Personal Injury Income Tax Exclusion: An Analysis and Update

Frank J. Doti
PERSONAL INJURY INCOME TAX EXCLUSION: AN ANALYSIS AND UPDATE

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I. Introduction
Congress finally got into the act by amending the section 104(a)(2) exclusion in the Small Business Job Protection Act of 1996. [FN6] Under prior law, the exclusion extended to any compensatory damages received on account of personal injuries or sickness. [FN7] The amendment limits the exclusion to any compensatory damages received on account of personal physical injuries or physical sickness. [FN8]
Prior to Burke, Schleier, and the 1996 amendment, lower courts were extending the scope of the exclusion to the point where practically all personal tort or tort-like recoveries were held to be excludable. [FN9] Starting with the Ninth Circuit's liberal decision in 1983 in Roemer v. Commissioner [FN10] and the Tax Court's acquiescence in 1986 in Threlkeld v. Commissioner, [FN11] the personal injury exclusion was expanded from traditional torts like libel and slander to statutorily created causes of action in various employment discrimination laws of the federal and state governments. [FN12]
I have two purposes to serve with this work. First, I believe that most of the confusion and controversy surrounding the personal injury exclusion would have been avoided if Congress had carefully considered the scope of the exclusion from its inception. [FN13] In my opinion, the exclusion should apply only to personal injury damages attributable to lost human capital and not lost wages and earning power. Allowing tax-free treatment for lost wages and earning power for the victim of a physical injury tort (such as an automobile accident) has caused confusion regarding the scope of the exclusion. [FN14] Unlike other scholars who believe that Congress went too far in restricting the exclusion in the 1996 Act, [FN15] I believe that Congress did not go far enough. Congress should have eliminated the section 104(a)(2) exclusion for lost wages and earning power in all cases. Furthermore, the 1996 amendment has not cleared up the confusion over the exclusion. Uncertainty and resulting litigation will continue until Congress limits the exclusion to damages attributable solely to losses of human capital.
Second, the new legislation raises a notable issue: What is meant by physical injuries or physical sickness? Although amended section 104(a)(2) specifically provides that "emotional distress shall not be treated as a physical injury or physical sickness," [FN16] there still are many uncertainties over the meaning of these terms. Since Congress did not define them, I provide some guidance for practitioners and the Treasury Department with respect to regulations to be issued under section 104(a)(2).
I begin with an analysis of the human capital theory of the exclusion in Part II. Part III
explains how the pre-amended 1996 personal injury exclusion in section 104(a)(2) generated considerable confusion and controversy. Part IV deals with the 1996 Act and the meaning of physical injury and physical sickness. I conclude with a proposal to Congress to adopt the human capital theory to make the exclusion more equitable and to avoid confusion and controversy about the meaning of physical injury and physical sickness.

II. Human Capital Theory
From its inception, in my opinion, the exclusion for personal injury awards should have been limited to losses of human capital. By this I mean any losses to a person's birthright—an uninjured body and mind. So far the Internal Revenue Service has not treated an individual's birth as an accession to wealth under the broad definition of income enunciated by the U.S. Supreme Court in Commissioner v. Glenshaw Glass Co. [FN17] Besides being ludicrous, taxing an individual at birth would resemble a capitation or head tax that would have to be apportioned under the Constitution. [FN18] After birth, of course, persons are subject to federal income tax on any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." [FN19]

The victim of an automobile accident may receive damages from the tortfeasor to compensate for medical bills, pain and suffering, and lost wages. [FN20] Under the birthright concept of human capital, the reimbursement of medical bills and pain and suffering is not income, because the victim is compensated for losses to his/her birthright—an uninjured body and mind. The tortfeasor injured the victim's body and mind, and the reimbursement of medical costs and pain and suffering compensates for such losses. There is no gain, since money damages are intended to put the victim back in the same position as before the accident. [FN21]

The payment of lost wages, however, compensates for a loss of earnings that would have been received from working but for the accident. This is an accretion to wealth and would clearly be income had the victim not been injured. The victim has realized a financial gain that was not part of his human capital (body and mind) at birth. [FN22] Under the human capital theory, any damages received on account of injuries to body and mind should be excludable under the Code. Thus, even damages for emotional distress should be excludable, since the victim's nervous system (mind) has been adversely affected. On the other hand, any damages for lost wages or earning power should be taxable in all cases, even in the automobile accident scenario.

The human capital or birthright concept should also extend to damages received on account of an individual's harmed reputation in cases of defamation and other dignitary torts. Perhaps not as obvious as damages to body and mind, the victim's untainted reputation in the community is no less a birthright than an uninjured body and mind. On the other hand, reimbursement of lost profits in a business or profession is not replacement of lost capital, it is a replacement of lost income due to the defamatory remarks. The courts have struggled with the application of section 104(a)(2) to defamation, particularly in the case of business and professional reputation. [FN23] In my opinion, adoption of the human capital theory would have resulted in much less litigation and the inconsistencies resulting therefrom.

