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ARTICLES

WHEN ARE DAMAGES TAX FREE?: THE ELUSIVE MEANING OF "PHYSICAL INJURY"

Ronald H. Jensen[*]

In 1996, Congress reversed nearly seventy-five years of settled law by amending § 104(a)(2) of the Code, making damages recovered for personal *non-physical* harms (e.g., emotional distress) taxable.[1] Previously, such damages had been non-taxable, but after this change became effective on August 20, 1996, only damages for personal "physical injuries" or personal "physical sickness" continue to qualify for tax-free treatment.[2] Surprisingly, the skimpy legislative history gives, at best, a limited explanation for this startling change in the legislative firmament.[3] Equally surprising is

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[*] Professor of Law, Pace University School of Law. I would like to express my appreciation to Penni Stathakos for her outstanding research assistance in the preparation of this article. I would also like to thank Professors Eric A. Lustig and David F. Shores who kindly read a draft of this article and made helpful and insightful comments.

[1] Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (codified at I.R.C. § 104). The statute was enacted on August 20, 1996. Under prior law, the IRS recognized as early as 1922 that recoveries of damages for non-physical injuries (e.g., alienation of affection, defamation, etc.) were non-taxable. Sol. Op. 132, I-1 C.B. 92 (1922). Unless otherwise indicated, all references herein to Internal Revenue Code sections are to those sections as they were in effect on August 20, 2012.

[2] Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838. Section 1605(d), 110 Stat. at 839, makes the change effective for amounts received after the date of enactment, i.e., August 20, 1996, except for amounts received pursuant to a binding agreement, court decree, or mediation award in effect on or before September 13, 1995.

[3] The relevant committee reports and the portions thereof relevant to the changes made in I.R.C. § 104 are the House Ways and Means Committee Report, H.R. REP. NO. 104-586, at 142–44 (1996), *reprinted in* 1996-3 C.B. 331, 480–82, the Senate Finance Committee Report, S. REP. NO. 104-281, at 115–16 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1589–92, and the House Conference Report, H.R. CONF. REP. NO. 104-737, at 300–02 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1792–94. The Senate simply proposed to make it clear that all punitive damages were taxable. The House of Representatives proposal, in addition to taxing all punitive damages, also limited the exclusion under § 104 of the Code

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Congress's decision to base tax treatment on a supposed sharp distinction between physical and emotional harms. This decision ignores years of scientific research showing that emotional and physical aspects of human health are closely intertwined and cannot be easily disentangled.[4] Moreover, the decision to treat damages for emotional distress more harshly than damages for physical harm runs counter to the historical trend in tort law, which recognizes that emotional distress can be as injurious as physical harm (sometimes more so) and therefore should be compensated on a similar basis.[5]

Congress's failure to explain its reasons for changing the law or to define "physical injury" or "physical sickness," combined with its apparent disregard of scientific learning on the close relationship of the emotional and physical aspects of human health, have created a perfect storm resulting in great uncertainty in applying the law. Moreover, Congress's failures and oversights have established inequitable differences in the tax treatment of individuals suffering the same amount of harm. Nevertheless, taxpayers, the IRS, and the courts must apply the new provisions as best they can. The purpose of this article is to try to resolve difficult questions that have arisen, and are likely to arise, in construing and applying the amendments made by Congress in 1996 (hereafter the "1996 Amendments" or the "Amendments"). Part I of this article traces the evolution in the tax treatment of litigation damages from 1918 through the enactment of the 1996 Amendments and reviews the various rationales that have been offered for such treatment. Part II sets forth a number of hypothetical cases illustrating some of the issues created by the 1996 Amendments. Part III through Part VI set forth my analyses of these issues. Finally, Part VII critiques the 1996 Amendments and makes a proposal that would eliminate much of the uncertainty and inequity that the 1996 Amendments created while satisfying an apparent concern that led to their enactment.

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to recoveries for physical injuries and physical sickness. The Conference Committee adopted the changes proposed by the House. All references in the text to the "Committee Report" are to the Report of the House Ways and Means Committee.

[4] *See infra* Part VI.

[5] For cases and illustrations showing the severe pain and hurt that emotional harm can produce, see *infra* notes 159–60 and accompanying text. For a thumbnail sketch of the evolution of the common law in relaxing and in some instances eliminating the special limitations on the recovery of damages for emotional distress, see *infra* note 36 and accompanying text.

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I. HISTORY OF TAX TREATMENT OF DAMAGES FOR PERSONAL INJURIES

A. Law Prior to the 1996 Amendments

Congress enacted the original predecessor of § 104(a)(2) in 1918.[6] It exempted damages for "personal injuries or sickness" from taxation,[7] apparently because Congress believed it "doubtful" whether such damages constituted "income" within the meaning of the Sixteenth Amendment and thus, whether they could constitutionally be taxed.[8] Initially, the IRS held that only damages for *physical* injuries were exempt from taxation.[9] However, in 1922, the IRS reversed itself and recognized that damages for various non-physical injuries (i.e., alienation of affection, defamation, etc.) were likewise tax-exempt.[10] Since then, until the 1996 Amendments, it was universally held that damages for non-physical personal injuries were excludible from income.

This expansive and liberal interpretation of "personal injury" perhaps reached its high water mark in *Threlkeld v. Commissioner*, which held that damages were exempt from tax so long as they were received "on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."[11] Under this approach, a violation of a person's human rights (i.e., a right granted by virtue of being a person) was deemed a "personal injury" within the meaning of § 104(a)(2) and, therefore, all damages flowing therefrom, including lost income, were tax-exempt. This generous approach was significantly curtailed in a trilogy of cases decided by the Supreme Court beginning in 1992.

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[6] Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

[7] *Id.*

[8] H.R. REP. NO. 65-767, at 9–10 (1918), *reprinted in* 94 THE INTERNAL REVENUE ACTS OF THE UNITED STATES 1909–1950: LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979).

[9] S. 1384, 2 C.B. 71 (1920).

[10] Sol. Op. 132, I-1 C.B. 92 (1922).

[11] Threlkeld v. Comm'r, 87 T.C. 1294, 1308 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988). Note that under this formulation, monetary damages for breach of contract would not be tax exempt because profit under a contract is not guaranteed to a party solely by virtue of being a person but arises from a contract negotiated between the parties. Tax-exempt treatment is thus restricted to tort recoveries.

The first case, *United States v. Burke*, involved a female employee of the Tennessee Valley Authority who obtained a settlement under Title VII of the Civil Rights Act of 1964 based on her claim that she was deprived of salary increases because of sex discrimination.[12] The Court held the settlement was taxable because it failed to satisfy the requirements in the Treasury Department regulations limiting tax relief to amounts recovered in an action "based upon tort or tort type rights."[13] The Court concluded that this criterion was not met because the remedies provided by Title VII were too circumscribed in comparison with those in a typical tort action.[14] At that time, the only remedies under the Act were awarding back pay and granting injunctions.[15] Thus, the Act failed to provide "for any of the other traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages (e.g., a ruined credit rating)."[16]

The second case in the trilogy, *Commissioner v. Schleier*, concerned an airline employee who had been terminated by his employer at age sixty in accordance with its established employment policy.[17] He obtained a settlement based on his claim that his termination violated the Age Discrimination in Employment Act of 1967 (ADEA).[18] Similar to its ruling in *Burke*, the Court held that the settlement was taxable since it was not based upon "tort or tort type rights" in light of the limited remedies ADEA provided to age discrimination victims.[19]

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[12] 504 U.S. 229 (1992).

[13] *Id.* at 234; *see also* Treas. Reg. § 1.104-1(c) (1970). This requirement was deleted from the Regulations by a Treasury Decision issued in 2012, T.D. 9573, 2012-12 I.R.B. 498. The Preface to the Treasury Decision states that the requirement, which was originally intended to distinguish damages for personal injuries from, for example, damages for breach of contract, was rendered unnecessary by the 1996 Amendments that limit the exclusion under § 104(a)(2) to damages for personal physical injuries and physical sickness and by the decision in *Comm'r v. Schleier*, 515 U.S. 323 (1995) that requires a direct link between the damages and the injuries or sickness.

[14] *Burke*, 504 U.S. at 241.

[15] *Id.* at 238–39.

[16] *Id.* at 239.

[17] 515 U.S. 323, 324 (1995).

[18] *Id.* at 326.

[19] *Id.* at 334–36.

More importantly, for purposes of this article, the Court also held that the recovery failed to satisfy the requirement of § 104(a)(2) that the recovery be "received on account of" a personal injury.[20] The taxpayer, relying on *Threlkeld*, argued that his unjust termination was a "personal injury" because it violated a right the law (in this case, the ADEA) accorded him as a human being—the right to be free from age discrimination—and hence the damages he recovered were nontaxable. But the Court rejected this approach, summarily stating that the unjust termination cannot "fairly be described as a 'personal injury.'"[21] Instead of defining "personal injury" by reference to the wrongful act of the wrongdoer (in this case, the employer's unlawful termination of the taxpayer's employment), the court defined it in terms of the subjective hurt or harm experienced by the taxpayer.[22] The Court seemed to view "personal injuries" to be of two types: (1) harm or hurt to a person's body and (2) harm or hurt to a person's psyche (i.e., emotional distress).[23] While acknowledging that the taxpayer's termination may have caused him psychological pain, the psychological pain did not *cause* his loss of income or affect his recovery. The Court explained as follows:

> In age discrimination, the discrimination causes both personal injury [i.e., psychological pain] and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury. In short, § 104(a)(2) does not permit the exclusion of respondent's back wages because the recovery of back wages was not "on account" of any personal injury and because no personal injury affected the amount of back wages recovered.[24]

The Court distinguished the present case from that of a taxpayer, who, as a result of an injury sustained in an automobile accident, suffers medical expenses, lost wages, pain, and emotional distress for which he subsequently recovers monetary damages.[25] In that case, the entire amount

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[20] *Id.* at 330–31.

[21] *Id.* at 330.

[22] *Id.*

[23] *Schleier*, 515 U.S. at 330.

[24] *Id.* at 330–31.

[25] *Id.* at 330.

of the damages is tax free because his "personal injury" (i.e., the injury to his body) *caused* the medical expenses, the lost wages, and the pain, suffering, and emotional harm.[26] In contrast, in Schleier's case, his "personal injury," as defined by the Court (i.e., any psychological pain he sustained), did not cause his loss of wages or affect the amount of his recovery.[27]

The Supreme Court expanded on the "on account of" phraseology in *O'Gilvie v. United States* when it held that punitive damages were taxable.[28] The Court held that punitive damages were not awarded "on account of" the taxpayer's injuries because they were not awarded to compensate the victim for his or her injuries, but rather to punish the wrongdoer.[29] Thus, they were not "awarded by reason of, or because of, the personal injuries."[30] The Court rejected the taxpayer's argument that any damages that would not have been awarded *but for* the personal injury were excludible, holding instead that the statute required "a stronger causal connection."[31]

B. The 1996 Amendments

The 1996 Amendments made it clear that punitive damages awarded in personal injury cases, with one very narrow exception, were always taxable.[32] More significantly, for purposes of this article, it restricted tax-free treatment to recoveries "on account of personal *physical* injuries or

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[26] *Id.* at 329–30. However, any amount deducted by the taxpayer under § 213 of the Code (relating to medical expenses) in a prior taxable year would be taxable. *See also* I.R.C. § 104(a) (introductory language to the subsection).

[27] *Schleier*, 515 U.S. at 239–30.

[28] 519 U.S. 79 (1996).

[29] *Id.* at 83–84.

[30] *Id.* at 83.

[31] *Id.*

[32] Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (codified at I.R.C. § 104(a)(2)). The 1996 Amendments were enacted on August 20, 1996 and thus preceded the Supreme Court's holding in *O'Gilvie v. United States*, 519 U.S. 79 (1996) (decided on Dec. 10, 1996) that punitive damages did not qualify for exclusion under I.R.C. § 104(a)(2). The 1996 Amendments created a limited exception for punitive damages awarded in certain wrongful death actions. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(c), 110 Stat. 1755, 1838–39.

