

2023

Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards

Joseph M. Dodge

Florida State University College of Law

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Dodge, Joseph M. (2023) "Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards," *Florida Tax Review*: Vol. 8, Article 6.

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FLORIDA TAX REVIEW

VOLUME 8

2007

NUMBER 4

MURPHY AND THE SIXTEENTH AMENDMENT IN RELATION TO THE TAXATION OF NON-EXCLUDABLE PERSONAL INJURY AWARDS

by

Joseph M. Dodge*

I. FRAMING CONSTITUTIONAL TAX ISSUES	371
<i>A. Constitutional Provisions Relating to the Taxing Power of Congress</i>	371
<i>B. Is the Indirect Tax Issue Relevant to Murphy?</i>	373
II. INTERPRETING THE SIXTEENTH AMENDMENT	380
<i>A. Textualism Rules</i>	380
<i>B. Interpreting Ambiguous Text</i>	385
<i>C. Interpretative Theory</i>	386
III. DOES “INCOME” UNDER THE SIXTEENTH AMENDMENT INCLUDE EMOTIONAL HARM DAMAGES?	392
<i>A. The No-gain Theory</i>	392
1. <i>“Incomes” under the Sixteenth Amendment means “gross receipts”</i>	392
2. <i>The meaning of “capital” under the income tax</i>	408
3. <i>There is no recoverable basis in personal injury recoveries</i>	420
<i>B. The “In Lieu Of” Theory</i>	424
1. <i>There really is no “in lieu of” doctrine</i>	425
2. <i>The Murphy version of the doctrine would destroy the income tax</i>	427
IV. CONCLUSION	427

* Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor of Law,
Florida State University College of Law.

**MURPHY AND THE SIXTEENTH AMENDMENT IN RELATION TO THE
TAXATION OF NON-EXCLUDABLE PERSONAL INJURY AWARDS**

A recent panel decision of the U. S. Court of Appeals for the District of Columbia, *Murphy v. Internal Revenue Service*,¹ shocked the tax community² by holding that Internal Revenue Code section 104(a)(2) was unconstitutional by failing to exclude from gross income revenue (damages for emotional distress and injury to professional reputation) that is not “income” under the Sixteenth Amendment to the U.S. Constitution.

A petition for rehearing *en banc* was filed,³ but, in a highly unusual move, the D.C. Circuit panel that decided the case, on its own motion, vacated its judgment and set the case for re-argument.⁴

Before 1996, section 104(a)(2) had excluded from gross income compensatory damages on account of personal injuries, including non-physical personal injuries of the type suffered by plaintiff Murphy. In 1996, Congress narrowed the exclusion so that it only applied to damages on account of *physical* personal injuries, thereby removing the exclusion for non-physical injuries. The panel stated its constitutional holding as follows:

Insofar as § 104(a)(2) permits the taxation of compensation for a personal injury, which compensation is unrelated to lost wages or earnings, that provision is unconstitutional.⁵

Part I contains a brief description of the federal constitutional provisions concerning taxation and how they are related to each other. Part II discusses the issue of how to interpret the Sixteenth Amendment. Part III considers the on-the-merits exclusionary theories offered by the *Murphy* panel.

1. 460 F.3d 79 (Aug. 22, 2006).

2. See *Murphy v. IRS Leaves Tax Community Reeling*, at <http://www.taxanalysts.com/www/website.nsf/Web/SpotlightonMurphy?OpenDocument&simple=1> (providing link to 5 pieces that appeared in Tax Notes within three weeks of the *Murphy* decision).

3. On October 5, 2006, the government filed a petition for rehearing *en banc*. The petition can be found at: http://taxprof.typepad.com/taxprof_blog/files/murphy_en_banc_petition.pdf.

4. See 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

5. See 460 F.3d at 92. On a point of procedure, the U.S. Court of Appeals for the District of Columbia held that the Internal Revenue Service (the IRS) was not a proper party (and not subject to injunction), but that it could entertain a refund suit against the United States. See *id.* at 83.

I. FRAMING CONSTITUTIONAL TAX ISSUES

Section A describes the constitutional provisions relating to the taxing power of Congress (with which most readers will be familiar) and Section B deals with the issue of whether the *Murphy* panel properly ignored the “indirect tax” issue.

A. Constitutional Provisions Relating to the Taxing Power of Congress

Under the Articles of Confederation, the federal government had only the power to impose requisitions on the states in proportion to the value of land and improvements thereon.⁶ However, the states typically refused to pay over their assigned quotas,⁷ and the federal government possessed no other taxing power. The Constitutional Convention of 1787 was called in part to overcome this problem.⁸ Under Article I, § 8, Clause 1, of the Constitution, Congress is granted authority to “lay and collect Taxes, Duties, Imposts, and Excises,” but “all Duties, Imposts and Excises shall be uniform throughout the United States.” The uniformity requirement has been construed by judicial decisions to apply to “taxes” (other than direct taxes) as well as to duties, impost, and excises,⁹ but it is deemed to prevent only patent or intentional discrimination based on geography.¹⁰

The “direct tax” concept appears in Article I, § 2, dealing with representation in the House of Representatives. Clause 3 thereof requires both direct taxes and representatives to be apportioned among the states in accordance with population, in which slaves were counted as three-fifths of a person. Somewhat redundantly, Article I, § 9, Clause 4, states that no “capitation or other direct tax shall be laid except in proportion to the census.” There is no definition of “direct tax” in the Constitution, and none was offered

6. See Arts. of Confederation, Art. VIII (Mar. 1, 1781), at: <http://www.yale.edu/lawweb/avalon/artconf.htm#art8>.

7. See *The Federalist* No. 15, at 89-90 (Alexander Hamilton), at: <http://www.foundingfathers.info/federalistpapers/fedindex.htm> (stating that the states treated requisitions as mere recommendations); Calvin H. Johnson, *The Apportionment of Direct Taxes: The Foul-Up at the Core of the Constitution*, 7 *Wm. & Mary Bill of Rights J.* 1, 131-33 (1998) (hereinafter “Foul-Up”) (difficulty of honest appraisals).

8. See *Cohens v. Virginia*, 6 *Wheat.* (19 U.S.) 264, 388 (1821) (Marshall, C.J.): “The requisitions of Congress, under the confederation, were as constitutionally obligatory as the laws enacted by the present Congress. That they were habitually disregarded, is a fact of universal notoriety. With the knowledge of this fact, and under its full pressure, a convention was assembled to change the system.”

9. See *Hylton v. United States*, 3 U.S. (3 *Dall.*) 171, 173, 176, 181 (1796).

10. See *Fernandez v. Wiener*, 326 U.S. 340 (1945); *United States v. Ptasynski*, 462 U.S. 74 (1983).

in the Constitutional Convention.¹¹ Thus, the matter has been left to judicial construction,¹² culminating in the 1895 case of *Pollock v. Farmers' Loan & Trust Co.*,¹³ invalidating the unapportioned 1894 income tax on the ground that a tax on the income from any property (real or personal) was a tax on the property itself, and therefore "direct." *Pollock* created an uproar, and in subsequent years various federal taxes were upheld as indirect taxes, not subject to the apportionment requirement.¹⁴

The political impetus that gave rise to the 1894 income tax not only survived *Pollock* but gained support. The Sixteenth Amendment, proposed by Congress in 1909 and ratified in 1913, states:

The 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.

Congress enacted a personal (individual) income tax in 1913, which has continued (with numerous additions and changes) to the present. The Supreme Court upheld the tax in 1916,¹⁵ stating that the purpose of the 16th Amendment

11. On Aug. 20, 1787, Rufus King asked for the meaning of "direct tax," but no reply was given. See Madison's Notes of Aug. 20, 1787, at: <http://www.teachingamericanhistory.com/convention/debates/0820.html>.

12. See *Hylton v. United States* 3 U.S. (3 Dall.) 171 (1796), upholding an unapportioned annual tax on the value of carriages, where it was stated that a direct tax is a tax (like a head tax or requisition on the states) that was capable of apportionment among the states in proportion to population, but it was also stated in dictum that a tax on real estate (including slaves) would also be a direct tax. The federal government initially subsisted on customs duties and excises, but on three occasions imposed a tax on real estate that was apportioned among the states in accordance with population. See Act of July 14, 1798, 1 Stat. 597, v. 75, 5th Cong., 2d Sess.; Acts of July 22 and Aug. 2, 1813, 3 Stat. 22, 53, chs. 22 & 37, 13th Cong., 1st Sess.; Act of Aug. 5, 1961, 12 Stat. 292, ch. 45, 37th Cong., 1st Sess. The Civil War income tax was upheld as an indirect tax in *Springer v. United States*, 102 U.S. 586 (1881).

13. 157 U.S. 429 (1895) (holding tax on rents to be unconstitutional as an unapportioned direct tax), on rehearing, 158 U.S. 601 (holding tax on income from personal property to be equally unconstitutional).

14. See *Knowlton v. Moore*, 178 U.S. 41 (1899) (federal inheritance tax of 1898 is an excise); *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911) (1909 tax on privilege of doing business as corporation, measured by annual net income, is an excise).

15. See *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916).

was to remove the apportionment requirement from federal income taxes, rather than to redefine the contours of “direct tax.”¹⁷

To summarize, Congress lacks the power to impose a tax only if the tax is not on “income” *and* it is an unapportioned direct tax.¹⁸ Thus, an unapportioned federal tax is valid if it is *either* an income tax *or* an indirect tax.

B. Is the Indirect Tax Issue Relevant to Murphy?

Given that a federal tax provision, to be unconstitutional, must flunk *both* the “income” (16th Amendment) test *and* the (unapportioned) direct tax test, it would appear to be the case that any enactment that flunks the 16th Amendment must also be tested under the direct tax test. However, it is first necessary to ascertain how, if at all, the Constitution is relevant in *Murphy*, as it is axiomatic that a court should not reach the constitutionality of a federal statute if such can be avoided and the case can be resolved on other grounds, such as statutory interpretation.¹⁹ The *Murphy* panel violated this axiom, because it could have avoided the invalidation of any statutory provision.

Section 104(a)(2), the provision held by the *Murphy* panel to be unconstitutional as applied to the facts of that case, merely excludes specified recoveries from gross income. The panel seemed to believe that the failure of the exclusion to apply to the facts automatically resulted in inclusion. Indeed, Congress probably assumed that removal of the exclusion resulted in automatic gross income inclusion.²⁰ However, Congress creates law through legislation, not by way of assumptions, understandings of existing law, and statements in

17. *Pollock* is now a dead letter with respect to its holding that a tax on income from property is a direct tax. See *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112-13 (1915) (general repudiation of *Pollock* rationale); *New York v. Graves*, 300 U.S. 308, 314 (1937) (New York could tax a New York resident on rents from New Jersey property, although New York could not impose a property tax on New Jersey real estate); *South Carolina v. Baker*, 485 U.S. 505 (1988) (overruling that portion of *Pollock* that held that a tax on state bond interest was a tax on the state itself in violation of the 10th Amendment). However, the portion of *Pollock* that held that a tax on personal (as well as real) property is a direct tax was implicitly followed in *Eisner v. Macomber*, 252 U.S. 189 (1920).

18. See *Penn Mutual Ins. Co. v. Comm’r*, 277 F.2d 16, 19-20 (3d Cir.1960).

19. See, e.g., *Edward DiBartolo Corp. v. Florida Gulf Coast Building Construction Trade Council*, 485 U.S. 568 (1988); *Rust v. Sullivan*, 500 U.S. 173 (1991).

20. See Conference Report No. ???, 104th Cong., 2d Sess. 141-44 (with caption: “Include in income damage recoveries for non-physical injuries”). However, the text under the caption makes no mention of inclusion.

Committee Reports.²¹ Such matters might be considered by courts or the Treasury (in promulgating regulations) in interpreting statutory text or filling a gap in the statutory scheme. However, the assumption that a non-excluded item is automatically included is neither an interpretation of the text of section 104(a)(2), nor does it fill any gap, because any such gap as may exist is already filled by section 61(a), which specifies what is included in gross income.

Section 61 states that “Except as otherwise provided in this subtitle [by way of statutory exclusion], gross income means all income from whatever source derived, including (but not limited to) the following items: [there follows a list of enumerated items, such as compensation for services, gains from property transactions, interest, dividends, and so on].” Note that the lead-in clause to section 61(a) itself picks up where the statutory exclusions leave off. Thus, it was error to hold that section 104(a)(2) was unconstitutional, because the nonapplicability of that exclusionary rule must lead to consideration of the issue of whether the recoveries in question were gross income under section 61(a). If section 61 did not purport to include the item in question, then there could be no unconstitutional tax.²² Since none of the enumerated items in section 61(a) refer explicitly or implicitly to recoveries of damages, the controlling language with respect to the *Murphy* facts is “all income from whatever source derived,” which is commonly referred to as the “catch-all clause.”

At this point the relevance of the Constitution to *Murphy* comes into focus: “income” in the catch-all clause is the same as “income” in the 16th Amendment. This position derives support from the fact that the catch-all clause language (“all income from whatever source derived”) tracks the 16th Amendment language (“incomes, from whatever source derived”). Further support is lent by an oft-repeated Supreme Court dictum to the effect that section 61 represents the “full measure of the taxing power [of Congress].”²³ Thus, the relevant exercise is that of defining a statutory term with reference to the 16th Amendment, and not of holding that section 61 (as applied) is unconstitutional, much less that section 104(a)(2) is constitutionally defective.

21. Examples of erroneous Congressional assumptions are found in IRC §§ 195(c)(1)(B) (assumption as to what is an “expense”) and 274(b) (assumption as to what is “gift”).

22. Holding that an exclusion doesn’t go far enough smacks of judicial legislation. It might be said that the *Murphy* panel decision goes beyond merely striking of the word “physical” from the statutory exclusion provided by IRC § 104(a)(2), because it also states (460 F.3d at 91, 92) that damages (from non-physical injuries) relating to lost wages or earnings would be taxed. Thus, the panel effectively amended the statute to read that the exclusion applied to damages for “non-physical personal injuries (except for damages related to lost wages or earnings) and physical personal injuries.”

23. This dictum is discussed in the text accompanying notes 25-32.

Whether the *Murphy* panel correctly held that emotional distress damages were not income under the catch-all clause as viewed through the lens of the 16th Amendment is a different issue, taken up later in Part III. The question considered here is whether the *Murphy* panel, after having held (erroneously, in my view) that such damages were not “income,” should have gone on to consider the power of Congress to lay indirect taxes without apportionment. On this point, the *Murphy* panel correctly (if perhaps without reflection) declined to consider the indirect tax issue. No provision exists that specifically states that non-excludible damages are taxed (by being included in gross income). Therefore, the sole locus of the inclusion of emotional distress damages must be in the catch-all clause of section 61,²² which states that the item is includible (only) if it is “income.” If it is not “income,” it is not taxed under the statute. The fact that other inclusion provisions might derive their power (in whole or in part) from the power to impose indirect taxes is beside the point with regard to the *Murphy* facts.

It seems unlikely that “income” under the catch-all clause could have a broader meaning than “incomes” under the 16th Amendment. A contrary supposition would run into several problems. First, it would violate a general canon of constitutional interpretation that a power granted by the constitution should encompass particular statutory exercises of such power.²³ Second, if “income” in the catch-all clause of section 61 were construed to include *anything* that Congress *could* tax as an indirect tax, then it would no longer mean “income,” but something broader and perhaps indeterminate. Third, such a construction would amount to treating Congress as having legislated what it didn’t actually legislate, thereby violating separation-of-powers theory.

22. Several Supreme Court cases holding IRC § 104(a)(2) to be inapplicable resulted in inclusion, but in all of these cases inclusion (the issue posed in *Murphy*) was simply assumed (and conceded by the taxpayer). See *United States v. Burke*, 504 U.S. 229, 233 (1992); *Comm’r v. Schleier*, 515 U.S. 323 (1995); *Comm’r v. O’Gilvie*, 519 U.S. 79 (1996).

23. See *Martin v. Hunter’s Lessee*, 1 Wheat. (14 U.S.) 304, 326-27 (1816) (Story, J.):

[W]here a power is expressly given [by the Constitution] in general terms, it is not to be restrained to particular cases. ... The instrument was not intended to provide merely for the exigencies of a few years, but was to endure through a long lapse of ages... . It could not be foreseen what new changes and modifications of power might be indispensable to effectuate the general objects of the charter; and restrictions and specifications, which, at the present, might seem salutary, might, in the end, prove the overthrow of the system itself. Hence its powers are expressed in general terms, leaving to the legislature, from time to time, to adopt its own means to effectuate legitimate objects, and to mold and model the exercise of its powers, as its own wisdom, and the public interests, should require.

Congress has to act by actual legislation. It cannot enact an open-ended rule whose content is dictated by possible future (valid) legislation.

The indirect-tax power would come into play under two scenarios. The first scenario (not presented in *Murphy*) is where the statute specifically taxes an item (by including it in income), but such an item is not “income” under the 16th Amendment. The second scenario is where (contrary to the analysis in the preceding paragraph) the catch-all clause meaning of “income” is broader than the meaning of “incomes” under the 16th Amendment. But no court (including the *Murphy* panel decision) has, to my knowledge, taken such a view, and so it must be viewed as being only a remote theoretical possibility. The *Murphy* panel decision implicitly adopted a narrow construction of catch-all “income” because it adopted a restrictive view of 16th Amendment incomes.

It is worth pausing over the import of the dictum about Congress having “fully exercised its taxing power.” The full original statement of the dictum was: “The broad sweep of this language [the predecessor of IRC section 61(a)] indicates the purpose of Congress to use the full measure of its taxing power *within those definable categories*.”²⁴ [Emphasis added.] In other words, the dictum does not apply to the Code as a whole, but only to particular provisions therein. The position that Congress has fully exercised its taxing power in the Code as a whole is untenable, unless one makes the implausible assumption that each and every statutory income exclusion is mandated by the Constitution,²⁵ but in that case the statutory exclusions would be pointless. It is axiomatic that a reading of statutory and constitutional text that renders the same futile or redundant is to be avoided. In the context of particular Code provisions, the dictum has always been deployed as a maxim of statutory interpretation, rather than as a statement of constitutional principles. None of the cases in which the dictum appears seriously entertained a constitutional challenge to the provision requiring inclusion. Instead, the effect of the maxim was always to construe various clauses of section 61 (including the catch-all clause) as having a broad

24. See *Helvering v. Clifford*, 309 U.S. 331, 334 (1940).

25. If Congress has the power to tax compensation for services, it is hard to conceive of a theory under which all of the existing exclusions for employee fringe benefits are constitutionally mandated. Cf. *Comm’r v. Kowalski*, 434 U.S. 77, 82-83 (1977) (narrowly construed the IRC § 119 exclusion, resulting in inclusion).

reach,²⁶ and a broad construction of statutory provisions implies a broad construction of the federal taxing power.