In many tort settlements and judgements there is an award of a lump-sum amount without any breakdown of the specific damages. [FN24] Obviously this creates an allocation problem, and much of the litigation under section 104(a)(2) is attributable to the Internal
Revenue Service's frustrations with lump-sum settlements. [FN25] Since victims have the
burden of proving the excludable portion of any settlement, [FN26] there would be a
strong incentive to break down the settlement into its component parts under the
birthright view. To avoid unrealistic allocations, the Internal Revenue Service can apply
the arm's length (substance over form) standards that it applies in other areas of the
federal income tax law. [FN27]
Taxpayers should find it easier to comprehend the birthright view than the current
personal injury exclusion in section 104(a)(2). They surely can appreciate an exclusion
for damages to body, mind, and reputation, but would understand why lost wages and
earning power are taxable. Because lost wages and earning power would always be
subject to income tax, Congress could amend related Code provisions to treat the
reimbursement of lost wages and earning power as earned income. [FN28] Then these
damages could qualify for the various tax benefits of earned income, including social
security qualification and benefits and tax-favored employee and self-employed benefit
plans. [FN29] On the government's side, treating lost wages and earning power as taxable
earned income would increase not only the revenues collected from income taxes, but
also revenues from social security, Medicare, and self-employment taxes.

III. Historical Perspective

A. Early History
It appears that all branches of the federal government have been confused about the scope
of the personal injury exclusion from its inception. The misunderstanding seems to have
started with an opinion of the U.S. Attorney General addressed to the Secretary of the
Treasury in 1918. [FN30] The issue was the taxability of accident insurance policy
proceeds. [FN31] At the time, the income tax statute did not contain an exclusion for
personal injury awards. [FN32] The Attorney General advised that "the proceeds of an
accident insurance policy received by an individual on account of personal injuries
sustained by him through accident are not income taxable." [FN33] The rationale was
that accident insurance proceeds took the place of capital in human ability which was
destroyed by the accident. [FN34] Unfortunately, the Attorney General did not
distinguish between losses to the accident victim attributable to bodily injuries and losses
of future income from wages and earning power. [FN35]
Following the lead of the Attorney General in his opinion letter, the Treasury Department
held shortly thereafter that "an amount received by an individual as the result of a suit or
compromise for personal injuries sustained by him through accident is not income." [FN36]
Congress then effectively codified these positions in 1918 in the first version of a
statutory personal injury exclusion. [FN37] That provision excluded from income
"amounts received, through accident or health insurance or under workmen's
compensation acts, as compensation for personal injuries or sickness, plus the amount of
any damages received whether by suit or agreement on account of such injuries or
sickness." [FN38]

B. O'Gilvie v. United States
Recently the U.S. Supreme Court had the occasion to determine the scope of this original
personal injury exclusion statute in O'Gilvie v. United States. [FN39] At issue was the
taxability of punitive damages received in a personal injury case prior to the 1996
amendments to section 104(a)(2). [FN40] The Court held that punitive damages are taxable because they are not received "on account of personal injuries. [FN41] Instead, punitive damages are generally intended to punish the tortfeasor. [FN42] Justice Breyer, who delivered the majority opinion, analyzed the 1918 exclusionary provision and made the following significant comments:

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. To that extent, the provision can make the compensated taxpayer better off from a tax perspective than had the personal injury not taken place. [FN43] The U.S. Supreme Court recognized that the 1918 personal injury statute went beyond what might have been expected from Congress in an exclusionary provision. It excludes even lost wages, and thus puts the victim in a better income tax position than she would be if she had not suffered the personal injury. In my opinion, the Court is chiding Congress for not having limited the exclusion to human capital losses. It seems the Court would prefer that the personal injury exclusion be limited to losses to a victim's birthright ("physical or personal well-being") along the lines that I have suggested.

Congress did not carefully consider how extensive it wanted the personal injury exclusion to be in 1918. The legislative history adds little insight other than stating that "(u)nder the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income." [FN44] This language suggests that Congress was merely adopting the Attorney General's opinion with respect to accident insurance. [FN45] It is ironic that the original personal injury exclusion was worded so broadly, since Congress could have simply limited the exclusion to nontaxable losses of human capital.

Of course we have the benefit of hindsight. The federal income tax was relatively new in 1918. [FN46] Also, the Supreme Court's extension of the definition of income did not come until 1955 in Glenshaw Glass. [FN47] For many years before Glenshaw Glass, [FN48] the courts and Treasury Department thought that the concept of income was limited to gains derived from labor and capital under the rationale of Eisner v. Macomber. [FN49] Since the victim of a tort does not use labor or capital to produce the damage award, all of the proceeds would have been excludable under the old and now out-of-favor Eisner v. Macomber rationale. Glenshaw Glass extended the concept of income to any increase in a person's wealth regardless of its source. [FN50] So perhaps it is wrong to blame only the Attorney General for all the confusion that has existed with respect to the personal injury exclusion.