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physical sickness."[33] The statute, as amended, explicitly stated that "emotional distress" did not qualify as a physical injury or sickness.[34] There was an exception to this rule for damages for medical expenses attributable to the emotional distress (e.g., psychiatric fees), provided the taxpayer had not deducted them in a prior taxable year.[35] A footnote in the Committee Report states, somewhat cryptically, that the "Committee intends that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."[36]

C. Rationales for the Exclusion Under § 104(a)(2) and for the 1996 Amendments

Although formulated in slightly different ways, the principal justification for excluding damages for personal injuries from income has always been that such recoveries merely try to restore the plaintiff—to the extent money can do so—to the same financial, physical, and emotional well-being as he or she enjoyed before the injury. Hence, they entail no "gain" and therefore may not properly be taxed. In short, the plaintiff's "human capital" is not increased or enhanced but is merely returned to its status quo ante.[37] Indeed, most people would agree that the plaintiff is never made completely "whole" by monetary damages. Given the choice, few would be willing to trade, say, one's arms and legs for any amount of money.[38]

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

[34] I.R.C. § 104(a) (penultimate sentence).

[35] I.R.C. § 104(a) (last sentence).

[36] H.R. REP. NO. 104-586, at 144 n.24 (1996), *reprinted in* 1996-3 C.B. 331, at 482 n.24.

[37] *See, e.g.*, Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 770 (1988) (stating that recipient of damages "has been 'restored,' if only by a monetary payment, to the status quo. He has not received anything more than he had"). *See also O'Gilvie*, 519 U.S. at 86 (describing purpose of I.R.C. § 104(a) as excluding "those damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, 'return the victim's personal or financial capital.'").

[38] This rationale has been vigorously contested. It is contended that this rationale misconceives the way gain or loss is computed under the Internal Revenue Code. *See* Douglas A. Kahn,

A second major reason for the exclusion under § 104(a)(2) is compassion for the victim.[39] Yet another reason asserted for the exclusion is to prevent the government from being placed in the seemingly heartless position of profiting from the misfortunes of its citizens.[40] As one commentator states, "[i]f the government were to tax damages for the loss of a body part (or for the death of a relative), it would seem to many to have engaged in a vulturous act—analogous to feeding off the flesh of a dismembered arm or leg or off of the corpse of a recently departed."[41] A

Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?, 2 FLA. TAX REV. 327, 343 (1995). Gain is not computed by comparing the value of what is given up with the value of what is received but is instead determined by comparing the amount received (i.e., the "amount realized") with the taxpayer's "basis" in the property given up—usually the taxpayer's cost. I.R.C. § 1001. For example, if A sells Blackacre having a fair market value of $25,000 for $25,000, A cannot claim the sale is free from tax on the ground that the sale's proceeds merely restore him to his financial status quo ante (i.e., that the value of what he receives equals the value of what he gave up). Rather the taxpayer will normally have taxable gain or loss to the extent that the $25,000 he received exceeds, or is less than, what he paid for Blackacre. Opponents of the "return of capital" rationale assert that a taxpayer either has no basis in his or her human capital, or alternatively, that the taxpayer must be treated as having a zero basis because of the taxpayer's inability to establish such a basis. Kahn, *supra*, at 343–44; Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 152–53 (1992). Hence, under conventional tax principles, the entire amount of the recovery should be taxed.

Proponents of the "return of capital" rationale reply that using basis to measure gain or loss makes sense only when an asset is purchased with after-tax dollars. For example, where a taxpayer uses $100, which he or she has earned and paid tax on, to buy an asset, it is appropriate to give the taxpayer a $100 basis in the asset so that the taxpayer will not again be taxed on the $100 when he or she sells the asset. But basis is irrelevant and inappropriate in the case of assets which the taxpayer acquired without the expenditure of previously taxed funds, in particular assets that the taxpayer received free as part of the taxpayer's natural endowment, for example, physical and emotional well-being. Brooks, *supra* note 37, at 769–71. These are "personal assets that the Government does not tax and would not have taxed had the victim not lost them." *O'Gilvie*, 519 U.S. 79, 86 (1996). Here the recovery is not a substitute for something that would otherwise have been taxed but instead is something that would never have been taxed. Thus, it is argued, a recovery for the loss of these personal assets should not be taxed since it does not make the taxpayer better off. Critics respond that this position is akin to arguing that wages should be tax free. The receipt of "leisure" is tax free. Thus, under this approach, wages—compensation for giving up leisure—should likewise be tax free. Dodge, *supra*, at 183.

[39] J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13, 43 (1989). Opponents of the exclusion contend, however, that it is a very inefficient and indeed inequitable method of helping victims. It does nothing for those who presumably suffer the most, that is, victims who recover no damages for their injuries, while the exclusion provides the greatest benefit to those presumably best able to bear the loss, that is, victims who recover damages and are in the highest income tax brackets. *Id.* at 43–44.

[40] Kahn, *supra* note 38, at 349.

[41] *Id.*

fourth justification is the involuntary nature of the taxpayer's injury.[42] Since the taxpayer did not willingly incur his or her injury (e.g., loss of an arm or leg), it seems harsh and rapacious to tax a recovery from an injury that the taxpayer intensely desired to avoid.[43]

The 1996 Amendments seem to reject these rationales in the case of damages for nonphysical harm, but they continue to be the basis for excluding damages for physical injuries. Nothing in the Committee Report on the 1996 Amendments explains why these two types of damages are to be treated so differently. Damages awarded for emotional harm attempt to return the plaintiff to the same condition as he or she enjoyed before the injury, just like the damages for physical injury. If one's concern is compassion for the victim, exclusion seems as justified in the case of one suffering severe emotional distress as it does for one experiencing a physical injury (which could be relatively minor). Taxing damages for severe emotional distress seems as cruel and heartless as taxing damages for physical injury. Moreover, taxpayers no more willingly incur emotional pain than they do physical injuries.

What then is the rationale for the 1996 Amendments? Readers seeking the answer to this question in the legislative history will be disappointed. The Committee Report asserts in its section on "Reasons for Change" that "[d]amages received on a claim not involving a physical injury or physical sickness are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income."[44] Based on this language, one might surmise that the change was simply intended to put the claimant in the same position as other taxpayers who must of course pay tax on their compensation and profits. If so, the changes in the law are ill suited for this purpose. The Amendments tax *all* damages received for emotional distress—not simply the portion attributable to lost taxable income.

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[42] *Id.* at 347–48.

[43] *Id.* As Professor Kahn recognizes, the usual remedy in the Code for an involuntary gain is to allow the taxpayer to defer, but not permanently escape, taxation of the gain. *Id.* Professor Dodge contends that "[i]nvoluntariness may be a legitimate rationale for deferral of income . . . but not for total and permanent exclusion of a clearly-realized accession to wealth." Dodge, *supra* note 38, at 183–84 (footnotes omitted).

[44] H.R. REP. NO. 104-586, at 143 (1996), *reprinted in* 1996-3 C.B. 331, at 481.

Furthermore, the 1996 Amendments retain the exclusion for "lost profits" and "lost wages" in cases involving a physical injury or sickness. The Report provides no justification for the different treatment of lost taxable income in these two types of cases.

Again, one can speculate that Congress was concerned that taxing lost income in physical injury cases would create administrative problems since jury verdicts typically do not specify the portion of the judgment allocable to lost income and the portion allocable to the other types of damage. Or maybe Congress was concerned about the political resistance it would encounter from the personal injury bar if it attempted to tax awards for lost taxable income in physical injury cases. However, the Committee Report gives no hint on whether these concerns motivated Congress's actions.

Historically, common law courts have been reluctant to award damages for the negligent infliction of emotional distress—especially where no physical injuries are involved. The three principal concerns giving rise to this reluctance are succinctly stated in the Second Restatement of Torts:

> One is that emotional disturbance which is not so severe and serious as to have physical consequences is normally in the realm of the trivial and so falls within the maxim that the law does not concern itself with trifles. . . . The second is that in the absence of the guarantee of genuineness provided by resulting bodily harm, such emotional disturbance may be too easily feigned, depending, as it must, very largely upon the subjective testimony of the plaintiff; and that to allow recovery for it might open too wide a door for false claimants who have suffered no real harm at all. The third is that where the defendant has been merely negligent, without any element of intent to do harm, his fault is not so great that he should be required to make good a purely mental disturbance.[45]

More recently, however, courts have significantly relaxed, and in some cases even eliminated, the impediments to recovery for emotional distress. All states today allow recovery for the negligent infliction of emotional distress under certain circumstances and some have abolished all

[45] RESTATEMENT (SECOND) OF TORTS § 436A cmt. b (1965). *See also* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 54, at 360–61 (5th ed. 1984); 3 FOWLER V. HARPER ET AL., HARPER, JAMES & GRAY ON TORTS § 18.4, at 796–800 (3d ed. 2007); 2 DAN B. DOBBS ET AL., THE LAW OF TORTS § 383 (2d ed. 2011).

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restrictions on the recovery of such damages.[46] Was Congress, in enacting the 1996 Amendments, motivated by the same concerns that led common law courts in the past to deny or severely limit recovery for emotional distress? Once again, the Committee Report is silent on the subject.

In short, the Committee Report leaves one in a state of utter bewilderment as to the purpose or reason for the 1996 Amendments. Perhaps the best one can do is observe that Congress said that damages for emotional distress, in cases where no physical injuries occur, are "generally . . . for lost profits or lost wages that would otherwise be included in taxable income,"[47] thereby suggesting that Congress's intent, at least in part, was to put such tort victims in this respect on the same footing as other taxpayers who must pay tax on their compensation and profits. Beyond that, one cannot safely go.

II. INTERPRETIVE PROBLEMS RAISED BY THE 1996 AMENDMENTS

Since the amended statute gives no definition of either "physical injury" or "physical sickness," and given the opaqueness of the Committee Report, the 1996 Amendments have unsurprisingly created a number of issues in interpreting and applying § 104(a)(2). Some of these are illustrated by the following cases.

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[46] For succinct summaries of the evolution of the law regarding negligent infliction of emotional distress, see DAN B. DOBBS, THE LAW OF TORTS § 308 (Hornbook Series 2000) and *Payton v. Abbot Labs*, 437 N.E.2d 171, 176–78 (Mass. 1982) (describing developments through 1982). For more extended treatments, see John J. Kircher, *The Four Faces of Tort Law: Liability for Emotional Harm*, 90 MARQ. L. REV. 789, 806–39, 883–906 (2007); KEETON ET AL., *supra* note 45, § 54; DOBBS ET AL., *supra* note 45, § 393.

State courts have adopted a variety of approaches on this issue. A very few still limit recovery of damages to cases where the defendant's actions produced a "physical impact" on the plaintiff. A majority of the states apparently allow recovery where there is an objective manifestation of the emotional distress. Others require only that the plaintiff be in the "zone of danger" of potential bodily harm when the tortious conduct occurs. And, as stated in the text, some have eliminated all special limitations on recovery of damages for emotional distress. Courts have also adopted a variety of approaches in so-called "bystander" cases (e.g., whether a plaintiff may recover damages for emotional distress when he or she views physical injury to a loved one). For a comprehensive survey of the current law, see Kircher, *supra*, at 806–39, 883–906.

[47] H.R. REP. NO. 104-586, at 143 (1996), *reprinted in* 1996-3 C.B. 331, at 481.

Sexual harassment. An employer ("Boss") fondles his secretary ("Secretary") against her will while she is working on her job. Secretary subsequently recovers substantial damages for the battery. Does Boss's fondling of Secretary by itself constitute a "physical injury" or must there be some harm to Secretary's body, for example, a bruise or cut? If bodily harm is required, must the harm be of a certain severity, or will any harm, no matter how trivial or transient, suffice? Assuming there is bodily harm, will all damages recovered for the battery be tax free, or will tax-free treatment be limited to the portion of the damages directly attributable to the bodily harm?