The evolution of the tax treatment of alimony offers a useful case history of the interplay of the taxing statute and the federal taxing power from the earliest days of the income tax. The 1917 Supreme Court decision in *Gould v. Gould*²⁷ held that cash support received by a wife from her husband under a decree of separate maintenance was not income. Although *Gould* purported to rest on the predecessor of section 61 rather than the Constitution, *Gould* would have implicated the 16th Amendment if the dictum (which first appeared 20 years after *Gould* was decided) were taken at face value.²⁸ However, in 1942 Congress enacted the predecessor of section 71, which treats cash alimony (as defined therein) as gross income to the recipient. If *Gould* were implicitly a decision resting on the 16th Amendment, and if the 16th Amendment were “the only game in town,” then section 71 would necessarily be unconstitutional. But section 71 has been long held to be valid,²⁹ and such validity can be based only on three plausible theories.³⁰ One is that *Gould* correctly held that alimony is not “income” under the 16th Amendment, but that section 71 is valid as being

26. The *Clifford* statement, note 24, was followed by a cite to *Helvering v. Midland Mutual Life Insurance Co.*, 300 U.S. 216, 223 (1937), which found “interest” income to exist for tax purposes in a situation where interest was neither received in cash nor accrued on the taxpayer’s books. In a similar vein, “dividends” would include any kind of economic benefit transferred by a corporation to a shareholder on account of stock ownership, whether in cash or in kind, and whether or not treated as a “dividend” on the corporation’s books. The “full use of the taxing power” phrase was cited notably in *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), which held that punitive damages in a commercial setting were “income” under the catch-all “income” clause.

27. 245 U.S. 151 (1917).

28. It is possible that *Gould* may have simply been wrongly decided within the framework of 1917 jurisprudence. However, *Gould* is still considered “good law” for the rule that “support” payments are excluded unless specifically included.

29. See *Mahana v. United States*, 88 F. Supp. 285 (Ct.Cl.1950), cert. denied 339 U.S. 978; *Fairbanks v. Comm’r*, 191 F.2d 680 (9th Cir.1951), cert. denied, 343 U.S. 915 (taxation of alimony is statutory matter); *Neeman v. Comm’r*, 26 T.C. 864 (1956), *aff’d per curiam*, 255 F.2d 841 (2d Cir.1958) (*Gould* was statutory-construction case).

30. There is a fourth possible theory, namely, that Congress has the power to expand the meaning of “income” under the 16th Amendment. Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of “Incomes,”* 33 *Ariz. St. L.J.* 1057, 1091-1107 (2001), accuses certain commentators of endorsing this “delegation” theory. I do not. The notion that Congress can expand the concept of income under the 16th Amendment can only be true if the Constitution has delegated such a power to Congress, which is a proposition that cannot be gleaned from any constitutional text, and one that undermines the very idea of a constitution.

an indirect tax provision not subject to the apportionment requirement.³¹ (This possibility is not relevant to *Murphy*, because there is no “damages” analogue to section 71.) The second is that *Gould* (despite purporting to be a statutory-construction case) was a narrow construction of “incomes” under the 16th Amendment that was subsequently (if perhaps implicitly) overruled by the Supreme Court in later decisions.³² (This possibility undermines the *Murphy* panel’s view that early interpretations of the 16th Amendment are definitive.)³³ The third is that *Gould* was indeed (as it claimed) a statutory-construction case that adopted a narrow view of catch-all income as of 1913 but did not adopt a narrow construction of “incomes” in the 16th Amendment.³⁴ (Under this view, later cases could – and did – adopt a broader view of statutory construction, as evidenced by the emergence of the “full exercise of the taxing power” dictum in the late 1930s, without running afoul of the 16th Amendment, in the case of catch-all income, or the direct tax problem, in other cases.)

The effect of treating something (such as certain alimony) as gross income by statute is that it is included in the tax base that is subject to tax. A way of stating the problem is whether Congress has the power to tax something (such as alimony) as “income” that the Supreme Court has held not to be “income” (within the 16th Amendment). But the *power* of Congress is not thwarted by its means of expression. There is nothing in the Constitution requiring statutory law to be organized and labeled in a certain way,³⁵ and the

31. The IRC § 71 tax on alimony is not a tax on property (or the income from property), which is the only kind of tax (other than a head tax or requisition) that current doctrine clearly assumes to be a direct tax. See note 12. Conversely, a tax on a transfer is considered to be an indirect tax. See Marjorie Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 Conn. L. Rev. 1 (1992) (hereinafter “Gifts”).

32. See note 53 and accompanying text.

33. See 460 U.S. at 88-90.

34. In *Mahana*, note 29, the court upheld the validity of IRC § 71 under the 16th Amendment, stating that *Gould* only purported to be a case of statutory interpretation, and that the “full exercise of its taxing power” maxim appearing in later cases should not be deployed to treat *Gould* (retroactively) as having had constitutional import. See also, *Hawkins v. Comm’r*, 6 B.T.A. 1023, 1025 (1927) (stating that certain personal injury damages were non-income under the catch-all clause, but that Congress could reverse this result).

35. For what it is worth, the relevant title of the U.S. Code is called the “Internal Revenue Code,” not the “Income Tax Code.” Subtitle A thereof is called “Income Taxes,” but it includes provisions (relating to the corporate income tax) that were upheld (prior to ratification of the 16th Amendment) as an indirect tax. See note 13. Other titles contain excises and other indirect taxes.

scope of Congressional power cannot be constrained by mere labels.³⁶ If Congress has the power to tax cash alimony received on the ground that the tax is not a direct tax, then the exercise of that power must be valid despite the fact that the item is taxed under the rubric of “income.”³⁷

To summarize, a specific income-inclusion provision, whether found as an enumerated section 61(a) item or elsewhere in the Code, is constitutionally valid if it passes *either* the 16th Amendment “income” test *or* the “indirect tax” test.³⁸ However, if an item is potentially taxable *only* under the catch-all clause of section 61(a), then it *must* pass the “incomes” test, and it cannot be bootstrapped into validity as being potentially the subject of a hypothetical (but non-existent) provision that would be valid as an unapportioned indirect tax.³⁹

36. See *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1915) (provisions within an income tax that arguably do not tax income can be valid as indirect tax provisions); *Penn Mutual Ins. Co. v. Comm’r*, 277 F.2d 16, 19-20 (3d Cir.1960) (same).

37. The case that is most hostile to the taxing power, the *Pollock* case, note 12, supports this conclusion. There, the wage portion of the tax was held to be valid as an indirect tax, despite being contained within an “income tax.” In agreement with this analysis are, e.g., Kornhauser, note 31 (Gifts); Douglas A. Kahn, *The Constitutionality of Taxing Compensatory Damages for Mental Distress When There Was No Accompanying Physical Injury*, 4 Fla. Tax Rev. 128, 130 (1999); Bruce A. Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1, 16-18 (1999); Lawrence Zelenak, *Radical Tax Reform, the Constitution, and the Conscientious Legislator*, 99 Colum. L. Rev. 833, 843-44 (1999); Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 Const. Comm. 295, ??? (2004) (hereinafter “Apportionment”). Jensen, note 30, appears to be the only outlier, characterizing this position (at 1086) as “anything goes,” which is false, since (1) the item must be explicitly taxed by Congress, and (2) any tax on non-income must still pass the indirect-tax test.

38. The well-known case of *Eisner v. Macomber*, 252 U.S. 189 (1920), involved a specific statutory provision that treated stock dividends as gross income. The Supreme Court held that pro rata stock dividends were not “income” under the 16th Amendment, but it also held (at 217-18) that the resulting tax on (a portion of the value) of the shares of stock was an unapportioned direct tax.

39. Another example is presented by the statutory exclusion for “qualified scholarships” under IRC § 117. If the exclusion is found not to apply, it is not certain that it is includible in income, because no Code provision so states. Thus, the inclusion issue, if not otherwise settled under some specific Code provision (such as the “compensation for services” clause that is IRC § 61(a)(1)), must be dealt with under the catch-all clause of § 61(a) (and the 16th Amendment), and here certain scholarships might be viewed as entailing non-income commercial price discounts. See *Palmer v. Comm’r*, 302 U.S. 63 (1937); *Pellar v. Comm’r*, 25 T.C. 299 (1955) (acq.); Rev. Rul. 91-36, 1991-2 C.B. 17 (all holding that the excess of the value, or highest market price, over the actual price charged is non-income where the transaction is arms-length in commerce). As to the taxation of scholarships generally, see Joseph M. Dodge, *Scholarships Under the Income Tax*, 45 *The Tax Lawyer* 697 (1993).

This frame of analysis avoids the “delegation problem,” because it rejects the proposition that Congress can expand the concept of “income” without regard to the 16th Amendment.⁴¹

In the emotional damages situation considered in *Murphy*, there is no specific-inclusion provision. Therefore, the outcome hinges solely on the applicability of the catch-all clause of section 61 as viewed through the Sixteenth Amendment. The issue of what is a “direct tax,” although interesting and important, is not relevant to *Murphy*.

II. INTERPRETING THE SIXTEENTH AMENDMENT

Although the *Murphy* panel got one thing right (perhaps by accident) by not considering the indirect tax issue, it got the rest of it wrong in holding that the damages were not income under the catch-all clause of section 61 as interpreted by reference to the 16th Amendment. In discussing the 16th Amendment, it is necessary to discuss not only its substantive content (considered in Part III) but the “procedure” of its interpretation. The usual starting point for interpretation is the text itself. Only if the text is ambiguous should one refer to external sources, namely, (1) context and (2) original intent. The *Murphy* panel made no attempt at textual analysis, and made no finding that “incomes” was ambiguous as applied to emotional distress damages. Instead, the panel moved directly (and without discussion) to a particular version of the original-intent approach, which privileged early non-judicial interpretations of the 16th Amendment and allowed the panel to disregard later authority inconsistent with its views.

A. Textualism Rules

The *Murphy* panel erred in ignoring the settled law pertaining to the interpretation of the 16th Amendment, which overwhelmingly has adopted textualism as its guiding principle.

In the 1920 case of *Eisner v. Macomber*,⁴² considering (*inter alia*) whether a pro-rata stock dividend was income within the meaning of the 16th Amendment, the majority opinion stated:⁴⁴

41. *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925), is cited by the *Murphy* panel (460 F.3d at 87) for the proposition that Congress cannot make something income that is not income, but that is different from the false proposition that Congress cannot tax something that is not income. In any case, the holding in *Burk-Waggoner* (that an unincorporated joint stock company could be taxed as a corporation by Congress) lends no support whatsoever to the *Murphy* panel decision.

42. 252 U.S. 189 (1920).

44. *Id.* at 206-07.

The fundamental relation of “capital” to “income” has been much discussed by economists. ... For the present purpose we require only a clear definition of the term “income,” as used in common speech. After examining dictionaries in common use ..., we have little to add to the succinct definition adopted in two cases decided under the corporation Tax Act of 1909 ... “income may be defined as the gain derived from capital, from labor, or from both combined,” provided it be understood to include profit gained through a sale conversion of capital assets. ...

That the pedigree of the particular *Macomber* definition of income is suspect⁴⁵ need not be of concern here. What is significant is the *Macomber* definition is found in dictionaries circa 1920, as well as at least one of those in current use.⁴⁶ There is not a whiff of originalism in *Macomber*, but rather a clear commitment to textualism.

The *Murphy* panel ignored *Macomber* on the issue of interpretive stance, even though *Macomber* was the most influential case in constitutional tax jurisprudence for the next 25 years. Instead, it picked language out of the

45. The *Macomber* definition first appeared in *Stratton’s Independence v. Howbert*, 231 U.S. 399, 415 (1913), a case arising under the 1909 Corporation Tax Act. There it was offered without citation, and had no bearing on the holding, which was that the income from a mining operation was not required to be computed in a way that never showed a profit or loss. The Court noted (*id.* at 417) that the term “income” in the 1909 Act need not be construed the same as under the 16th Amendment. The Court also stated that theories of income didn’t matter under an excise tax, which the 1909 tax was held to be. See note 13. The next appearance of the definition was in *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918), where the “gain” notion was culled out to advance the notion that gross income under the 1909 Corporation Tax Act was net of “return of capital.”

46. “Income” is still defined in one dictionary as it might have been in the early 20th century. See Merriam-Webster Dictionary (online version as of Sept. 25, 2006), at <http://www.m-w.com/cgi-bin/dictionary>, as follows: “1: a coming in ...; 2: a gain or recurrent benefit usually measured in money that derives from capital or labor; also: the amount of such gain received in a period of time <has an income of \$30,000 a year.>” A more contemporary definition is found in Webster’s Dictionary (online version as of Sept. 25, 2006), at <http://www.websters-online-dictionary.org/definition/income>, as follows: “1. The financial gain (earned or unearned) accruing over a given period of time.” The dictionary definitions circa 1920, as reported in Kornhauser, note 31 (Gifts), at 9 (n. 30), laid more emphasis on the idea of “regular or recurring,” but at the same time referred to the income of persons (from all sources), not to particular items of income.

1921 case of *Merchants' Loan & Trust Co. v. Smietanka*,⁴⁷ where the Court, after setting out the passage from *Macomber* just cited, added:

In determining the definition of the word "income" thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, 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 16th Amendment to the Constitution.

This sentence was followed by citations to cases that made no reference whatever to any "original understanding" of the 16th Amendment.⁴⁸ In addition, *Merchants' Loan & Trust* was decided in 1921, only eight years after 1913, and there is no statement of any "contemporary" 1921 definition of income that was offered in opposition to the 1913 understanding. Thus, *Merchant's Loan & Trust* cannot be said to "hold" that an original-understanding approach is to be followed. In fact, the substantive holding of *Merchants' Loan & Trust*, that casual capital gains of an individual investor are income, rejected an original-understanding approach. Taxpayer's main argument was that the 1913 concept of "incomes" implied "regular and recurring," which would have excluded casual gains and windfalls.⁴⁹ This argument indeed had a firm (if not uncontested) basis in 1909-1913 sources.⁵⁰ But that argument was rejected.⁵¹ A second possible "original understanding" argument was that (in accordance with early 20th century trust law), investment capital gains were simply not income at all, but were upwards adjustments to "capital."⁵² Again this argument was rejected. *Merchants' Loan & Trust* rejected two originalist arguments and followed the *Macomber* textualist approach.

47. 255 U.S. 509, 519 (1921).

48. The cases were *Macomber*, already noted, and *Mitchell Bros. Co.*, which arose under a 1909 excise tax.

49. The Supreme Court brief for the taxpayer in *Merchants' Loan & Trust* is summarized at: http://www.lexis.com/research/retrieve/frames?_m=aa97e06c76aacdbae2eed82569ddbc79&csvc=le&cform=byCitation&_fmtstr=FULL&docnum=1&_startdoc=1&wchp=dGLbVtb-zSkAA&_md5=e5488b2ba312919186c999fdb917e65.

50. Such was the view of prominent commentators both during the gestation of the 16th Amendment and at the time of the *Merchants' Loan & Trust* decision. See E. R. A. Seligman, *The Income Tax* 675-704 (1911); Carl C. Plehn, *The Concept of Income, as Recurrent, Consumable Receipts*, 14 *Am. Econ. Rev.* 1, 5 (1924).

51. The significance of *Merchants' Loan & Trust* in this respect (and others) is discussed in Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 *Sw. L. J.* 869 (1985) (hereinafter "Origins").

52. This view was maintained in trust law until quite recently. See Revised Uniform Principal and Income Act, § 3 (1962), 7B *Un. Laws Ann.* 145 (1985).

In fact, the contemporaneous-understanding language in *Merchants' Loan & Trust* appears to have been added to unhinge the 16th Amendment from any limiting definition of income, since it is a clear *and intended* reference to Justice Holmes' brief dissent in *Macomber*, which stated:⁵³

I think that the word "incomes" in the 16th Amendment should be read in "a sense most obvious to the common understanding at the time of its adoption." [Citations to Indiana and Florida cases omitted.] For it was for public adoption that it was proposed. ... The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax [on pro rata stock dividends].

Holmes is here taking a functionalist approach to the 16th Amendment that by-passes text altogether. It is this approach that is adopted in *Merchants' Loan & Trust*, where the majority opinion has no patience with the taxpayer's attempt to advance a "nuanced" concept of the "common understanding" of income that limits its reach.⁵⁴

The *Macomber* definition held sway until the 1955 case of *Comm'r v. Glenshaw Glass*,⁵⁵ involving punitive damages in commercial litigation. The lower courts "found" that these damages were not derived from capital and/or labor, and therefore were non-income under the catch-all clause of the predecessor of section 61.⁵⁶ Neither the briefs nor the lower court decisions

53. 252 U.S. at 219-20.

54. The majority in *Merchants' Loan & Trust* stated (255 U.S. at 520-21): It is elaborately argued ... that the word "income" as used in the 16th Amendment and in the Income Tax Act ... does not include the gain from capital realized by a single isolated sale of property but that only the profits realized from sales by one engaged in buying and selling as a business ... constitute income which may be taxed. It is sufficient to say of this contention, that no such distinction was recognized [heretofore]. The interesting and ingenious argument ... that this distinction is so fundamental and obvious that it must be assumed to be a part of the "general understanding" of the meaning of the word "income" fails to convince us that a construction should be adopted which would, in a large measure, *defeat the purpose of the Amendment*. [Emphasis added.]

55. 348 U.S. 426 (1955).