C. United States v. Burke

In 1992, the U.S. Supreme Court had its first occasion to examine the section 104(a)(2) exclusion in United States v. Burke. [FN51] The majority held that damages received for gender discrimination under Title VII of the Civil Rights Act of 1964 are not excludable under section 104(a)(2). [FN52] The Court found that Title VII at that time was not a tort
or tort-like cause of action because the remedies thereunder were limited to back pay, injunctions, and other equitable relief. [FN53] Title VII, prior to its amendment in 1991, did not provide the traditional tort remedies for pain and suffering, emotional distress, and harm to reputation. [FN54] Thus, according to the majority, the taxpayer's cause of action failed the litmus test for a tort or tort-like claim. [FN55]

Justice Scalia wrote a concurring opinion that seems to embrace the birthright theory of the personal injury exclusion. Scalia admitted that the term "personal injury" was susceptible to the broad interpretation given by the majority. [FN56] Nevertheless, he concluded that a more literal interpretation would encompass only physical and mental injuries. [FN57] Scalia noted that the phrase "personal injury or sickness" is used in several other parts of Code section 104 in the context of physical and mental health. [FN58] Therefore, Scalia believed the phrase in section 104(a)(2) should be similarly limited to damages to physical and mental health, but damages received in the form of back pay should be taxable. [FN59]

I agree in concept with Justice Scalia's view that the personal injury exclusion should be limited to physical and mental injuries. Effectively it coincides with the human capital or birthright theory, which limits the personal injury exclusion. Since Congress wrote the 1918 and subsequent personal injury exclusionary provisions rather broadly, however, I do not agree with Scalia that section 104(a)(2) was so limited at that time. [FN60] The majority view as expressed in O'Gilvie [FN61] seems to be the better interpretation of section 104(a)(2) prior to the 1996 amendments. As noted above, the Court in O'Gilvie believes that the section 104(a)(2) exclusion extends to lost wages. [FN62]

D. Commissioner v. Schleier

The frustrations of the judiciary with section 104(a)(2) reached its zenith when the U.S. Supreme Court decided Commissioner v. Schleier in 1995. [FN63] The issue in Schleier was whether an Age Discrimination in Employment Act (ADEA) recovery of back-pay and an equal amount of liquidated damages was excludable under section 104(a)(2). [FN64] The taxpayer, Erich Schleier, was a pilot for United Airlines who was terminated when he reached the mandatory retirement age of sixty. [FN65] The ADEA provided for recovery of back-pay and an equal amount of liquidated damages if the employer acted wilfully in terminating an employee due to age. [FN66] The Supreme Court held that the entire recovery was taxable. First, the Court found that an action under ADEA is not a tort or tort-like cause of action. [FN67] Because ADEA allowed only recovery of back wages and an equal amount of liquidated damages when the employer's conduct is willful, the majority of the Court found that these remedies were not sufficient to treat an ADEA violation as a tort. [FN68] As the liquidated damages were punitive in nature, the majority felt that the only compensatory damages available under ADEA are back wages. [FN69]

The Court could have stopped there. Because the damages must be received "on account of" personal injury or sickness, however, the majority felt compelled to add a second prong to the test for exclusion that requires a link between the cause of action and the damages recovered. [FN70] This new test created a great deal of confusion about the scope of the section 104(a)(2) exclusion. [FN71] Many believe the Supreme Court's new test in Schleier effectively made recoveries of back wages taxable, unless the injured party suffered physical injury as a result of the tortfeasor's conduct. [FN72] If that is true,
employment discrimination and other dignitary tort awards of back wages would nearly always be taxable, because the victim usually does not suffer any physical injuries or sickness other than emotional distress. The majority noted that Mr. Schleier might have suffered emotional distress as a result of his firing. [FN73] This intangible injury, however, was not sufficient to link the tortious conduct of his employer with the award of back pay. [FN74]

In my opinion, the Court was troubled by the fact that one-half of the award was to compensate Mr. Schleier for lost wages and the other half was to punish the employer and was determined by reference to the amount of back wages to which Mr. Schleier was entitled. Therefore, all the damages were based upon lost income with no compensation for pain and suffering attributable to emotional distress. Although the majority opinion makes no reference to the human capital theory, I believe that the Court was concerned with opening the door to tax-free treatment of employment discrimination recoveries. Since employment discrimination recoveries are so heavily weighted with lost wages, [FN75] it seems that the Court could not accept the fact that Congress intended such a loophole to exist for lost wages—a classic form of taxable income.

