explicit basis for this exclusion, two reasons for the approach have been suggested.[70] First, the exclusion is viewed as the result of congressional adoption in 1918 of the view that damages for personal injury constitute a return of capital and that, therefore, the damages are not income under the Sixteenth Amendment.[71] Second, the exclusion is explained in terms of congressional

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68. Revenue Act of 1918, § 213(b)(2), 40 Stat. 1057, 1066 (1919) (current version at 26 U.S.C.A. § 104(a)(2) (West 1997)).

69. The impact of this approach was increased by the use of "structured settlements" that allowed plaintiffs to receive tax-free damages payments over time in lieu of lump sum payments which would have generated taxable income. *See* Lawrence A. Frolik, *The Convergence of I.R.C. §104(a)(2),* Norfolk & Western Railway Co. v. Liepelt, *and Structured Tort Settlements: Tax Policy "Derailed,"* 51 FORDHAM L. REV. 565 (1983).

70. In addition to the reasons given in the text, it also has been suggested that the approach was adopted to address two other problems: (1) the involuntary nature of the "exchange" of tort injury for tort settlement or award; and (2) the "bunching" of income in the year of the award or settlement payment, which results in a higher rate of taxation. *See* Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 33 CASE W. RES. L. REV. 43, 46-47, 49 (1987); Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 340-41 (1995); Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 712-19 (1977). However, these problems do not require a complete exclusion of the settlement or award. Special treatment of involuntary awards or income averaging can address these problems, at least to some extent. *See* 26 U.S.C. § 1033 (involuntary conversions); *id.* §§ 1301-1305 (income averaging); Cochran, *supra*; Yorio, *supra*, at 712-19. It also has been suggested that the treatment is designed to help tortfeasors because juries may award damages high enough to make the victim whole after taxation or despite a higher "bunch" rate. *See, e.g.*, Kahn, *supra*, at 340-41; Yorio, *supra*, at 719-22.

71. *See* O'Gilvie v. United States, 117 S. Ct. 452, 456 (1996) (history of exclusion of personal injury recoveries based on decision not to tax "damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, 'return the victim's personal or financial capital' "); *Glenshaw Glass Co.*, 348 U.S. at 432 n.8 ("The long history of departmental rulings holding personal injury recoveries nontaxable [is based] on the theory that they roughly correspond to a return of capital. . . ."). For more complete reviews of this historical development, see *O'Gilvie*, 117 S. Ct. at 455-56; BITTKER & LOKKEN, *supra* note 10, ¶ 5.6; Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendation for Reform*, 56 TENN. L. REV. 601, 663-68 (1989); Burke & Friel, *supra* note 67, at 13; Paul C. Feinberg, *Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions*, 42 CASE W. RES. L. REV. 339, 356-403 (1992); Bertram Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614 (1952); Mary L. Heen, *An Alternative Approach to the Taxation of Employment*

benevolence. Under this view, though Congress could tax the awards, it has made a generous, humanitarian policy decision to assist tort victims by treating damages recoveries as tax-free.[72] In the alternative, this humanitarian reason is phrased in favor of a desire to avoid the appearance of heartlessness which could result from taxing victims.[73] Both reasons have been subjected to considerable criticism.

The "return of capital" view has been criticized as being flawed and outmoded in two respects. First, to the extent that punitive damages or compensatory damages for injuries such as lost income are involved, the damages award can be viewed as a gain, not as simply a return of capital.[74] Therefore, the proper approach is to ask, "What are the damages in lieu of?"[75] If the damages are in lieu of capital, then there is no income so long as there is simply a return of that capital with no gain; if the damages are in lieu of a loss such as income, then there

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Discrimination: Recoveries Under Federal Civil Rights Statutes: Income from Human Capital, Realization, and Nonrecognition, 72 N.C. L. REV. 549, 579-606 (1994); Kahn, *supra* note 70, at 330-39, 341-42; Daniel Candee Knickerbocker, Jr., *The Income Tax Treatment of Damages: A Study in the Difficulties of the Income Concept*, 47 CORNELL L.Q. 429 (1962); Tami Dokken Sandberg, Comment, *Unraveling the "In Lieu of What" Test: Title VII Employment Discrimination Damages and the Personal Injury Exclusion:* United States v. Burke, 112 S. Ct. 1867 (1992), 19 WM. MITCHELL L. REV. 1019, 1020-24 (1993); Steven Jay Stewart, Note, *Damage Award Taxation Under Section 104(a)(2) of the I.R.C.—Congress Clarifies Application of the* Schleier *Test*, 47 SYRACUSE L. REV. 1255, 1258-61 (1997).

72. *See, e.g.*, Blackburn, *supra* note 71, at 668-69; Cochran, *supra* note 70, at 51-64; Thomas D. Griffith, *Should "Tax Norms" Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115, 1159-60.

73. *See* Kahn, *supra* note 70, at 349-52; *cf., e.g.*, Hartnett, *supra* note 71, at 627 ("[T]axation of recoveries carved from pain and suffering is offensive, and the victim is more to be pitied rather than taxed.").

74. *See, e.g.*, Blackburn, *supra* note 71; Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759 (1988); Burke & Friel, *supra* note 67; Douglas K. Chapman, *No Pain—No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407 (1986/1987); Cochran, *supra* note 70; Joseph M. Dodge, *Torts and* Taxes, 77 CORNELL L. REV. 143, 150 (1992); Lawrence A. Frolik, *Personal Injury Compensation as a Tax Preference*, 37 ME. L. REV. 1 (1985); Griffith, *supra* note 72; Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701 (1986); Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 LA. L. REV. 875 (1988); Malcolm L. Morris, *Taxing Economic Loss Recovered in Personal Injury Actions: Towards a Capital Idea?*, 38 U. FLA. L. REV. 735 (1986); Bernard Wolfman, *Current Issues of Federal Tax Policy*, 16 U. ARK. LITTLE ROCK L.J. 543 (1994); Yorio, *supra* note 70; *cf., e.g., O'Gilvie*, 117 S. Ct. at 456 (punitive damages within statutory definition of income); United States v. Burke, 504 U.S. 229, 235 (1992) (statutory back pay award within statutory definition of income and not within exclusion of § 104).

75. See *infra* notes 112-19 and accompanying text for discussion of the "in lieu of what" test in context of damages not falling within § 104.

should be an income tax on this part of the damages. In other words, the award should be allocated between damages that involve a gain and damages that involve only a return of capital.[76]

One response to this criticism is that the benefits of the allocation are not worth the administrative difficulties and that, therefore, all personal injury damages should be excluded for reasons of administrative convenience.[77] The strength of the administrative convenience response is questionable,[78] particularly where punitive damages are involved, given that the Internal Revenue Service has been able to impose its own allocation between the compensatory and punitive components of settlements where the parties were not negotiating the settlement allocation in an adversarial manner.[79]

The second criticism of the return of capital explanation is based on a rejection of the view that compensation for personal injury involves a return of capital. More specifically, viewing compensation as a return of capital is criticized, as a matter of policy, on the ground that this characterization requires that "human capital" be treated as having a "basis"—i.e., an identifiable value reflecting the amount of the taxpayer's investment.[80] For *non*human capital, the identification of the amount of basis is crucial to the determination of whether there has been a gain because gain has traditionally been defined as any excess over basis received, for example, through the sale or other exchange of goods.[81] Thus, if compensatory damages for the tortious destruction of a truck exceed the plaintiff's basis in the truck, then the plaintiff has a

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76. *See* Morris, *supra* note 74 (arguing for allocation and taxation of otherwise taxable "economic losses"); Wolfman, *supra* note 74, at 547-51.

77. *See* Dodge, *supra* note 74, at 150; Griffith, *supra* note 72, at 1130-35; Henry, *supra* note 74, at 726-28.

78. *See supra* note 76.

79. *Compare, e.g.*, Bagley v. Commissioner, 105 T.C. 396, 410 (1995) (service not bound by nonadversarial settlement) and Robinson v. Commissioner, 70 F.3d 34, 37 (5th Cir. 1995) (same) *with, e.g.*, McKay v. Commissioner, 102 T.C. 465, 487 (1994) (allocation in settlement upheld where parties bargained from adversarial positions); *cf., e.g., O'Gilvie*, 117 S. Ct. at 457 ("The administrative problem of distinguishing punitive from compensatory elements is likely to be less serious than, say, distinguishing among the compensatory elements of a settlement (which difficulty might account for the statute's treatment of, say, lost wages)."). *See generally* J. Martin Burke & Michael K. Friel, *What Schleier and Amended 104(a)(2) Mean to Your Practice; Tax Considerations in Pleadings and Settlement Agreements*, TRIAL, Nov. 1996, at 64, 68-69.