56. *Glenshaw Glass v. Comm'r*, 18 T.C. 860 (1952), *non-acq.*, 1953-1 C.B. 7, and *William Goldman Theaters v. Comm'r*, 19 T.C. 637 (1953), *non-acq.*, 1953-1 C.B. 8, both cases *aff'd*, 211 F.2d 928 (3d Cir. 1954) (*en banc*).

played up the constitutional dimension of the case, but that was necessarily implied, because the Supreme Court cited the “full exercise of its taxing power” dictum. The Supreme Court reversed, stating that the *Macomber* definition may have been useful in earlier days in order to distinguish capital from income, but did not constitute a comprehensive definition of income.⁵⁷ The Court noted that “source” was irrelevant under both the catch-all clause and the 16th Amendment. Crucially, the Supreme Court stated that it was following a “plain meaning” approach.⁵⁸

Glenshaw Glass effectively further confirmed the rejection of originalism in favor of textualism. *Glenshaw Glass* has not been overruled or questioned on this point since. The *Murphy* panel’s originalist approach ignores *Glenshaw Glass* (not to mention *Macomber*), and misinterprets *Merchants’ Bank & Trust*, which actually supports a textual and/or functional approach.

Is the term “incomes” ambiguous as applied to damages for emotional harm? Disregarding possibly-relevant judicial gloss, the term “incomes” does possess a literal meaning, namely, “coming in.” This literal meaning has to be applied to a statute imposing a tax. Since the tax in question is payable in cash, income must refer to cash (and what might be converted to cash) coming in to the taxpayer, namely, material wealth (as opposed to, say, “utility”). In short, the plain meaning concept of “income” is a taxpayer’s increase in material (i.e., objective) wealth. No Supreme Court case has held that “incomes” is to be measured by utility or the absence thereof.⁵⁹ Utility is a concern of policy makers in deciding what to tax and what not to tax, but it does not define “incomes” in the catch-all clause of section 61 or the 16th Amendment.

The most recent authoritative judicial gloss on “income” is found in *Glenshaw Glass*, where the Court said: “Here we have an accession to wealth, clearly realized, and over which the taxpayers have complete dominion.”⁶⁰ The “accession to wealth” phrase is a pretty close to the literal meaning of “income” (increase in material wealth), with perhaps a hint that the increase occurs at a definite point in time (“realization”) and is attributable to a particular taxpayer (“dominion and control”).

B. Interpreting Ambiguous Text

57. 348 U.S. at 430-31.

58. 348 U.S. at 432-33.

59. See *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 379 (1934) (imputed income is not “income” in the tax sense); *United States v. Gotcher*, 401 F.2d 118 (5th Cir.1958) (consumption-type benefits received are not income under catch-all clause).

60. 348 U.S. at 431.

If the textual meaning of a term is clear in the proposed application, no further inquiry is made. In order to go beyond the text to consult extrinsic sources, an ambiguity must be found. The *Murphy* panel did not “find” an ambiguity in the text or its application, but rather created it by citing a particular theory of “income” that had a following in the first decade or so of the income tax that limited the plain meaning thereof (increase in material wealth). This move is wholly illegitimate. It allows a court to “find” an ambiguity in text (where none exists on its face) by discovering a theory or the view of a losing faction as evidence of an ambiguity and then adopting the same theory or (losing) view to resolve the ambiguity.

But not so fast! Assuming *arguendo* that the meaning of “incomes” is unclear as applied to personal injury damages, the first fall-back interpretive mode is context (including function), which can be objectively determined, rather than original intent.⁶¹ Certain context features have already been alluded to. Thus, context is provided for simply by the fact that the 16th Amendment relates to taxation (implying the determination of taxpaying capacity), which as an inquiry into changes in objective wealth. A second context scenario already alluded to is that the creation of the modern income tax (involving both the proposal and ratification of the 16th Amendment and the enactment of revenue acts that contained an income tax) was concerned with the “big issue,” which was enabling the federal government to tax income from property.

A third context point derives from the fact that personal injury (and especially emotional distress) damages of individuals are an issue unique to tax. Trusts and business entities do not obtain such damages, and there are no trust and business accounting precedents. The return-of-capital concept derived from business and trust accounting has no relevance, because in those contexts the concept has the function of determining the liquidation rights of stakeholders or rights of holders of successive temporal interests, as the case may be, whereas in tax the issue is simply one of objective taxpaying capacity.

The fact that Congress enacted a statutory exclusion for personal injury damages in 1918 is contextual evidence for the proposition that it was thought that such damages clearly were, or might be held to be, income under both the

61. Among the problems of original intent as applied to lawmaking are: (1) the problem of multiple authors and coalition building, (2) the fact that statements of lawmaker intent may be strategically motivated (and therefore unreliable), (3) the fact that reliance on lawmaker intent violates separation-of-powers theory by conferring both legislative and interpretive powers on the lawmakers, and (4) the possibility that ambiguity was deliberately crafted to pass the buck on to courts and administrative agencies.

16th Amendment and the catch-all clause of the predecessor of section 61.⁶² Otherwise the enactment would serve no purpose.

If text and context do not supply the answer, the last resort is lawmaker intent. However, the fact that the personal-injury damages issue is unique to tax also suggests that there was no “original intent” in the 1909-1913 period on this issue. Indeed, the *Murphy* panel cites no direct evidence of framer intent on this issue, and indeed it appears not to exist. The absence of any tax provision dealing with such damages in the 1913 Revenue Act is explained by (1) the hypothesis that the narrow issue of the taxation of damage recoveries was simply not on the radar screen in 1913 or (2) the supplementary hypothesis that it might have been on the radar screen but that its resolution was deliberately deferred due to lack of agreement.⁶³ The *Murphy* panel goes to great lengths to show that emotional damages were recognized by tort law in many states,⁶⁴ but citations to numerous libel and slander cases prove nothing about the overall level of personal injury litigation or the amount of recoveries. If these were low, then it can be surmised that it could not have been viewed as a significant tax issue. Supporting the “insignificance” hypothesis is the fact that the income tax was aimed at the few who were very wealthy. Thus, the 1913 income tax was imposed at a rate of only one percent on a very small percentage of the population (the highest in terms of taxable income). It was only the United States entry into World War I, occurring in 1917, that caused expansion of the population subject to the income tax, and that expansion would have significantly expanded the visibility of tax issues that otherwise would have been barely noticed.

If recoveries for nonphysical personal injuries were significant enough by 1913 to be viewed as a tax issue, then the failure of Congress to address it suggests that the issue was consciously put off to the future. Supporting this “disagreement” hypothesis is the fact that in 1913 disputes existed over several quite fundamental issues pertaining to the concept of income that possessed “priority” over (and which might determine the resolution of) the taxation-of-damages issue.⁶⁵

62. The 1918 House Report stated that it was “doubtful” that personal injury damages were gross income.” See H.R. Rep. No. 65-767, 9-10 (1918). But doubt cuts both ways, and even the *Murphy* panel declined to cite this statement in support of the claim that such taxation was unconstitutional. See 460 F.3d at 90.

63. See Sidney Ratner, *American Taxation: Its History as a Social Force in Democracy* 326-36 (1942).

64. See 460 F.3d at 90-91.

65. See note 80.

C. Interpretative Theory

The *Murphy* panel ignored text, context, and original intent in the conventional sense of “lawmaker intent.”⁶⁶ Instead it relied on an interpretative theory that might be stated as follows: what controls is the text as it was likely to be understood by the audience at the time of its initial application, and the best evidence of that understanding is found in near-contemporaneous implementing legislation (specifically, the 1918 enactment of the predecessor of section 104(a)(2)).⁶⁷ This approach fails both as a matter of positive law and as theory.

It has already been pointed out that the positive law of the interpretation of the 16th Amendment is plain-meaning textualist, with the “audience” being posited to be that in existence at the time of the application (which in *Murphy* would be the early 21st century). The principal case⁶⁸ cited by the *Murphy* panel for the proposition that early implementing legislation fixes the meaning of a constitutional provision, *Myers v. United States*,⁶⁹ is a non-tax case that deals with the much different problem of who has the power to fire “presidential appointees” (executive-branch employees whose appointment requires Senate confirmation), an issue about which the 1787 Constitution was silent. In 1876, Congress enacted a statute providing that certain presidential appointments could be removed by the President only with the consent of the Senate. *Myers* held this statute to be unconstitutional on the ground that the power to remove

66. A brief discussion of the pros and cons of using legislative history (the official repository of lawmaker intent) in construing statutes is found in Abner J. Mikva & Eric Lane, *An Introduction to Statutory Interpretation and the Legislative Process*, 27-41, 50-54 (1997). In general, the use of Committee Reports in interpreting federal tax statutes has long been accepted practice.

67. See 460 F.3d at 90 (“And to discern the original understanding of a provision of the Constitution, we must examine any contemporaneous implementing legislation.”) In theory, the original-audience version of originalism avoids some of the problems of looking to the subjective intent(s) of the enactors, which in the case of a constitutional amendment includes the ratifiers as well as the proposing Congress. See, e.g., Antonin Scalia, *Originalism: The Lesser Evil*, 57 U. Cin. L. Rev. 849, 862-64 (1989).

68. The *Murphy* panel, 460 F.3d at 90, also cites *Macomber*, 252 U.S. at 202, where it was stated the District Court properly treated the construction of the 1913 Revenue Act as inseparable from the interpretation of the 16th Amendment. But here the reference was not to construction by Congress or the Treasury, but to construction by the courts. Moreover this statement is no longer good law, because the Supreme Court’s construction of the 1913 Act in *Gould*, note 27, was validly overridden by the later (1942) enactment of IRC § 71, see text accompanying note 29.

69. 272 U.S. 52, 175 (1926) (“This Court has repeatedly laid down the principle that a contemporaneous legislative exposition of the Constitution ... acquiesced in for a long-term of years, fixes the construction to be given its provisions.”).

executive officers was inherently an executive function that could be exercised by the President alone. The Court cited separation-of-powers theory, a vote in the House on a 1789 bill in which it was agreed that the power of removal was lodged only in the President, and subsequent government culture up to 1866.⁷⁰

It is hard to see any parallel between *Myers* and *Murphy*. *Myers* had to do with a dispute between two branches of government on which the Constitution was silent, so that the practice filled a gap in the constitutional scheme, whereas *Murphy* involves the meaning of a specific term used in the constitutional text. The 1789 statute cited in *Myers* followed the 1787 Constitutional Convention by one year, occurred in the same year as ratification, involved the same illustrious personalities (the Framers) in the stages of constitutional deliberation, ratification, and statutory enactment, and was backed by legislative history that addressed the constitutional issue; in addition, the practice continued for several decades, and it is reasonable that “practice” should be given weight in cases involving relations between different branches or levels of government.⁷¹ The 1918 statute cited in *Murphy* followed the proposal of the 16th Amendment (1909) by nine years, a different party was in control of the White House and Congress,⁷² the existing legislative history

70. The attempt by the Congress to restrict Presidential powers had its origin in the strong disapproval of the Republican Congress regarding the post-civil-war actions of President Andrew Johnson.

71. All but one of the cases cited by *Myers* (as well as *Myers* itself) for the stated proposition involved separation-of-powers and/or federalism issues. See *Stuart v. Laird*, 1 Cranch (5 U.S.) 299, 309 (1803) (jurisdiction of inferior federal courts); *Martin v. Hunter’s Lessee*, 1 Wheat. (14 U.S.) 304, 351-52 (1816) (power of Supreme Court to hear appeals from state courts under the Judiciary Act of 1789); *Cohens v. Virginia*, 6 Wheat. (19 U.S.) 264, 420-21 (1821) (Marshall, C.J.) (same); *Cooley v. Board of Wardens*, 12 How. (53 U.S.) 299, 320 (1852) (dormant Commerce Clause issue); *Ames v. Kansas*, 111 U.S. 449 (1884) (power of Congress to allow certain actions brought in state courts, involving federal questions, to be removed to federal circuit courts); *In re The Laura*, 114 U.S. 411 (1885) (issue was whether explicit exclusive Presidential power to grant pardons barred the Secretary of the Treasury to remit fines and penalties); *Wisconsin v. Pelican Ins. Co.*, 127 U.S. 265 (1887) (holding that original Supreme Court jurisdiction did not lie in a case where the state was effectively enforcing its own penal laws); *McPherson v. Blacker*, 146 U.S. 1 (1892) (upholding the power of the States, expressly granted by Art. II, § 1, cl. 2, to decide how Presidential Electors were to be chosen); *Knowlton v. Moore*, 178 U.S. 41, 56-57 (1900) (power of Congress to levy inheritance tax was not barred by state power to control inheritance rights); *ex parte Grossman*, 267 U.S. 87 (upholding right to President to grant pardon for criminal contempt). The only exception is *Burrow-Giles Lithographic Co. v. Sarony*, 111 U.S. 53, 57 (1884) (power of Congress to confer copyright protection on photographs), and that case involved an expansion of a granted power.

72. President Taft, who in 1909 supported the proposal of the 16th Amendment, became Chief Justice, and wrote the majority opinion in *Myers*.

takes no definite stand on the constitutional issue in question,⁷³ and no sensitive issues of inter-governmental relations are involved. Finally, *Myers* and all of the cases cited by it involved situations where the federal government (or a branch thereof) *asserted* a power that was acquiesced in, whereas *Murphy* cited a near-contemporaneous enactment as *limiting* a power.

This last point is fatal to the interpretive approach of the *Murphy* panel. Early statutory (and administrative)⁷⁴ decisions to *exclude* personal injury damages from income (and that do not cite the Constitution) cannot be viewed as “interpretations” of the *Constitution*. The scope of a constitutional power conferred upon the federal government by the Constitution cannot be *reduced* by the way the power is exercised. Congress has the discretion not to assert its constitutional authority to the fullest, and statutory exclusions from income are unnecessary if such exclusions are already inherent in the Constitution itself. Similarly, administrative agencies have discretion not to enforce the law to the maximum extent.

Indiscriminately treating early Congressional and administrative applications as binding (or even persuasive) interpretations of constitutional text verges on being a violation of separation of powers norms by positing a kind of “delegation” by the constitutional framers to the Congress and administrative agencies to define the content of the Constitution. Such a delegation would invert the hierarchy: administrative interpretation is supposed to be subordinate to statutory utterance, and the latter in turn is supposed to be subordinate to the Constitution. In addition, the view that early statutes and administrative interpretations are an authoritative-for-all time *limiting* interpretation of the Constitution is plainly dysfunctional from the point of view of republican political theory, because tentative solutions to new problems should be subject to revision as understandings of the problems increase. This point is basic to established constitutional jurisprudence.⁷⁵

The branch of government that is charged with interpreting the Constitution is the judiciary. Courts have no inherent obligation to construe federal taxing statutes in the broadest possible manner. This was certainly the early attitude of the courts, although it later shifted.⁷⁶ Since the ultimate

73. See note 60.

74. The administrative decisions are cited and discussed in the text following note 181.

75. See note 23.

76. The first Supreme Court case, *Gould*, note 27, that had an opportunity to construe the catch-all clause of the predecessor of section 61 treated it as having no independent significance whatsoever, but instead treated the catch-all clause as referring to things “like” the then-enumerated items (income from wages, investments, and business). This restrictive approach was overturned by *Comm’r v. Glenshaw Glass*, 348 U.S. 426 (1955). *Gould* also adopted the maxim that revenue acts are to be construed against the sovereign. That was rejected in the 1938 case of *White v. United States*, 305

authority on constitutional matters is the Constitutional text, constitutional interpretation allows not only for case-by-case “evolution” but outright overruling of prior decisions. In fact, judicial interpretation of the Sixteenth Amendment (and the catch-all clause of section 61 of the Code) has expanded on several occasions.⁷⁷

As a matter of pure interpretative theory, the better view (in my opinion) is that constitutional and statutory text should be deemed to be addressed to the audience that exists at the time of any particular application (as opposed to the audience in existence at the time of enactment).⁷⁸ Otherwise, the notion that law is a command that binds future actors (until repealed or amended) lacks sufficient justification.⁷⁹

This point is especially forceful in the case of the U. S. Constitution, which is extremely difficult to amend.⁸⁰

But even if one takes a more originalist view of interpretative theory, the citing of early statutes and administrative applications proves little in the case of such an abstract term as “incomes,” which encompasses almost an infinite number of potential applications. The particular application (to exclude certain damages) is just one way in which the statutory and constitutional text

U.S. 281, 292 (1938), and replaced by the maxims that (1) gross income provisions are to be broadly construed, see note 26, and (2) exclusion and deduction provisions are to be narrowly construed, see, e.g., *Chickasaw Nation v. United States*, 534 U.S. 84 (2001) (exclusions generally); *Comm’r v. Schleier*, 515 U.S. 323 (1995) (the IRC § 104(a)(2) exclusion specifically).

77. In 1921, the notions that income excluded gains and nonrecurring items were both rejected. See notes 47-50 and accompanying text. In 1940, the notion that “realization” was a constitutional prerequisite for income was cast off. See *Helvering v. Bruun*, 309 U.S. 461 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940). See also *Cottage Savings Ass’n v. Comm’r*, 499 U.S. 554, 559 (1991).

78. See Jack M. Balkin, “Abortion and Original Meaning” (Aug. 28, 2006). Yale Law School, Public Law Working Paper No. 119, available at SSRN: <http://ssrn.com/abstract=925558>. Balkin argues that “original intent” (in a constitutional context) might refer to: (1) the subjective intent of the enactors, (2) the way the enactors would have expected the text to be applied to issues of their time, or (3) the way the enactors would have expected agents (judges) to apply the text in changing future circumstances. The first of these refers to lawgiver’s intent, and the other two implicitly refer to “audience” insofar as the interpreters (judges) are part of the “audience community”).

79. The question is, “Why should I in 2007 be bound by a Constitution and laws enacted in prior years without my (deemed) participation?” The “To prevent anarchy” response doesn’t explain why any law is better than any other law. Allowing prior laws to be applied and interpreted with reference to contemporary problems, attitudes, values, linguistic usages, and so on, creates a bridge between the past and the present.

80. Thus, “original expected application” is inconsistent with the very idea of a constitution. See Balkin, note 76.

could have been interpreted at the time, but it is not a “necessary” conclusion *from the text itself*. This particular application could have been motivated by such post-enactment instrumental considerations as politics, the outcome of a debate, a misunderstanding of tax principles, administrative convenience, or reliance on lawgiver statements of intended meaning that may have been strategically motivated.⁸¹

Even if the early interpretations are deemed to be principled, the move from the text (“incomes”) to the applications (exclusion of personal injury damages) requires a theory, and it turns out that from 1909 on there were many theories of “income” competing for dominance.⁸² The early rationale offered for the exclusion for personal injury damages is consistent with some theories but not others.⁸³ The theory, which effects a bridge from the text to the application, is not itself the text (and certainly not any common understanding thereof). Theories, concocted by intellectual elites (often after the fact), are contestable, and the theories advanced for excluding personal injury damages around 1918 (and thereafter) have been discredited and superseded,⁸⁴ as will be explained in Part III immediately following.