E. Recent U.S. Tax Court Decisions

The U.S. Tax Court has applied the Schleier tests in two recent cases that predate the application of the 1996 amendments of section 104(a)(2). In Barnes v. Commissioner, the petitioner worked as a bookkeeper for the National Livestock Commission Association (NLCA). [FN76] After she was served with a subpoena to give a deposition in an lawsuit involving the NLCA, she was fired. [FN77] As a result of the termination, petitioner suffered embarrassment, humiliation, and other mental distress. [FN78] Petitioner also claimed that the mental distress manifested itself in the appearance of precancerous tumors which were being monitored by her doctor. [FN79] She filed a wrongful termination action and eventually settled with the NLCA for $27,000. [FN80] Although the petitioner signed a general release of all claims, there was no allocation of the settlement award between the specific claims that she had alleged. [FN81] A special trial judge for the Tax Court examined Oklahoma law to determine if the first prong in Schleier was satisfied. [FN82] The judge found that the Oklahoma Supreme Court had held that a wrongful termination cause of action was founded in tort. [FN83] Thus, the requirement that the cause of action be tort or tort-like was satisfied. With regard to the second prong in Schleier, the court determined whether the damages were received "on account of personal injury or sickness." [FN84] Since there was no allocation of the damages, the court examined the surrounding facts and circumstances and, in particular, the testimony of the petitioner's attorney in the wrongful termination action and settlement. [FN85] The judge decided: "Based upon our examination of the record and upon due consideration, we allocate $13,500 to the mental distress claim and $13,500 to the punitive damages claim . . . ." [FN86] The judge interpreted Schleier liberally and permitted the exclusion of damages received for intangible harms such as mental distress where the state law governing the cause of action provides for such damages. [FN87] Thus, the amount allocated to mental distress was held to be excludable, whereas the portion allocated for punitive damages was taxable under O'Gilvie. [FN88] It is significant that the court did not require the taxpayer-petitioner to have suffered any physical injury or physical sickness when the tort was
committed. Consequently, this court views the second prong of Schleier as not requiring physical injury or physical sickness at the time the tort was committed. Presumably the court would have ruled differently with respect to the damages for mental distress, if amended section 104(a)(2) applied to this case. [FN89]

A similar result was reached in Knevelbaard v. Commissioner. [FN90] The Tax Court held that damages awarded in an action for negligent infliction of emotional distress were excludable under section 104(a)(2) as it is read prior to the 1996 amendments. [FN91] The petitioner claimed that he suffered mental stress after a bank engaged in fraudulent business practices and made risky loans to one of the petitioner's debtors, which resulted in significant financial losses to the petitioner. [FN92] Despite his stress, the petitioner did not seek any professional mental health assistance. [FN93] As in Barnes, the damages were measured by the petitioner's lost income. [FN94] Yet the court held that the damages were excludable as a personal injury award under section 104(a)(2). [FN95] These very recent Tax Court decisions illustrate the conflicting signals that taxpayers faced in light of Schleier. Because of Schleier, Congress finally recognized the inconsistencies in the application of section 104(a)(2), especially with respect to employment discrimination awards. [FN96] I believe the confusion and controversy would have been avoided if Congress had originally adopted the human capital theory of the exclusion.

IV. 1996 Act & Physical Injury Requirement

A. Background

In 1995, Congress attempted to narrow the scope of Code section 104(a)(2) in the Revenue Reconciliation Act of 1995, which President Clinton chose to veto. [FN97] In 1996, the amendments to section 104(a)(2) became law as part of the Small Business Job Protection Act. [FN98] The amendment and legislative history are substantially the same as that in the 1995 Act. [FN99]

The new law applies to amounts received after August 20, 1996 (the date of enactment), in taxable years ending after such date. [FN100] Under a transition rule, the amendments do not apply to amounts received under a written binding agreement, court order, or mediation award in effect (or issued on or before) on September 13, 1995. [FN101] Thus, Congress adopted a transition rule date that is nearly one year earlier than enactment, instead of one closer to enactment as is typical, presumably because of its action regarding the Revenue Reconciliation Act of 1995. Although that 1995 Act did not become law, Congress apparently felt taxpayers had notice about its intention to narrow the scope of section 104(a)(2).

As amended, section 104(a)(2) provides that gross income does not include:

(2) the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness. . . . For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress. [FN102]

The amendment and legislative history are clear with respect to punitive damages received after August 20, 1997. [FN103] Punitive damages are taxable whether or not related to a physical injury or physical sickness. [FN104] The only exception is for
punitive damages received in a wrongful death action, if the applicable state law (as in effect on September 13, 1995 without regard to subsequent modification) provides that only punitive damages may be awarded in a wrongful death action. [FN105]

B. Legislative History
With respect to compensatory damages, the House Conference Report contains an explanation of the requirement of physical injury or physical sickness that may not be gleaned from the statutory language. [FN106] Since the House version of the bill was adopted in conference, the following conference report statements are helpful in understanding part of the meaning of physical injury or physical sickness: [FN107] The House bill provides that the exclusion from gross income applies to damages on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income under present law. The House bill also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress. . . . [FN108]

The conference report explains Congress' intent with regard to some aspects of the physical injury or physical sickness requirement that must be met before compensatory damages are excludable. As the following hypotheticals illustrate, however, there are many issues that are not resolved by the Code and conference report.