80. For discussion of basis in the context of income taxation, see BITTKER & LOKKEN, *supra* note 10, ¶¶ 41.1, 42.1-.7. As a very general matter, the amount of the investment is defined as the purchase price, plus the cost of investments and minus the cost of depreciation for which a deduction has been or could have been claimed. *See id.*

81. *See* BITTKER & LOKKEN, *supra* note 10, ¶ 41.1.

gain in the amount of that excess, which can be treated as income.[82] Where human capital is involved, some argue that the basis is zero; therefore, *any* compensation for personal injury (as opposed to property loss, which involves a thing with an identifiable basis) constitutes a gain in the form of an excess over basis and thus constitutes income.[83] This second criticism will be addressed in more detail below.[84]

The benevolence explanation for the statutory exclusion has been criticized as bad policy on two grounds. First, it is far too benevolent so long as punitive damages also are excluded, as they have been up until recently. Second, the exclusion is an unfair method of helping victims, given that many victims receive no tort compensation.[85] Moreover, the benefit would go to the tortfeasor in many instances, because in some jurisdictions the jury is informed that the award is not taxable.[86] Because this Article focuses on the constitutional power of Congress, the merits of these policy criticisms will not be addressed herein.

2. Judicial Interpretation of the Statutory Exclusion

Regardless of the reason for the exclusion, it clearly has had an important effect: The Supreme Court has not had to address the issue of whether compensatory damages constitute income under the Sixteenth Amendment. Instead, the Court has focused on matters of statutory interpretation. Three recent decisions addressing the exclusion from income of "damages received on account of personal injury" set forth in section 104 of the Internal Revenue Code reflect this statutory focus.

In *O'Gilvie v. United States*,[87] the Court held that punitive damages were not included in the statutory exemption in section 104 because they

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82. *See infra* note 119 and accompanying text.

83. *See, e.g.*, Cochran, *supra* note 70, at 45-46, 48-49; Dodge, *supra* note 74, at 153, 182-87; Frolik, *supra* note 74, at 15-32; Griffith, *supra* note 72, at 1130-35, 1142-58; Kahn, *supra* note 70, at 341-47; *cf.* Stanley Ingber, *Rethinking Intangible Injuries: A Focus on Remedy*, 73 CAL. L. REV. 772, 784 (1985) ("Rather than compensating, . . . [damages for mental distress] merely would assure a wealthier existence than would have been experienced had there been no accident."); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 90-92 (1990) (noting the problem of whether an uncompensated victim should be entitled to a deduction).

84. *See infra* notes 155-59, 205-25 and accompanying text.

85. *See* Cochran, *supra* note 70, at 51-64.

86. *See* Todd C. McKee, Comment, Klawonn v. Mitchell: *Does a Refusal to Instruct a Jury that Wrongful Death Damages Are Excluded from Income Taxation Make the Jury's Task Simpler or More Difficult?*, 19 AM. J. TRIAL ADVOC. 211, 211 (1995).

87. 117 S. Ct. 452 (1996). Before *O'Gilvie* was decided, Congress had amended § 104 to provide that the exemption only applied to damages "other than punitive damages." 26 U.S.C.A. § 104(a)(2) (West 1997). Since this provision was not retroactive, it did not control the result in *O'Gilvie*. *See O'Gilvie*, 117 S. Ct. at 458.

did not satisfy the statutory requirement that the exempted damages award must be received "on account of" personal injuries.[88] *O'Gilvie* indicates that one reason for this interpretation of the statute is that, when the exemption was originally adopted in 1918, Congress was concerned with the constitutionality of taxing a "return to capital."[89]

> This history and the approach it reflects suggest there is no strong reason for trying to interpret the statute's language to reach beyond those damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, "return the victim's personal or financial capital."[90]

Punitive damages do not fall within the exclusion because they "do not compensate for any kind of loss," and there is "no evidence that congressional generosity or concern for administrative convenience" provide a reason for exempting these noncompensatory damages.[91]

In *Commissioner v. Schleier*,[92] the Court held that money received to settle a claim under the Age Discrimination in Employment Act (ADEA)[93] did not fall within the section 104 exclusion. The majority in *Schleier* focused on the statutory phrase " 'damages . . . received on account of personal injury or sickness' "[94] and viewed the issue as whether the settlement was received on account of personal injuries or sickness. The majority concluded that the settlement was not received for this reason and therefore held that the settlement did not fall within the exclusionary language of section 104.[95]

United States v. Burke[96] held that a back pay award received as a settlement of a sex discrimination claim under Title VII of the Civil

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88. *See O'Gilvie*, 117 S. Ct. at 454.

89. See *supra* note 71 and accompanying text for discussion of this historical context.

90. *O'Gilvie*, 117 S. Ct. at 456.

91. *See id.*

92. 515 U.S. 323 (1995).

93. 29 U.S.C. §§ 621-634 (1994).

94. *See Schleier*, 515 U.S. at 328 n.3, 329.

95. The ADEA permits "the recovery 'of wages lost and an additional equal amount as liquidated damages.' " *Id.* at 325 (citing the Age Discrimination in Employment Act of 1967, § 216(b), 29 U.S.C. § 621 (1994)). There is no separate recovery for pain and suffering or emotional distress. *See id.* at 326. Given that the claim was based on discrimination, rather than personal injury, and given the limited remedies available, the Court concluded that damages under the ADEA were not received on account of personal injury or sickness. The Court also held that the claim was not tort-like and that, therefore, the payment did not satisfy the requirement established by *United States v. Burke*, 504 U.S. 229 (1992). *Schleier*, 515 U.S. at 333.

96. 504 U.S. 229 (1992).

Rights Act of 1964[97] did not satisfy the requirements for exemption under section 104. *Burke* interpreted section 104 to be limited to compensation for tort or tort-like claims. Based on its review of the nature of the claim and the limited remedies established by Title VII,[98] the Court concluded that the claim was not tort-like and therefore not included within the scope of section 104.[99]

It is important to note that *O'Gilvie*, *Schleier*, and *Burke* all focus on statutory interpretation; the constitutional definition of income is not at issue.[100] As a result of this focus, the Court has not developed a definition of income in the context of personal injuries. However, when faced with the issue of whether damages constitute income in other contexts, the Court has consistently focused on whether the award or settlement involved a gain. If the damages simply involved a "return of capital," there was no gain and therefore no income.[101] In contrast, where the damages involved an accession to capital or a gain in a form like compensation for lost income or profits, then this accession or gain constitutes income.[102]

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97. 42 U.S.C. §§ 2000e-1 to -17 (1994).

98. *Burke*, 504 U.S. at 238-39. The Court noted, for example:

> Indeed, in contrast to the tort remedies for physical and nonphysical injuries . . . , Title VII does not allow awards for compensatory or punitive damages; instead, it limits available remedies to backpay, injunctions, and other equitable relief.
>
> . . . Nothing in this remedial scheme purports to recompense a Title VII plaintiff for any of the other traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages (e.g., a ruined credit rating).

Id.

99. *Id.* at 241-42.

100. This point is made explicitly in *Schleier*, 515 U.S. at 328 (Taxpayer "concedes that his settlement constitutes gross income unless it is expressly excepted. . . ."). The same point was made in *Burke*, 504 U.S. at 233 ("There is no dispute in this case that the settlement awards would constitute gross income within the reach . . ." of the statutory definition of income.).

101. *See, e.g., supra* notes 39-53, 58-62 and accompanying text; *infra* notes 112-19 and accompanying text; Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1994) (damages award for loss of goodwill not income to extent that return of capital involved).

102. *See, e.g., supra* notes 39-53, 58-62 and accompanying text; *infra* notes 112-19 and accompanying text; *Glenshaw Glass Co.*, 348 U.S. at 431 (Awards of punitive damages constitute a gain that is taxable as income because they involve "instances of undeniable accessions to wealth. . . ."); *Raytheon Prod. Corp.*, 144 F.2d at 113 (damages award for goodwill income to extent that return of capital not involved); *cf.* United States v. Manufacturers Nat'l Bank, 363 U.S. 194, 198 (1960) (receipt of life insurance proceeds income since death of insured "creates a genuine enlargement of the beneficiaries' rights").

3. Recent Legislative Limits on the Exclusion

Congress now has explicitly limited the scope of section 104 in two ways. First, section 104(a)(2) provides that "gross income does not include . . . the amount of any damages (*other than punitive damages*) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. . . ."[103] Second, the section provides: "For purposes of . . . [subsection 104(a)(2)], emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress."[104] The Conference Report indicates that though the exclusion requires physical injury, the injury does not have to be sustained by the claimant in a suit.

> If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.[105]

In contrast, the section 104 exclusion from income is not applicable if the claim does not have "its origin in a physical injury or physical sickness."[106] "Thus, the exclusion from gross income does not apply to any damages received . . . based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress."[107] The Report also indicates that the phrase "physical injury or physical sickness" does not include the physical manifestations of emotional distress. Instead, "[i]t is intended that the term emotional

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103. 26 U.S.C.A. § 104(a)(2) (West 1997) (emphasis added).

104. *Id.* § 104(a).