False imprisonment. The police wrongfully imprison a citizen ("Citizen"). Citizen is handcuffed and jailed. Any attempt by Citizen's to leave custody of the police will be physically prevented, but the police use no force to effect Citizen's imprisonment and he sustains no bodily harm. Thereafter, Citizen recovers damages for false imprisonment. Is Citizen's false imprisonment a "physical injury" since his freedom was physically restrained?

Charging bull. A farmer ("Farmer") negligently allows his bull to escape its pen. The bull charges a passing pedestrian ("Pedestrian") but at the last moment the bull is diverted from its path and avoids hitting Pedestrian. However, Pedestrian experienced severe emotional distress in the form of terror and shock and as a consequence suffered a heart attack.[48] Pedestrian recovers damages for emotional distress (i.e., terror and horror from the bull's charge) and for the heart attack (i.e., medical expenses, pain and suffering, loss of income because of his resulting inability to work, diminution in his quality of life, etc.). Are the damages for the heart attack tax free because the heart attack is a "physical injury" or are they taxable because they had their origin in, and were caused by, emotional distress?

Post-traumatic stress disorder. A man, who secured access to a guest's ("Guest") motel room because the lock was defective, robbed Guest at gunpoint in her room. As a result, Guest sustains a condition that is medically diagnosed as post-traumatic stress disorder (PTSD). Guest's PTSD is manifested by flashbacks, nightmares, and inability to concentrate,

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[48] This hypothetical was suggested by the facts of *Bosley v. Andrews*, 142 A.2d 263 (Pa. 1958), *overruled by Niederman v. Brodsky*, 261 A.2d 84 (Pa. 1970).

but also by physical phenomena including palpitations, shortness of breath, tremor, nausea, insomnia and pain. Guest is still suffering from these afflictions two years following the incident. Are the damages she recovers from the motel owner for the physical manifestations of PTSD excludible from income because they are "physical injuries" or are they taxable because they are merely symptoms of emotional distress? Is it relevant that physical processes occurring within the body (i.e., excessive production of certain neurotransmitters in the brain) produce these physical phenomena? What if it is shown that the persistence of these symptoms results from detrimental physical changes occurring in the brain?

III. WHAT IS A "PHYSICAL INJURY"?

Although the term "physical injury" may initially seem self-evident, its meaning becomes increasingly elusive upon examination. This section discusses some plausible definitions of this term.

A. A "Physical Injury" Is a Physical Impairment of the Body

Everyone seems to agree that physical harm to the body constitutes a "physical injury." Thus, the latest edition of *Black's Dictionary* defines "bodily injury" (which it equates to "physical injury") as "[p]hysical damage to a person's body."[49] The Third Restatement of Torts defines "bodily harm" as "physical impairment of the human body."[50] Under the Restatement's usage, the phrase "bodily harm" encompasses "illness, disease, impairment of bodily function, and death" as well as "physical injury."[51] An earlier edition of *Black's Dictionary*, drawing on case law, defined "physical injury" as "bodily harm or hurt, excluding mental

[49] BLACK'S LAW DICTIONARY 856 (9th ed. 2009).

[50] RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 4 (2010).

[51] *Id.* Although § 104(a)(2) of the Code refers to "physical sickness" as well as to "physical injury," the term "physical sickness" is rarely, if ever, discussed in either the cases or the literature as a separate legal concept; in practice both concepts are subsumed in the term "physical injury." Under the terminology of the Third Restatement, a physical sickness would be an illness or disease manifested by a physical impairment of the human body.

distress, fright, or emotional disturbance."[52] The IRS adopted this latter definition in a private letter ruling issued in 2000; indeed it appears that the IRS adopted it as the *exclusive* definition of "physical injury."[53]

In that ruling—the so-called "bruise ruling"—the taxpayer's driver engaged in a series of attempts to make sexual contact with the taxpayer on her business trips, culminating in his actual touching of taxpayer's body.[54] Initially these contacts did not result in any observable bodily harm. A subsequent physical contact caused the taxpayer extreme pain but again no observable bodily harm ("First Pain Incident").[55] Ultimately, the employer assaulted taxpayer, both cutting and biting her ("First Physical Injury").[56] Drawing upon the definition of physical injury in *Black's Dictionary*, the ruling holds that "direct unwanted or uninvited physical contact resulting in observable bodily harms such as bruises, cuts, swelling and bleeding are personal physical injuries."[57] Therefore, the damages recovered by taxpayer that were attributable to the period beginning with the First Physical Injury were tax free, but damages attributable to events prior to the First Pain Incident were not.[58]

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[52] BLACK'S LAW DICTIONARY 1304 (Rev. 4th ed. 1968).

[53] I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.* Although the ruling refers to "observable bodily harms," it is generally understood that the injury need not be visible to the naked eye; it is sufficient if the injury can be verified by objective means. *See* G. Christopher Wright, Comment, *Taxation of Personal Injury Awards: Addressing the Mind/Body Dualism That Plagues § 104(a)(2) of the Tax Code*, 60 CATH. U. L. REV. 211, 238 (2010) (stating that it is sufficient if the "injury can be demonstrated, for example, by an x-ray or other objective evidence"). I.R.S. Priv. Ltr. Rul. 200121031 (May 25, 2001) held that lung cancer caused though the inhalation of asbestos was a "physical injury" even though damage to the lungs could not be observed from outside the body.

[58] Because of its ruling policy, under § 7.01 of Rev. Proc. 2000-1, the IRS declined to rule on whether the pain the taxpayer experienced during the First Pain Incident was a physical injury. I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000). As the ruling noted, the perception of "pain" is subjective and thus an inherently factual matter on which the IRS will not issue rulings. *Id.* In my opinion, pain, by itself, should not be treated as a physical injury. Pain is a "feeling" and thus is more akin to an emotion than what one normally thinks of as a "physical injury." The definitions of physical injury cited in the text emphasize damage to, or impairment of, the body. However, one can have pain without any accompanying damage to the body, as apparently was the case in the First Pain Incident. Moreover, treating pain as a physical injury would make the law difficult to administer and could easily lead to

Although it is undisputed that the cuts and bruises sustained by the taxpayer in the above ruling constituted "physical injuries," some commentators have argued or suggested that the IRS approach is too narrow and restrictive. For example, some have suggested that damages recovered for any unwanted touching of a person may be tax free regardless of whether the person touched suffers any bodily harm.[59] The remainder of this Part discusses several theories that arguably support this approach.

B. A Physical Injury Occurs When a Violation of the Taxpayer's Legal Rights Is Effected Through Physical Means

Perhaps the definition of "injury" the IRS uses is too colloquial. After all, "injury" has a special meaning in the law: a "violation of another's legal right, for which the law provides a remedy."[60] Likewise, the Second Restatement of Torts distinguishes "injury," which it defines as the "invasion of any legally protected interest of another,"[61] from a "harm" which is the "loss or detriment" suffered by the victim.[62] Using this terminology, the victim's "injury" in the bruise ruling was not her cuts and bruises (these were "harms") but rather the perpetrator's invasion of her right to be free of an offensive touching of her body. According to Blackstone, "every man's person [is] sacred, and no other [has] a right to meddle with it, in [] the slightest manner."[63] Since this invasion of the taxpayer's right was "physical," in the sense that it was accomplished by the *physical* actions of the perpetrator, the touching itself, even in the

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abuse. For example, would any pain suffice, or must the pain be of a certain magnitude? If the latter, how would one determine whether the taxpayer's pain crossed the requisite threshold? Also a taxpayer could easily assert that there was pain, and it would be difficult to verify or disprove that assertion. There appears to be no case or ruling holding that pain, without any accompanying damage to the body, is a physical injury.

[59] *See, e.g.*, J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 MONT. L. REV. 167, 186 (1997) (stating that where Boss fondles Secretary, she "arguably has a claim that has its origin in a personal physical injury, i.e., the unwanted touching.").

[60] BRYAN A. GARNER, GARNER'S DICTIONARY OF LEGAL USAGE 458 (3d ed. 2011).

[61] RESTATEMENT (SECOND) OF TORTS § 7(1) (1965).

[62] *Id.* § 7(2).

[63] 3 WILLIAM BLACKSTONE, COMMENTARIES *120 (Wayne Morrison ed., 2001).

absence of bodily harm, could plausibly be characterized as a "physical injury"—a violation of her legal right effected through physical means. Under this approach, the physical injury in the bruise ruling occurred when the employer first touched her against her will—even though no bodily harm occurred at that time.

Moreover, courts have on occasion defined "physical injury" in this manner in tort cases. In one bizarre—possibly humorous—case, the court found there was "physical injury" where a circus horse evacuated his bowels into plaintiff's lap causing her embarrassment, mortification and mental suffering, but no "physical hurt."[64] The court explained: "Any unlawful touching of a person's body, although no actual physical hurt may ensue therefrom, yet, since it violates a personal right, constitutes a *physical injury* to that person."[65] Note that this analysis focuses on the actions of the defendant (more precisely, defendant's horse) rather than the subjective harm experienced by the plaintiff.

Could a similar analysis be applied to § 104(a)(2) so that the physical injury would be deemed to occur in a sexual harassment case when an employer gropes or fondles the employee even in the absence of bodily harm? This is unlikely following the Supreme Court's decision in *Schleier*.[66] In that case, the Court rejected the holding in *Threlkeld* that a "personal injury" was "any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law,"[67] and held instead a taxpayer's injuries are the harms or hurts he or she subjectively experiences.[68] Therefore, in the case of the employee fondled or groped by her employer, the "injury" she sustained was not her employer's violation of her legal right not to be touched against her will. Rather it was her feelings of humiliation, degradation, shame and embarrassment resulting

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[64] Christy Bros. Circus v. Turnage, 144 S.E. 680, 681 (Ga. Ct. App. 1928), *overruled by* OB-GYN Assocs. of Albany v. Littleton, 386 S.E.2d 146, 149 (Ga. 1989), *overruled in part by* Lee v. State Farm Mut. Ins. Co., 533 S.E. 2d 82 (Ga. 2000).

[65] *Christy Bros.*, 144 S.E. at 681 (emphasis added). *See also* S. Brilliant Coal Co. v. Williams, 91 So. 589, 591 (Ala. 1921) (stating that where defendant kicked plaintiff, "[i]n a legal sense it was a physical injury, though it may have caused no physical suffering . . . .").

[66] Comm'r v. Schleier, 515 U.S. 323 (1995).

[67] Threlkeld v. Comm'r, 87 T.C. 1294, 1308 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

[68] *Schleier*, 515 U.S. at 330–31.

from the unwanted touching, and since these "injuries" are not "physical," no exclusion is allowable under § 104(a)(2).

C. Any Unwanted Touching of a Person's Body Constitutes a "Physical Injury" by Analogy to the Common Law "Impact Rule"

In *Burke*, the Supreme Court recognized that "common law tort law concepts are helpful in deciding whether a taxpayer is being compensated for a 'personal injury.'"[69] Similarly, one commentator has suggested that in "questionable situations under amended § 104(a)(2)" it might be useful "to study the common law rules with respect to negligent infliction of emotional distress," including the common law "impact rule."[70]

Historically courts awarded damages for the negligent infliction of emotional distress only if the defendant made or caused a "physical impact" on the plaintiff.[71] However, the courts came to apply this standard so loosely that it allowed recovery even where that impact caused no bodily harm (i.e., a physical impairment of the body).[72] Thus, if the 1996 Amendments are interpreted by reference to the "impact rule," there would be a "physical injury" whenever the defendant's actions resulted in an unwanted "impact" on the plaintiff—even in the absence of bodily harm. This approach should be rejected outright. Even if one believes that state tort law concepts are relevant in interpreting the 1996 Amendments, resort to the "impact rule" would nonetheless be unjustified, since the "impact rule" simply does not reflect current tort law. Although it is difficult to determine exact numbers, a 1982 case put the number of states still

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[69] United States v. Burke, 504 U.S. 229, 234 (1992) (quoting with approval *Threlkeld*, 87 T.C. at 1305, *aff'd*, 848 F.2d 81 (6th Cir. 1988)).