C. Hypotheticals
For example, examine the situation of the victim of an automobile accident (caused by a tortfeasor) who suffers lacerations and broken bones and is unable to work. She recovers damages which reimburse her for medical costs, pain and suffering, and lost wages from her job. All of the damages are excludable because she suffered a physical injury as a result of the negligence of the tortfeasor. Since her cause of action had its origin in a physical injury or physical sickness, all compensatory damages that flow therefrom (including the lost wages) are treated as payments received on account of physical injury or physical sickness, and are thus excludable. If the accident victim in the example also suffers emotional distress as a result of the
accident, then any damages received on account thereof are also excludable. This is due to the fact that the emotional distress is attributable to a physical injury or physical sickness. Thus any damages received for emotional distress caused by the victim being upset about her bodily injuries or her inability to work would be excludable. This seems clear under the above conference report, although the statute does not specifically so provide.

When we look at the victim of defamation or employment discrimination, any damages awarded to the victim are normally taxable. This is because the victims of defamation and employment discrimination normally do not suffer physical injury or physical sickness. Although the victim usually suffers emotional distress, it is clear under the conference report that any damages (including emotional pain and suffering and lost wages) are taxable. The only exception is for costs incurred for medical care attributable to emotional distress. Thus, if the victim of a dignitary tort pays a psychiatrist for consultation on her emotional problems attributable to the tortfeasor's conduct, reimbursement of the doctor's fees are excludable. [FN109]

With respect to wrongful death actions, any damages received by loved ones from the tortfeasor are excludable even though the plaintiffs did not suffer physical injury or physical sickness. Although the statute does not specifically cover wrongful death actions, the conference report makes clear that the plaintiff effectively steps into the shoes of the victim of the wrongful death.

Problems will certainly arise on what constitutes a physical injury or physical sickness. Neither the Code nor legislative history defines physical injury or physical sickness, except to tax recoveries for emotional distress not accompanied by physical injury or physical sickness caused initially by the tortfeasor.

In a footnote to the conference report, the conferees state: "The Committee intends that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." [FN110] Thus it is clear that rather typical and benign physical symptoms of emotional distress of the types listed will not transform the emotional distress into physical injury or physical sickness. It is not clear, however, whether more serious physical manifestations of emotional distress, such as a nervous breakdown or heart attack, will constitute physical injury or physical sickness.

For example, take the situation of the victim of defamation or employment discrimination who has severe emotional distress that ultimately manifests itself in a mental breakdown. Most medical practitioners consider a mental breakdown to be physical injury or physical sickness. [FN111] The problem, however, is that defamation or employment discrimination does not normally have its origin in a physical injury or physical sickness. The conference report is not clear on whether the victim of a dignitary tort is required to suffer a physical injury or physical sickness contemporaneous with the time the tort was committed. The conference report states: "If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness. . . ." [FN112]

The issue becomes whether the dignitary tort had its origin in the mental breakdown. An argument, no doubt, could be made that the bodily processes that ultimately manifested themselves in a mental breakdown started at the time the dignitary tort was committed.
The conference report does go on to provide, however, that the exclusion extends only to the amount paid for medical care attributable to emotional distress. [FN113] If the conferees meant this language to apply to the mental breakdown scenario, then the exclusion would be limited to doctor and other medical costs. On the other hand, the conferees' statement with respect to medical care may be referring to psychiatric care for purely emotional distress not accompanied by physical injury or physical sickness, such as a mental breakdown. This ambiguity in Congressional intent will probably not be resolved until the issue is litigated.

Another issue is how serious the physical injury or physical sickness has to be. For example, a tortfeasor spits on a victim who then suffers emotional distress. Or the victim of sexual harassment at work endures unwanted fondling by her superior. Have these victims suffered physical injury or physical sickness? Stated directly, does mere touching of the human body constitute a physical injury or physical sickness? The Code and legislative history are silent on how extensive the physical injury or physical sickness has to be such that it is covered by the section 104(a)(2) exclusion.

Or take a different kind of involvement of the human body. A patron of a fancy restaurant ingests rat feces as part of his Beef Wellington entree. He suffers emotional distress from the unwanted ingredient, but no apparent bodily injury or sickness. Has he suffered a physical injury merely because the restaurant caused an unwanted substance to enter his body? Again, the extent of involvement of one's body under the new law for purposes of exclusion is an unanswered issue.

Black's Law Dictionary defines physical injury as: "Bodily harm or hurt, excluding mental distress, fright, or emotional disturbance." [FN114] The spitting, fondling, and rat feces in the above examples do not normally result in bodily harm or hurt in the literal sense. In fact, these disturbances usually result in only mental distress, fright, or emotional disturbance. Nevertheless, in our examples, an argument could be made that the body was adversely affected and thus harmed or hurt, although to a lesser degree than when the victim suffers cuts and bruises and more obvious bodily injury.

D. Comparison to Negligent Infliction of Emotional Distress

In tort law there is a common law rule that physical injury or physical impact is a prerequisite to the recovery of damages for negligent infliction of emotional distress. [FN115] Although the trend is for jurisdictions to reject the physical injury/physical impact requirement, the ebbing majority view is to adhere to the traditional rule requiring some form of physical injury or physical impact to recover under negligent infliction of emotional distress. [FN116] It seems unlikely that Congress had in mind this majority rule of tort law when it amended section 104(a)(2), and the legislative history is silent on the issue.