105. H.R. CONF. REP. No. 104-737, at 301 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1793.

106. *Id.*

107. *Id.*

distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."[108]

It is not clear why Congress decided to limit the exclusion of compensatory damages for mental distress to situations that have their "origin in a physical injury or physical sickness." One plausible guess is that Congress—given the various criticisms of compensating mental distress voiced by proponents of "tort reform"[109]—was using the tax code as a tool for tort reform.[110] If this tort reform explanation is valid, such a "back door" approach to reform raises serious questions of policy concerning not only the failure to articulate this reason publicly but also the substantive merits of an approach that allows some persons to exclude both mental distress and lost wages while requiring others to include awards for mental distress as income.[111] However, these policy issues concerning how Congress should exercise its powers are beyond the scope of this Article. The concern herein is whether Congress has the power to tax compensatory awards for mental distress as income.

B. *Other Injuries—The "In Lieu of What" Test*

Because the exclusion from income in section 104 has been limited to "personal" injuries, the courts and the Internal Revenue Service have had to determine how to address the taxability of other types of injuries—for example, injuries to property or to a corporate business entity.[112] The approach adopted follows the general scheme for inter-

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108. *Id.*

109. *See infra* notes 148-52 and accompanying text.

110. *See* J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(A)(2)*, 58 MONT. L. REV. 167, 184 (1997) ("[T]reatment suggests a fundamental distrust on the part of Congress in the reality of emotional distress. . . ."); *cf.* Kahn, *supra* note 70, at 350 (noting that reasons to tax compensation for noneconomic losses, like mental distress, are that they are not really compensatory in nature and that nonphysical losses arouse less compassion).

111. In assessing the merits of the approach of the new version of § 104, it is important to note that most tort reform proposals criticize the granting of *any* damages for mental distress or pain and suffering but *only* where the claim is based on negligence or strict liability in tort. *See infra* note 148 and accompanying text. Few, if any, of the proposals have advocated eliminating damages for mental distress for intentional torts like assault. Thus, by focusing on whether physical injury is involved, rather than on the nature of the wrongdoing of the defendant, § 104 is inconsistent with virtually all tort reform proposals.

112. *See, e.g.*, Blackburn, *supra* note 71, at 670-72; Berkowitz & Greenstein, *supra* note 60; Brooks, *supra* note 74, at 794-99; Harnett, *supra* note 71, at 622-24; Yorio, *supra* note 70, at 722-33. *See generally* Robert W. Wood, *Tax Aspects of Settlements and Judgments*, Tax Mgmt. (BNA), No. 522, at A-1 to A-41 (May 12, 1997). There are also special statutory provisions addressing other types of compensation. *See, e.g.*, 26 U.S.C. § 186 (1994) (deduction for compensatory damages for patent infringement, for breach of contract or fiduciary duty, and

preting income within the context of the Tax Code. This scheme begins with the basic premise that Congress intended to use the full measure of its taxing power and then uses this premise to find legislative intent to tax any gain or accession to wealth not explicitly excluded by the Code.[113]

Consistent with this approach, an "in lieu of what" test has been utilized to determine whether taxable gain was involved.[114] *Raytheon Production Corp. v. Commissioner*,[115] perhaps the leading case utilizing this approach, notes that in determining whether a compensatory award to a corporate business entity is taxable, "the question is 'In lieu of what were the damages awarded?' "[116] If the award is in lieu of lost profits, then it is taxable as income.[117] If the award is in lieu of lost or damaged capital, then it is necessary to determine whether the award exceeds the taxpayer's "basis" or investment in the property.[118] This process is illustrated in *Raytheon* by a simple example:

> A buys Blackacre for $5,000. It appreciates in value to $50,000. B tortiously destroys it by fire. A sues and recovers $50,000 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to the appreciation in value of Blackacre is realized when it is turned into cash by the money damages.[119]

III. COMPENSATORY DAMAGES IN TORT LAW

A. *Basic Framework—Making People Whole Again*

Though it is sometimes said that compensation is one goal of tort law,[120] a compensatory damages award is simply a *remedy* for a tort. A tort is not involved unless the defendant's breach of a tort duty has caused the plaintiff to suffer a legally recognized injury. The liability rules involved in addressing duty, breach, and causation may be adopted on the basis of a particular goal or purpose of tort law—for example, to

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for antitrust violations).

113. *See supra* note 58 and accompanying text.

114. *See supra* note 112.

115. 144 F.2d 110 (1st Cir. 1994).

116. *Id.* at 113.

117. *See id.*

118. *See supra* notes 81-83 and accompanying text (discussion of basis).

119. *Id.* at 114; *see supra* note 48 (discussion of realization of gain).

120. *See, e.g.*, Peter A. Bell, *The Bell Tolls: Toward Full Tort Recovery for Psychic Injury*, 36 U. FLA. L. REV. 333, 391 (1984).

deter unreasonable or other wrongful behavior[121] or to spread certain types of loss among a large pool of persons so that the victim does not suffer a lump-sum loss.[122] These liability rules identify who will be liable for the loss—the plaintiff or the defendant. If, and only if, the defendant is liable, then damages rules are relevant.[123] Thus, compensation is a remedy that is used as a means of accomplishing goals; it is not a goal in itself. The distinction between a goal and a means is more obvious when a different remedy, like injunctive relief for a nuisance, is involved. In discussing the nature and existence of a nuisance or the proper role of injunctions as a remedy for nuisance, no one argues that injunctions are a goal of nuisance law.[124]

Since goals and means can be related, there may be a connection between the nature and amount of damages and the particular goal to be furthered. For example, if tort law, or an area of tort law, is viewed as an insurance-type mechanism to spread losses, then one can argue that compensation should be measured by what a person would want in an explicit insurance scheme.[125] Similarly, if deterrence or corrective

121. For a classic analysis of deterrence and tort law, see GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970). For a deterrence-based defense of compensating for psychic harm, see Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law*, 108 HARV. L. REV. 1785 (1995).

122. *See* CALABRESI, *supra* note 121, at 39-67. In actual practice, the decision to adopt a particular liability rule is more often a matter of "balancing" or "weaving" together conflicting goals to reach a result in a particular context. *See id.* at 17-33; F. Patrick Hubbard, *Efficiency, Expectation, and Justice: A Jurisprudential Analysis of the Concept of Unreasonably Dangerous Product Defect*, 28 S.C. L. REV. 587, 627-30, 634-38 (1977); *cf. infra* notes 172-74 and accompanying text (discussion of role of weaving conflicting values together in Dworkin's model of judicial decisionmaking).

123. Similarly, if, and only if, a defendant has committed a wrong, then it can perhaps be said that providing compensation *for that wrong* is a goal of tort law. However, this same statement could be made for contract law. In both tort and contract, providing a remedy for a breach of a duty is central, but the provision of remedies (without regard to the breach of a duty) is not a goal.

124. *See, e.g.*, Boomer v. Atlantic Cement Co., 257 N.E.2d 870 (1970); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 89, at 640-41 (5th ed. 1984); Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rues, and Inalienability, One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972); A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075 (1980).

125. For an argument to this effect concerning mental distress, see Mark Geistfeld, *Placing a Price on Pain and Suffering: A Method for Helping Juries Determine Tort Damages for Nonmonetary Injuries*, 83 CALIF. L. REV. 773 (1995). The classic article arguing against compensation for mental distress in insurance-based schemes is Louis L. Jaffe, *Damages for Personal Injury: The Impact of Insurance*, 18 LAW & CONTEMP. PROBS. 219 (1953). For more general criticisms of awarding damages for mental distress, see *infra* note 148.

justice[126] is the goal, then damages, whether compensatory or punitive,[127] should be designed to accomplish these goals.

It is interesting to note that the debate about the relationship between the goals of tort law and the damages recoverable has had virtually no effect on the measure of compensatory damages in general or of mental distress in particular. The measure of compensatory damages is the amount necessary to make the victim whole again—i.e., to place the victim in the same position he or she would have been in but for the defendant's tortious conduct.[128] Though this *status quo ante* measure is clearly an ideal that can never be realized in practice, it has been the universal starting place for the determination of compensatory damages for over a century.[129]

There are many problems with restoring the victim to the *status quo ante*. As an initial practical matter, attorneys' fees will reduce recoveries significantly. Intangible nonpecuniary losses present other, more conceptual difficulties because there is no objective market value for these injuries and because an award for pain and suffering or for mental distress cannot literally restore the status quo.[130] It is important to note that similar problems with full restoration of the status quo often exist with tangible, pecuniary losses as well. Even with pecuniary injuries, the passage of time may make it impossible to restore the victim to *status quo ante* in a literal sense. For example, compensation for wages lost prior to trial cannot literally restore the *status quo ante* because the wage earner had to survive without the wages up until the payment of the compensatory award. Given the uncertainties of tort litigation, it is not likely that a wage earner could or would borrow the full after-tax amount of the lost wages pending the outcome of the litigation.

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126. For discussions of corrective justice as a goal of tort law, see, e.g., ALAN CALNAN, JUSTICE AND TORT LAW 99-109 (1997); JULES L. COLEMAN, RISKS AND WRONGS (1992); Jules L. Coleman, *The Practice of Corrective Justice*, *in* PHILOSOPHICAL FOUNDATIONS OF TORT LAW (David G. Owen ed., 1995).