81. Proponents of ratification of the 16th Amendment would have been motivated to underplay its significance in order to persuade moderates that the Amendment was not radical.

82. Models of “income” were offered by various disciplines and tax commentators: (1) financial accounting, (2) trust accounting, (3) macro-economics (the share-of-national-income concept), (4) the “accretion” (Schanz-Haig- Simons) model, (5) the cash-flow consumption (Vickrey) model, and (6) eclectic concepts (such as advanced by E.R.A. Seligman). See Richard Goode, *The Economics Definition of Income*, in Joseph Pechman (ed.), *Comprehensive Income Taxation* 1-30 (1977); Kornhauser, note 49 (Origins).

83. Specific issues of tax theory that bear on the exclusion for personal injury damages included (but were not limited to): (1) the meaning of “capital” (as opposed to “income”), (2) the role and content of the realization principle, (3) whether irregular items could be income, and (4) whether receipts not generated by labor or capital could be income.

84. Thus, the early exclusion of personal injury damages was consistent with the contemporaneous notion that income had to be the product of capital or labor. See notes 41 and 43. Under this definition of income, the receipt of a “transfer” (such as personal injury damages) is not income. This theory held sway until it was expressly jettisoned by the case of *Comm’r v. Glenshaw Glass*, 348 U.S. 426 (1955) (holding that punitive damages in commercial litigation were within the catch-all clause even if not, as the lower courts had found, derived from capital or labor).

III. DOES “INCOME” UNDER THE SIXTEENTH AMENDMENT INCLUDE EMOTIONAL HARM DAMAGES?

The plain-meaning approach to what is “income” under the 16th Amendment effectively liberated the income tax concept of income from (1) concepts borrowed from other disciplines and (2) theories advanced by particular commentators.⁸⁵ According to the most recent Supreme Court pronouncement on the subject of catch-all income (and, hence, the 16th Amendment), *Glenshaw Glass*,⁸⁶ the core idea of income is “accession to wealth.”⁸⁷ *Glenshaw Glass* itself involved punitive damages received in a commercial context. Against this principle, the *Murphy* panel offered two theories for exclusion: (1) a “no gain” theory, and (2) an “in lieu of non-income” theory. The discussion below will explain the bankruptcy of both theories both as a matter of principle and as applied to personal injury damages.

A. The No-Gain Theory

The no-gain theory as applied in *Murphy* requires that the following propositions *all* be correct: (1) the catch-all concept of *gross* income is net of “recovery of capital,” (2) the term “capital” extends meaningfully beyond the technical concept of income tax “basis,” and (3) the taxpayer has basis that is lost or used up in the transaction giving rise to the damages award. All of these propositions are false.

1. “Incomes” under the Sixteenth Amendment means “gross receipts”

It is clear by long usage that “incomes” under the 16th Amendment does not mean “net income,” in the sense of being net of *all* costs of producing income.⁸⁸ At the other extreme, “incomes” could mean “gross receipts,” with offsets *never* being required. The common wisdom is that “incomes” under the 16 Amendment means “gross income,” and that gross income usually means

85. This point is elaborated upon in Joseph M. Dodge, *The Story of Glenshaw Glass: Towards a Modern Concept of Gross Income*, Chapter 1 of TAX STORIES (Paul Caron ed.) (2002), pp. ???.

86. See note 82.

87. This concept was reaffirmed in *United States v. Burke*, 504 U.S. 229, 233 (1992). In the most recent Supreme Court case involving income issues, *Glenshaw Glass* was cited for the proposition that gross income under the catch-all phrase reaches “all economic gains unless otherwise exempted.” See *Comm’r v. Banks*, 543 U.S. 426, 433 (2005).

88. It is commonplace for various business and investment expenses to be disallowed. See IRC §§ 67, 68, 183, 264, 265, 266, 267, 269, 271, 274, 275, 280A, 280E, 280G.

gross receipts, but in the case of a disposition of an asset it means “gross receipts less recovery of capital.”⁸⁹ The concept of “capital” certainly includes “basis,” which in its most elemental meaning denotes the cost of an asset.⁹⁰ I argue here, perhaps controversially, that the term “incomes” refers only to gross receipts, so that subtractions *are never constitutionally* required by the 16th Amendment. There is very little law or discussion of this issue because of the fact that a tax on gross receipts would be valid as an indirect tax, independently of the 16th Amendment.⁹¹ The issue only matters in a case, like *Murphy*, where the item is taxed (if at all) only under the catch-all clause as considered together with the 16th Amendment, and there the dispute may be resolved on some other ground.

(a) *Limitations on judicial power*

The deep norm of separation of powers argues against allowing the courts to decide what costs *must* be subtracted in arriving at “incomes” under the 16th Amendment. Since it is settled that such term does not mean “net income,” the courts are left with the options of (a) requiring the subtraction of *no* costs or (b) requiring the subtraction of *some* costs. But costs are costs, and saying that the subtraction of some costs (but not others) is necessary to arrive at “gross income” amounts to the waving of a magic wand to create new terminology based on thin air rather than substance. The constitutional text offers no basis for distinguishing some costs of producing income from others. It is best left up to Congress to decide what costs of producing income should be subtracted as a matter of policy. If certain subtractions were considered mandatory in arriving at “incomes,” then courts, which lack the power to require subtractions,⁹² are placed in the quandary of either having to usurp Congressional power (by creating subtractions) or else holding unconstitutional a tax seemingly within the letter and spirit of the 16th Amendment that does not provide for the “required” subtractions.

89. The paradigm scenario is the sale of shares of stock purchased for \$7,000, in which the sales proceeds are \$10,000. The issue is whether the Constitution requires a “basis offset” (representing a “recovery of capital”) of \$7,000 against the gross proceeds of \$10,000.

90. See IRC §§ 1011, 1012.

91. See *Pacific Insurance Co. v. Soule*, 74 U.S. 433 (1869); *Veazie Bank v. Fenno*, 75 U.S. 533 (1869); *Nicol v. Ames*, 173 U.S. 509 (1898); *Spreckels Sugar Refining Co. v. McClain*, 192 U.S. 397 (1904); *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

92. In *Gould v. Gould*, note 27, the Court appeared to frame the issue as whether the alimony payment was taxable to the payor or the payee. But since the Court lacked the power to create a deduction for the payor, the only available option was to hold that the receipt was non-income to the wife.

(b) *The function of the Sixteenth Amendment*

A structural (or purposive) interpretation of the 16th Amendment supports the view that “income” effectively means gross receipts. The 16th Amendment was designed solely to overturn the result⁹³ of the pre-16th-Amendment *Pollock* case,⁹⁴ which held that a tax on *gross* rents was invalid as an unapportioned direct tax. *Pollock* based its holding on the bare proposition that a tax on the issue of land (gross rents) is essentially a tax on the land itself (taking it as given that a tax on land is a direct tax). But *Pollock* also acquiesced in the proposition that a tax on wages or gross income from professions would be valid as an indirect tax.⁹⁵ The 16th Amendment removed the apportionment requirement with respect to taxes on the gross yield from property. That the income tax act that was invalidated by *Pollock* provided for deductions and offsets to arrive at net income was irrelevant to *Pollock*. It follows, then, that the 16th Amendment can have nothing to do with recovery of capital, however conceived.

The more sweeping proposition that the Constitution, by way of the 16th Amendment, commands capital (basis) recovery is an argument that the 16th Amendment actually added a restriction on the federal taxing power that did not exist prior to 1913. Prior to the 16th Amendment, the federal government had the power to lay and collect taxes on anything or anyone, the only meaningful restriction being that direct taxes had to satisfy the apportionment requirement. The distinction between direct and indirect taxes had nothing to do with subtractions from gross receipts. In fact, a tax on gross receipts from asset sales is a common form of excise (indirect) tax. There is nothing in the history of the 16th Amendment that suggests a trade-off or compromise in which the apportionment requirement was removed for a certain kind of (what was then taken to be a) direct tax (an income tax) in return for a concession in the form of the imposition of a new “subtraction” limitation on what could be taxed without apportionment (as an indirect tax). The Supreme Court has explicitly stated that constitutional provisions relating to the taxing power will not be treated as conflicting with each other, and that the 16th Amendment is not to be viewed as a limitation on the general taxing power.⁹⁶

93. See *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 13-19 (1916) (stating that the 16th Amendment did not redefine “direct tax” but only removed the apportionment requirement with respect to taxes on income.) *Brushaber* made no reference to the netting issue in upholding the denial of interest deductions to certain taxpayers.

94. See note 12.

95. See 157 U.S. at 579.

96. See *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 12, 17-19, 24 (1916); *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112-14 (1916).

If Congress has the power to tax gross receipts in any event under its power to lay indirect taxes without apportionment, then any subtraction requirement under the 16th Amendment is wholly pointless. In the abstract, it is conceivable that constitutional or statutory text might explicitly state a pointless rule, but surely a pointless rule should not be imported into such a text where no such rule is clearly stated.

(c) The incoherency of a netting mandate

The view that “incomes” under the 16th Amendment is net of capital recovery is incoherent and unworkable in comparison to the view that subtractions are a matter of legislative discretion. The income tax has long separated, for the most part, gross income and deduction (subtraction) issues, and “deductions” are conceded to be a matter of legislative grace.⁹⁷ There is no principled distinction between “deductions” for costs of producing income and (capital recovery) “offsets.” Even (cost) basis in an asset can be recovered either by way of “offset” against the “amount realized” (gross proceeds of sale or other disposition) or by way of (depreciation or loss) “deduction.”⁹⁸ It is Congress that decides when basis is to be recovered by offset and when it is recovered by way of deduction.⁹⁹ If Congress can require that capital recovery be taken as a “deduction,” and if Congress also can enact rules that permanently disallow such deductions, then capital recovery cannot be a constitutional mandate.¹⁰⁰

97. See *Comm’r v. Sullivan*, 356 U.S. 27, 28 (1958) (also stating, at 29, that Congress could disallow all deductions of a business); *Burnet v. Thompson Oil & Gas Co.*, 283 U.S. 301 (1931); *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112-14 (1916).

98. See IRC §§ 165, 167, 168, 179, and 612.

99. See *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 188 (1918) (“It may be observed that it is a mere question of methods, not affecting the result, whether the amount necessary to be withdrawn in order to preserve capital intact should be deducted from gross receipts in the process of ascertaining gross income, or should be deducted from gross income in the form of a depreciation account in the process of determining net income.”).

100. Congress can also manipulate basis recovery rules by deciding what costs to match against what income. Initially, any alleged basis-recovery mandate only extends to the preclusion of double taxation of the same dollars. Thus, if a taxpayer purchases an asset for \$13,000 and sells it for \$10,000, only the first \$10,000 of basis offset against the sales proceeds could be constitutionally mandated, with the \$3,000 loss deduction being subject to possible disallowance. But suppose the asset is a machine and the \$13,000 cost is to be taken as depreciation deductions against gross manufacturing income. In that case, there would be no claim that depreciation deductions of \$13,000 would be constitutionally mandated up to the amount of such income. Alternatively, Congress might decide that the \$13,000 cost of the machine should be added to the basis of an asset constructed by the machine, see IRC § 263A(a),

It can be argued that depreciation is a mere acceleration of capital recovery that is not itself constitutionally mandated. If such acceleration did not occur, the basis would remain with the asset to be recovered on sale or disposition.¹⁰¹ However, the Supreme Court has held that Congress can enact a depreciation system that results in the permanent loss of basis.¹⁰² Although the majority opinion in the case so holding did not discuss possible constitutional issues, such issues were implicit, because such a loss of basis would violate the alleged constitutional mandate that capital (basis) recovery (sooner or later) is mandatory. Thus, Congress has control over accounting issues and can require that income be accounted for on an annual basis, and let the chips fall where they may.¹⁰³

There are, of course, statutory gross income provisions that do allow for built-in basis recovery, the most notable being the enumerated categories of “gross income from business” and “gains from dealings in property.”¹⁰⁴ However, the fact of their statutory existence does not prove that they are mandated by the 16th Amendment. Two possible alternative explanations exist. First, netting at the gross income stage may result from the recognition of sound policy.¹⁰⁵ Second, netting may serve the cause of administrative convenience. In any event, even these netting provisions are “dependent” on other Code provisions that prescribe the *method* (timing) of basis recovery.¹⁰⁶ Indeed, the entire domain of methods of basis recovery is controlled by statutory provision.

and that would defer capital recovery beyond the time the machine is exhausted or disposed of.

101. See IRC § 1016(a).

102. See *Virginia Hotel Corp. v. Helvering*, 319 U.S. 523 (1943). The Court held that basis was to be reduced by depreciation claimed in a year even though the depreciation deduction failed to reduce taxable income. This result was later changed by Congress. See IRC § 1016(a)(2).

103. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364-66 (1931) (Congress can impose annual accounting system even though resulting in effective disallowance of costs of producing income); *Burnet v. Thompson Oil & Gas Co.*, 283 U.S. 301, 307 (1931) (disallowed depletion could not be taken as depletion in later years).

104. See IRC § 61(a)(2) & (3).

105. See note 113 and accompanying text.

106. The category of “gross income from business” is dependent upon methods of inventory accounting allowed by IRC §§ 471 & 472; the category of “gains from dealings in property” is dependent upon IRC §§ 453 and 1001; those of “annuities” and “pensions” are dependent upon IRC § 72; that of “dividends” is dependent upon IRC §§ 301(c) and 316; that of “interest” is partly dependent upon IRC §§ 461, 483, 1272-1278, and 7872.

Capital-recovery offsets in the case of asset dispositions are equal to basis. Basis in turn derives from capital expenditures. However, there are numerous statutory provisions that treat capital expenditures as “expenses,”¹⁰⁷ as well as rules and regulations dealing with the imprecise boundary between capital expenditures and expenses.¹⁰⁸ And it is a given that expenses can be disallowed under various Code provisions.¹⁰⁹ If basis recovery were constitutionally mandated, and if basis derives from capital expenditures, then provisions treating capital expenditures as expenses, in combination with provisions disallowing deductions for any such deemed expenses, must violate the Constitution. Indeed, Congress could enact statutory rules that accelerate *all* capital recovery to the date of expenditure (that is, rendering them as “expenses”). In that event, there would be no basis in anything at all, and there would be no such thing as “capital recovery,” as that term is understood in tax culture. A tax in which there is no capital recovery (positive or negative) is called by different names, such as “expenditure tax,” “consumed income tax,” and “cash-flow consumption tax.”¹¹⁰ Could such a tax be unconstitutional because it fails to *require* capitalization (so as to create basis that can be “recovered”)?¹¹¹ And what is one to make of the fact that the so-called income

107. See IRC §§ 163(a), 164(a), 173, 174, 175, 179, 180, 213, 217, 219; Regs. §§ 1.162-6, -20.

108. See, e.g., Regs. §§ 1.212-1(k), 1.263(a)-2, -4, -5; Rev. Rul. 77-354, 1977-2 C.B. 63; Rev. Rul. 83-105, 1983-2 C.B. 51; Rev. Rul. 2001-4, 2001-1 C.B. 295. As further evidence of the imprecise line between capital expenditures and expenses, consider the case of loss carryovers, derived from the excess of deductions over gross income, which are often allowed to expire. See IRC §§ 172, 280A(c), 465, and 467. Many loss carryovers result from the taking of deductions that are subsequently judged to be premature, suggesting that they were “really” capital expenditures.

109. See note 95. There are very few provisions disallowing capitalization (and, hence, basis). See IRC §§ 195(c)(2), 263A(a)(2); Regs. §§ 1.61-3(a) & 1.471(3)(d); Rev. Rul. 77-244, 1977-2 C.B. 58.

110. A classic exposition is found in Nicholas Kaldor, *An Expenditure Tax* (3d ed. 1955).

111. Jensen, note 30, argues that a consumption tax is unconstitutional as an unapportioned direct tax that is not an “income tax,” on the ground that an income tax is a tax on investment income, whereas a consumption tax effectively exempts investment income. For what it is worth, I disagree on the points (1) that a consumption tax is a direct tax (the holding of *Pollock*, note 12, being that a tax on investment income was a direct tax) and (2) that a consumption tax really exempts investment income. In any event, Jensen appears to be the only commentator taking this position.

tax already has numerous consumption tax features?¹¹² Would there be a “tipping point” at which the entire tax would be unconstitutional?¹¹³

The only conceivable textual basis for mandating capital recovery would derive from a question-begging *assumption* that “incomes” is something distinct from “capital.” It didn’t help the early evolution of tax doctrine that thinking about “capital” was confused (a matter discussed shortly). The relevant notion of capital under an income tax is “costs of income production.” The distinction between basis offsets and business and investment “expenses” is, therefore, not fundamental with respect to the concept of income in the tax sense, because both are equally costs of producing income. Conceptually, the only difference is that basis is a carryover from a prior-year’s expenditure, whereas an expense is a current expenditure. It is unimaginable that a mere timing rule has constitutional significance, and in fact the Supreme Court has held that Congress has the power to decide tax accounting issues as it sees fit.¹¹⁴

Capital recovery (in the tax sense) reflects a core policy to avoid double taxation of the same dollars to the same taxpayer.¹¹⁵ Without capital recovery, business and investment would be systematically disfavored by the tax system relative to wage-earning and consumption. This is a classic policy justification. But tax policy issues are also best left to Congress to decide (and to balance against non-tax policies). This particular policy cuts across the distinction between basis offsets and expenses. Thus, just as basis is an offset against the proceeds of sale (but only to the extent of such proceeds) even in the case of personal-use assets,¹¹⁶ so expense deductions with respect to personal (hobby) activities are allowed to the extent of the gross income from such activity.¹¹⁷ If

112. Any provision of the current income tax that allows “expensing” of a capital expenditure or that exempts investment income can be called a consumption tax feature. Examples abound. See note 105.

113. It might be said that a (consumption tax) that is alleged (falsely, in my view) to exempt investment income is not an “income tax” that can be supported by the 16th Amendment. Whatever the dubious merits of this argument, it would not rule out validation as an indirect tax.

114. See the discussion of the Sanford & Brooks Co. case in the text accompanying note 130. See also *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916) (Congress is not required by the Constitution to provide for an adequate depreciation or depletion allowance); *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503, 524 (1917) (Congress did not intend the “depreciation” allowance to include depletion of minerals in place).