Florida's application of the physical injury/physical impact requirement in cases of negligent infliction of emotional distress is representative of the majority view. [FN117] At common law, the physical injury/physical impact rule barred recovery for purely psychological injuries. [FN118] A plaintiff could only recover damages for emotional distress which flowed from physical injuries caused by a tortfeasor's negligence. [FN119] The common law rule is based on judges' skepticism about the reliability of evidence regarding the plaintiff's mental state and the possibility that plaintiffs may be faking emotional distress. [FN120] Because it is usually harder to fake physical injuries, the
physical injury/physical impact requirement was interposed in an attempt to avoid the
problem of proof of injury. [FN121]

Congress may have the same concerns that judges have had with respect to emotional
distress that is not attributable to physical injury or physical sickness. [FN122] Hence,
Congress imposed the requirement of physical injury or physical sickness for the personal
injury exclusion to apply. Furthermore, in its conference report, Congress allows tax-free
treatment for emotional distress that is attributable to a physical injury or physical
sickness. [FN123] Coincidentally, Congress' view mirrors the common law rule that
allows damages for negligent infliction of emotional distress only if the emotional
distress is attributable to physical injury.

Interestingly, the common law physical injury/physical impact rule of negligent infliction
of emotional distress has an exception. [FN124] Recovery is possible for emotional
distress attributable to defamation. [FN125] The conference report, however, provides
that the exclusion does not apply to injury to reputation accompanied by a claim of
emotional distress, [FN126] thus departing from the common law tort rule in the case of
defamation.

In questionable situations under amended section 104(a)(2), practitioners, the Treasury
Department, and the Internal Revenue Service may want to study the common law tort
rules with respect to negligent infliction of emotional distress. Although there are
differences (such as in the case of defamation) between the traditional tort rules and
Congress' intent regarding the scope of the exclusion, there are many similarities.
Obviously, if there is no recovery in an action for negligent infliction of emotional
distress because the jurisdiction adheres to the physical injury/impact rule of the majority
of jurisdictions, there is no tax issue. If the jurisdiction has abandoned the physical
injury/impact rule, then tort recovery for emotional distress is possible and an issue of
taxability arises. More important, the issue of taxability arises in other tort or tort-like
causes of action for emotional distress, such as in battery and employment discrimination,
where there may be a minimal degree of physical contact.

I have identified a few questionable areas in the application of amended section
104(a)(2). For example, in the case of the restaurant patron who ingests rat feces, there is
an issue of whether he suffered a physical injury or physical sickness. The majority rule
in negligent infliction of emotional distress is that the mere ingestion of a toxic substance
is not sufficient physical harm on which to base a claim for damages for emotional
distress. [FN127] The plaintiff must prove that he suffered some present physical harm or
sickness caused by the toxic substance to recover damages for emotional distress.
[FN128]

In my opinion, it is likely that amended section 104(a)(2) will be construed against the
taxpayer in cases involving emotional distress and minimal physical contact, in
accordance with the general rule of narrowly construing an exclusionary Code provision.
[FN129] Where the majority tort law with regard to negligent infliction of emotional
distress is unfavorable to the restaurant patron (but he recovers in a jurisdiction following
the minority position), the taxpayer's burden of overcoming the presumption of taxability
may be insurmountable.

Regarding the bodily contact example of unwanted fondling, there may be a more
favorable tax result based on the majority rule in negligent infliction of emotional
distress. The amount of physical contact or injury that must be shown is minimal.
[FN130] Contact, no matter how slight, trifling, or trivial, will support a cause of action in tort law. [FN131] The difference is probably attributable to the fact that, unlike the restaurant patron, there is direct physical contact between the tortfeasor and the victim of fondling or similar touching of the human body. For purposes of section 104(a)(2), there must be physical injury or physical sickness. [FN132] In negligent infliction of emotional distress, however, either physical injury or physical impact will normally suffice under the majority rule. [FN133] Therefore, the Internal Revenue Service may argue that the physical impact must result in a physical injury or physical sickness--not mere physical contact.

It remains to be seen if, when, and how the Treasury defines physical injury or physical sickness in regulations to be issued under section 104(a)(2). Since the Code and legislative history leave many unanswered questions, it is certain that the issues will be litigated in spite of regulatory guidance. For guidance on Congress' intent with respect to the meaning of physical injury or physical sickness, the Treasury and courts may want to review the tort law with respect to negligent infliction of emotional distress.