127. Punitive damages are said to be given because of concerns for deterrence and for corrective or vindicative justice. *See, e.g.*, BMW of N. Am. v. Gore, 116 S. Ct. 1599, 1589, 1601-03 (1996) (concern for punishment, deterrence, and relationship between amount of actual harm and punitive damages); Gilbert v. Duke Power Co., 179 S.E.2d 720, 723 (S.C. 1971) ("[P]unitive damages are generally regarded not only as punishment for the wrong but also as vindication of a private right. . . .").

128. *See* RESTATEMENT (SECOND) OF TORTS §901 cmt. a (1979); Heidi L. Feldman, *Harm and Money: Against the Insurance Theory of Tort Compensation*, 75 TEX. L. REV. 1567, 1577-80 (1997).

129. *See* DAN B. DOBBS, LAW OF REMEDIES: DAMAGES—EQUITY—RESTITUTION §§ 8.1(1), 8.1(4) (2d ed. 1993); Feldman, *supra* note 128, at 1577-80.

130. *See infra* notes 144-47 and accompanying text.

B. *Mental Distress*

1. Liability Rules Protecting the Right to Psychic Well-Being—Assault and Defamation

The liability rules that determine when a plaintiff may recover for injury to psychic well-being are extremely complex. For example, the rules concerning negligent infliction of emotional distress are characterized not only by special proof rules but also by a wide variety of limits on liability.[131] Where intentional wrongdoing is involved, a plaintiff cannot usually recover for mental distress unless it accompanies a physical injury or unless the defendant's conduct is extreme and outrageous.[132] Despite these limited liability rules for many instances of mental trauma, there has long been widespread agreement on the right to recover in some instances. For example, the courts have imposed liability for mental distress without physical injury for centuries in assault and defamation cases.

Historically, the uniquely human dimension of psychic security has been viewed as a basic right, and the law has granted protection for the fear resulting from intentional acts involving a threat of physical harm.[133] A long established tenet of criminal law is that actions "amounting to an attempt or offer to commit personal violence . . . [are regarded] as breaches of the peace, because they directly invade that personal security, which the law guarantees to every citizen."[134]

The right to personal security, including security from fear and mental trauma, has also been protected for centuries by the tort action for assault, which is defined as intentional conduct that puts the victim

131. *See* F. PATRICK HUBBARD & ROBERT L. FELIX, THE SOUTH CAROLINA LAW OF TORTS 41-44 (2d ed. 1997); KEETON ET AL., *supra* note 124, § 54.

132. *See* HUBBARD & FELIX, *supra* note 131, at 416-24; KEETON ET AL., *supra* note 124, § 12.

133. *See infra* note 135.

134. State v. Morgan, 24 N.C. (3 Ired.) 134, 136 (1842).

in reasonable apprehension of a harmful or offensive touching.[135] One court explained the rationale as follows:

> One of the most important objects to be attained by the enactment of laws and the institutions of civilized society is, each of us shall feel secure against unlawful assaults. Without such security society loses most of its value. Peace and order and domestic happiness, inexpressibly more precious than mere forms of government, cannot be enjoyed without the sense of perfect security. We have a right to live in society without being put in fear of personal harm.[136]

Consistent with the principle that a right implies a remedy,[137] the victim of an assault is "entitled to recover full compensation, which includes compensation for her mental suffering, even if there was no unlawful touching of the body and no physical injury."[138] Thus, it is clear that our society has long recognized that the victim of an assault has a right to recover compensatory damages for the mental trauma caused by the fright resulting from an assault.

The uniquely human interest in selfhood and psychic well-being has also been protected for centuries by the right to sue for libel and slander.[139] Blackstone regarded a person's reputation as one of the interests encompassed within the natural, absolute right to personal security.[140] "The security of his reputation or good name, from the arts of detraction and slander, are rights to which every man is entitled, by

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135. *See, e.g.*, Smith v. Newsom, 84 Eng. Rep. 722 (1674) (recognizing claim for assault for "shaking a sword . . . on the other side of the street"); RESTATEMENT (SECOND) OF TORTS § 21 (1965); HUBBARD & FELIX, *supra* note 131, at 394-396; KEETON ET AL., *supra* note 124, § 10. Blackstone describes the action for assault as follows:

> An assault is an attempt or offer to beat another, without touching him: or as if one lifts up his cane, or his fist, in a threatening manner at another; or strikes at him, but misses him; this is an assault, *insultus*, which Finch describes to be "an unlawful set upon one's person." This also is an inchoate violence, amounting considerably higher than bare threats; and therefore, though no actual suffering is proved, yet the party injured may have redress by action of *trespass vi et armis*; wherein he shall recover damages as a compensation for the injury.

4 WILLIAM BLACKSTONE, COMMENTARIES *120.

136. Beach v. Hancock, 27 N.H. 223, 229 (1853).

137. *See, e.g.*, 4 BLACKSTONE'S COMMENTARIES 122 (St. George Tucker ed., 1803).

138. Kline v. Kline, 64 N.E. 9, 10 (Ind. 1902).

139. *See, e.g.*, KEETON ET AL., *supra* note 124, at 772-73.

140. 2 WILLIAM BLACKSTONE, COMMENTARIES *129, *174.

reason and natural justice; since without these it is impossible to have the perfect enjoyment of any other advantage or right."[141] A human defamation victim suffers not only economic injury but also psychic harm. "Indeed, the more customary types of actual harm inflicted by defamatory falsehood include impairment of reputation and standing in the community, personal humiliation, and mental anguish and suffering."[142] Moreover, these nonphysical harms are sufficiently important to justify an award of compensatory damages in a negligence-based defamation action even though such awards may have some chilling effect on the exercise of First Amendment rights.[143]

2. Damages Rules for Compensating for Mental Distress

The analysis of the nature and measure of compensatory damages for mental distress must account for four things. First, mental trauma is a real experience; those who suffer mental distress suffer an actual loss.[144] Second, psychological pain is uniquely personal; only the victim can know how it feels. Others can empathize, but they cannot literally share, evaluate, or measure the experience. Third, there is no objective market value for mental trauma. Consequently, determining the dollar amount of the award requires the subjective conversion of a nonmarket injury into the market terms of money. Fourth, a money award to compensate for mental distress cannot literally restore the victim to *status quo ante* because money cannot replace, repair, or eliminate the psychological trauma. It is not possible to go out and buy a replacement for mental well-being.

In assessing the importance of the last item, it is important to consider several points concerning the inability of money to correct a psychological harm. First, the lack of reparation is only partially true. Money has some restorative effect for victims who suffer from mental trauma because it can be used to secure psychological counseling[145] or to provide alternate ways to secure psychic well-being.[146] It is also important to remember that damages for tangible, economic losses can

141. *Id.* at 134; *see id.* at 123-26.

142. Gertz v. Robert Welch, Inc., 418 U.S. 323, 350 (1974).

143. *See id.* at 349.

144. *See Gertz*, 418 U.S. at 349-50 ("Actual injury [includes] mental anguish and suffering.").

145. *See* Ingber, *supra* note 83, at 782-83. Expenses for such counseling are excluded from income under § 104. *See supra* note 104 and accompanying text.

146. *See* Richard N. Pearson, *Liability to Bystanders for Negligently Inflicted Emotional Harm—A Comment on the Nature of Arbitrary Rules*, 34 U. FLA. L. REV. 477, 502 (1982) ("Ten units of pain is still ten units of pain, but it will be easier to bear in Bermuda.").

provide only partial restoration where past economic losses are involved.[147] Finally, it is not clear what the lack of restoration means in terms of the victim's condition. When one hears of a large award to compensate a victim who has suffered and will continue to suffer substantial psychic trauma as a result of an egregious assault, is the reaction envy ("Wow—what a windfall! I wish I could suffer pain and get all that money.") or pity ("How sad! That money won't erase the pain; I'm sure glad that's not me.")? To the extent that pity is common, it seems clear that the lack of restorative effect does not mean that the award constitutes a gain to the victim.

Traditionally, the courts have resolved the tension between the reality of mental distress and the corrective shortcomings and subjectivity of money damages by relying on the jury to determine an amount necessary to provide compensation for mental trauma. There has been academic criticism of awarding any damages[148] and there has been debate about how the jury process should be conducted, for example, questions have been raised concerning such things as evidence,[149] closing arguments,[150] jury charges,[151] and control of the jury's discretion through the use of award maximums or schedules.[152] However, the courts consistently have held that, where the appropriate liability rules have been breached, a psychic injury is compensable and that the substantive measure of damages is the amount necessary to restore the

147. *See supra* text following note 130.

148. *See, e.g.*, DOBBS, *supra* note 129, at 657-60 (review of criticisms and of "reform" proposals); Ingber, *supra* note 83, at 809-10 (arguing against awards for mere negligence but recognizing role for awards for reckless and intentional misconduct); Jaffe, *supra* note 125, at 223-25 (arguing against awards in cases where negligence or insurance based schemes are involved); Clarence Morris, *Liability for Pain and Suffering*, 59 COLUM. L. REV. 476, 476-82 (1959) (reviewing proposals for eliminating or reducing awards in negligence and strict liability schemes and arguing for continuing role, particularly for intentional wrongs).