115. See generally Joseph M. Dodge, *The Logic of Tax* pg. 20-21 (1989).

116. In this case, the “loss” under IRC § 1001(a) is disallowed under IRC § 165(c), but gross proceeds are non-taxable by reason of the basis offset.

117. See IRC §§ 183(b), 280A(c)(5). However, the deductions may be of little value on account of the fact that such deductions are “miscellaneous itemized deductions” under IRC § 67 that are subject to a significant “floor,” as well as being wholly disallowed for purposes of the Alternative Minimum Tax. In addition,

basis and expenses of income production are equally “capital,” then all expenses of income production must be deducted. Yet the Supreme Court has rejected attempts to require such deductions where not authorized by Congress,¹¹⁸ and has rejected constitutional attacks on the disallowance of business deductions.¹¹⁹ The only doctrinal answer that makes sense is that recovery of capital is not constitutionally mandated at all.

(d) Income as gain?

The *Murphy* panel cited numerous statements in Supreme Court cases to the effect that “income” is “gain”¹²⁰ in an effort to establish the self-evidence (or *a priori* necessity) of the proposition that “incomes” in the 16th Amendment must be net of capital recovery (as is the case with gain in the statutory sense).¹²¹

Essentially the notion of gain depends on accounting conventions. Even in the paradigm gain scenario (sale of an asset), it is logically possible that “amount realized” could be a gross income item and an amount equal to basis could be a separate “loss” deduction by reason of a complete disposition of the property. It is simply more convenient to do the netting at the gross income stage,¹²² and accordingly the tax return published by the IRS would undoubtedly allow netting in arriving at “gross income” regardless of the statutory organization.¹²³ But surely a constitutional principle does not emerge from what looks like a pragmatic choice as to how to organize netting rules in a statute.

deductions in excess of gross income (disallowed in the current year) are not carried over to future years.

118. See *Higgins v. Comm’r*, 312 U.S. 212 (1941) (holding that costs of managing investments could not be claimed as deductions of carrying a business).

119. See note 95.

120. These and other cases referring to “gain” are discussed below, mainly in note 153.

121. See IRC § 1001(a) (defining “gain” on sale or disposition as the excess of amount realized over basis).

122. Even the decision to account for property dispositions on an asset-by-asset basis is arbitrary. Assets (within a class having the same relevant tax attributes) could simply be aggregated into a mass asset account in which aggregate gross receipts are compared to aggregate basis. See IRC §§ 165(d) (gambling gains and losses), 471 (inventories).

123. The deductions that are listed in IRC § 62 (to be taken in arriving at “adjusted gross income”) are effectively netted against gross income for tax reporting purposes, because they are allowed in full. Schedules C, D, and E of the current Form 1040 provide for netting of certain § 62 deduction items against gross receipts in the “gross income” section of the Form 1040 individual income tax return, even though such items are “deductions” under the Code.

That the word “gain” does not necessarily require any offset is evidenced by numerous examples where gross receipts standing alone constitute gains: compensation for services, prizes and awards, punitive damages, found treasure trove, and (possibly) compensatory damages (not involving property losses). Basis recovery is simply not relevant to these situations, because the taxpayer acquired something without reference to any kind of prior investment.

The concept of “gain” posits the question, “Relative to what?” “Gain” only means that material wealth has increased relative to some baseline. There are different ways of conceptualizing the baseline, and none are *a priori* correct. This point is reflected in tax doctrine. The early case of *Bowers v. Kerbaugh Empire Co.*¹²⁴ involved an investment financed with borrowed foreign currency. There the Supreme Court held that the gain from the debt transaction could be offset by the loss on the related investment transaction. However, this related-transaction-netting approach is now considered to be passé, and it is settled that the components of even integrally-related transactions are to be accounted for separately.¹²⁵ The most closely-connected common transactions are asset-purchase installment obligations, and even here the borrowing aspect is treated separately from the asset aspect.¹²⁶ This same bifurcation approach can be readily applied to the forms of income that currently entail built-in basis recovery: they can all be conceptualized as involving separate, but linked, accessions to wealth and losses. Thus, a sale of an asset represents both an increase in cash wealth (in the full amount of the gross proceeds) and a decrease

124. 271 U.S. 170 (1926).

125. See *Old Colony R. Co. v. Comm’r*, 284 U.S. 552, 556 (1932) (“interest” construed to mean stated interest and not stated interest net of amortized bond premium); *Vukasovitch v. Comm’r*, 790 F.2d 1409 (9th Cir. 1986) (stating that *Kerbaugh-Empire* is a dead letter); *Estate of Newman v. Comm’r*, 934 F.2d 426, 431-32 (2d Cir.1991) (*Kerbaugh-Empire* is “discredited”); Rev. Rul. 92-99, 1992-2 C.B. 35 (same). *Kerbaugh-Empire* was wrong on the facts, because the loss, having been already deducted, was counted twice. With respect to the currency transaction, *Kerbaugh-Empire* was superseded by *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). In *Helvering v. American Chicle Co.*, 291 U.S. 426 (1934), the Court followed *Kirby Lumber* in a case involving purchase-money debt. The *Sanford & Brooks* case, note 101, effectively interred *Kerbaugh-Empire*, because a combined-transaction approach is inconsistent with an annual accounting approach.

126. See *Gershkowitz v. Comm’r*, 88 T.C. 984 (1987); Rev. Rul. 91-31, 1991-1 C.B. 19 (both holding that a reduction in non-recourse acquisition debt is debt-discharge income, with no effect on basis); Rev. Rul. 90-16, 1990-1 C.B. 12 (separating debt-discharge income from amount realized upon transfer of appreciated property to creditor in lieu of foreclosure). See generally, Deborah A. Geier, Tufts and the Evolution of Debt-Discharge Theory, 1 Fla. Tax Rev. 115 (1992); Theodore P. Seto, The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System, 51 Tax Law Rev. 199 (1997) (discussing the separation of debt accounting from asset accounting in the case of debt-financed investments).

in property wealth (measured by the entire basis).¹²⁷ Business accounting operates in exactly this fashion.¹²⁸

The precise point advanced here was made by the Supreme Court in the 1987 case of *Luckhard v. Reed*,¹²⁹ a case arising under the AFDC program. The state eligibility requirement in question treated personal injury damages as “income,” resulting in disqualification of the applicant. The applicant argued that “income” for welfare eligibility purposes should exclude personal injury damages on the basis of a similar exclusion in the income tax. The Supreme Court rejected this contention, the plurality opinion¹³⁰ stating:¹³¹

Respondents’ principal contention is that Virginia’s revised regulations are inconsistent with the meaning of “income: ... used in the AFDC statute. To support this argument they first advance the broader proposition that it does violence to common usage to interpret “income” to include personal injury awards. This argument begins from the premise that since personal injury awards are purely compensatory, they do not result in any gain to their recipients. And since both general and legal sources define “income” as involving gain, see, e. g., Webster’s Third New International Dictionary 1143 (1976) (“a gain or recurrent benefit that is usu. measured in money ...”); *Eisner v. Macomber*, ... [other citations omitted], respondents conclude that personal injury awards cannot fairly be characterized as income. But the premise that personal injury awards cannot involve gain is obviously false, since they often are intended in significant part to compensate for the loss of gain, e. g., lost wages... n2 [Note 2: Moreover, as we discuss below, ... other typical components of personal injury awards,

127. The loss (measured by basis, see IRC § 165(b)), is realized because the taxpayer “loses” (disposes of) the property that possessed basis. Of course, in the case of personal-use assets, the excess of basis over amount realized would be disallowed as a personal-use loss representing consumption. See IRC § 165(c).

128. In financial accounting, the sale transaction (at a gain) would be accounted for by (1) a debit to Cash account, (2) a credit to the asset account equal to its book value (the accounting analogue to basis) and (3) a credit to Income account in the amount of the excess of (1) over (2).

129. 481 U.S. 368 (1987).

130. Four justices signed the plurality opinion. One justice concurred on the ground of deference to the eligibility regulations. Four judges dissented on the ground that the tax-law exclusion for personal injury recoveries indicates that Congress would have adopted the same rule in the AFDC context. 481 U.S. at 384, 389. Significantly, no judge treated the tax issue as having a constitutional dimension.

131. See 481 U.S. at 374-77.

including compensation for pain and suffering, can reasonably be treated as gain under the AFDC statute.] More importantly, however, ... general and legal sources also commonly define “income” to mean “any money that comes in,” without regard to any related expenses incurred and without any requirement that the transactions producing the money result in a net gain. See, e. g., 5 Oxford English Dictionary 162 (1933) (“That which comes in ... (considered in reference to its amount, and commonly expressed in money); ... receipts ...”); 42 C. J. S., Income, p. 529 (1944) (“Generally or ordinarily the term means all that comes in; ... something which is paid over and delivered to the recipient; ... without reference to the outgoing expenditures ...” (footnotes omitted)); *Heckler v. Turner*, 470 U.S. 184 (1985) (“income” under the AFDC statute means gross income, without reference to expenses reasonably attributable to its earning)... . Thus, contrary to respondents’ assertion, Virginia’s revised regulations are consistent with a perfectly natural use of “income.”

So, of course income entails “gain” in some sense, but there are various accounting methods that can be used in calculating income and gain, and it seems far-fetched to suppose that the 16th Amendment mandates one particular accounting approach in preference to others. As noted earlier, the Supreme Court has held that accounting for profits and gains is within the realm of Congress’s discretion. Particularly relevant is *Burnet v. Sanford & Brooks Co.*,¹³² where the Court held that losses (i.e., the excess of expenses over revenue) from early years were not required by the Constitution to be treated as “capital” that had to be offset against the profits of later years. But if early-year costs ended up generating revenue in later years, then such costs really were capital expenditures. The Court’s refusal to treat them as capital expenditures necessarily acknowledges the power of Congress to decide what are capital expenditures and expenses on a year-to-year basis. If Congress can decide what is “capital,” then there can be no constitutional mandate relating to capital recovery.

In light of the foregoing, the move of equating “income” with “gain,” with the implication that “gain” *must* be taken in its current statutory meaning as being the excess of amount realized over basis,¹³³ is deceptive (intentionally or not). Effectively, it is an argument that current statutory law defines the 16th Amendment concept of “income.” Alternatively, it is tautological, as a particular definition of “gain” is trotted out that has the desired conclusion

132. 282 U.S. 359 (1931).

133. See § 1001(a).

embedded within it. But the equation of income with gain ultimately backfires, because the authority to decide on accounting methods resides with Congress.

(e) Authority re-examined

The following will show that the Supreme Court authority that supposedly establishes the proposition that recovery of capital is constitutionally mandated does no such thing.

The first relevant case is *Stratton's Independence v. Howbert*,¹³⁴ decided (in October, 1913) under the 1909 Corporation Tax Act, an Act that preceded ratification of the 16th Amendment and whose validity was based on its being an indirect tax.¹³⁵ The Act purported to tax only net income, and specifically allowed deductions for expenses and depreciation, but not for depletion. The actual holding of *Stratton's Independence* is that, in computing net income from mining, the *value* of the ore in place was not required to be subtracted as a depreciation deduction. The Court made it clear that it was dealing with an excise tax, not an income tax as such. Thus, the distinction between capital and income was not of particular import.¹³⁶ The Court simply rejected the theory advanced by the taxpayer that would have effectively exempted mining operations from tax,¹³⁷ and refused to speculate on the issue of whether some kind of cost depletion could have been taken under the "depreciation" provision of the Act¹³⁸ (although a later case answered this question in the negative)¹³⁹. The Court made it clear that the 16th Amendment was not applicable and, therefore, not under consideration.

The most oft-cited case for the proposition that income is net of capital recovery is *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918), which again construed the 1909 Corporation Income Tax Act.¹⁴⁰ Although that act purported to tax "net income," it only provided for the deduction of business "expenses" from gross income. The taxpayer had purchased timber property in 1903, which had substantially appreciated as of December 31, 1908, the day before the Act came into effect. The then Treasury Regulations allowed the cost of inventory (costs of goods sold) to be netted against gross receipts from the sale of

134. 231 U.S. 399 (1913).

135. See note 13.

136. See 231 U.S. at 414 ("... we are little aided by a discussion of theoretical distinctions between capital and income").

137. The taxpayer's position was that gross proceeds from mining, less expenses, less the *value* of ore in place extracted, equals zero.

138. 231 U.S. at 422-23.

139. In the later case of *Von Baumbach v. Sargent Land Co.*, 242 U.S. 503, 524 (1917), the Court held that the removal of ore did not constitute depreciation as intended by Congress. (Congress subsequently enacted a depletion allowance.)

140. Corporation Excise Tax, Act of August 5, 1909, c. 6, § 38, 36 Stat. 11.

inventory, but in the case of other assets (including timber) the subtraction was (in effect) the greater of the cost or the value at the end of 1908. The Commissioner allowed a subtraction only for the 1903 cost, apparently on the ground that the timber sold was inventory. In a somewhat impenetrable opinion, the 6th Circuit applied the rule for non-inventory assets.¹⁴¹ The Solicitor General argued in the Supreme Court that “net income” under the Act equaled gross income (meaning gross receipts) less “expenses” construed to include the cost of the timber. The Supreme Court held that the intent of Congress was to exclude pre-enactment appreciation from net income, but the problem was that the statute did not appear to provide for such a result.¹⁴² The Court’s (ingenious) solution involved the following moves: (1) that “income” under the Act does not mean gross receipts but implies “gain,” (2) that gain is net of return of capital, and (3) that “capital” includes (or is) pre-enactment value. In short, the desired result of excluding pre-enactment appreciation from tax was obtained by defining “gross income” to mean “gross receipts less capital recovery,” with “capital” defined to include (or to mean) pre-enactment appreciation.¹⁴³

There are problems with all of these moves. Since the government already conceded that cost could be subtracted as an “expense” deduction in

141. 235 F. 686 (6th Cir.1916). The opinion in this case contains a long discussion of the difficulties of accounting for inventory goods, as opposed to what were then called “capital assets.”

142. “If the gross receipts upon such a conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses ..., ... losses, [and] depreciation. ... There is no express provision that even allows a merchant to deduct the cost of the goods that he sells.” 247 U.S. at 184.

143. See 247 U.S. at 184-85:

Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of “income,” it imports, as used here, something entirely distinct from principal or capital ...; conveying rather the idea of gain or increase. ... Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces ... loss. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the “gross income” ...; and by applying to this the authorized deductions we arrive at “net income.” In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must *withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.* [Emphasis added.]

arriving at “net income,” the implication (if any) that the subtraction of basis occurs at the “gross income” stage is simply *obiter dictum*, and lies in contradiction to *Stratton’s Independence*, which rejected the notion that basis recovery was required even in arriving at net income. The only true “holding” of *Mitchell Bros.* is that pre-1909 appreciation is exempt from tax, a result that might have been achieved by less devious means. The idea that any appreciation could be “capital” was problematic even at the time,¹⁴⁴ and (being derived from trust accounting) was soon cast off altogether in arriving at the modern view that capital refers to some notion of cost, not value.¹⁴⁵ Of course, nothing in the *Mitchell Bros.* opinion rests on the 16th Amendment.

A trio of other cases decided in the same Term as *Mitchell Bros.* can be similarly characterized as effective date cases. All of them were decided under the 1913 income tax statute, which also purported to tax only net income,¹⁴⁶ and

144. The reasoning in *Mitchell Bros.* on the effective-date issue requires acceptance of *Gray v. Darlington*, 82 U.S. (16 Wall.) 63 (1872), involving the Civil War income tax, which had held that the gain accruing over a four-year period could not all be allocable to the year of sale on the theory that unrealized appreciation up the year of sale itself was “capital.” See *Lynch v. Turrish*, 247 U.S. 221, 229, 230 (1918) (relying on *Gray v. Darlington* in case similar to *Mitchell Bros.* but arising under the 1913 income tax). In *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189, 191 (1918), *Gray v. Darlington* was held to be no bar to taxing the entire post-1908 gain resulting from a stock sale in 1911 under the 1909 Corporation Tax Act, the Court noting that the holding of the earlier case was under the different language of the Civil War income tax. The entire group of 1918 cases cited in this note and in notes 143, 146, 148, and 150, has only to do with effective dates, and none of them hold that *gross* income is net of basis recovery. In fact, *Stratton’s Independence v. Howbert*, note 132, appears to have rejected any requirement of basis recovery, and nothing in *Mitchell Bros.* questions this aspect of *Stratton’s Independence*.

145. See *Merchants’ Loan & Trust Co. v. Smietanka*, note 45 (gain accrued over several years subject to tax in year of sale). *Stratton’s Independence*, note 132, had already rejected the contention that gain was net of the value just prior to the disposition.

146. 38 Stat. 166, 167 (1913), stating: (A)(1) that there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, and to every person residing in the United States, a tax of one per centum per annum upon such income, except as hereinafter provided; (B) that, subject only to such exemptions and deductions as are hereinafter allowed, *the net income of a taxable person shall include gains*, profits, and income derived from salaries, wages, or compensation for personal service, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever. Among the deductions allowed for the purpose of the normal tax is the amount received as dividends upon the stock or from the net earnings of any corporation, which is taxable upon its net income as hereinafter provided. [Emphasis added.]

which stated that gains were to be taken into account in arriving at net (not gross) income, while expressly providing that only net income that accrued after February 28, 1913, was to be taxed.¹⁴⁷ In *Lynch v. Turrish*,¹⁴⁸ the transaction was a corporate liquidation, and it was held that none of the gain accrued after that date, the liquidation proceeds being less than the then value of the stock.¹⁴⁹ But in *Lynch v. Hornby*¹⁵⁰ the Court held that (1) dividends paid after the effective date of the 1913 Act out of profits accumulated before such date were intended to be taxed,¹⁵¹ and (2) Congress was not prohibited by the Constitution from doing so. The third case, *Southern Pacific Co. v. Lowe*,¹⁵² was held to be distinguishable: since the dividend there was paid by a controlled corporation (out of earnings accumulated before March 1, 1913), such earnings were viewed as having accrued to the controlling corporation itself before that date, resulting in non-taxation thereof. These cases all involve application of a clear statutory provision relating to the effective date of the tax, none of them really involve “return of capital,” and none involve a construction of the 16th Amendment.¹⁵³

Mitchell Bros. has been often cited by the Supreme Court for the proposition that income includes gain, and there is one *ipse dixit* to the effect that “income” under the 16th Amendment is the same as income under the Corporation Tax Act of 1909 (as re-written by *Mitchell Bros.*).¹⁵⁴ Perhaps this confusion derived from the fact that the 1909 Corporation Tax Act appeared in the same year as the proposal by Congress of the 16th Amendment. However, the Act used the term “net income” and the proposed amendment used “incomes” without any modifier. In any event, *none* of the Supreme Court cases citing *Mitchell Bros.* actually *held* that the 16th Amendment requires capital

147. *Id.* at subsection (D).