Conclusion

For nearly eighty years, taxpayers, their advisors, and the government have wrestled with the scope of the personal injury exclusion. This author believes that the primary cause of the confusion has been the failure to limit the exclusion to losses of human capital. Once the door was opened by allowing tax-free treatment for financial losses in the form of lost wages and earning power, there was no longer any symmetry to the exclusion. Congress' attempt in 1996 to limit the scope of the exclusion to physical injury and physical sickness torts has gone a long way to cut back on the loss of federal revenue. Unfortunately, it does little to bring symmetry to the personal injury exclusion. Now victims of defamation, employment discrimination, and other dignitary torts must pay income taxes on damages received for emotional distress in practically all cases. This is wrong, since such victims are merely being made whole for the tortfeasor's conduct in taking away a part of the victim's human capital or birthright. [FN134] On the other hand, the victims of physical injury type torts, such as an automobile accident, can receive lost wages and earning power tax free. Accretions to wealth in the form of lost wages and earning power are quintessential sources of income, not reimbursement for human capital losses. These anomalies appear to be the result of a mistake by Congress in understanding the appropriate limitations on its power to tax personal injury awards. [FN135]

In my opinion, Code section 104(a)(2) should be amended to read as follows: Gross income does not include the amount of compensatory damages, received by an individual on account of personal injuries, that are attributable to losses to the body, mind, and reputation of such individual. Such damages shall be excludable whether received by suit or agreement and whether as lump sums or as periodic payments. The birthright concept of the personal injury exclusion is incorporated in this proposed amendment of section 104(a)(2). Excludable damages would be limited to human capital losses to the body, mind, and reputation of the victim of a tort or tort-like claim. [FN136] By negative implication, damages for lost wages, earning power, and punitive damages would always be taxable, regardless of the nature of the tortious cause of action. I believe that this form of section 104(a)(2) would make much more sense to taxpayers, their advisors, and the Internal Revenue Service. It would also avoid the confusion and
controversy on what physical injury or physical sickness really means under current section 104(a)(2).

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FN[FN1]. All references to the "Code" are to the Internal Revenue Code of 1986, as amended.


FN[FN7]. Confusion with respect to the taxability of punitive damages prior to the 1996 amendment of Code § 104(a)(2) was settled by the U.S. Supreme Court in O'Gilvie v. United States, 117 S.Ct. 452 (1996). The Court held that punitive damages are not excludable under section 104(a)(2). For pre-O'Gilvie contrary positions see Rev. Rul. 84-108, 1984-2 C.B. 32; Miller v. Commissioner, 93 T.C. 330 (1989), rev'd, 914 F.2d 586 (4th Cir. 1990); Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983).


FN[FN9]. See Redfield v. Insurance Co. of North America, 940 F.2d 542 (9th Cir. 1991) (excluding damages for age discrimination); Rickel v. Commissioner, 900 F.2d 655 (3rd
(excluding damages for age discrimination); Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990) (excluding damages for age discrimination); Byrne v. Commissioner, 883 F.2d 211 (3rd Cir. 1989) (excluding damages for wrongful discharge); Bent v. Commissioner, 835 F.2d 67 (3rd Cir. 1987) (excluding damages for violation of the right to free speech).

FN[FN10]. 716 F.2d 693 (9th Cir. 1983).


FN[FN18]. U.S. Const. art. I, § 9, cl. 4, which provides: "No capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration before directed to be taken." In Fernandez v. Wiener, the U.S. Supreme Court held that Congress may tax real estate or chattels only if the tax is apportioned. 326 U.S. 340, 345 (1945).


FN[FN21]. For a discussion of the definition of income that is broad enough to encompass most damage awards, see Mark W. Cochran, Should Personal Injury Damage Awards Be Taxed?, 38 Case W. Res. L. Rev. 43, 45 (1987), and Joseph M. Dodge, Taxes and Torts, 77 Cornell L. Rev. 143, 151 (1992).


FN[FN23]. See Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983) (holding that damages awarded in a defamation suit were excludable from gross income); Church v. Commissioner, 80 T.C. 1104 (1983) (stating that compensatory damages are excludable from gross income calculations); Threlkeld v. Commissioner, 87 T.C. 1294, 1298 (1986) (holding that "there is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury to professional reputation").

FN[FN24]. See supra note 20.


FN[FN28]. For instance, I.R.C. § 3121(b) (1997), which contains the definition of income for social security purposes, and I.R.C. § 1402(b) (1997), which contains the definition of self-employment income. A problem arises, if the tortfeasor is not an employer, with respect to the employer's share of social security (FICA) tax liability under I.R.C. § 3111 (1997) and unemployment tax under I.R.C. § 3301 (1997). A
possible solution is to exempt the lost wages portion of a personal injury settlement from these employer taxes.


FN[FN31]. Id.

FN[FN32]. Id.

FN[FN33]. Id.

FN[FN34]. Id. at 308.

FN[FN35]. 31 Op. Att'y Gen. 304 (1918). The Attorney General Opinion does not specifically address the receipt of accident insurance proceeds to compensate for lost wages and earning power. Id. Normally accident insurance is intended to cover various losses suffered by the insured including lost income and earning power. John Alan Appleman, Insurance Law and Practice § 24 (1981). Thus, the Treasury Department may have interpreted the Attorney General Opinion broadly to exclude lost wages and earning power in connection with an accident.


FN[FN39]. 117 S. Ct. 452.

FN[FN40]. O'Gilvie, 117 S. Ct. at 457.
FN[FN41]. Id. at 454.