149. Proof of "loss of enjoyment" or "hedonic" damages, particularly through the use of expert testimony, has been one such issue. *See generally* Roy F. Gilbert, *The Application of Hedonic Models to Personal Injury Litigation*, 4 J. LEGAL ECON. 13 (1994); Reuben E. Slesinger, *The Demise of Hedonic Damages Claims in Tort Litigation*, 6 J. LEGAL ECON. 17 (1996).

150. One dispute concerns the use of the so-called *per diem* argument, which asks the jury to consider pain in terms of a money price for a unit like a minute, hour, or day and then multiplies this by the years the pain is to be experienced to get a total dollar figure. The jurisdictions have split over the propriety of such argument. *See* James O. Pearson, Jr., Annotation, *Per Diem or Similar Mathematical Basis for Fixing Damages for Pain and Suffering*, 3 A.L.R.4th 940 (1981).

151. *See generally* Geistfield, *supra* note 125 (summarizing various jurisdictions' approaches).

152. *See, e.g.*, DOBBS. *supra* note 129, at 657-58.

plaintiff to the *status quo ante*.[153] Moreover, empirical studies of verdicts indicate that juries do, in fact, consistently use this measure in granting awards for psychic injury.[154] Given this consistent adoption and use of the *status quo ante* measure, can an award for mental distress be regarded as income?

The most common argument for treating the award as income relies upon the concept of "basis," which is the value of a taxpayer's investment in some property.[155] According to this argument, each person's basis in psychic well-being is zero for two reasons: (1) people do not purchase their psychic health; and (2) any expenses for the maintenance of psychic health are consumption, not investment. Because of these reasons, any monetary payment for injury to psychic well-being is a gain over the initial basis of zero.[156] Thus, the victim who receives damages for a psychic injury has received a windfall gain, much like a person who finds lost property,[157] receives a free sample,[158] or wins a lottery.[159] This argument will be addressed below in the discussion of the constitutionality of taxation of compensatory mental distress damages as income.[160]

IV. CONSTITUTIONAL ANALYSIS

A. *Constitutional Interpretation*

One of the ironies of modern legal scholarship is that theories of constitutional interpretation are so diverse and complex that they cannot be fully addressed in an article addressing a specific, concrete constitutional issue.[161] Nevertheless, despite this diversity, there are several points on which theorists agree. First, interpretation must somehow

153. *See, e.g., id.* at 652-60; KEETON ET AL., *supra* note 124, §§ 10, 12; Feldman, *supra* note 128, at 1577-80.

154. *See* Marc Galanter, *Real World Torts: An Antidote to Anecdote*, 55 MD. L. REV. 1093, 1120-26 (1996).

155. *See supra* note 80 and accompanying text.

156. *See supra* notes 81-83 and accompanying text.

157. *See* BITTKER & LOKKEN, *supra* note 10, ¶ 5.5.2.

158. *See id.*

159. *See* 26 U.S.C. § 74(a) (1994); Simmons v. United States, 308 F.2d 160 (4th Cir. 1962) (Cash prize for catching specially tagged fish constitutes income.).

160. *See infra* notes 205-25 and accompanying text.

161. For a sense of the diversity and complexity of the literature on constitutional interpretation, see Symposium, *Fidelity in Constitutional Theory, Editor's Foreword*, 65 FORDHAM L. REV. 1247 (1997). For a useful review and application of theories of constitutional interpretation interpreting the meaning of "income" in the Sixteenth Amendment in the context of deciding whether a gift is income, see Kornhauser, *supra* note 48, at 2-28.

address the language contained in the Constitution.[162] It is not appropriate to ignore the words in the text or to insert new words. Second, decisions of the United States Supreme Court have a special, authoritative role.[163] Once again, it is not proper to ignore or invent the content of these decisions. Third, there is no universally accepted process for determining the meaning of the constitutional language or of the authoritative decisions of the United States Supreme Court.[164] However, despite this lack of agreement on the process, there appears to be some agreement that part of the process is to consider what the authors of the Constitution might have meant when using particular language.[165] In other words, the intent of the original drafters has some weight, even if there is disagreement about the content of that intent, about the methods used to ascertain it, or about the weight it should be given.[166]

Because these points are nearly universally accepted, this Article has: quoted and discussed the relevant constitutional provisions; discussed Supreme Court decisions addressing those provisions; and reviewed the historical treatment of compensatory damages for mental distress, particularly in terms of the actions for assault and defamation, to develop some view as to how these damages might have been viewed at the time of the adoption of the constitutional provisions. These three types of materials must be placed within some sort of interpretive context to determine the constitutionality of taxation of compensatory damages for mental distress. As indicated above, there is no agreement on the process or method that should be used to provide this context.

Despite the lack of agreement on process, the consensus on the authoritative role of constitutional language and of Supreme Court decisions bars one approach to interpretation. This approach, which could be termed "constitutional desuetude," adopts the view that certain parts of the constitution, or certain decisions by the Supreme Court, are so obviously outmoded, antiquated, and lacking in a meaningful role to

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162. *See* Ronald Dworkin, *The Arduous Virtue of Fidelity: Originalism, Scalia, Tribe, and Nerve*, 65 FORDHAM L. REV. 1249, 1250 (1997); Richard H. Fallon, Jr., *A Constructivist Coherence Theory of Constitutional Interpretation*, 100 HARV. L. REV. 1189, 1189-90, 1195-98 (1987).

163. *See* Dworkin, *supra* note 162, at 1254-55; Fallon, Jr., *supra* note 162, at 1189-90, 1202-04.

164. *See* LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 1-2 (2d ed. 1988). *See generally* Dworkin, *supra* note 162; Fallon, Jr., *supra* note 162, at 1189-92. There is also dispute over what other factors or sources should be considered. *See, e.g.*, Dworkin, *supra*; Fallon, Jr., *supra*.

165. *See* Dworkin, *supra* note 162, at 1250; Fallon, Jr., *supra* note 162, at 1195-98.

166. *See* RONALD DWORKIN, LAW'S EMPIRE 359-69 (1986); Dworkin, *supra* note 162, at 1250; Fallon, Jr., *supra* note 162, at 1189-90, 1195-98.

play in modern society that they can be ignored or dismissed with virtually no discussion.[167] In terms of taxation, this view takes the position that taxation is so important and complex that the Supreme Court should simply allow Congress to make policy choices without interference because, in the modern context, constitutional limits on Congress's power to tax are so outmoded, arbitrary, and inapplicable that the proper approach is simply to ignore or reject them. Some commentators explicitly adopt this view.[168] Others adopt it implicitly because, for example, they discuss theories of the meaning of income for taxation purposes as if the language of the Sixteenth Amendment imposed no limits on the meaning of the term.[169] This approach of dismissal without discussion would be impermissible under any theory of interpretation. The proponents of the constitutional desuetude view must present an interpretive argument indicating why the authoritative materials are no longer relevant and binding. The authorities cannot be simply ignored.

One reason for treating the constitutional limits as irrelevant could be the lack of modern cases holding tax legislation unconstitutional. However, this lack of cases is more likely the result of congressional recognition of the constitutional limits[170] than the result of an unspo-

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167. *See generally* Arthur E. Bonfield, *The Guarantee Clause of Article IV, Section 4: A Study in Constitutional Desuetude*, 46 MINN. L. REV. 513 (1962).

168. Though it is not always clear what doctrine or theory is at issue, these commentators are very clear about their view. *See, e.g.*, JOSEPH T. SNEED, THE CONFIGURATIONS OF GROSS INCOME 125-26 (1967) (The author refers to the "decrepitude of *Eisner v. Macomber*" and argues that it "should be consigned to the junk yard of judicial history" so that courts will have the "freedom to interpret Section 61 [of the Code, which defines 'income,'] in a rational manner unimpaired by inhibitions derived from *Pollock* and *Eisner v. Macomber*."); Burke & Friel, *supra* note 67, at 21 ("line of authority [excluding nonphysical injuries from income] based on a discredited theory of gross income"); Kornhauser, *supra* note 48, at 14, 24 (Based on a detailed, but debatable, review of cases, author concludes: "Although *Macomber* has never been explicitly overruled, the Court has so narrowed the decision that it retains no force. . . . *Macomber* and its constitutional restraints of realization and ordinary meaning are dead. . . . Income's meaning is to be determined by Congress, not the Court. . . ."); Thuronyi, *supra* note 83, at 100-01 ("[T]he definition of income . . . in *Eisner v. Macomber* has been rejected. . . . [Under a proper policy approach based on a concern with fairness, is] the concept of income would be an elastic one, since it could accommodate virtually any congressional definition of income. . . . Since income is an arbitrary concept that can be given content only by judgments about fairness, it is difficult to sustain any other approach as a constitutional matter."); *cf.* Christopher S. Jackson, *The Inane Gospel of Tax Protest: Resist Rendering unto Caesar—Whatever His Demands*, 32 GONZ. L. REV. 291 (1996-1997) (critical review of "constitutional" bases for resisting income taxation); Edward L. Rubin, *The Fundamentality and Irrelevance of Federalism*, 13 GA. ST. U. L. REV. 1009 (1997) (arguing that federalism is rightfully irrelevant today).