148. 247 U.S. 221 (1918).

149. The Court relied on *Gray v. Darlington*, note 142, for the notion of allocating gain realized in one year over the period in which it accrued.

150. 247 U.S. 339 (1918).

151. Congress changed its mind in 1916 in what is now IRC § 316(a)(1).

152. 247 U.S. 330 (1918).

153. Curiously, the *Murphy* panel decision cites *Southern Pacific Co. v. Lowe* for the proposition that “return of capital is not income under ... 16th Amendment.” But *Southern Pacific Co.* neither holds nor states any such thing. It states (247 U.S. at 335) that the 1909 Act and the 1913 Act, both of which refer to “net income,” are to be construed in a like manner.

154. *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 177 (1926).

recovery.¹⁵⁵ The one case that clearly so stated has been discredited.¹⁵⁶ And several of the cases undermine such a proposition.¹⁵⁷

A 1948 Tax Court decision, not acquiesced in by the Commissioner, did hold that Congress could not constitutionally disallow basis.¹⁵⁸ This case has

155. Apart from companion cases to *Mitchell Bros. Co.* and cases already discussed (*Macomber*, note 41; *Merchants' Loan & Trust*, note 45; *Bowers v. Kerbaugh-Empire Co.*, note 122; *Luckhard v. Reed*, note 127; *Burnet v. Sanford & Brooks Co.*, note 130), the Supreme Court has cited *Mitchell Bros. Co.* in the following cases: *La Belle Iron Works v. United States*, 256 U.S. 377, 390 (1921) (appreciation is not recoverable "invested capital"); *Lucas v. Alexander*, 279 U.S. 573, 577 (1929) (computation of Feb. 28, 1913 value of life insurance policy); *Bromley v. McCaughn*, 280 U.S. 124, 130 (1929) (upholding gift tax as an excise); *Burnet v. Thompson Oil & Gas Co.*, 283 U.S. 301, 307 n. 9 (1931) (disallowed depletion of earlier years could not be taken as depletion in later years); *Burnet v. Logan*, 283 U.S. 404, 413 (basis in contingent-payment sale to be recovered according to the then-current method of taxing annuities); *Old Colony R. Co. v. Comm'r*, 284 U.S. 552, 556 (1932) ("interest" construed to mean stated interest and not stated interest net of amortized bond premium); *MacLaughlin v. Alliance Ins. Co.*, 286 U.S. 244, 252 (1932) (Congress intended, and had power, to tax insurance company gains accruing after 1913 but prior to a 1928 amendment removing the exemption for life insurance company capital gains); *Helvering v. Independent Life Ins. Co.*, 392 U.S. 371, 379 (1934) (upholding disallowance of deductions relating to company owned-and-used building unless rental value was included in gross income); *Snyder v. Comm'r*, 295 U.S. 134, 140 (1935) (stock trader could use inventory-like accounting approach); *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 97 (1936) (damages from patent infringement claim that was fixed after 1913 was entirely taxable, even though damages related back in part to before 1913); *Helvering v. Midland Mutual Life Ins. Co.*, 300 U.S. 316, 322-23 (1937) (broadly construing category of "interest" income in opposition to taxpayer's accounting treatment); *Foster v. United States*, 303 U.S. 118, 122 (1938) (issue was whether dividends were out of pre-1913 earnings and profits); *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 430 (1955) (*Mitchell Bros.* as source of *Macomber* definition of income); *United States v. Catto*, 384 U.S. 102, 109 (1966) (upholding regulation requiring capitalization of costs of raising livestock); *O'Gilvie v. United States*, 519 U.S. 79, 84 (1996) (narrating history of exclusion for personal injuries).

156. See note 123 (discussing discreditation of the *Kerbaugh-Empire* case, note 122).

157. See *Luckhard v. Reed*, note 127; *Sanford & Brooks Co.*, note 130; *Thompson Oil & Gas Co.*, note 153; *Independent Life Ins. Co.*, note 153.

158. See *Sullenger v. Comm'r*, 11 T.C. 1076 (1948) (reviewed), non-acq. 1949-1 C.B. 6, non-acq. withdrawn 1952-2 C.B. 3, nonacq. reinstated 1976-2 C.B. 4 (Congress barred by 16th Amendment from disallowing cost of goods sold); *Hochman v. Comm'r*, T.C. Memo. 1986-24 (stating in dictum that Congress cannot disallow cost of goods sold, but holding that gambling losses were not costs of goods sold). Cf. IRC § 280E (disallowing expenses of carrying on the business of illegally dealing with controlled substances but not disallowing cost of goods sold). Compare *Max Sobel Wholesale Liquors v. Comm'r*, 69 T.C. 477 (1977), acq. 1982-2 C.B. 2 (issue avoided

lain dormant because of the now-recognized power of Congress to impose a gross receipts tax under its indirect-taxation authority.¹⁵⁹ It is worth noting that Congress disallows basis in a few instances under the current Code.¹⁶⁰

In conclusion, the proposition that “incomes” under the 16th Amendment (and the catch-all gross income clause of section 61) requires basis recovery or other “netting” is not supported by text, purpose, reason, or authority. If there is no netting requirement, then a cash recovery for emotional damages, being an accession to wealth in itself, must be gross income under section 61 as construed in light of the 16th Amendment.

2. The meaning of “capital” under the income tax

Assuming (contrary to the conclusion reached above) that the 16th Amendment defines “incomes” to be net of capital recovery, it next has to be determined what is meant by “capital, the receipt of which is non-income. The circa-1913 notion of “capital” was taken to mean something like “starting point.”¹⁶¹ However, it took a relatively short time for “capital” to be equated with income tax basis. This story is told below, with its ramifications for *Murphy* explained.¹⁶²

by holding that payments were not disallowed by the Code), aff’d 630 F.2d 670 (9th Cir.1980) (Congress intended to disallow only “deductions;” Treasury regulations purporting to extend disallowance rule to cost of goods sold were invalid as inconsistent with the statute; no constitutional issue decided).

159. See *Penn Mutual Ins. Co. v. Comm’r*, 277 F.2d 16, 19-20 (3d Cir.1960); cases cited at note 89. The opinion in the *Sullenger* case (in the previous note) simply (and improperly) ignored the indirect tax issue.

160. See note 107 for explicit disallowance provisions. Implicit basis disallowance occurs when: (1) a depreciated value asset is held at death (see IRC § 1014(a)), (2) loss carryovers expire (see note 106), (3) basis is reduced on account of losses and depreciation that produce no tax benefit (see note 100), and (4) there is no realization event that gives rise to a deduction or offset. An example of the latter situation is presented by the case of *Frank v. Comm’r*, 20 T.C. 511(1953) (individual’s costs of searching for business or investment).

161. The oft-quoted passage from *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185, is:

In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore *the capital value that existed at the commencement of the period under consideration*. [Emphasis added.]

162. For another version that reaches essentially the same conclusion as reached here, see Deborah A. Geier, *Murphy and the Evolution of Basis*, 113 Tax Notes 576 (Nov. 6, 2006).

(a) The endowment theory of capital and its collapse

There was little *detailed* understanding as to what “income” meant in the purely tax sense in 1913,¹⁶³ and so it was natural that reference would be made to existing lore in other disciplines in which “income” had prominence, namely, business accounting, trust accounting, and economics. In these disciplines, “income” was conceived of as being distinct from “capital,” and the distinction was often captured by such metaphors as “the flow that proceeds from the source” and “the fruit that falls from the tree.”¹⁶⁴

Business and trust accounting (circa 1913) both pertained exclusively to legal entities (trusts, estates, corporations, etc.), and so it was necessary to articulate the distinction between the entity itself and its stakeholders. The concept that was the fulcrum of this articulation was that of “endowment.” Thus, in the case of business accounting, endowment (capital) mostly (but not exclusively) took the form of the proceeds of initial-issue stock sales (or contributions of cash or property by partners in a partnership). However, the “capital” concept extended further to encompass additions to the entity’s earnings base from sources other than retained earnings and profits.¹⁶⁵ This concept of “capital” was followed by the Supreme Court in an early (1925) decision, *Edwards v. Cuba R.R. Co.*,¹⁶⁶ holding that a non-shareholder contribution to capital dedicated to long-term investment was non-income. The decision in *Cuba R.R.* was clearly influenced by the 1920 *Macomber* definition of income as being gain “proceeding from” capital or labor,¹⁶⁷ because the contribution went into the earnings base, and was not itself the fruit of operating the business.¹⁶⁸

163. Cases dealing with the concept of income were virtually non-existent under the Civil War income tax. *Gray v. Darlington*, note 142, is an exception, but that case clearly is obsolete as far as the modern income tax is concerned.

164. See *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (pro-rata stock dividend is a portion of capital); *Lucas v. Earl*, 281 U.S. 111 (1930) (income is attributed to the owner of the source).

165. Capital could also be contributed (without a quid pro quo) by shareholders and non-shareholders. Capital was the “base” from which income (earnings and profits) flowed. Borrowed money was neither capital nor income; creditors possessed liquidation priority over equity-holders. A legal consequence of “capital” was it that was not available for “dividends” (to equity-holders), to the potential detriment of creditors. Capital could be created “internally” by an accounting adjustment (usually accompanied by a “stock dividend”) that subtracted from accumulated profits.

166. 268 U.S. 628 (1925).

167. See note 162.

168. See 268 U.S. at 633 (“The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad ...”).

But *Cuba R.R.* was soon shorn of all effect by the Supreme Court in a case holding that a corporation obtained no basis from a non-shareholder contribution of capital,¹⁶⁹ and was later implicitly overruled by *Glenshaw Glass*,¹⁷⁰ holding that an accession to wealth (regardless of source or use) is gross income (unless specifically excluded). In the case of entity taxation, the concept of endowment capital has been comprehensively implemented by detailed statutory provision.¹⁷¹

In the case of trusts (and estates), the equivalent of “capital” is “principal,” which originally consists of the gratuitous transfers that fund the entity, but was also deemed to have included net appreciation in property, whether realized or unrealized.¹⁷² This “endowment” concept appears to lie behind the long-standing statutory exclusions for gratuitous receipts of not only trusts and estates but also of individuals.¹⁷³ However, the 1929 case of *Taft v. Bowers*¹⁷⁴ rejects the notion that the “original endowment” notion is built into the 16th Amendment. That case dealt with the constitutionality of the predecessor of section 1015, providing that the donee of an in-kind gift takes the same income tax basis as the donor, exposing the donee to being taxed on a portion of the gift.¹⁷⁵ The donee in *Taft* argued that the entire value of the gift was permanently-excludible “capital” under the 16th Amendment, because the value of the property received was endowment to the donee. The Supreme Court upheld the statutory provision, holding that the only non-taxable “capital” was the cost of the property to the donor.¹⁷⁶ Since the carry-over basis rule upheld in *Taft* effectively overrides the section 102 gift exclusion, it must be the case that the exclusion for gratuitous receipts itself is not mandated by the 16th

169. See *Detroit Edison Co. v. Comm’r*, 319 U.S. 98 (1943). A zero basis results in eventual taxation of the item in question.

170. See note 82.

171. See IRC §§ 118 (exclusion for contribution to capital of corporation), 305(a) (exclusion for pro-rata stock dividend), 721 (exclusion for contributions to tax partnership), and 1032 (exclusion for proceeds of sale by corporation of its own stock).

172. See note 50.

173. See IRC §§ 101(a) (exclusion for life insurance proceeds received by reason of death) and 102(a) (exclusion for other gratuitous receipts).

174. 278 U.S. 470 (1929).

175. For example, if X buys property for \$10,000 that is gifted to B when the property is worth \$100,000, and B sells the property for \$100,000, B is taxed on gain of \$90,000. If the gift is to be “permanently” exempt from donee tax, the donee would have to have a basis equal to its value as of the date of gift. (Such is the rule for property acquired by bequest and inheritance under IRC § 1014.)

176. The Court relied on *United States v. Phellis*, 257 U.S. 156 (1921) (holding that a shareholder could be taxed on the entire dividend even though the dividend represented earnings and profits of the corporation accrued before the shareholder acquired the stock), and *Irwin v. Gavit*, 268 U.S. 161 (holding that the exclusion for bequests did not exempt a bequest of a right to trust income).

Amendment.¹⁷⁷ That being the case, “capital” (to the extent that it has any constitutional status under the 16th Amendment) can no longer, in the realm of the income tax, be equated with “taxpayer endowment.”

Numerous early cases rejected the thesis that realized gains from property are non-income on the trust-accounting theory that the gains represented a conversion into cash of an increase in “capital.”¹⁷⁸ Critically, these cases establish the proposition that gain (or loss) is to be measured with reference to the basis, not the value, of the thing given up. The *Mitchell Bros.* case,¹⁷⁹ holding that “income” under the 1909 Corporation Tax Act did not include pre-enactment appreciation, was one of statutory construction and not the meaning of the 16th Amendment. The issue dealt with in *Mitchell Bros.* is dealt with under the current income tax by explicit statutory rule.¹⁸⁰ If Congress were to attempt to reach pre-1913 income, issues (of unfair retroactivity) might be raised under the Due Process clause,¹⁸¹ but that issue is distinct from the 16th Amendment.

In sum, there is no longer any support for the proposition that “capital” is equated with “starting point,” “original endowment,” or “earnings base.” It is worth re-emphasizing that the issue here is one of the interpretation of the 16th Amendment. Statutory provisions embodying business and trust accounting concepts of capital do not define the content of the 16th Amendment. Instead “*capital*” under the income tax is now understood to be synonymous with “*basis*,” which is a technical tax concept roughly meaning “dollars in the investment previously subject to tax.” It follows that personal injury damages broadly viewed (as well as the narrower category of emotional distress damages) cannot be said to be non-income (under the 16th Amendment and the catch-all income clause) on any theory (except possibly that of income tax basis).

177. Treating gratuitous receipts as gross income would be valid as an indirect tax as well. See notes 13 and 89; Kornhauser, note 31 (Gifts).

178. See, e.g., *Stratton’s Independence v. Howbert*, note 132; *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189 (1918); *Merchants’ Loan & Trust Co. v. Smietanka*, note 45; *La Belle Iron Works v. United States*, 256 U.S. 377 (1921).

179. See text accompanying note 138.

180. See IRC §§ 316(a)(1) (exclusion of corporate distributions out of profits accumulated prior to March 1, 1913), 1053 (basis of property acquired before March 1, 1913).

181. See, e.g., *Nichols v. Coolidge*, 274 U.S. 531 (1927); *Helvering v. Helmholz*, 296 U.S. 93 (1935) (both cases holding that the estate tax could not constitutionally be applied to pre-enactment gratuitous transfers).

(b) *The lack of any constitutional doctrine barring the taxation of damage recoveries*

The *Murphy* panel decision cites early rulings, some cases, and the enactment of the predecessor of section 104 for the proposition that “income” does not encompass personal injury awards under a recovery (or replacement) of capital theory. However, the early authorities are all based on obsolete notions of capital, and the more recent ones merely note the theory without endorsing it. None of the authorities rely on the 16th Amendment, and the only judicial decision that actually held personal injury damages to be excluded (apart from section 104) stated that Congress has the power to tax such damages.¹⁸²

The predecessor of section 104(a)(2) first appeared in the Revenue Act of 1918. The earliest interpretation of prior law was in a 1918 opinion by the U. S. Attorney General addressed to the Treasury Secretary,¹⁸³ which held that accident insurance policy proceeds were non-income under the 1916 Revenue Act.¹⁸⁴ That the Attorney General was then giving advice to the Treasury Secretary on a matter of basic income tax doctrine shows the inchoate status of the concept of income immediately following ratification of the 16th Amendment and the lack of any acknowledged expertise on the subject. The Attorney General opinion clearly embraces the now-irrelevant¹⁸⁵ endowment theory of capital:

The proceeds of life insurance policies are expressly exempted from the act ... “The value of property acquired by gift, bequests, devise, or descent” is treated in the same way, and yet the “income” from such property is included. This seems to imply that the property itself is capital.

182. See *Hawkins v. Comm’r*, 6 B.T.A. 1023, 1025 (1927) (declining to base the exclusion on the *Macomber* definition of income, but stating that personal injury damages are excludible in the absence of a statute including them). The opinion doesn’t state whether such a statute would be valid under the 16th Amendment or under the power to lay indirect taxes (or both).

183. 31 Op. Atty Gen. 304 (1918).

184. The IRS then applied the reasoning of the Attorney General Opinion to personal injury recoveries obtained by way of suit or settlement. See T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

185. See *Downey v. Comm’r*, 97 T.C. 150, 158 (1991) (reviewed) (criticizing the Atty Gen. opinion as advancing “too generous a view” of the return-of-capital concept, but holding IRC § 104(a)(2) to be applicable), *on reconsideration*, 100 T.C. 634 (1993) (reviewed), *rev’d*, 33 F.3d 836 (7th Cir. 1994) (holding ADEA damages to be fully includible), *cert. denied*, 515 U.S. 1141 (1995).

As applied to accident insurance, the “property” implicated in this passage is human capital, which is the source of compensation income.¹⁸⁶

The opinion then embraces another wholly incorrect theory of income, namely, that there is no gain if the *value* of the property disposed of (as opposed to its basis) equals the recovery amount.¹⁸⁷

In 1918, Congress enacted the predecessor of section 104(a), which excludes personal injury recoveries from gross income. The House Report stated (without elaboration) that it was “doubtful” under current law whether such recoveries were income.¹⁸⁸ The issue was indeed doubtful, because no case

186. 31 Op. Atty. Gen. 304, at p. 9:

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

The idea that compensatory damages replace human capital is sometimes referred to as the “make whole” theory.