[70] Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U. L. REV. 61, 78 (1997).

[71] KEETON ET AL., *supra* note 45, at 363–64; HARPER ET AL., *supra* note 45, at 800. However, courts have allowed recovery where the defendant *intentionally* inflicted the emotional distress even where there is no impact or bodily harm. HARPER ET AL., *supra* note 45, at 800.

[72] HARPER ET AL., *supra* note 45, at 801 (stating that courts have found rule satisfied "by the most trivial of impacts"). See also *Zelinsky v. Chimics*, 175 A.2d 351, 353 (Pa. Super. Ct. 1961), where the court stated that the impact rule was satisfied if there was "physical impact in any degree, no matter how slight" and if there was such an impact, recovery for emotional distress would be allowed "regardless of whether there is any physical injury manifested."

adhering to the "impact rule" at five,[73] while a 2007 article put the number at six.[74]

The impact rule is inconsistent with the methodology adopted by the Supreme Court. In *Schleier*,[75] the Court emphasized the need for a strong causal relationship between the taxpayer's harm or injury and the damages he or she recovered. Under the "impact rule," however, recovery is allowed even when the causal relationship between the "impact" and the damages allowed is exceedingly attenuated and possibly non-existent. According to one leading treatise on torts, that "courts have found 'impact' in minor contacts with the person which often play no part in causing the real harm and in themselves can have no importance whatever."[76]

Moreover, the state courts themselves recognize that the "impact" required by the rule often produces no "physical injury." Nevertheless, they allow recovery even in these cases.[77] For example, some courts have held that ingestion of a contaminated foreign substance permits recovery for emotional distress—even if it causes no "physical injury"—because the ingestion itself is an "impact."[78] Florida explicitly recognizes this dichotomy between physical injuries and physical impacts: "If the plaintiff has suffered an impact, Florida courts permit recovery for emotional distress [even in the absence of physical injury] . . . . If, however, the plaintiff has not suffered an impact, the complained–of mental distress must be 'manifested by physical injury,' . . . ."[79] If the federal courts applying federal tax law are to defer to state law by applying the "impact rule" to

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[73] Payton v. Abbott Labs, 437 N.E.2d 171, 176 n.6 (Mass. 1982).

[74] Kircher, *supra* note 46, at 810 n.113.

[75] Comm'r v. Schleier, 515 U.S. 323, 329–31 (1995) (denying exclusion for taxpayer's recovery of back pay because any psychological pain he suffered from being unlawfully fired did not *cause* him to lose the pay). In *O'Gilvie v. United States*, 519 U.S. 79, 82–83 (1996), the Court held that § 104(a)(2) of the Code required a "stronger causal connection" than mere "but-for" causation.

[76] KEETON ET AL., *supra* note 45, at 363 (5th ed. 1984) (footnote omitted).

[77] *See, e.g.*, *Zelinsky*, 175 A.2d at 353 (stating that if there is an impact, recovery for emotional distress is allowed "regardless of whether there is any physical injury manifested.").

[78] Hagan v. Coca-Cola Bottling Co., 804 So. 2d 1234 (Fla. 2001).

[79] Willis v. Gami Golden Glades, LLC., 967 So. 2d 846, 850 (Fla. 2007) (quoting with approval Eagle-Picher Indus., Inc. v. Cox, 481 So. 2d 517, 526 (Fla. Dist. Ct. App. 1985)).

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§ 104(a)(2), they should, by the same token, respect a state's determination that an impact is *not* a "physical injury," and accordingly disallow the tax exclusion in those cases.

On the other hand, courts applying the "impact rule" have refused to allow recovery where the emotional harm resulted in serious bodily harm. In a famous early New York case (since overruled), defendant's team of horses bore down upon plaintiff but ultimately did not touch her.[80] Nevertheless, the experience caused her severe shock resulting in a loss of consciousness and a miscarriage.[81] The court denied recovery because, among other reasons, there was no impact.[82]

Due to the capricious manner in which the "impact rule" was applied—allowing recovery in the absence of bodily harm in some cases and denying recovery where serious bodily harm ensued in others—virtually all jurisdictions have abandoned it.[83] It should not be used as a template for applying § 104(a)(2), since it is an obsolete and irrational rule that is rarely followed today and runs counter to the Supreme Court's approach in *Schleier*.

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[80] Mitchell v. Rochester Ry. Co., 45 N.E. 354 (N.Y. 1896), *overruled by* Battalla v. State, 176 N.E. 2d 729 (N.Y. 1961). *See also* Bosley v. Andrews, 142 A.2d 263 (Pa. 1958), *overruled by* Niederman v. Brodsky, 261 A.2d 84 (Pa. 1970); Spade v. Lynn & Boston R.R., 47 N.E. 88 (Mass. 1897) (dictum).

[81] *Mitchell*, 45 N.E. at 354.

[82] *Id.* at 354–55. The court expressed concern that allowing recovery without an "impact" would result in "a flood of litigation in cases where the [alleged] injury . . . may be easily feigned." *Id.* The court also found that the miscarriage was not the "proximate result of defendant's negligence" because it could not have been "reasonably anticipated." *Id.* at 355. The court in *Bosley*, 142 A.2d at 266–67, expressed similar concerns: if recovery allowed it would "open a Pandora's box" and invite "tremendous number of illusory or imaginative or 'faked'" claims which could not be detected or disproved by medical science.

[83] *See* Rickey v. Chicago Transit Auth., 457 N.E.2d 1, 4 (Ill. 1983) (stating rule abandoned because the impact requirement had become "purely formal" as it was satisfied by "minor physical contacts which in reality were insignificant and played trivial or no part in causing harm to the plaintiff."); Payton v. Abbott Labs, 437 N.E.2d 171, 176 (Mass. 1982) (referring to the "arbitrariness of the impact rule"); DOBBS ET AL., *supra* note 45, § 393 (after noting cases where recovery was denied for serious physical injury caused by emotional distress because there was no impact, the stated rule was abandoned because it "did not draw the line against liability at a satisfactory place . . . .").

D. False Imprisonment Constitutes a "Physical Injury"—Even If There Is No Bodily Harm—Because the Taxpayer's Freedom Is Physically Restrained

In the hypothetical case above involving false imprisonment, the victim did not suffer any harm to his body. One commentator, a prolific writer on the taxation of damages, has vigorously argued that false imprisonment under these circumstances still constitutes a "physical injury."[84] He asserts that the taxpayer was "injured" (i.e., he lost his freedom) and that such "injury" was clearly "physical": "It is hard to imagine a more obvious degree of physicality than being physically confined behind bars. Even if no bruises or broken bones befall the plaintiff while behind bars, it seems axiomatically physical to be physically confined."[85] This approach classifies the nature of the taxpayer's "injury" based on the *means* used to produce that injury. Hence, the "injury" is said to be "physical" since physical means are used to deprive the victim of freedom. This approach seems at odds with that taken by the Supreme Court in *Schleier*, which defined a taxpayer's "injury" in terms of the "harm" he or she suffers rather than the actions of the wrongdoer. In *Schleier*, the taxpayer argued that his "injury" was the unlawful termination of his employment by the employer, but the Court rejected this approach out of hand holding that his "injuries" were the harms he suffered by being terminated (i.e., loss of income and psychological pain).[86] Following this approach, the "injury" in a false imprisonment case is the victim's loss of freedom—arguably a psychological harm—authorities used to effectuate that harm.

One might argue, consistent with *Schleier*, that the harm to the victim is nonetheless physical, since the victim's power of locomotion—a *physical*

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[84] *See* ROBERT W. WOOD, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS (4th ed. 2009); Robert W. Wood, *Tax Aspects of Settlements and Judgments*, 522-3d TAX MGMT. PORT. (BNA) (2012). The following articles by Mr. Wood specifically address the tax treatment of damages recovered for false imprisonment: Robert H. Wood, *Are False Imprisonment Recoveries Taxable?*, 119 TAX NOTES 279 (2008); Robert H. Wood, *Why False Imprisonment Recoveries Should Not Be Taxable*, 123 TAX NOTES 1217 (2009); Robert H. Wood, S*hould False Imprisonment Damages Be Taxable?*, 81 N.Y. ST. B.J. 38 (2009) [hereinafter *False Imprisonment*].

[85] *False Imprisonment*, *supra* note 84, at 38.

[86] Comm'r v. Schleier, 515 U.S. 323, 330–31 (1995).

capacity—is restricted by the false imprisonment. This argument will probably not succeed. First, it is too far removed from the commonly accepted definition of "physical injury": damage to, or impairment of, the human body. In the case under consideration, there was no damage to the taxpayer's body at all.

Moreover, the legislative history of § 104(a)(2) suggests that factors restricting a taxpayer's ability to fully exercise or enjoy his or her body's powers that are *outside* or *external* to the taxpayer's body do not amount to a "physical injury." The Committee Report notes that the exclusion under § 104(a)(2) may apply even where the recipient of the damages sustains no "physical injury," so long as such damages are received "on account of" somebody's physical injury.[87] Hence, damages "received [by a taxpayer] on account of a claim of loss of consortium due to the physical injury . . . of such individual's spouse are excludible from gross income."[88] For purposes of this article, it is important to note that the requisite "physical injury" is not the *taxpayer's* loss of opportunity to have sexual intercourse with his or her spouse; rather it is the injury that rendered the *taxpayer's spouse* incapable of having sex. In the eyes of the Committee Report, the taxpayer suffered no "physical injury"; the spouse did. Therefore, it seems that a person will be considered to have a "physical injury" only where there is a physical impairment of *that person's body*. A limitation on a taxpayer's ability to fully exercise or enjoy his or her bodily powers due to external factors (that is, factors outside the taxpayer's own body) does not constitute a "physical injury" to the taxpayer.

The one case thus far to consider this issue, *Stadnyk v. Commissioner*, correctly held that "physical restraint and physical detention are not 'physical injuries' for purposes of section 104(a)(2)."[89] Unfortunately, the Tax Court apparently based its decision in part on state law that characterized the interest protected by the tort of false imprisonment as "in large part a mental one."[90] This was inappropriate since terms used in the

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[87] H.R. REP. NO. 104-586, at 143–44 (1996), *reprinted in* 1996-3 C.B. 331, at 481–82.

[88] *Id.* at 144, *reprinted in* 1996-3 C.B. 331, at 482.

[89] Stadnyk v. Comm'r, 96 T.C.M. (CCH) 475, 478, 2008 T.C.M. (RIA) ¶ 2008-289, *aff'd*, 367 Fed. Appx. 586 (6th Cir. 2010).

[90] *Id.* (quoting Banks v. Fritsch, 39 S.W.3d 474, 479 (Ky. Ct. App. 2001)).

Internal Revenue Code, such as "physical injury," should normally be decided using federal criteria rather than varying state characterizations, "so as to give a uniform application to a nationwide scheme of taxation."[91]

E. Conclusion

Based on the above analysis, "physical injury" means physical damage or impairment to one's body.

IV. WHERE A TORT INVOLVES A PHYSICAL INJURY, ARE ALL DAMAGES RECOVERED FOR THAT TORT AUTOMATICALLY TAX FREE OR MAY AN APPORTIONMENT BE REQUIRED?

Let's reconsider an expanded version of the sexual harassment hypothetical discussed above. Boss engages in a pattern of sexual harassment toward his female Secretary; the harassment consists of making lewd comments and fondling her. The fondling results in a slight bruise, which clears up in a few days, but her emotional distress arising from this incident—her feelings of humiliation, degradation, shame, and embarrassment—persist. Secretary brings an action for common law battery and obtains a substantial recovery. Only a small portion of her emotional distress is attributable to the bruise; indeed she would have experienced much of the same emotional distress had there been no bruise.[92] Should the entire recovery be tax free, since she had incurred a "physical injury" or

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[91] Lyeth v. Hoey, 305 U.S. 188, 194 (1938) (quoting Burnet v. Harmel, 287 U.S. 103, 110 (1932)).