169. *See supra* note 83 and accompanying text.

170. For example, the broad exclusions in § 104 prior to the recent amendments have made

ken Supreme Court view that constitutional provisions like the Sixteenth Amendment are so archaic and irrelevant today that it is best not to mention them, much less apply them.[171]

This Article addresses this interpretive problem by adopting the framework for constitutional interpretation adopted by Ronald Dworkin. Dworkin's framework has two components. The first is a model of the process of interpretation. The second is a substantive theory of justice or morality. Dworkin's process component asserts that a judge, after considering the language of the Constitution and Supreme Court decisions, must then fit these authoritative materials together in a way that provides the best "fit" between these materials and a theory of justice or morality.[172] This process component of Dworkin's interpretive framework is adopted partly because it is familiar[173] and well-developed and partly because it is sufficiently general to provide a basis for both agreement and disagreement. One might agree with Dworkin's position that a judge must "weave" authorities together with a view of justice, but disagree as to what that means in terms of a constitutionally relevant theory of justice or in regard to a specific issue.[174]

In developing his substantive model of justice, Dworkin consistently has focused on the nature of human personhood and on the role of rights

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it unnecessary to address constitutional issues. *See supra* notes 87-102 and accompanying text.

171. *Cf.* United States v. Lopez, 514 U.S. 549 (1995) (first instance since 1930s of holding that legislation unconstitutionally exceeded power granted by the Commerce Clause).

172. *See, e.g.*, RONALD DWORKIN, FREEDOM'S LAW: THE MORAL READING OF THE AMERICAN CONSTITUTION (1996); DWORKIN, *supra* note 166, at 355-413; Dworkin, *supra* note 162; McCaffery, *supra* note 20, at 87 (Using Dworkin's interpretive model within the context of the tax code requires that one "always have at least one foot in our actual, contingent, historically situated community and context, and another foot in political, social, and moral theory."); *cf.* Jennifer J.S. Brooks, *Taxation and Human Capital*, 13 AM. J. TAX POL'Y 189, 194 (1996) (Given changes in society the term "income" in the Sixteenth Amendment must be interpreted in today's context; "[i]t would be ludicrous . . . to suggest that the definition of 'income' should be limited to the common understanding of the term in 1913."). This creative process of "weaving" two equal values into a coherent scheme is also a necessary part of Dworkin's substantive theory of justice, which stresses the need for granting persons equal concern *and* respect. *See infra* note 179 and accompanying text. "Weaving" of conflicting values or goals is also necessary in the development of liability rules in tort law. *See supra* note 122.

173. One example of the widespread use of Dworkin's framework is its use for analyzing the tax code. *See* McCaffery, *supra* note 20, at 115-21.

174. *See, e.g.*, DWORKIN, *supra* note 172, at 3 ("The moral reading [of the Constitution] is not, in itself, either a liberal or conservative charter or strategy."); F. Patrick Hubbard, *Justice, Creativity, and Popular Culture: The "Jurisprudence" of Mary Chapin Carpenter*, 27 PAC. L.J. 1139, 1149-50 (1996) (comparison of agreement among diverse theorists, including Dworkin, as to creative process of combining disparate materials but not on specific content of combination).

in defining what it is to be a person.[175] The tort claim for assault is based on the basic "natural" right to be free from intentional invasions of the psychic sense of personal security.[176] Because this right is central to personhood, Dworkin's scheme provides a useful framework for analyzing the nature of compensation for harm inflicted in violation of the right. To Dworkin, rights serve as "trumps" that protect individuals from the imposition of majoritarian preferences, including the preference for "efficiency."[177] The constitutional requirement of apportionment of direct taxes provides such a trump insofar as national majorities are concerned.[178] Dworkin stresses that his view of justice "rests on the assumption of a natural right of all men and women to equality of concern and respect, a right they possess not by virtue of birth or characteristic or merit or excellence but simply as human beings with the capacity to make plans and give justice."[179]

This focus on equality and on living a life in terms of plans is useful because it helps structure the analysis of whether compensation for human psychological suffering constitutes a gain or is, instead, a rough substitute that places us back where we were before.[180] In particular, Dworkin's concern for granting each person equal concern and respect makes it clear that, absent a strong justification, it is arbitrary and unjustifiable to adopt a definition of income that: (1) treats the compensation received by an assault victim for loss of mental well-being as taxable income; and (2) does not treat the enjoyment of mental security and well-being by those who have not been victimized as

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175. *See generally* DWORKIN, *supra* note 166; RONALD DWORKIN, LIFE'S DOMINION (1993); RONALD DWORKIN, TAKING RIGHTS SERIOUSLY (1978) [hereinafter DWORKIN, TAKING RIGHTS SERIOUSLY].

176. *See supra* notes 134-38 and accompanying text.

177. *See generally* RONALD DWORKIN, A MATTER OF PRINCIPLE 359-65 (1985); DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 175, at 81-130, 139-49, 184-205.

178. *See supra* notes 17-21 and accompanying text.

179. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 175, at 182. Though the quotation in the text is from Dworkin's discussion of Rawls' views set forth in JOHN RAWLS, A THEORY OF JUSTICE (1971), it is clear that Dworkin shares this view. For example, Dworkin also asserts the following:

> I presume that we all accept the following postulates of political morality. Government must treat those whom it governs with concern, that is, as human beings who are capable of suffering and frustration, and with respect, that is, as human beings who are capable of forming and acting on intelligent conceptions of how their lives should be lived. Government must not only treat people with concern and respect, but with equal concern and respect.

DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 175, at 272-73.

180. *See infra* notes 205-25 and accompanying text.

income. To the extent that there is any difference between the two, the difference is that the victim appears to be in a worse position. Money is a limited, and possibly inadequate, substitute for psychic well-being; compensation is certainly not a gain for the victim. As a result, the victim's ability to make and implement a life-plan has been substantially reduced because of the tortious conduct.

Arguably, this conception of justice fits the authorities better than other conceptions or interpretations of the proper constitutional meaning of income in the context of taxing mental distress compensation.[181] This argument, like any argument based on justice, will be contentious. However, no other arguments have been developed thus far. In any event, it is only possible to present one's personal views about interpretation and hope that shared cultural understandings will provide the basis for dialogue and perhaps for persuasion.[182]

B. *Whether the Tax Is an Indirect Excise Tax on a Transaction*

As indicated above in Part I, the initial constitutional issue is whether the tax on compensatory damages for mental distress is an indirect tax on income relating to "business, privileges, or employments."[183] *Pollock* indicates that an indirect tax is involved when Congress taxes the income from "gains or profits from business, privileges, or employments"[184] because "taxation on business, privileges, or employments has assumed the guise of an excise tax and been sustained as such."[185] Thus, it is necessary to consider whether Congress used an excise tax scheme when it imposed a tax on damages for mental distress.

Excise taxes are indirect taxes[186] " 'laid upon the manufacture, sale, or consumption of commodities within the country, upon licenses to pursue certain occupations, and upon corporate privileges.' "[187] Because of the indirect nature of excise taxes, it is constitutionally permissible to impose excise taxes on transactions involving property without apportionment.[188] In contrast, direct taxation, which required

181. *See infra* notes 205-25 and accompanying text.

182. *See* Hubbard, *supra* note 174, at 1142-50.

183. *See supra* notes 63-65 and accompanying text.

184. *Pollock II*, 158 U.S. at 635.

185. *Id.*; *see also id.* at 637 (indicating that Congress has the power to impose "excise taxes on business, privileges, employments, and vocations").

186. Apparently, the only indirect taxes other than excise taxes are duties and imposts. *See* Flint v. Stone Tracy Co., 220 U.S. 107, 151 (1911).

187. *Id.* at 151 (quoting THOMAS M. COOLEY, CONSTITUTIONAL LIMITATIONS 680 (7th ed. 1903)).

188. *See supra* note 16.

apportionment in all cases before the Sixteenth Amendment allowed direct taxation of income, is involved when the tax is imposed on the ownership of property.[189] Because a tax on a transaction is an excise tax, there is no direct tax involved where, for example, the federal government taxes the sale,[190] gift,[191] or bequest[192] of property. In such cases, the taxation is imposed on the transaction, not on the property. Though it could be argued that the taxation of compensation for mental distress is an excise type of tax on the privilege of engaging in the transaction of receiving money as a result of a judgment or settlement, there are several difficulties with this view of the tax.