187. 31 Op. Atty. Gen. 304, at p. 6:

As to fire, marine, and casualty insurance, [the Revenue Act] impliedly prohibits the deduction of losses when compensated for by such insurance. Upon this point the ... 6th Circuit in *Doyle v. Mitchell Brothers Co.* (235 Fed. 686, 688), in illustrating the principles subsequently declared to be sound by the Supreme Court in the same case, said: “If an illustration were needed to show that money received from selling capital assets cannot be ‘income,’ it would be found in the statutory treatment of insurance money... . Fire insurance money is clearly a substitute for the assets burned; but we find that in case of a fire loss uninsured the loss may be deducted from income, while if it is insured, and if the insurance money is ‘income,’ the loss may not be deducted, and the insurance money must be added – an absurdity which can be avoided only by saying that such insurance money is not income at all. The proceeds of the sale of a building or other permanent assets are as clearly a substitute therefor as is the insurance money paid to indemnify for a building burned.” ... [I]f the proceeds of accident insurance are held to be “income,” they are in a category different from the proceeds of any other kind of insurance.

This passage demonstrates utter confusion. Fire insurance proceeds are excluded only to the extent of the *basis* of the property, not its value. See Regs. §§ 1.165-1(c), 1.1033(a)-1(c) (fire, marine and casualty insurance); *Raytheon Production Co. v. Comm’r*, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944) (damages for appropriation of property). The Supreme Court affirmance did not comment on this passage, which is contrary to the holding of the cases cited at note 136.

188. H.R. Rep. No. 65-767, 65th Cong., 2d Sess., pp. 9-10 (1918).

up to that point had considered the issue, and the government had announced that it wouldn't pursue the matter. Contrary to the view expressed by the *Murphy* panel opinion, an expression of doubt on the "law" is not the same as a conclusion that taxing personal injury damages would be unconstitutional.¹⁸⁹ Moreover, the opinion of Congress on what the law was prior to a statutory enactment does not really count. This precise issue was raised in the 1996 case of *O'Gilvie v. United States*,¹⁹⁰ involving the exclusion of punitive damages received in personal injury litigation. The taxpayer noted that Congress in 1989 added a sentence to section 104(a) stating that punitive damages would henceforth not be excluded, the inference being that Congress thought that such damages were excludable under prior law. In holding that the pre-1989 punitive damages were nevertheless includible, contrary to any such implication, the majority opinion stated:¹⁹¹

Why, petitioners ask, would Congress have enacted this amendment removing punitive damages (in nonphysical injury cases) unless Congress believed that, in the amendment's absence, punitive damages did fall within the provision's coverage? The short answer to this question is that Congress might simply have thought that the then-current law about the provision's treatment of punitive damages ... was unclear, that it wanted to clarify the matter in respect to nonphysical injuries, but it wanted to leave the law where it found it in respect to physical injuries. The fact that the law was indeed uncertain at the time supports this view. [Citations omitted.] ... *We add that, in any event, the view of a later Congress cannot control the interpretation of an earlier enacted statute.* [Citations omitted.] [Emphasis added.]

Separation-of-powers theory supports this view: Congress legislates, and the courts interpret the law.

189. The *Murphy* panel opinion, 460 F.3d at 87, cites *Dotson v. United States*, 87 F.3d 682, 685 (5th Cir. 1996) for the statement: "Congress first enacted the personal injury compensation exclusion ... when such payments were considered the return of human capital, and thus not constitutionally taxable 'income' under the 16th Amendment." This statement was offered merely as background, and no authority is cited to support the reference to the Constitution. The *Dotson* case itself dealt strictly with the application of IRC § 104(a)(2), and did not consider the return-of-capital theory.

190. 519 U.S. 79 (1996).

191. See *id.* at 89-90.

In 1922, the Internal Revenue Service issued Solicitor's Opinion 132,¹⁹² which held that damages for (1) alienation of affection, (2) libel and slander, and (3) surrendering custody of a minor child were excludible. Apparently, the IRS thought that the 1918 statute did not cover these items. Sol. Op. 132 advanced a "new" theory on account of the fact that wives and children, as things, are not unequivocally "assets" in the financial sense (due to the inherent support obligations), so that application of the conventional (equal-value) no-gain theory would be unconvincing. That new theory was that there is no gain in these situations because: (1) personal rights are not transferable in the market, (2) cash recoveries and personal rights are incommensurable, and (3) to hold these recoveries to be includible would be to treat the alienated wife and surrendered child as chattels. However, none of these "reasons" relate to tax doctrine. Moreover, the fact that the law provides damages in these situations answers both the "non-market" and "incommensurability" points.¹⁹³ The logic of this version of the no-gain theory would treat sales of personal rights as non-income, but the authority is overwhelmingly to the contrary.¹⁹⁴ Finally, taxing the damages (in full) would not treat the alienated wife and surrendered child as chattels, because there would be no basis offset and the income would not be capital gain. In any event, the IRS later came around to the view that compensatory damages in these categories were excluded by statute under section 104(a)(2) under a broad construction of "personal injury," and Solicitor's Opinion 132 has been effectively withdrawn.¹⁹⁵

The *Murphy* panel opinion cited both the *Glenshaw Glass* and *O'Gilvie* decisions as having endorsed the proposition that the 16th Amendment bars Congress from taxing personal injury recoveries. Neither case does anything of the kind. In *Glenshaw Glass*,¹⁹⁶ the issue was whether punitive damages in a commercial context were excludible on the theory that punitive damages are not the product of capital or labor. In holding such damages to be gross income under the catch-all clause, the Supreme Court noted in a footnote that the return-of-capital theory underlying the exclusion for compensatory damages for

192. 1-1 C.B. 92.

193. Actually, sex, companionship, domestic services, children, and even wives are all available in the market.

194. See *United States v. Garber*, 607 F.2d 92 (5th Cir.1979) (en banc) (sale of one's own rare blood plasma); *Starrels v. Comm'r*, 304 F.2d 574 (9th Cir.1962) (future loss of privacy); *Roosevelt v. Comm'r*, 43 T.C. 77 (1964) (rights in family member's privacy and reputation). These cases cannot turn on the voluntariness of the transaction, as involuntariness is not a ground for exclusion (absent a specific Code provision). See note 215.

195. See Rev. Rul. 54-418, 1958-2 C.B. 18 (libel and slander of personal reputation); Rev. Rul. 74-77, 1974-1 C.B. 33 (stating also that Sol. Op. 132 was thereby "superseded").

196. See note 82.

personal injuries could not possibly apply to punitive damages, which are not compensatory at all.¹⁹⁷ The holding of *Glenshaw Glass*, that accessions to wealth are income, implies that all compensatory damages in excess of statutory basis recovery are income. The *Glenshaw Glass* opinion itself neither states nor implies any limitations on the taxing power of Congress.

In the *O'Gilvie* case,¹⁹⁸ the Supreme court held that punitive damages in a personal injury context were not excluded under the pre-1989 version of section 104(a)(2). Again the Supreme Court majority cited the no-gain rationale of section 104(a)(2) for the purpose of showing its inapplicability to punitive damages arising from the same cause of action as compensatory damages. The discussion of the rationale is strictly in terms of theory and policy,¹⁹⁹ and not in terms of Congressional taxing power.

In *Luckhard v. Reed*, a welfare-eligibility case that was noted earlier,²⁰⁰ the income tax exclusion for personal-injury compensatory damages was discussed. In that case, four Justices²⁰¹ signed the plurality opinion that stated the view that the word "income" could encompass personal injury awards.²⁰² The swing vote relied on deference to the federal administrative agency.²⁰³ The dissent²⁰⁴ argued that section 104(a)(2) of the Internal Revenue Code manifests Congress's considered judgment that personal injury awards should be excluded

197. 348 U.S. at 423 n. 8. Curiously, the *Murphy* panel quotes (460 F.3d at 86) the beginning of the footnote as follows: "The long history of ... holding personal injury recoveries nontaxable [etc.]." The omission (indicated by three dots) is of the three words "of departmental rulings." This omission alters the import of the footnote. As quoted by the *Murphy* panel opinion, the implication is that *Glenshaw Glass* is noting a series of court decisions. The actual *Glenshaw Glass* footnote only acknowledges a series of departmental rulings, which do not have the status of "law."

198. 519 U.S. 79 (1996).

199. In *O'Gilvie* the majority opinion states (519 U.S. at 86):

We concede that the original provision's language does go beyond what one might expect a purely tax-policy-related "human capital" rationale to justify. That is because the language excludes from taxation ... those damages that substitute, say, for lost wages, which would have been taxed had the victim earned them. To that extent, the provision can make the compensated taxpayer better off from a tax perspective than had the personal injury not taken place.

200. See note 127.

201. Three of the four Justices on the plurality opinion were among the most "conservative" on the Court at that time: Justice Scalia, who authored the opinion, Chief Justice Rehnquist, Justice White, and Justice Stevens.

202. 481 U.S. at 374-78.

203. See 481 U.S. at 383-84 (concurring opinion of Justice Blackmun).

204. The dissent was authored by Justice Powell and was joined by Justices Brennan, Marshall, and O'Connor, none of whom are on the current Court.

as a policy matter²⁰⁵ because it was “not reasonable” to treat an entire personal injury award as gain.²⁰⁶ Of course, Congress has the power to legislate, whether reasonably or unreasonably. None of these opinions raised any issue regarding the federal taxing power, and eight of the nine Justices couched their discussion in terms of the judgment of Congress.

In two modern-era Supreme Court cases, the actual outcome was the taxation of compensatory damages for personal injury on account of a narrow construction of section 104(a)(2).²⁰⁷ It is true that no constitutional issue in these cases was raised by the taxpayer or by any judge or Justice involved in the proceedings at any level, but surely that fact is itself not without significance.

(c) The attempted move to a “replacement of capital” theory

The *Murphy* panel actually relies on a “restoration” (replacement) of capital theory.²⁰⁸ The replacement-of-capital (make-whole) theory is advanced as a way of getting around conventional tax analysis by way of substituting the term “replacement of capital” for the very similar term “recovery of capital.” The latter term has the specific meaning of subtracting basis upon the disposition of an asset. In contrast, the term “replacement of capital” attempts to avoid tax analysis (basis and loss thereof) by positing a truth that is supposedly self-evidently true on its face: where all or a portion of one’s capital is (wrongfully) destroyed or removed, then it would seem that any recovery (computed with reference to lost future earnings) that replaces that capacity should be untaxed, because otherwise the taxpayer would be diminished relative to her prior state.

However, “replacement of capital” is not a recognized tax term. Instead, it is a description of a fact situation that is meant to invoke, in the manner of a metaphor, the notion of “no gain.” Unfortunately, a cash damages award does not even fit the proffered replacement-of-capital description, because the receipt of damages for emotional distress does not represent any loss of “capital” as that term is being advanced in this context, namely, as the “tree” that produces income. Certain personal injury recoveries are for loss of “human capital” in the economic sense,²⁰⁹ meaning an individual’s uniquely personal capacity to earn wages. Whether the capacity to have a “normal”

205. 481 U.S. at 387-88.

206. 481 U.S. at 389-90.

207. *United States v. Burke*, 504 U.S. 229 (1992); *Comm’r v. Schleier*, 515 U.S. 323 (1995).

208. See 460 F.3d at 85.

209. The *Murphy* panel, 460 F.3d at 85, invokes the concept of human capital as advanced by the Nobel-Prize-winning economist Gary Becker. However, the *Murphy* panel makes no attempt to connect emotional distress damages to the concept of “capital.”

emotional life is a component of human capital is highly debatable: observation of the human scene suggest little correlation between earnings and emotional well-being. Moreover, emotional well-being produces its own “psychic income,” but psychic income is not income in the tax sense, and it follows that emotional well-being is not “capital” in the tax sense. Even if the capacity to feel positive and negative emotion were viewed as “capital” in the tax sense, such capital is not “lost” as a result of the events giving rise to the damages recovery. Suffering does not manifest any lack (or loss) of capacity. On the contrary, the suffering demonstrates that the capacity is fully intact. Finally, even if capacity to enjoy life were demonstrably lost, such a *capacity* is an aspect of a person’s natural “endowment.” But endowment (natural or otherwise) is not considered to be “capital” in the income tax sense.

Furthermore, the receipt of a cash damages award is not a “replacement” of capital. Replacement can occur only if the cash award is invested. The disposition of an asset and its replacement are separate transactions for tax purposes.²¹⁰ There is no general doctrine that the replacement of one investment by another (whether voluntarily or involuntarily) results in a permanent exemption from tax. Whether any “replacement transaction” is structured as an exchange of properties or as a sale followed by a reinvestment, the disposition of the original investment is a taxable event unless the Code expressly states otherwise.²¹¹ Even if there is a gain that the Code expressly treats as not being recognized (currently taxed), there is no permanent exemption of gain.²¹²

If there never was a general replacement-of-capital doctrine (apart from basis recovery), how can one exist uniquely in the case of personal injury recoveries, and, if so, how can it be located in the 16th Amendment? The embarrassing truth is that there has never been a “replacement” requirement under section 104 or any of the non-statutory authority for excluding personal injury damages. Shorn of any relevance to facts or even broad (non-tax) notions of capital, the replacement-of-capital theory appears to be nothing more than a new cover draped over the “no (economic) gain” theory. But (to sound like a broken record) gain in tax is measured with reference to basis, not comparative values.

210. Congress can override this separateness by conditioning the tax treatment of the disposition to the reinvestment of the cash. It has done so in the case of involuntary conversions of property (see IRC § 1033), but not (under IRC § 104) in the case of involuntary dispositions of human capital.

211. See IRC § 1001(c); *Cottage Savings Ass’n v. Comm’r*, 499 U.S. 554 (1991) (replacement of mortgage investments with virtually identical mortgage investments is a taxable event).

212. The gain is deferred by treating the basis of the original investment as being (with appropriate adjustment) the basis of the replacement investment. See, e.g., IRC §§ 358, 722, 1031(b), 1033(b).

Even on its own terms, the notion that an income tax exclusion for personal injury damages is necessary to maintain the victim's pre-injury condition is false. A problem relevant to *Murphy* is that a recovery for emotional harm, even if reinvested, does not make the victim "whole" (does not restore any lost capacity). It is merely compensation for having undergone an unpleasant experience, just as wages are compensation for the loss of the psychic benefits of not working. A broader problem for personal injury recoveries generally is that a norm of making tort victims whole is nowhere expressed in the federal Constitution, much less the 16th Amendment. The notion of making victims whole is a "policy," but there are competing policies in tort law, namely, the deterrence of wrongdoing and the internalization of social costs, and these policies might conflict with each other and with the policy of making victims whole.²¹³ The Constitution shows no preference for one tort-law policy over others.

Even if there were a federal Constitutional right of individual tort victims to be made whole,²¹⁴ an income tax exemption is not a necessary means of securing it. Such a claim may lie against the government itself, not the wrongdoer. Assuming the claim resides against the wrongdoer, the correct end result of making the victim whole is not obtainable by tax law alone but by the proper synergy of tax law and tort law.²¹⁵ It is up to tort law to determine whether lost earning capacity is to be figured before-tax or after-tax, and whether to use a before-tax or after-tax discount rate. Depending on the damages formula used, it is possible that including damages for lost earning capacity in income is the only way to make the victim whole.²¹⁶

There is the further issue of whether structured settlements (annuity-type recoveries) should be treated as having a taxable interest component.

Personal-injury recoveries result from "involuntary" occurrences, but the "replacement of capital" theory of exclusion makes no reference to involuntariness. In tax law, involuntariness is often seen as posing a hardship issue that is accommodated (if at all) by a statutory deferral rule rather than by

213. Thus, excluding damages recoveries from tax (while allowing damages paid by business to be deductible) has the net effect of lowering the cost of wrongdoing.

214. If there were such a right, then comparative negligence regimes could well be unconstitutional.

215. Several of the ideas set out here and below are presented in a different form in Joseph Dodge, et al., *Federal Income Tax: Doctrine, Structure & Policy: Text, Cases, Problems* 270-72 (3d ed. 2004).

216. Various damage-computation and tax scenarios are explored in Joseph M. Dodge, *Taxes and Torts*, 77 *Cornell L. Rev.* 601 (1992). If the damages are figured on a before-tax basis (future wages unreduced by tax), then taxing the damages is the correct way to make the victim whole.

total exclusion.²¹⁷ There is nothing inherently illegitimate in Congress fashioning tax rules to alleviate hardship. Such an accommodation would be within the policy-making competence of Congress, and is not mandated by the 16th Amendment.

3. *There is no recoverable basis in personal injury recoveries*

The inescapable conclusion is that a receipt of cash is income unless a basis offset is available. In order to obtain a basis offset, it is necessary *both* (1) that the item in question *possess* a basis *and* (2) that the item be “disposed of” so as to entitle the taxpayer to *offset* the basis against the cash receipt.²¹⁸ There is no basis in personal attributes generally, and in the *Murphy* case there was no “disposition” of any personal attribute.

(a) *Personal attributes have no basis*

The idea of “gain” under the income tax is defined purely in monetary terms, and not in terms of overall well-being.²¹⁹ In technical jargon, gain is net receipts (amount realized) minus net cost (adjusted basis), both being measured in money or money’s worth received or spent, as the case may be. Thus, “cost” means net *monetary* outlay,²²⁰ not “effort,” “pain,” “prior status,” or “opportunity cost.”²²¹

217. See, e.g., IRC §§ 1033 (involuntary conversion gains) and 1038 (gains on property foreclosure).

218. See IRC § 1001(b) (basis subtracted from amount realized upon sale or disposition).

219. See *United States v. Burke*, 504 U.S. 229, 233 (1992) (in narrowly construing IRC § 104(a)(2), stating that, “Congress intended ... to exert the full measure of its taxing power, and to bring within the definition of income ‘any accession to wealth.’” An accession to wealth entails a “before and after” measurement of “wealth,” which refers to material wealth (cash and property), not well-being, utility, and other intangibles.

220. See IRC §§ 1011-1023 (defining basis). For the function of basis, see note 113 and accompanying text.

221. In economics jargon, “opportunity cost” means foregone utility: The true cost of something is what you give up to get it. This includes ... the economic benefits (utility) that you did without because you bought (or did) that particular something... . For example, the opportunity cost of choosing to train as a lawyer is not merely the tuition fees, price of books, and so on, but also the fact that you are no longer able to spend your time holding down a salaried job or developing your skills as a footballer... . Economics is primarily about the efficient use of scarce resources, and the notion of

It is settled that a person's physical being (and the components thereof) possess no basis for tax purposes.²²² Assuming that human capital has both physical and non-physical components, neither component possesses basis. There are no depreciation or loss deductions on account of the wasting or loss of human capital.