FN[FN42]. Id. at 455.

FN[FN43]. Id. at 456.


FN[FN45]. Id.

FN[FN46]. See Lawrence M. Friedman, History of American Law 494-97 (1973) (discussing the history of federal taxation including the origination of the federal income tax in 1862).


FN[FN48]. Id.


FN[FN50]. Glenshaw Glass, 348 U.S. at 476.


FN[FN52]. Burke, 504 U.S. at 242.

FN[FN53]. Id. at 241.

FN[FN54]. Id. at 239.

FN[FN55]. Id. at 240.
FN[FN56]. Id. at 243.

FN[FN57]. Id.

FN[FN58]. Id.

FN[FN59]. Id. at 245.

FN[FN60]. Before its amendment in 1996, Code § 104(a)(2) provided as follows: "gross income does not include--(2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as period payments) on account of personal injuries or sickness." 26 U.S.C. § 104(a)(2) (1994). The use of the term "any" damages and the fact that no reference is made to requiring physical injuries for exclusion suggests a broader interpretation of § 104(a)(2) as it existed prior to amendment.


FN[FN62]. Id. at 455.


FN[FN64]. Id.

FN[FN65]. Id.

FN[FN66]. Id. at 326.

FN[FN67]. Id. at 336.

FN[FN68]. Id. at 330.

FN[FN69]. Id. at 336.

FN[FN70]. Id. at 337.

FN[FN72]. See supra note 71.

FN[FN73]. Schleier, 515 U.S. at 330.

FN[FN74]. Id. at 330 n.4.


FN[FN76]. Barnes v. Commissioner, No. 21856-95, 1997 WL 12138, at *1 (U.S. Tax Ct. Jan. 15, 1997). This case was decided by a special trial judge under the small claims procedures of I.R.C. § 7443A(b)(3) and Rules 180, 181, and 182. Id.

FN[FN77]. Id.

FN[FN78]. Id.

FN[FN79]. Id. Curiously, the judge in Barnes did not make any reference to the precancerous tumors suffered by the plaintiff in his opinion, other than in the recitation of facts. Id. Thus, it is difficult to draw any inference between the significance of this possible physical injury and the judge's decision that the mental distress damages were excludable.

FN[FN80]. Id.

FN[FN81]. Id. at *4.

FN[FN82]. Id. at *2.
FN[FN83]. Id.

FN[FN84]. Id. at *3.

FN[FN85]. Id.

FN[FN86]. Id.

FN[FN87]. Id. at *4.

FN[FN88]. Id.

FN[FN89]. See discussion infra Part IV with respect to the amended Code § 104(a)(2) requirement that the damages be received on account of physical injury or physical sickness.


FN[FN92]. Id. at *2.

FN[FN93]. Id. at *3.

FN[FN94]. Id. at *4.

FN[FN95]. Id. at *12.

FN[FN96]. See supra text accompanying notes 44-45.


FN[FN100]. Id. § 1605(d).

FN[FN101]. Id.


FN[FN103]. For the law regarding punitive damages prior to the 1996 amendments, see supra note 7.


FN[FN105]. Id. Alabama's wrongful death statute is a good example of such a state law. See Ala. Code §§ 6-5-391 to-410 (1975).


FN[FN107]. Id.

FN[FN108]. Id. at 301.

FN[FN109]. Id. at 301.

FN[FN110]. Id. at 301.


FN[FN113]. Id.


FN[FN118]. See supra note 115.

FN[FN119]. Id.

FN[FN120]. See Marrs, supra note116, at 43.

FN[FN121]. Id.


FN[FN123]. Id.

FN[FN124]. Miami Herald Publ'g Co. v. Brown, 66 So. 2d 679, 681 (Fla. 1953) (holding that mental suffering damages are recoverable in an action for negligent infliction of emotional distress caused by defamation).

FN[FN125]. Id.


FN[FN128]. See supra note 127.


FN[FN131]. Zelinski v. Chimics, 175 A.2d 351, 354 (Pa. 1961) ("(A)ny degree of physical impact, however slight . . . .").


FN[FN133]. See supra note 115.

FN[FN134]. A question arises as to whether taxpayers can successfully argue that Congress lacks the power to tax as income damages to human capital. Under the rationale of Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), income is defined as accretions to wealth that are clearly realized. Id. at 476. Has the victim of emotional distress really gained anything when he or she is merely put back in the position occupied before the tort was committed?

FN[FN135]. See supra text accompanying notes 30-38.

FN[FN136]. The current Treasury regulations require that a personal injury be attributable to a tort or tort-like claim. 26 C.F.R. § 1.104-1(c) (1997). The regulations
define damages received as amounts received "through prosecution of a legal suit or action based upon torts or tort type rights." Id. at 414. See Commissioner v. Schleier, 115 S. Ct. 2159 (1995); United States v. Burke, 504 U.S. 229 (1992) (showing the U.S. Supreme Court's approval of this regulation with respect to requiring tort or tort-like conduct prior to applying an exclusion).