First, Congress apparently intends to tax the damages as income. The taxation provisions are in the Internal Revenue Code, and section 104(a) addresses inclusions and exclusions in income. Moreover, though the tax is imposed on the judgment or settlement amount, the rate of the tax on a damages award or settlement varies from transaction to transaction because the rate is determined by the taxpayer's income as a whole. Indeed, there would be no tax at all if, despite the receipt of the compensatory award, the taxpayer had no net income for the year.[193] Treating such an income-oriented tax as an excise tax would require a substantial enlargement of the concept of excise tax beyond its ordinary usage. *Pollock* clearly rejected such enlargement beyond the "natural and obvious sense" of the term.[194]

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189. *See, e.g.*, United States v. Wells Fargo Bank, 485 U.S. 351 (1988). Addressing the estate taxation of obligations issued under the Housing Act of 1937, the Court notes:

> Well before the Housing Act was passed, an exemption of property from all taxation had an understood meaning: the property was exempt from *direct* taxation, but certain privileges of ownership, such as the right to transfer the property, could be taxed. Underlying this doctrine is the distinction between an excise tax, which is levied upon the use or transfer of property even though it might be measured by the property's value, and a tax levied upon the property itself. The former has historically been permitted even where the latter has been constitutionally or statutorily forbidden.

Id. at 355 (emphasis added).

190. *See* Spreckels Sugar Ref. Co. v. McClain, 192 U.S. 397, 416-17 (1904).

191. *See* Bromley v. McCaughn, 280 U.S. 124, 136 (1929).

192. *See* New York Trust Co. v. Eisner, 256 U.S. 345 (1921); Knowlton v. Moore, 178 U.S. 41 (1900); Scholey v. Rew, 90 U.S. (23 Wall.) 331 (1874).

193. *See* 26 U.S.C. §§ 151-197 (1994) (The Internal Revenue code allows numerous deductions that reduce taxable income, sometimes to zero.).

194. *Pollock II*, 158 U.S. at 619. The Court noted the following:

> We know of no reason for holding otherwise than that the words "direct taxes," on the one hand, and "duties, imposts and excises," on the other, were used in the

Second, imposing an excise type of transaction tax on tort awards would be such a novel concept that it is difficult to characterize and evaluate such a tax without the benefit of a specific scheme that explicitly adopts an excise framework. Without such a context, it is difficult to address a wide range of issues. For example, a broad approach to transaction taxation could seriously erode cases like *Pollock* and *Macomber*. If payment of money to settle a claim prior to litigation is a taxable transaction, then the concept of transaction could be used to tax other returns to capital—for example, repayment of loans. Similarly, treating the receipt of rental income from property as a transaction involving the property would be a semantic maneuver that would circumvent the holding of *Pollock* that taxation of the income from property is a direct tax.[195] Even if it were proper to treat payments of compensatory awards as taxable transactions, there would be serious equal treatment problems with an excise imposed only on awards for mental distress unaccompanied by a physical injury and imposed at a rate which varies with the taxpayer's overall income.[196]

Third, the very nature of the compensatory award indicates that the tax is, in effect, a direct tax in the ownership of the property interest in security one owns by virtue of being a person, not a tax on a transaction. Psychic well-being is a uniquely human aspect that is central to what it means to be a human person.[197] Given this importance, the right to security from certain types of invasions is regarded as a basic, natural right.[198] Taxing each human for the benefits of possessing and enjoying emotional well-being would be effectively a poll tax because it would be laid upon persons without regard to their occupations or property.[199] This characterization of the nature of the tax does not change simply because the tax is only levied on the compensation for the loss of this human dimension received by those unfortunate enough to suffer a tortious injury like an assault.

> constitution in their natural and obvious sense. Nor, in arriving at what those terms embrace, do we perceive any ground for enlarging them beyond, or narrowing them within, their natural and obvious import at the time the constitution was framed and ratified.

Id.

195. *See supra* notes 29-31 and accompanying text.

196. *See supra* note 10 (Due Process Clause as limit on taxation power).

197. *See supra* notes 134-43 and accompanying text; *infra* notes 203, 217-23 and accompanying text.

198. *See supra* notes 134-43 and accompanying text.

199. *See* Breedlove v. Suttles, 302 U.S. 277, 281 (1937) (definition of poll tax as tax "laid upon persons without regard to their occupations or property"); *cf. infra* note 203 and accompanying text (nontaxable nature of enjoyment of psychic well-being).

C. *Whether the Tax Is a Tax on Income*

Income is defined in terms of gain; if there is no gain to a person, there is no income.[200] Thus, the issue of whether compensatory damages constitute income subject to taxation and the Sixteenth Amendment depends upon whether the victim who receives compensatory damages for mental distress has received a gain. Given that the measure of damages is the amount of money necessary to make the victim whole again,[201] it is hard to see how the victim receives a gain.

Except when applying statutory exceptions like section 104, the federal courts traditionally have applied an "in lieu of what" test to determine whether a damages award or settlement involves a gain.[202] Under this test, it is necessary to ask whether a compensatory payment for mental distress is in lieu of something that is otherwise taxable. Insofar as compensation for mental distress is concerned, the answer to this question is clear: The damages are not rendered in lieu of something that is otherwise taxable because the enjoyment of psychic well-being is not taxable as income.[203] Thus, under the traditional test for gain in the context of compensation, payments to restore this nontaxable aspect of being human are not a gain.[204]

The only argument for viewing these compensatory damages as a gain under this traditional test relies upon the assumption that the "basis" in psychic well-being is zero.[205] If this assumption is accepted, then the compensatory award constitutes a gain because any award will exceed the basis of zero. Thus, a compensatory payment for mental distress is in lieu of nothing and is, therefore, a windfall gain like a

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200. *See supra* notes 39-62 and accompanying text.

201. *See supra* notes 128-30, 153 and accompanying text.

202. *See supra* notes 112-19 and accompanying text.

203. It would not be a tax on income because enjoyment of an asset is not, by itself, income. *See, e.g.*, Helvering v. Independent Life Ins. Co., 292 U.S. 371, 379 (1934) ("[R]ental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment."). Moreover, because only humans (as opposed to physical property like machines and land) enjoy psychic well-being, taxation of all humans for their enjoyment of this uniquely human aspect would be a capitation tax. *See supra* notes 197-99 and accompanying text. Though livestock and pets can suffer psychic harm, they also can be bought and sold. Psychic injury to these animals is not recoverable in tort unless the "productive value" of the animal is reduced. *See* 4 AM. JUR. 2D *Animals* § 145 (1995). Moreover, because there is a market in the sale of animals, it is possible to speak in terms of "basis" as the cost of acquiring and maintaining the animal.

204. *See, e.g.*, United States v. Kaiser, 363 U.S. 299, 311 (1960) (Frankfurter, J., concurring) ("The principle at work [in determining taxability as income] is that payment which compensates for a loss of something which would not itself have been an item of gross income is not a taxable payment."); Brooks, *supra* note 74, at 768-73; Yorio, *supra* note 70, at 713-14.

205. *See supra* notes 80-83 and accompanying text.

prize in a lottery.[206] Does the Sixteenth Amendment prohibit Congress from adopting the assumption that the basis in psychic health is zero?

It should be noted that the argument that there is no basis in psychic well-being has been presented in terms of policy analysis. The proponents of the position have not considered whether the argument is applicable in terms of interpreting the Sixteenth Amendment.[207] Going beyond policy and evaluating this argument in terms of the Sixteenth Amendment requires a more complete consideration of the nature of the right to psychic well-being and of whether the restoration of this right by a compensatory payment of money can be regarded as a gain under the traditional "in lieu of what" test.

The analysis of taxation of any aspect of human enjoyment or conduct requires a recognition of the fact that humans have overlapping, dual aspects—economic and personal.[208] In many ways, it makes sense to speak of humans as a form of "economic property" or "capital." For example, even though we cannot be bought and sold, we can choose to sell our labor in market transactions, and some are able to market their personae even after death.[209] However, humans have another, noneconomic aspect. In contrast to property like machines and factories, we are not simply economic property that can be viewed solely in terms of market transactions. Humans also use their talents and economic property to make and live out their "life plans."[210] As a result of this duality,

> [f]or income tax purposes Congress has seen fit to regard an individual as having two personalities: "one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."[211]

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206. *See supra* note 159 and accompanying text.

207. *See supra* note 83 and accompanying text.

208. This duality of human personhood has always presented problems in terms of taxation analysis. When the Supreme Court was initially trying to identify and define "capitation" and other "direct taxes," it recognized that taxation of a slave might fall either into the category of capitation tax or of direct property tax. *See, e.g.*, Springer v. United States, 102 U.S. 586, 598 (1880) (noting that 1798 tax act imposed a capitation tax on slaves and that in 1813 slaves were taxed on the basis of their property value); Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533, 543-44 (1869) (concluding that "Congress, after 1798, regarded slaves, for the purposes of taxation, as realty").

209. *See generally* Note, *Federal Estate Tax and the Right of Publicity: Taxing Estates for Celebrity Value*, 108 HARV. L. REV. 683 (1995).

210. *See supra* notes 179-80 and accompanying text.