[92] Feminist scholars recognize that significant harm and suffering results from sexual discrimination and harassment even in the absence of physical injury and therefore condemn § 104(a)(2) of the Code for limiting the tax exclusion to instances of physical injury. *See* Mark J. Wolff, *Sex, Race, and Age: Double Discrimination in Torts and Taxes*, 78 WASH. U. L.Q. 1341, 1456–60 (2000) (describing ill-effects resulting from sexual discrimination even when no physical injury occurs); Marisa J. Mead, *Taxing the Victims: Compensatory Damage Awards and Attorneys' Fees in Sexual Harassment Lawsuits*, 11 J.L. & POL'Y 801, 848 (2003) (arguing that a "victim of discrimination suffers a dehumanizing injury as real as, and often far more severe and lasting harm than, a blow to the jaw." (quoting Mardell v. Harleysville Life Ins. Co., 31 F.3d 1221, 1232 (3d. Cir. 1994))); Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress and the Income Tax*, 35 HARV. J. ON LEGIS. 447, 502 (1998) (stating that "[v]ictims of unlawful discrimination on the basis of . . . gender . . . may suffer as great a harm . . . as victims of physical injury.").

should only that portion of the recovery directly attributable to the bruise be tax free?

Let's consider a less emotion-laden example. A national producer ("Producer") of cottage cheese distributes cartons containing broken glass. A customer ("Customer") buys a carton, places the cottage cheese in her mouth and discovers the presence of the glass. The glass causes a small cut on the side of her mouth. The cut heals in a short period of time, but Customer remains terrified that she may have swallowed some of the broken glass. Although the cut may have intensified Customer's fear, she would have been afraid even if she were not cut.[93] It is subsequently verified that in fact she did not swallow any glass. Customer obtains a substantial recovery from Producer for negligent infliction of emotional distress. Should all of her recovery be tax free or only that portion of the recovery that is attributable to the *additional* emotional distress that she experienced by reason of the cut?

None of the commentators seem to have directly addressed this issue. However, Private Letter Ruling 200041022 (the bruise ruling), although not explicit on this point, seems to hold—without discussion—that *all* damages allocable to the period beginning when the victim suffered her physical injuries (i.e., cuts, bruises, swelling and bleeding) are excludible from income.[94] I, on the other hand, believe that an apportionment is required, first because the statute and Supreme Court precedent mandate it, and secondly because an apportionment best implements the policy of the 1996 Amendments.

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[93] This is shown by cases where plaintiffs have sought damages for emotional distress even though they did not incur any cuts or other physical harm. For example, see *Tuttle v. Meyer Dairy Prods. Co.*, 138 N.E.2d 429 (Ohio Ct. App. 1956), where evidence showed plaintiff ate three-quarters of the cottage cheese in a container before she encountered a piece of glass whereupon she expelled the glass from her mouth without cutting or scratching herself. *Id.* at 429. She testified: "I don't claim that I [swallowed any glass], but I didn't know. It was the worrying and shock of not knowing whether you swallowed it or not." *Id.* at 430. Although the defendant acknowledged that plaintiff suffered "fright, apprehension and mental anguish," the court dismissed her claim because she had not suffered any "contemporaneous physical injury." *Id.* at 429–30. *See also* RESTATEMENT (SECOND) OF TORTS § 436A illus. 1 (1965).

[94] I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000). The Ruling states that "damages that [the taxpayers] received under the Settlement Agreement for pain, suffering, emotional distress and reimbursement of medical expenses that are properly allocable to the period beginning with the First Physical Injury are excludable . . . ."

Damages recovered for emotional distress that exist independently of the physical injury are simply not recovered "on account of" that physical injury.[95] In such a case, recovery of damages for this type of emotional distress does not even satisfy the "but-for" test of causation, since the emotional distress would have occurred if there had been no physical injury. The Supreme Court in *O'Gilvie* held that § 104(a)(2) requires a "stronger causal connection" than the "but-for" test.[96] *A fortiori*, the portion of the damages for emotional distress that would have occurred even in the absence of a physical injury may not be excluded from gross income.

Analogous decisions under the Warsaw Convention, which governs the liability of an international air carrier when its passenger sustains a "bodily injury," support this approach.[97] The mainstream view adhered to by all courts that have considered the issue (save one district court) is that "recovery for mental injuries is permitted only to the extent the [emotional] distress is caused by the physical injuries sustained."[98]

The case of *In re Air Crash at Little Rock, Arkansas, on June 1, 1999 (Lloyd v. American Airlines) ("Lloyd")* illustrates this approach.[99] In that case, a passenger's leg was punctured and scraped in a crash by bolts from an airplane seat.[100] In addition, she suffered tendinitis when other seats fell

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[95] *Cf.* Longo v. Air France, No. 95 CV 0292 (BDP), 1996 U.S. Dist. LEXIS 21947, at *5 (S.D.N.Y. July 25, 1996) (stating that "[a]llegations of mental distress that is unrelated to physical injury—i.e., mental distress that does not flow from physical injury or that does not flow from the physical manifestations of mental distress—are no different from . . . pure mental injury claims . . . .").

[96] O'Gilvie v. United States, 519 U.S. 79, 82–83 (1996).

[97] Convention for the Unification of Certain Rules Relating to International Transportation by Air, art. 17, Oct. 12, 1929, 49 Stat. 3000, T.S. No. 876. Although the only authentic text of the Convention is in French, the Supreme Court held that the relevant French phrase in the treaty—lesion corporelle—is properly translated as "bodily injury." Eastern Airlines, Inc. v. Floyd, 499 U.S. 530, 535–42 (1991).

[98] Ehrlich v. Am. Airlines, 360 F.3d 366, 376 (2d Cir. 2004) (quoting *In re* Air Crash at Little Rock, Ark., on June 1, 1999 (Lloyd v. Am. Airlines), 291 F.3d 503, 509 (8th Cir. 2002). The *Ehrlich* court states that of all the courts to consider this issue, only two district courts had taken a contrary position. However, one of those cases was the district court decision in *Lloyd v. American Airlines*, which was reversed on appeal on this issue and therefore is no longer "good law." That leaves the district court decision in *In re Aircrash Disaster Near Roselawn, Ind. on October 11, 1994*, 954 F. Supp. 175 (N.D. Ill 1997), as the only case not yet reversed that would allow recovery for emotional distress not attributable to a physical injury.

[99] *In re* Air Crash at Little Rock, 291 F.3d at 510.

[100] *Id.* at 507.

on her knee.[101] After the crash, she became anxious and nervous, and her condition was diagnosed as post-traumatic stress disorder [PTSD] and a major depressive disorder.[102] At trial, a psychiatrist testified that the physical injuries to the passenger's legs were a factor in her PTSD and depression, but later testified that her experience in the crash, when she believed she was going to die, was so terrifying that he thought she would have developed PTSD without sustaining the knee injury.[103]

The court concluded that it was "clear that some of her emotional trauma can be fairly traced to [her physical] injuries, albeit much less than would account for the $6.5 million" awarded by the jury.[104] The court remanded the case for a new trial but permitted the plaintiff to forego a new trial if she accepted a final judgment of $1.5 million, an amount the court found "more in line with [the] evidence presented at trial."[105] In short, damages for emotional trauma that would have resulted even in the absence of a physical injury were not recoverable.

Unlike § 104(a)(2), the Warsaw Convention does not explicitly impose a causation requirement. Indeed, the Second Circuit found that the text of the Convention was susceptible of different interpretations on this issue.[106] Thus, the case for requiring an allocation under § 104(a)(2)—which explicitly requires causation[107]—is stronger than under the Warsaw Convention. A principal reason why courts have required causation in Warsaw Convention cases, despite the absence of a clear mandate to do so, is to prevent anomalous and illogical results. In the absence of an apportionment, a passenger incurring a minor physical injury—even one

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[101] *Id.*

[102] *Id.*

[103] *Id.*

[104] *Id.* at 512.

[105] *In re* Air Crash at Little Rock, 291 F.3d.at 513.

[106] Ehrlich v. Am. Airlines, Inc., 360 F.3d 366, 379 (2d Cir. 2004) (finding that the Warsaw Convention was "susceptible to more than one interpretation" on this issue).

[107] Indeed, the Supreme Court held that mere "but-for" causation does not satisfy the requirement in § 104(a)(2) of the Code that damages be paid "on account of" the injury" holding instead that the section requires "a stronger causal connection." O'Gilvie v. United States, 519 U.S. 79, 82–83 (1996).

unrelated to her emotional distress—would be allowed full recovery for such distress, while a co-passenger who suffered the same amount of emotional distress, but no physical injury, would receive nothing.[108] The danger of anomalous and illogical results is equally likely under § 104(a)(2) if no apportionment is required; a taxpayer who suffers a minor physical injury would completely avoid tax on her recovery for her emotional distress (as well as any other damages she receives), while a taxpayer who suffers the same amount of emotional distress but no physical injury would be taxed on her entire recovery. This approach might be called the "all-or-nothing-approach": if there is a physical injury, all damages (except for punitive damages) are excluded; if no physical injury, nothing is excluded.

The language of the Committee Report appears to support the need for an apportionment. The Report notes that if "an action has its origin in 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 . . . ."[109] The language seems to say that only damages (including damages for emotional distress) that "flow" from the physical injury or physical sickness are excludible. Conversely, damages for emotional distress that do not "flow" from the physical injury or physical sickness will be taxable. The language reiterates the point the Supreme Court made in *Schleier*, rephrased however to reflect the new requirement of a physical injury or sickness: damages including damages for emotional distress will be excludible *if*, *but only if*, such damages are caused by, that is, flow from, a "physical injury or physical sickness."[110]

The strongest objection to requiring apportionment in these circumstances is that it creates a severe administrative problem. How can one possibly determine the portion of a recovery for emotional distress attributable to the physical injury and the portion not so attributable? Such an apportionment seems to require the fact finder to determine how much emotional distress the taxpayer would have experienced had there been no physical injury—a daunting task. However, this task does not seem impossible. The court in *Lloyd* was able to make such an apportionment.

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[108] *Ehrlich*, 360 F.3d at 386.

[109] H.R. REP. NO. 104-586, at 143–44 (1996), *reprinted in* 1996-3 C.B. 331, at 481–82.

[110] *Id.*

Moreover, this apportionment is only one of many difficult apportionments required in applying § 104(a)(2). Private Letter Ruling 200041022 (the bruise ruling) itself requires difficult apportionments. In that Ruling, the taxpayer filed an action seeking damages for emotional and physical harm arising out of a pattern of sexual harassment and reserved the right to seek punitive damages.[111] The agreement settling the action made no allocation of damages.[112] The Ruling held that (1) any damages properly allocable to punitive damages were taxable; (2) any damages allocable to the period preceding the infliction of physical injuries were also taxable; but (3) damages allocable to the period beginning with the physical injuries were non-taxable.[113] The ruling therefore requires three separate allocations. Note that an allocation will always be required in every action seeking both damages for physical injury and punitive damages since punitive damages are always taxable. An allocation will also be required where emotional distress is experienced both before and after the physical injuries.

In another case, the defendant settled an action for a physical injury he was alleged to have inflicted on the taxpayer.[114] The taxpayer made several covenants in the settlement agreement: (1) not to defame the defendant; (2) not to disclose the existence and terms of the settlement agreement; (3) not to publicize the incident; and (4) not to assist in any criminal proceeding against defendant arising from the incident.[115] The court apportioned $80,000 of the $200,000 settlement to the covenants, which was therefore taxable, and the balance to the alleged physical injury.[116] It would appear that such covenants are common in settlement agreements and thus will frequently trigger a need to make an apportionment. Also, when an employee recovers damages, a determination of the portion properly

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[111] I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

[112] *Id.*

[113] *Id.*

[114] Amos v. Comm'r, 86 T.C.M. (CCH) 663, 663, 2003 T.C.M. (RIA) ¶ 2003-329 (2003).