The *Murphy* panel opinion attempts to avoid the no basis difficulty by suggesting that the reason human capital basis does not generate deductions is simply because it is too difficult to account for it;²²³ in contrast, in a personal injury recovery the basis can be deemed to be equal to the amount of the recovery. But damages simply represent a determination of value, and the loss of value attendant upon a non-compensated loss of human capital is capable of determination in the same manner as in any case where there is compensation.²²⁴ In addition, it cannot simply be assumed that the basis of the lost human-capital component equals its value. First, it must be established that such basis exists in the first place (and that it exceeds the amount of the loss).²²⁵ Second, the *amount* of basis that can be taken as an offset is the taxpayer's basis in the particular component of human capital that is lost; if such basis cannot be identified (which is certain to be the case), the taxpayer's basis in the lost component is the same percentage of her total basis in her entire human capital as the total amount of the loss bears to the total pre-loss value of the human capital.²²⁶

The problem isn't simply one of accounting difficulties. Human capital simply does not possess basis as a matter of law. Basis represents a taxpayer's

opportunity cost plays a crucial part in ensuring that resources are indeed being used efficiently.

See <http://www.economist.com/research/Economics/alphabetical.cfm?TERM=OECD>.

222. See *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979) (*en banc*) (zero basis in one's own rare blood plasma).

223. See 460 F.3d at 88.

224. It might be argued on behalf of the *Murphy* panel decision that uncompensated losses (and depreciation) of human capital are not deductible on the theory that they are "personal" losses. See *Welch v. Helvering*, 290 U.S. 111 (1933) (suggesting that human capital is "personal"); *Sharon v. Comm'r*, 66 T.C. 515 (1976), aff'd 591 F.2d 1273 (9th Cir. 1978) (*per curiam*), *cert. denied*, 442 U.S. 941 (1979) (education costs not amortizable); Regs. § 1.162-5 (cost of acquiring human capital by way of education never results in deductions or offsets). In contrast, basis is recoverable upon the disposition of a personal-use asset for cash, but not to exceed the amount of the cash, and the same principle could apply to personal injury recoveries. Neither the *Murphy* panel decision nor any other commentator (of whom I am aware) has made this argument. In any event, it does not survive the critiques stated in the text following this note.

225. See IRC § 165(b); Regs. § 1.165-1(c).

226. See the discussion of partial losses in Dodge et al., note 213, at 711-12.

cost expressed in dollars that have previously been taxable to that taxpayer.²²⁷ The principal component of human capital is a person's body and its attendant capabilities. Other components result from the acquisition of learning, culture, social skills, and the like. However, none of these items is considered "income" (an accession to wealth) upon acquisition.²²⁸ In addition, any costs incurred by third parties (parents, relatives, friends, government) in providing a person with human capital do not transfer to the taxpayer, the Supreme Court having held that third-party contributions to the capital of a corporation have a zero basis to the corporation.²²⁹ Finally, most costs incurred by the taxpayer with her own funds that result in the acquisition of human capital (living costs) are treated as expenses, not capital expenditures. About the only item that might create basis (in theory, at least) would be self-paid education that qualifies one for a new trade or business.²³⁰ However, it appears that such costs do not create basis as a matter of positive law, on the theory that inherently personal costs (that cannot be deducted as expenses) cannot be deducted indirectly through capitalization and depreciation or basis offset.²³¹ In any event, most people incur no human-capital capital expenditures, and none were alleged to have been incurred in *Murphy*. Note, however, that such a discrete category of cost is capable of accurate accounting.²³² In sum, human capital is similar to self-created goodwill in having a zero basis (or close to it) as a matter of law.²³³

It is not clear that the *Murphy* panel really relied on a restoration-of-human-capital theory. Not only does a recovery for emotional harm fail to demonstrate any loss of human capital in fact, but also it is not clear that as a matter of purely tax policy (as distinct from tort policy) an exclusion is appropriate where human capital is lost and replaced by cash.²³⁴ A recovery for

227. Basis can derive from "income" expressly exempt from tax. In such a case, basis "preserves" the express exclusion.

228. Such "wealth" (if it be so conceived) is not transferable, nor can it be liquidated.

229. See note 167. The basis rules for gifts and bequests (IRC §§ 1014 and 1015) do not apply, as these only apply to "property" that can be transferred (gratuitously). Human capital is not transferable. See *Bateman v. Comm'r*, 686 F.2d 217 (4th Cir. 1982).

230. See Regs. § 1.162-5(b).

231. This appears to be the theory underlying the basis disallowance rules referred to in note 107.

232. Not only can the costs be recorded and tallied, but also the basis can be amortized as an intangible over the taxpayer's actuarially-determined professional life expectancy. Cf. *Sharon v. Comm'r*, note 222 (allowing amortization of the cost of obtaining a license to practice law).

233. See generally, Joseph M. Dodge, *Taxing Human Capital Acquisition Costs - Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 *Ohio St. L. J.* 927 (1993).

234. See 460 F.3d at 87-88.

lost earning capacity can be viewed as a conversion from human capital, which is “before tax,”²³⁵ to either wages or investment capital, both of which are supposed to be after-tax.²³⁶ A recovery for lost human capital can be invested in an annuity that would replace the lost wage stream. Taxing the recovery would simply place the annuitant on an equal tax footing with other investors. Excluding the award would have the effect of preserving the taxpayer’s status as a (deemed) wage-earner, rather than investor (despite being an investor in fact). Surely it is in the discretion of Congress to make this choice or to perhaps to select some other approach, such as conditioning the exclusion on an actual annuity investment.²³⁷

Even if the taxpayer in *Murphy* had a basis in her human capital, she could not have a basis in her capacity for emotional well-being (even if such a basis could be calculated). At least in the realm of speculation, costs of acquiring human capital might be capitalized, because human capital is the capacity to generate future wage income, and capital expenditures are present costs of obtaining future includible income. However, emotional capacity or normalcy is not an asset capable of producing income in the tax sense, present or future. Emotional states (positive and negative) do not measure changes in material wealth, and “highs” and “lows” are neither income nor loss items.

(b) There was no disposition of anything in Murphy

Even if one were deemed to have an income tax basis in one’s capacity to enjoy a normal emotional life, the suffering of emotional distress cannot be equated with the loss (“disposition”) of any asset. Cash-for-pain is a simple trade-off, resulting in economic (or tax) gain, just as is the trading of services for wages. Suffering (like wage-earning) does not manifest any lack (or loss) of capacity. As noted earlier, the suffering demonstrates that the capacity remains in place.

Without a loss of a portion of an asset, there can be no basis offset against a cash receipt. A case directly on point in this respect is the 1941 decision of the Supreme Court in *Hort v. Comm’r*,²³⁸ where the taxpayer-lessor received a payment from the lessee for the termination of a lease that was unfavorable to the lessee. The taxpayer argued that the lease termination

235. Although some human capital may be viewed as having been acquired with after-tax (nondeductible) dollars of the taxpayer, most of it is acquired tax-free from third parties and the environment.

236. Wages are taxed. Cash that is invested (treated as a capital expenditure) is not deductible in theory and in a good deal of practice, see IRC § 263, and therefore retains its after-tax status.

237. Cf. IRC § 1033 (no gain on involuntary conversion of property if entire proceeds are rolled-over into similar-use property).

238. 313 U.S. 28 (1941).

payment was compensation to the lessor for the loss of the premium value of the lease. It is true that the taxpayer was compensated for losing the lease, but the tax issue was whether any of the lessor's basis in the underlying real estate could be "allocated to" the premium lease and used as an offset against the termination payment. The Court held that such payment was not subject to any basis offset whatsoever, because there was no final disposition of any identifiable portion of the underlying real estate investment, given that the premises could be re-leased upon the lessee's departure. In other words, a loss (decline) in rental value does not necessarily reflect a realized loss of income-producing capacity.

Similarly, there was no permanent or final disposition in *Murphy* of anything that (even if it had a basis) could support a basis recovery. Emotional states are temporary. The capacity to experience emotional states, both high and low, persisted.

To sum up, the *Murphy* panel is wrong on all three of the elements needed to establish the existence and applicability of the no-gain theory. There is no netting requirement in the 16th Amendment concept of "incomes." "Capital" means only "basis" (or, more broadly, the monetary "cost" of producing income). There is no basis in human capital, much less in emotional distress damages, and (even if there were) there can be no basis offset without a realized (permanent) loss of an asset (or a portion thereof). In the tax sense, personal injury recoveries (other than recoveries of non-deductible costs) are pure monetary gain, and therefore "income."

B. The "In Lieu Of" Theory

The entire notion of "capital" in the history of the income tax (as well as in business and trust accounting) is as something that produces monetary income. Emotional well-being does not produce monetary income. Its presence might contribute to it, but so might its absence. And non-monetary (psychic) benefits (and detriments) do not count under the income tax. If psychic benefits are non-income, then any costs of producing the same cannot be allowed as deduction or offset, explicitly or implicitly.²³⁹ In short, the human capital notion cannot provide a theory for excluding damages for emotional harm. Another theory is needed, and the theory offered by the *Murphy* panel is the "in lieu of" theory. As applied in the *Murphy* panel opinion, this theory operates to exclude emotional-harm damages on the ground that the recovery is a substitute for (in

239. See, e.g., IRC §§ 165(c), 167(a), and 262 (disallowing personal expenses, losses, and depreciation), and 264 and 265 (disallowing costs of producing tax-exempt income).

lieu of) a non-taxed (non-income) benefit, namely, emotional well-being. This section demonstrates that there is no doctrinal support for the version of the in-lieu-of theory advanced in *Murphy*, and that the theory, if accepted, would cause the income tax to collapse.

1. There really is no “in lieu of” doctrine

The *Murphy* panel decision’s application of the so-called “in lieu of test” is radical in that no other case has applied this notion to find that that an item is non-income.

The “in lieu of” phrase is found in the Supreme Court 1938 decision in *Lyeth v. Hoey*,²⁴⁰ but that case only construed the statutory exclusion for gratuitous receipts, holding that an heir’s receipt of an estate in settlement of a will contest was as much an “inheritance” as if obtained by way of a routine intestacy scenario or a court judgment.

The most frequently cited authority for the so-called in-lieu-of doctrine is the First Circuit’s 1944 decision in *Raytheon Production Co. v. Comm’r*,²⁴¹ in which the taxpayer received a settlement in a civil anti-trust suit. The court stated: “The test is not whether the action was in tort or contract but the question to be asked is “In lieu of what were the damages received?”²⁴² The court then asked whether the recovery was of lost profits (fully taxable) or of the value of an asset (goodwill) that was wrongfully appropriated by the defendant. The court decided that the damages were for appropriated goodwill, but that the taxpayer failed to show any basis therein.

240. 305 U.S. 188, 196 (1938):

There is no question that petitioner obtained that portion [of a decedent’s estate], upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity. It does not seem to be questioned that if the contest had been fought to a finish and petitioner had succeeded, the property which he would have received would have been exempt under the [predecessor of section 102]... . We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption.

241. 144 F.2d 110 (1st Cir.1944), *cert. denied*, 323 U.S. 779 (1944).

242. See *id.* at 113.

Other cases cited by the *Murphy* panel opinion²⁴³ are of like import. In all of them there was a settlement (or its equivalent), and the issue was categorization of the settlement proceeds under the tax Code.

Given that all of the cases invoking the in-lieu-of concept involve litigation settlements, its adoption by the *Murphy* panel decision is both odd and inappropriate, because in *Murphy* there was no settlement, but rather an award specifying that the damages were for “emotional distress or mental anguish” and for “injury to professional reputation.” Thus, the nature of the recovery is manifest on its face. Moreover, the relevant statutory category is also clear: the cash award is a recovery on account of a non-physical injury.

Instead of using the in-lieu-of idea to characterize the facts in relation to one or more relevant legal rules, the *Murphy* panel treats the concept as a “theory” that cash received in lieu of non-income (emotional well-being) is itself non-income. No case is cited as so holding, and none (to my knowledge) exists. The theory is implausible on its face, because it treats a cash accession to wealth as if it were an immaterial psychic benefit. The *Murphy* panel suggests,²⁴⁴ nevertheless, that the *O’Gilvie* case²⁴⁵ endorses such a theory as a principle of 16th Amendment jurisprudence. However, *O’Gilvie* does no such thing, but merely cites the notion as a possible reason for Congress’s decision to exclude certain compensatory damages from gross income.²⁴⁶

243. See *Francisco v. United States*, 267 F.3d 303, 319 (3d Cir. 2001) (part of settlement of tort action treated as taxable interest); *Tribune Publishing Co. v. United States*, 836 F.2d 1176 (9th Cir.1988) (settlement of securities fraud suit treated as a taxable boot-dividend received in a tax-free reorganization); *Gilbertz v. United States*, 808 F.2d 1374 (10th Cir.1987) (characterizing payments received by ranch-owner from oil and pipeline companies, treating some as the equivalent of rent and others as warranting capital recovery).

244. See 460 F.3d at 88.

245. See note 196.

246. The majority opinion in *O’Gilvie* states (519 U.S. at 86-87):

We concede that the original provision’s language does go beyond what one might expect a purely tax-policy-related “human capital” rationale to justify. That is because the language excludes from taxation not only those damages that aim to substitute for a victim’s physical or personal well-being – personal assets that the Government does not tax and would not have taxed had the victim not lost them. It also excludes from taxation those damages that substitute, say, for lost wages, which would have been taxed had the victim earned them.

...

Finally, we have asked *why* Congress might have wanted the exclusion to have covered these punitive damages, and we have found no very good answer. Those damages are not a substitute for any normally untaxed personal (or financial) quality, good, or “asset.” ...

It is worth noting that the in-lieu-of idea, which emerged in the late 1930s and early 1940s, cannot possibly be said to have been part of the 1913 understanding of the 16th Amendment, assuming *arguendo* that such understanding is relevant to the interpretation thereof.

2. The Murphy version of the doctrine would destroy the income tax

The function of the in-lieu-of idea is simply to ascertain the “substance” of a settlement in relation to statutory categories under the tax law.²⁴⁷ Thus, in *Lyeth v. Hoey* the settlement was an “inheritance,” excluded by statute, and in *Raytheon Production* it was “payment for a stolen asset” (rather than profits). Really, the “in lieu of” notion is misnamed: it really should be called the “what is it?” doctrine. A doctrine that is designed to accurately describe facts is perverted if it is used to misdescribe facts. Such a perversion occurs where, as in *Murphy*, it is deployed to treat a receipt of cash as if it were really a (non-income) psychic benefit. The “substance” of the transaction in *Murphy* was precisely the conversion of emotional well-being into cash. The cash award cannot be viewed as *not* being a cash award!

The tax Code would be wholly undermined if transactions involving material wealth could be converted by a magic wand into non-material ephemera. Such a “transubstantiation doctrine” would have the potential to operate virtually without constraint so as to change income into non-income. Are wages in lieu of the untaxed psychic benefits of not working? Are interest, dividends, rents, property royalties, and even capital gains “in lieu of” pride of possession and feelings of security derived from possessing cash and property?” Are punitive damages a substitute for moral indignation and a desire to wreak revenge? These are truly silly and irrelevant questions in the context of an income tax.

IV. CONCLUSION

The *Murphy* panel decision should not only be reversed, but it should be condemned in the strongest terms. Contrary to this decision, cash damages for personal injury (that are not excluded under Code section 104) are included under the catch-all clause of section 61 and the 16th Amendment. In addition,

The dissenting opinion (Justice Scalia, joined by Justices O’Connor and Thomas) was based on a textual approach. In passing, it debunks (519 U.S. at 97-99) the replacement-of-capital rationale of the early administrative rulings.

247. See, e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935), *aff’g*, 69 F.2d 809, 810 (2d Cir.1934) (opinion by L. Hand) (issue was dividend vs. capital gain); *Knetch v. United States*, 364 U.S. 361 (1960) (no interest deduction allowed where there is no real indebtedness).

it is certain that Congress has the power to tax such damages under its power to levy indirect taxes without apportionment.

The *Murphy* panel was correct in not reaching the indirect tax issue, although it should have mentioned this issue and explained why it was not relevant. However, the case was wrongly decided on every other point. The 16th Amendment is construed according to its text (not by early misunderstandings. On the merits, the 16th Amendment does not require netting. “Capital” means basis. A taxpayer has no basis in a personal injury recovery, and (even if a taxpayer were to have such basis) it cannot be recovered against an award of emotional distress damages. There is no support for the theory that an accession to wealth can be treated as if it were a mere non-taxable psychic benefit, and adoption of any such theory would cause the collapse of the income tax.

The “craft” of the *Murphy* panel decision is abysmal. The holding is inaccurately and confusingly stated.²⁴⁸ The opinion is a disorganized pastiche of quotes and generalizations²⁴⁹ culled from various sources without regard to the facts of *Murphy*,²⁵⁰ the facts, context, or holdings (of cases),²⁵¹ the current status of authorities or theories,²⁵² or any real analysis of relevant legal materials.

The panel opinion is truly radical in showing no real respect for constitutional text, the body of judicial authority as it has evolved up to the present, or even the nature of the judicial function. It is one thing to invoke outdated and obsolete theories in class discussion or e-mail colloquies for their instructional or entertainment value. It is another to actually adopt them at in a judicial opinion at the next-to-highest level. In contrast to Congress or the Executive, who are free to recycle old ideas, courts do not decide issues in a vacuum. Decisions close doors, although they may open others. “Anything goes” is the wrong motto.

248. See the text accompanying notes 17-21.

249. For example, the opinion (460 F.3d) cites the quote “the power to tax is the power to destroy” (*McCulloch v. Maryland*, 4 Wheat. (17 U.S.) 316, 431 (1819)), as if the Supreme Court has adopted a narrow construction of the taxing power. However, it has done just the opposite. In *Knowlton v. Moore*, 178 U.S. 1, 60 (1899), the Court stated that this concern only comes into play where “there is no power to tax a particular subject,” and went on to hold that a federal inheritance tax was valid as an indirect tax. In this connection, see also note 23. Some other examples of non-relevant generalizations are noted in note 40, the text accompanying notes 67-69, and note 187.

250. The discussion of the replacement-of-capital theory in *Murphy* is pointless, because the taxpayer neither lost nor replaced anything considered to be “capital.”

251. Examples of the mis-citation of cases are noted at note 24 and in the text accompanying notes 45-52 and 194-197.

252. Examples are noted in the text accompanying notes 41-58 and 180-193.