211. United States v. Gilmore, 372 U.S. 39, 44 (1963) (quoting from STANLEY S. SURREY

Because of this uniquely human duality, a concept like basis, which functions well with property like trucks or stocks, cannot be simply transferred with no changes or limits to discussions of injuries to humans. Basis is generally regarded as purchase price, plus investments and less depreciation for which a deduction in income has been allowed.[212] Humans do not have a purchase price, and calculations of the dollar value of human genetic endowments and of the dollar value of additions to and subtractions from those endowments raise considerable theoretical and practical problems.[213] Moreover, as indicated above, genetic and learned talents and capabilities are used not only for seeking after profit but also for satisfying needs as a human—i.e., for living a human life. As a result, "investments" in and "depreciation" of humans are not treated like investments in property for tax purposes.[214] For example, though it might seem that educational expenditures are investments in human capital, most educational expenditures are not treated in this manner. Instead, they are viewed as investments in increased enjoyment of life and are, therefore, not viewed as deductions or as adding to "basis."[215] Similarly, it is not clear how to address living expenses for food, shelter, and health where a taxpayer engages in the sale of renewable body parts like blood and hair.[216] Educational expenses and living expenses in relation to the sale of renewable body parts present difficulties in terms of basis analysis because they involve the activities of humans both as market oriented "seekers after profit" and as "creatures satisfying needs as a human."

However, no such difficulties in characterization are involved in terms of psychic well-being. Emotions only function as a part of an aspect of our unique "needs as a human" as each of us makes and implements an individual plan for life. There is no economic dimension.

& WILLIAM C. WARREN, CASES ON FEDERAL INCOME TAXATION 272 (1960)); *see* BITTKER & LOKKEN, *supra* note 10, ¶ 20.1, at 20-39 (discussing the "business—personal borderline").

212. *See supra* note 80.

213. *See* Stephan, *supra* note 48, at 1361.

214. *See* 26 U.S.C.A. § 262(a) (West Supp. 1997) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."); Brooks, *supra* note 74, at 766-68; Heen, *supra* note 71, at 555-60; Stephan, *supra* note 48, at 1358-60.

215. *See* Griffith, *supra* note 72, at 1146-47; *see generally* Clifford Gross, *Tax Treatment of Educational Expenses: Perspectives from Normative Theory*, 55 U. CHI. L. REV. 916 (1988); Heen, *supra* note 71, at 555-60; Stephan III, *supra* note 48, at 1407-13.

216. *See* Lary v. United States, 787 F.2d 1538 (11th Cir. 1986) (no basis in blood); United States v. Garber, 607 F.2d 92 (5th Cir. 1979) (issue of whether any profits from sale of unique blood plasma would constitute income), *rehearing en banc rev'g* 589 F.2d 843 (5th Cir. 1979); Green v. Commissioner, 74 T.C. 1229 (1980) (receipts from sale of blood income); Frolik, *supra* note 74, at 23-25; Stephan III, *supra* note 48, at 1417-18; Note, *Tax Consequences of Transfers of Bodily Parts*, 73 COLUM. L. REV. 842 (1973).

Humans cannot seek after profit by simply buying and selling emotional states like happiness, sorrow, or fear in market transactions in the way one can buy and sell one's ability to perform services. Having to work, rather than to play, may make a person unhappy; but the payment to the person is for the work, not the unhappiness.[217] However, this lack of economic dimension does not mean that basis is zero. Instead, the lack of marketability indicates that there is reason to be uncertain concerning whether this type of human capital can be analyzed in the same way as economic property. Analysis of basis in terms of dollars spent on investment is useful when speaking of real or personal property. Such analysis can also provide assistance in analyzing investment in humans insofar as humans are acting as market seekers after profit. However, the literal use of market based concepts of basis is inappropriate in dealing with an aspect of human personhood like psychic well-being.

Human capital analysis is useful in considering uniquely human emotional injuries, but only by way of analogy. In particular, the analogy between economic capital and human capital helps in seeing that a person receives no gain when receiving "damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, 'return the victim's personal or financial capital.' "[218] This analogy does not require any identification of basis to be applicable. The traditional torts of assault and defamation protect basic human rights. In order to protect and implement those rights, victims are entitled to compensatory damages for the loss suffered. These compensatory damages "aim to substitute for a victim's physical or personal well-being."[219] The measure of these damages is the amount necessary to restore the victim to *status quo ante*—no more, no less.[220] Thus, the damages are in lieu of psychic well-being and simply restore whatever basis a person already had in his or her human capital.[221] They are not a windfall receipt of something for nothing. Nor do they constitute the

217. The amount of the payment for the work may reflect whether the work is psychologically pleasant or unpleasant. However, it is not clear how to treat this point. For example, is the variation in payment viewed as increased monetary pay for psychic stress and trauma and/or as "pay" for some jobs in terms of both money and pleasant working conditions? In any event, it is clear: (1) that employers are not simply purchasing psychic trauma; and (2) employees are not taxed for any psychic pleasures they derive from their employment.

218. *O'Gilvie*, 117 S. Ct. at 456.

219. *Id.*

220. *See supra* notes 128-30, 153 and accompanying text.

221. *Cf.* United States v. Davis, 370 U.S. 65, 73-74 (1962) (treating, in the context of statutory construction, wife's basis in marital rights as equal in value to property received in exchange for such rights); Comment, *The Lump Sum Divorce Settlement as a Taxable Exchange*, 8 U.C.L.A. L. REV. 593, 600-04 (discussing wife's basis in property received in exchange for marital rights).

replacement of human endowment that can be marketed through the sale of services, a unique persona, or a renewable body part. Indeed, the taxation of a nonmarketable, uniquely human aspect like emotional well-being is, in effect, a capitation or poll tax because it is laid upon persons without regard to their occupations or property.[222] Imposing such a capitation tax only on those who have been compensated for the loss of this human aspect is both unjustifiably unequal and an unconstitutional, unapportioned capitation tax.

When placed in the context of compensation for the uniquely human harm of mental distress, the argument that we have a zero basis in psychic well-being and that therefore compensatory payments for mental distress are a windfall gain is inapplicable to the constitutional question. There is no reason or need to identify any specific basis because the rules for measuring compensation, by their explicit terms, simply return whatever basis the victim had before the tortious injury. Moreover, the designation of the basis as zero is not only unnecessary but also a totally arbitrary refusal to grant any value to rights that cannot be purchased in a market transaction.[223] Money is a measure of value, but it is not the only measure. Instead of following this arbitrary approach to compensation for a loss with no market value, it is better to grant such intangible and uniquely human losses a "basis" equal to the amount necessary to restore the *status quo ante*. This traditional approach was summarized by Justice Frankfurter as follows:

> The principle at work here is that payment which compensates for a loss of something which would not itself have been an item of gross income is not a taxable payment. The principle is clearest when applied to compensation for the loss of what is ordinarily thought of as a capital asset, e.g., insurance on a house which is destroyed. . . . If a capital asset is sold for no more than its basis there is no taxable gain. The result, then, is the same if it is destroyed and there is paid in compensation no more than its basis. There are, to be sure, difficulties, not present where ordinary assets are involved, in applying this principle to compensation for the loss of something which has no basis

222. *See supra* notes 197-99 and accompanying text.

223. *Cf. Griffith, supra* note 72, at 1157-58 (contrasting measurement of taxpayers' positions by considering utility or by considering only monetary receipts); Harnett, *supra* note 71, at 627 (Designations of basis in context of intangible injuries "are only statements of the conclusion [about gain and taxability] and not assistive of reaching it."); William T. Plumb, Jr., *Income Tax on Gains and Losses in Litigation*, 25 CORNELL L.Q. 221, 234 (1940) ("[T]he human body and the reputation which are injured are in no true sense capital or property upon which a value can be placed for the purpose of computing the profit realized. . . .").

> and which is not ordinarily thought of as a capital asset, such as health or life or affection or reputation.[224]
>
> [P]ayment . . . as compensation for a loss or injury that had been suffered . . . [is] not taxable either because not greater in amount than the loss or because the thing lost or damaged had no ascertainable market value and so it could not be said that there had been any net profit to the taxpayer through the effectual exchange of the thing lost for the payment received.[225]

V. CONCLUSION

Compensation for mental distress is measured by the amount necessary to restore the victim to the *status quo ante*. This determination is made in an adversarial context applying traditional tort rules of liability and damages. The only way to view this compensation as a gain to the victim is to ignore the reality of the loss suffered by arbitrarily placing a zero basis on the value of psychic well-being. Such an arbitrary evaluation ignores the uniquely human quality of mental distress. Viewing the award as a gain is also contrary to common usage. People do not think they have experienced a gain when they are simply returned to *status quo ante*. The inability of money damages for mental trauma to restore the status quo in a literal sense does not change this assessment. Instead, this inability reinforces the conclusion that there is no gain. We do not ordinarily want to become victims of a vicious assault even if we believe we will receive monetary compensation for our fear and continuing psychic trauma. Because there is no gain to the compensated victim, there is no income under the Sixteenth Amendment. Consequently, because the taxation of compensatory damages for mental distress is a direct tax and is not apportioned, the tax is unconstitutional.

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224. *Kaiser*, 363 U.S. at 311 (Frankfurter, J., concurring). The opinion also notes that the taxability of the uniquely human aspects like "health or life or affection or reputation" is not at issue in the case. *Id.*

225. *Id.* at 310.