[115] *Id.* at 667.

[116] *Id.*

allocable to back pay or as compensation for loss of future pay will often be required to compute the amount of the applicable employment taxes.[117]

In short, making an apportionment between emotional distress actually caused by the physical injuries and emotional distress not so caused is simply another of the difficult apportionments required in applying § 104(a)(2), especially after the 1996 Amendments.[118] Nothing in the statute or in policy justifies ignoring or avoiding this type of apportionment. On the contrary, requiring such an apportionment would mean, in general, that the greater the severity of the physical harm, the greater the amount of the tax exclusion. This would further, rather than defeat, the policy of the 1996 Amendments.

Limiting the exclusion for emotional distress damages to the portion actually caused by the physical injury has certain benefits. Consider two women who are subjected to the same degree of unwanted physical touching by their respective employers. One sustains a minor bruise, while the other, who is less susceptible to bruising, receives none. It seems clear that the woman who has no bruise cannot exclude any of her damages from taxable income. However, under the all-or-nothing approach, the other woman would be able to exclude both her recovery for emotional distress

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[117] Rev. Rul. 78-336, 1978-2 C.B. 255 (payment of back pay is subject to income tax withholding); Pvt. Ltr. Rul. 200244004 (June 19, 2002) (payment of back pay is subject to income tax withholding, FICA and FUTA); Rev. Rul. 78-176, 1978-1 C.B. 303 (payment for loss of pay from prospective employment is subject income tax withholding, FICA and FUTA); Abbott v. United States, 76 F. Supp. 2d 236 (N.D.N.Y. 1999) (holding that payment for loss of future income not qualifying for the § 104(a)(2) exclusion was subject to Social Security tax). However, the IRS does not regard payments of back pay or for loss of future pay as subject to employment taxes if they are excludible from gross income pursuant to § 104(a)(2) of the Code. I.R.S. Pvt. Ltr. Rul. 200244004 (June 19, 2002) (stating there is "general agreement that . . . damages . . . excludable from gross income under section 104(a)(2) . . . are not subject to employment taxes. *See* Temp. Reg. [§] 32.1."). With the enactment of the 1996 Amendments, which require either a physical injury or physical sickness, there will be fewer cases qualifying for the § 104(a)(2) exclusion. Even if there is an injury or sickness, the direct causal link between the injury or sickness and such damages required by *Schleier* will often be lacking. *See* Wood, *supra* note 84, III.E.4.c. (discussing the practical problems encountered by employers in complying with the rules on employment taxes).

[118] *See* Burke & Friel, *supra* note 59, 189–93. The authors suggest it may be necessary in the case of awards made taxable by the 1996 Amendments to determine the portion of such awards that is properly taxable as back pay or lost self-employment income to compute the amount of payroll tax due. They also describe the difficulties the IRS will encounter in determining a proper allocation in cases involving multiple causes of action where some claims give rise to amounts that are tax exempt under § 104(a)(2) of the Code and others do not.

(including the emotional distress she would have experienced even if she had not been bruised) and all other damages she recovers. The apportionment approach eliminates this unfair disparity in treatment by limiting the tax exclusion to just the damages caused by the physical injury.

The all-or-nothing approach creates very high stakes for finding a physical injury and this inevitably creates an incentive for perjury. This was also true of the old "impact rule" where recovery was dependent on showing there was some "impact"; indeed, this effect was a major criticism of the rule.[119] Limiting the exclusion for emotional and other damages to the portion actually caused by the physical injury reduces this incentive.[120]

The need for an apportionment might be lessened if the exclusion under § 104(a)(2) were conditioned upon the physical harm exceeding a specified minimum. Such a requirement would reduce the number of anomalous cases where a minor physical injury permits a taxpayer to escape tax on the entire recovery, including damages for emotional distress not caused by the injury, while a taxpayer suffering the same quantum of emotional distress but no physical harm is taxed in full. But nothing in the statute authorizes the courts or the IRS to impose such a minimum. Moreover, imposing a minimum requirement would raise administrative problems at least as serious as those created by requiring an apportionment.

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[119] *See* Battalla v. State, 176 N.E.2d 729 (N.Y. 1961). In abandoning the "impact rule," the court noted that since the rule was satisfied by even a trivial impact and because of various exceptions to the rule:

> [T]here is good ground for believing that they [i.e., the slight impact rule and the exceptions] breed dishonest attempts to mold the facts so as to fit them within the grooves leading to recovery. (1936 Report of N.Y. Law Rev. Comm., p. 450) The ultimate result is that the honest claimant is penalized for his reluctance to fashion the facts within the framework of the exceptions.

Id. at 731. *See also* Harold F. McNiece, *Psychic Injury and Tort Liability in New York*, 24 ST. JOHN'S L. REV. 1, 80–81 (1949) (stating that the only one hurt by the impact rule is the "honest litigant who will not falsify . . . .").

[120] In case of a serious physical injury, objective evidence (e.g., medical records, x-rays, MRI and CAT scan images, etc.) verifying its existence and extent would normally exist. Thus a taxpayer falsely claiming that a physical injury occurred is likely to assert it was relatively minor, since otherwise he or she would be hard pressed to explain the absence of such objective evidence. Under an apportionment approach that limits the § 104(a)(2) exclusion to damages actually caused by the physical injury, the amount of the exclusion will be limited where the claimed injury is slight and thus the incentive for perjury in such cases will be reduced and possibly eliminated.

It would be difficult to formulate a standard specifying the quantum of physical injury required and also difficult to assure consistent application of that standard once formulated.[121] Perhaps this is why neither the Second nor Third Restatements of Torts limit the definition of "bodily harm" to any specified minimum.[122]

The decided cases are consistent with, and seem to support, the apportionment approach rather than one that conditions the exclusion upon some minimum amount of harm. In one case, the taxpayer was harassed by a coworker who made inappropriate statements to her, stared at her, visited her office when there was no business purpose to do so, and on one occasion, pinched her on the upper arm.[123] The pinch resulted in a small contusion, which lasted about 10 to 14 days.[124] The taxpayer filed a complaint against the employer claiming damages for the harassment, "as well as the assault and battery."[125] A settlement was paid and the taxpayer claimed it was completely excludible on the ground that it was paid on account of a physical personal injury (i.e., the pinch). The court rejected this claim, noting that the settlement agreement did not specify what portion of the settlement was being paid for the harassment claim, for the emotional stress claim, or for the assault and battery claim. It ruled that where the parties settle claims for different types of the damages without making any allocation of the settlement amount among the claims, and where there is no evidence that the parties intended to single out any particular claim, the court must treat the entire amount as taxable.[126] Although one authority

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[121] *See* Burke & Friel, *supra* note 59, at 187 ("[D]rafting a regulation creating a more stringent physical injury standard presents its own problems. How does one draw the line between a physical injury which is cognizable under § 104(a)(2) and one that is not? Must the taxpayer have received medical attention? Obviously, that would not solve the problem. Must the injury be something which at a minimum would be considered greater than a bruise, but less than a broken bone? . . . . [W]hat becomes clear is that Congress . . . has only created new problems by creating a dichotomy between physical and nonphysical injuries."); *cf. False Imprisonment*, *supra* note 84, at 42 (2009) (noting that basing recovery on a distinction between a serious and a non-serious false imprisonment "is analytically difficult and perhaps impracticable.").

[122] RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 4 cmt. c; Reporters' Note to cmt. c.

[123] Mumy v. Comm'r, T.C. Summ. Op. 2005-129, 2005 WL 2077789, at *1.

[124] *Id*.

[125] *Id.*

[126] *Id.* at *5–*6.

explains the case as holding that the exclusion under § 104(a)(2) will not apply "unless the taxpayer can demonstrate physical harm that is more than nominal,"[127] a better explanation is that only damages shown to be specifically attributable to the physical injury may be excluded. Had the parties made a reasonable allocation of the amount attributable to the pinch, the court may well have excluded that amount from taxation. Nothing in the opinion suggests that the court's holding was based on the relative mildness of the physical injury.

In another case, the taxpayer claimed a pattern of sexual harassment resulted in the aggravation of Sweet's syndrome (a rare skin disease).[128] A settlement was reached and the taxpayer excluded the settlement amount from her income under § 104(a)(2). The court held the entire amount was taxable because there was no evidence that the sex discrimination caused or aggravated taxpayer's Sweet's syndrome,[129] but added that if it did, the settlement agreement "did not specifically carve out any portion of the settlement payment" to the amount paid for the physical injury and the record provided no evidence supporting such an allocation.[130]

The discussion in this Part answers a question that has perplexed the commentators: does the tax exclusion apply whenever a physical injury occurs—no matter how trivial it may be? The answer is "yes" but the exclusion is limited to the damages directly caused by that physical injury.

V. DOES A PHYSICAL INJURY HAVING ITS ORIGIN IN EMOTIONAL DISTRESS QUALIFY FOR THE EXCLUSION UNDER § 104(A)(2)?

Consider the case of a taxpayer who recovers damages for physical injury caused by emotional distress. Examples might include a women who sustains a miscarriage from fright caused by a reckless driver who barely misses hitting her; a man who suffers a heart attack induced by fright when a bull negligently released from its pen charges at him but makes no impact

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[127] 5 MERTENS LAW OF FEDERAL INCOME TAXATION § 24A:5 (Daniel W. Matthews ed., 2011).

[128] Prasil v. Comm'r, 85 T.C.M. (CCH) 1124, 1124–25, 2003 T.C.M. (RIA) ¶ 2003-100 (2003).

[129] *Id.* at 1127–28.

[130] *Id.* at 1128.

because it is diverted from its path at the last moment; or a plaintiff who develops a bleeding ulcer caused by verbal bullying by a colleague. Some commentators have expressed the view that where the origin of the injury is emotional distress (as in these cases) all consequent damages, including any damages for a resulting physical injury, are taxable.[131] This seems strange since in each of these instances the taxpayer sustained an impairment of the body—the classic definition of a physical injury. Indeed, exclusion of such damages would seem compelled by the language of the statute: "gross income does not include . . . damages . . . received . . . on account of personal physical injuries."[132] Let us consider arguments supporting the opposite position.

A. No Physical Impact

Note that in these cases, there is no physical impact to or upon the victim's body. At least one commentator has argued that the absence of a physical impact means there has been no "physical injury."[133] He asserts that there "must be a proximate *physical impact* causing an immediate physical injury or sickness . . . ."[134] Thus, he argues that a taxpayer should be taxed on damages she received for a physical impairment resulting from emotional distress because she "did not suffer a *physical injury*—an impact—from which excludible damages could flow."[135] The most serious objection to this position is simply that the statute does not condition the tax

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[131] Gregory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis of* Murphy v. Internal Revenue Service, 60 ARK. L. REV. 185, 200–06 (2007–2008); Habib Hanna, *Heads I Win, Tails You Lose: The Disparate Treatment of Similarly Situated Taxpayers Under the Personal Injury Income Tax Exclusion*, 13 CHAP. L. REV. 161, 166 (2009) (stating that "if someone suffered latent physical injuries that manifested themselves as a result of a purely emotional injury, then that person is not covered by the exclusion . . . ."); Nicholas M. Whittington, Note, *Against the Grain: An Interdisciplinary Examination of the 1996 Federal Statutory Changes to the Taxability of Personal Injury Awards*, 37 WASHBURN L.J. 153, 176 (1997) (stating that exclusion does not apply to "amounts received for physical injuries that flow from an emotional injury."). *See also* JOEL S. NEWMAN, FEDERAL INCOME TAXATION: CASES, PROBLEMS, AND MATERIALS 138, Problem 2 (5th ed. 2012) (raising issue) and accompanying Teacher's Manual (discussing issue).

[132] I.R.C. § 104(a)(2).

[133] Germain, *supra* note 131, at 202–06.

[134] *Id*. at 203 (emphasis added).

[135] *Id*. at 205–06.

exclusion upon the existence of a physical impact.[136] Section 104(a)(2) merely requires that there be a physical injury—a physical impairment of the body; this requirement is satisfied in the examples set out above. To require a physical impact would incorporate into § 104(a)(2) the discredited common law "impact rule." As discussed above, this would be improper. There is no statutory warrant for it; it is not in accord with modern tort law, it lacks any discernible policy justification, and it produces inequitable and irrational results.[137] The Tax Court has allowed the exclusion in cases where no physical impact occurred.[138]

B. The Physical Injury Does Not Have a Physical Origin

Commentators asserting that physical injuries caused by emotional distress are taxable may have been unduly influenced by the following passage from the Committee Report: "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."[139] These commentators apparently believe that the language "an action [having] its origin in a physical injury" at least implies that amounts recovered in an action *not* having its origin in a physical injury are not received on account of physical injury and are therefore taxable.[140] Of course, this passage does no such thing. Rather it

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[136] Wright, *supra* note 57, at 238 (stating that "[a]lthough a physical-impact requirement might provide more clarity in the statute, neither the plain language of § 104 nor the legislative history supports such a narrow reading.").

[137] See *supra* Part III.C.

[138] In *Domeny v. Comm'r*, 99 T.C.M. (CCH) 1047, 2010 T.C.M. (RIA) ¶ 2010-009 (2010), the taxpayer obtained a settlement based on her claim that her work environment exacerbated her pre-existing physical illness, i.e., multiple sclerosis. Although there was no allegation of any physical contact or impact involving the taxpayer, the court allowed the exclusion under § 104(a)(2). *See also* Parkinson v. Comm'r, 99 T.C.M. (CCH) 1583, 2010 T.C.M. (RIA) ¶ 2010-142 (2010) (allowing exclusion of damages attributable to heart attack allegedly caused by the verbal harassment of two coworkers; no physical contact or impact alleged).

[139] H.R. REP. NO. 104-586, at 143–44 (1996), *reprinted in* 1996-3 C.B. 331, at 481–82.

[140] *See* Germain, *supra* note 131, at 202. Professor Germain, in quoting this passage from the Committee Report, italicizes the phrase "origin in a physical," apparently in the belief that it supports his position that recoveries received in actions *not* having their origin in physical injuries are taxable.

merely makes the point, which is not immediately self-evident, that even damages for *emotional distress* will qualify for the tax exclusion so long at the emotional distress results from a physical injury. It simply says nothing about the converse situation, where the physical injury is caused by emotional distress.

C. Physical Manifestations Resulting from Emotional Distress Are Merely "Physical Symptoms" of Emotional Distress Rather Than Physical Injuries

A footnote in the Committee Report states that the "Committee intends that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."[141] Some commentators have read this language to mean that any physical consequence of emotional distress is simply a "physical symptom[]" of emotional distress rather than a physical injury and consequently any damages recovered are therefore taxable.[142]

The IRS took this position in a recent case.[143] The taxpayer received a settlement based on his claim that verbal harassment by two co-employees caused him to have a heart attack.[144] The IRS asserted that the heart attack was a physical symptom of emotional distress rather than a physical injury.[145] The court rejected the IRS's position noting that in a medical context, "a 'symptom' is "subjective evidence of disease or of a patient's condition, i.e., such evidence as perceived by the patient,'" while "a 'sign' is 'any objective evidence of a disease, i.e., such evidence as is perceptible to the examining physician as opposed to the subjective sensations (symptoms) of the patient.'"[146] Since heart attacks can be objectively verified, they are not "symptoms" and the exclusion applies.[147]

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[141] H.R. REP. NO. 104-586, at 144 n.24 (1996), *reprinted in* 1996-3 C.B. 331, at 482 n.24.

[142] *See, e.g.*, Germain, *supra* note 131, at 202–06.

[143] *Parkinson*, 99 T.C.M. (CCH) 1583, 2010 T.C.M. (RIA) ¶ 2010-142 (2010).

[144] *Id.* at 1584–85.

[145] *Id.* at 1586 (quoting SLOANE-DORLAND MEDICAL-LEGAL DICTIONARY 496 (Supp. 1992)).

[146] *Id.* (quoting SLOANE-DORLAND MEDICAL-LEGAL DICTIONARY 476 (Supp. 1992)).

[147] *Id.* at 1586–87.

Although I agree with the result in the case, I doubt that Congress used the word "symptom" in the Committee Report in its technical, medical meaning. What then is the distinction between a "physical symptom" resulting from emotional distress and a "physical injury"? Some idea of what the distinction means might be gleaned by considering the examples that the footnote in the Committee Report gives of "physical symptoms," which includes "insomnia, headaches, [and] stomach disorders."[148] These conditions share a common characteristic. In and of themselves, they involve no physical impairment of, or damage to, the body—the commonly accepted definition of "physical injury."[149] Everyone has had headaches, but once they pass, the body is as good as it was before. Likewise, everyone has had nights when sleeping is difficult and everyone has had stomach disorders, but once they pass, they leave no impairment of the body.[150] Simply stated, the listed symptoms are not physical injuries because they involve no physical impairment of the body. The footnote simply makes it clear that such symptoms, *notwithstanding their physical nature*, are not physical injuries.[151] Indeed, a different rule would eviscerate the distinction between emotional distress and physical injury since practically every case of emotional distress is accompanied by physical symptoms: tachycardia

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[148] H.R. REP. NO. 104-586, at 144 n.24 (1966), *reprinted in* 1966-3 C.B. 331, at 482 n.24.

[149] *See supra* Part III.A.

[150] *See* Wright, *supra* note 57, at 239 (noting that headaches, nausea, fatigue and sleeplessness "are indeed physical, but usually do not injure, or produce sickness in any part of the human body.") (footnotes omitted).

[151] In *Lindsey v. Comm'r*, 422 F.3d 684, 688 (8th Cir. 2005), the taxpayer received a settlement for stress-related ailments he experienced as a result of a failed business deal. The court held that the ailments (i.e., hypertension, periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence) were not physical injuries but symptoms related to emotional distress. *Id.* at 688. The holding may seem strange given the physical nature of the ailments but note that the taxpayer did not show or allege that these conditions either constituted or resulted from any physical impairment in his body. Urinary incontinence, for example, is a physical occurrence but need not be caused by any underlying defect in the body. As the Mayo Clinic points out, "Urinary incontinence isn't a disease. It's a symptom. It can be caused by everyday habits, underlying medical conditions or physical problems." *Urinary Incontinence: Causes*, MAYO CLINIC (June 25, 2011), http://mayoclinic.com/health/urinary-incontinence/DS00404/DSECTION=causes (last visited Aug. 20, 2012). *See also* Sanford v. Comm'r, 95 T.C.M. (CCH) 1618, 1619, 2008 T.C.M. (RIA) ¶ 2008-158 (2008) (treating "intensification of [] asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression" as physical symptoms of stress resulting from sexual harassment).

(increased pulse rate), hyperventilation (increased respiration rate) and tremor (involuntary rapid movement, usually in hands and fingers).[152]

On the other hand, if there is a physical impairment of the body—for example, a heart attack as in the case described above—there is a "physical injury" (as commonly understood) and any damages received on account thereof are properly tax-exempt. A heart attack is the loss or destruction of living heart muscle caused by a blockage of an artery[153] and clearly constitutes a physical impairment of the body. In many cases, however, distinguishing between physical effects that are merely symptomatic of emotional distress and those that constitute a physical impairment of the body will be an agonizingly elusive task.[154]

No policy justifies disallowing the exclusion under § 104(a)(2) where emotional distress results in a physical impairment of the body—and none has been suggested. The legislative history of the 1996 Amendments unfortunately gives scant insight into their purpose. However, to the extent the Amendments were motivated by the historical reasons for the law's reluctance to permit recovery for emotional distress as distinguished from physical injury, tax-free treatment should be accorded to damages for

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[152] Narbeh Bagdasarian, *A Prescription for Mental Distress: The Principles of Psychosomatic Medicine with the Physical Manifestation Requirement in N.I.E.D. Cases*, 26 AM. J.L. & MED. 401, 429 (2000) (stating that "it is hard to define a mental condition with literally no physical manifestation. Even purely mental conditions have some physical symptoms.").

[153] TABER'S CYCLOPEDIC MEDICAL DICTIONARY 1416 (20th ed. 2005) defines a myocardial infarction (i.e., a heart attack) as the "loss of living heart muscle as a result of coronary artery occlusion."

[154] Unfortunately, the decided cases have provided little guidance on distinguishing "physical injuries" from "physical symptoms" that result from emotional distress. *See, e.g.*, *Lindsey*, 422 F.3d at 688 (8th Cir. 2005) (stating without explanation that taxpayer's symptoms "relate to emotional distress, and not to physical sickness.").

The problem occurs in other areas of the law. Although the Warsaw Convention allows recovery for bodily injury, it does not allow recovery for "physical manifestation of emotional injury." Terrafranca v. Virgin Atlantic Airways, 151 F.3d 108, 111 (3d Cir. 1998). One district court, in applying this distinction, restricted the definition of bodily injury to "physical wounds, impacts, or deprivations, or any alteration in the structure of an internal organ . . . ." Turturro v. Cont'l Airlines, 128 F. Supp. 2d 170, 178 (S.D.N.Y. 2001). Although no court has explicitly adopted this approach in applying § 104(a)(2) of the Code, it is consistent with the results in the decided cases. For example, in *Lindsey*, where the court held that certain stress-related ailments that the taxpayer experienced as a result of a failed business deal were physical symptoms of emotional distress rather than physical injuries, the taxpayer did not show or allege that his ailments resulted from or constituted an alteration (i.e., a physical impairment) to any part of the taxpayer's body. *See supra* note 133.

physical injuries caused by emotional distress. Those reasons, as stated by the Second Restatement of Torts, were: (1) emotional distress was considered less serious than physical injury; (2) the absence of the guarantee of genuineness provided by a physical injury; and (3) in the case of the negligent infliction of emotional distress, the belief that the defendant's fault was not great enough to make him or her liable for a purely mental disturbance.[155] Obviously, none of these concerns applies where emotional distress causes physical impairment of the body, because there is, in such cases, a "physical injury," as that term is commonly understood.

Those who assert that damages for physical injuries caused by emotional distress are not excludible base their case primarily—if not exclusively—on a single cryptic footnote in the Committee Report. This position, however, contravenes the clear language of the statute, which unambiguously excludes damages recovered for physical injuries without regard to cause. Different judges and commentators accord different weight to congressional committee reports.[156] However, a committee report should never override the text of the statute unless it clearly provides for that result[157] and the non-textual alternative is supported by strong policy reasons. That is not the case here. On the contrary, as shown above, the footnote is susceptible of an interpretation consistent with the statutory language, and those who argue in favor of a non-textual interpretation have failed to present any convincing rationale for that result.

Note that even under the position advocated here—that the exclusion applies to physical injuries caused by emotional distress—damages for the emotional distress that caused the physical injury remain taxable. Recall the "Charging Bull" example posed above.[158] In that case, a bull escaped from its pen through the negligence of its owner and charged a passing

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[155] RESTATEMENT (SECOND) OF TORTS § 436A cmt. b (1965).

[156] *See* Michael L. Culotta, *The Use of Committee Reports in Statutory Interpretation: A Suggested Framework for the Federal Judiciary*, 60 ARK. L. REV. 687 (2007).

[157] *See, e.g.*, Henry T. Patterson Trust v. United States, 729 F.2d 1089, 1095 (6th Cir. 1984) (holding that language of Committee Report "falls short of a clear indication by Congress that the natural impact of the statutory language" should not be followed).

[158] *See supra* Part II.

pedestrian. The bull did not make contact with the pedestrian because it was diverted from its path at the last moment, but the terror and horror the pedestrian experienced caused him to have a heart attack. Under the position advocated here, any damages the pedestrian recovered for the heart attack (e.g., medical expenses, diminution in quality of life, loss of income, etc.) would be excludible. However, damages recovered for the fright and terror the pedestrian experienced before the heart attack would be fully taxable since such damages were not awarded "on account of" the physical injury (i.e., the heart attack).[159] Moreover, the heart attack did not cause the emotional distress (i.e., the terror and horror) that preceded it and therefore, the causal connection required by *Schleier* is not satisfied.[160] This result fully accords with the purposes of the 1996 Amendments: damages for the pedestrian's physical injury (and harms that flow therefrom) are excludible and damages for the emotional distress that exists apart from the physical injury are taxable. Taxing damages for the period preceding the physical injury and excluding damages for the period thereafter is, of course, the same approach that was taken in the "bruise ruling."[161]

The position set forth in the Committee Report with respect to "physical symptoms" resulting from emotional distress is similar, but not identical, to the position taken by the Second Restatement of Torts. In general, no damages could be granted for negligent infliction of emotional distress in the absence of bodily harm.[162] The Second Restatement explained what comprised "emotional distress" for purposes of this rule as follows:

> The rule stated in this Section applies to all forms of emotional disturbance, including temporary fright, nervous shock, nausea, grief, rage and humiliation. The fact that these are accompanied by transitory, non-recurring physical

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[159] *See* O'Gilvie v. Comm'r, 519 U.S. 79, 83 (1996).

[160] Comm'r v. Schleier, 515 U.S. 323, 329–31 (1995).

[161] Pvt. Ltr. Rul. 200041022 (Oct. 13. 2000). *See supra* notes 42–44 and accompanying text. The court applied the bifurcation approach suggested in the text in *Parkinson v. Comm'r*, 99 T.C.M. (CCH) 1583, 2010 T.C.M. (RIA) ¶ 2010-142 (2010). In that case, the taxpayer alleged that verbal harassment by two co-workers caused him mental distress, which in turn caused him to have a heart attack. The court treated the portion of the damages attributable to the mental distress caused by the harassment as taxable but the portion attributable to the physical injury, i.e., the heart attack, as excludible. *Id.* at 1587.

[162] RESTATEMENT (SECOND) OF TORTS § 436A. The Restatement imposed liability in certain cases where the emotional distress resulted in bodily harm. *Id.* § 436.

> phenomena, harmless in themselves, such as dizziness, vomiting and the like, does not make the actor liable where such phenomena are in themselves inconsequential and do not amount to any substantial bodily harm.[163]

In contrast, impairment of the body caused by emotional distress (e.g., heart attacks, miscarriages, and bleeding ulcers) are not cases of "transitory, non-recurring physical phenomena, harmless in themselves, such as dizziness, vomiting and the like . . . [which] are in themselves inconsequential and do not amount to any substantial bodily harm."

The Second Restatement of Torts suggested that recovery might be permitted, even in the absence of physical impairment, if the physical symptoms persisted for a long time, stating that "[o]n the other hand, long continued nausea or headaches may amount to physical illness, which is bodily harm . . . ."[164] However, the Third Restatement of Torts, which generally adopts a more liberal position on the allowance of damages for emotional distress than the Second Restatement, rejected this distinction between short-term and long-term physical phenomena because it had "the unfortunate effect of diluting the definition of bodily harm."[165]

Does the distinction that the Second Restatement of Torts made between short- and long-term physical phenomena or symptoms (but rejected by the Third Restatement) apply to § 104(a)(2)? Such an approach elicits our sympathy, since the symptoms are no longer everyday occurrences that are "transitory, non-recurring physical phenomena, harmless in themselves" but long-lasting ones that inflict considerable pain and suffering on its victims. I think this approach is unlikely to prevail.

It is true that the § 104(a)(2) exclusion applies to a "physical sickness" as well as to a "physical injury." It might be contended, as suggested by the Second Restatement, that long-term physical symptoms of emotional distress constitute a "sickness" even if they do not constitute a "physical injury." However, under § 104(a)(2), the "sickness" must be a "physical sickness." More importantly, the Committee Report makes it clear that

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[163] *Id.* at cmt. c.

[164] *Id.*

[165] RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 4 cmt. d.

physical symptoms are to be treated as "emotional distress" and therefore under the express terms of the statute may not be "treated as a physical injury or a physical sickness."[166] There is no indication in the Committee Report that either the duration or the severity of the symptoms can convert the symptoms into a "physical injury" or a "physical sickness." It may seem that a victim of emotional distress who experiences long-term physical symptoms has suffered sufficiently to qualify for the tax benefits of section 104(a)(2), but Congress has made the choice that damages for emotional distress, no matter how painful or long-lasting, are taxable.

VI. THE PROBLEMATIC NATURE OF THE DISTINCTION BETWEEN PHYSICAL SYMPTOMS OF EMOTIONAL DISTRESS AND PHYSICAL INJURIES: THE CASE OF PTSD

Advances in medical research have shown that the supposedly sharp distinction between "body" and "mind," which underlies § 104(a)(2), is largely illusory. As the Diagnostic and Statistical Manual of Mental Disorders, the leading guide to the clinical practice of psychiatry, points out, a "compelling literature documents that there is much 'physical' in 'mental' disorders and much 'mental' in 'physical' disorders."[167] The Manual describes the purported distinction "between 'mental' disorders and 'physical' disorders . . . [as] a reductionistic anachronism of mind/body dualism . . . ."[168] The case of post-traumatic stress disorder (PTSD) illustrates the problems of trying to apply this distinction.

PTSD is triggered by a traumatic event (e.g., assault, domestic abuse, rape, or war) and is manifested by symptoms like flashbacks, nightmares, difficulty in concentrating, intense physical reactions to reminders of the event (e.g., dizziness, agitation, rapid beating of the heart, or headaches).[169] Negligence on the part of the defendant, as well as intentional acts, that result in the trauma causing PTSD can therefore give rise to actions for

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[166] I.R.C. § 104(a) (penultimate sentence).

[167] AM. PSYCHIATRIC ASS'N, DIAGNOSTIC AND STATISTICAL MANUAL OF MENTAL DISORDERS: DSM-IV-TR, at xxx (4th ed. 2000).

[168] *Id.*

[169] *Post-traumatic stress disorder: PTSD*, PUBMED HEALTHNATIONAL, http://www.ncbi.nlm.nih.gov/pubmedhealth/PMH0001923/ (last visited Feb. 13, 2013).

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damages. Courts have often refused to treat PTSD as a physical injury. A 1985 federal case, applying Nebraska law, found that a plaintiff who had been diagnosed as suffering from PTSD had not sustained a physical injury even though he exhibited the following symptoms: nightmares, frequent headaches, dizziness, depression, nervousness, weight loss and poor appetite.[170] Note that these symptoms do not, at least at first glance, appear to involve any impairment of the body.

However, more recent research has indicated that PTSD may indeed be associated with an impairment of the body. The hypothesis is that the trauma affects the neural networks in the brain so that the amygdala, which triggers fear, becomes more active when the body is faced with a stressful situation, while the prefrontal cortex, which inhibits or overrides the fear response, is rendered less active. The two interactions result, it is believed, in the symptoms typifying PTSD. An article published in *The New England Journal of Medicine* states that:

> Recent neuroanatomical studies have identified alterations in two major brain structures—the amygdala and hippocampus—in patients with PTSD. [Tomography and magnetic resonance imaging (MRI)] have shown that the reactivity of the amygdala and anterior paralimbic region [which arouse fear] to trauma-related stimuli is increased and the reactivity of the anterior cingulate and orbitofrontal areas [which inhibit the fear response] is decreased. These areas of the brain are involved in fear responses. Differences in hippocampal function and in memory processes presumed to be dependent on the hippocampus have been found, suggesting a neuroanatomical substrate for the intrusive recollections and other cognitive problems that characterize PTSD.[171]

A lay commentator summarized the research as follows:

> In sum, the physiological changes that occur in the brain after an individual experiences or witnesses a traumatic event can result in dysfunction of the neural networks that regulate memory and fear. We rely on the prefrontal cortex inhibitory function to override adverse effects from emotional stress. However,

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[170] Wilson v. Sears, Roebuck & Co., 757 F.2d 948, 949 (8th Cir. 1985).

[171] Rachel Yehuda, *Post-Traumatic Stress Disorder*, 346 N. ENG. J. MED. 108, 110 (2002) (footnotes omitted).

> when the prefrontal cortex is prevented from carrying out this function, that dysfunction manifests itself in the symptoms of anxiety disorders.[172]

A recent case held that the plaintiff, who had been diagnosed with PTSD, had presented sufficient evidence to create a genuine issue of fact as to whether he had suffered a "bodily injury": an affidavit by a physician concluding that abnormalities in the plaintiff's brain as depicted on a PET scan were "consistent with an injury to [the plaintiff's] brain" and an affidavit by a second physician stating that PTSD "causes significant changes in brain chemistry, brain function and brain structure."[173] Likewise, a recent federal case, applying the Warsaw Convention, "acknowledge[d] that under some circumstances a diagnosis of chronic PTSD may fall within the Convention's definition of 'bodily injury.'"[174] Other courts have taken a more restrained position on this issue.[175]

If trauma for which the defendant is responsible is shown to cause adverse change in the structure and functioning of plaintiff's brain, then there has been a "physical injury" (i.e., an impairment of the body, specifically in the brain) and damages recovered for the effects of such injury should qualify for the § 104(a)(2) exclusion. However, this puts courts in a very difficult position. The science on this issue appears to be unsettled. Note the tentative nature of the conclusion in *The New England*

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[172] Betsy Grey, *Neuroscience and Emotional Harm in Tort Law: Rethinking the American Approach to Free-Standing Emotional Distress Claims*, *in* 13 LAW AND NEUROSCIENCE: CURRENT LEGAL ISSUES 203, 219 (Michael Freeman ed., 2011).

[173] Allen v. Bloomfield Hills Sch. Dist., 760 N.W.2d 811, 815–16 (Mich. Ct. App. 2008).

[174] Turturro v. Cont'l Airlines, 128 F. Supp. 2d 170, 179 (S.D.N.Y. 2001). However, the court granted defendant's motion for summary judgment on this issue with leave to amend her complaint because of her failure to plead "with the requisite specificity either a brain-lesion theory of PTSD or individualized proof of such lesions." *Id.* at 179, 182.

[175] In *In re Air Crash at Little Rock, Ark., on June 1, 1999 (Lloyd v. Am. Airlines)*, 291 F.3d 503 (8th Cir. 2002), the court rejected plaintiff's theory that her PTSD was a "bodily injury" since the trauma of the air crash had caused a detrimental physical change in her brain. The court advanced two reasons for its holding: first, there was no proof that such a change had occurred, and secondly, allowance of recovery on this basis would "blur" the clear distinction drawn in the Warsaw Convention between physical injury and mental injuries. *Id.* at 511–12. In *Bobian v. CSA Czech Airlines*, 232 F. Supp. 2d 319, 326 (D.C.N.J.), *aff'd*, 93 Fed. Appx. 406 (3d Cir. 2004), the court rejected a similar claim by the plaintiffs, arguing that since "all human thoughts and emotions are in some fashion connected to brain activity, and therefore at some level 'physical,'" acceptance of their argument would "break down entirely the barrier between emotional and physical harms that the [Warsaw] Convention requires us to maintain."

Journal of Medicine article cited above: there are research findings "*suggesting* a neuroanatomical substrate for the intrusive recollections and other cognitive problems that characterize PTSD." Yet the statute requires the courts and other actors applying the law (e.g., taxpayers, the IRS) to make a determination based on tentative scientific findings and hypotheses—a task for which they are ill-suited. This embarrassing situation results from the law's mandate to distinguish between "emotional distress" and "physical injury"—yet Congress has given no reason why the tax consequences of damages should turn on this distinction. Note also that this embarrassing situation is unlikely to be confined to cases of PTSD, since much research indicates that other mental and emotional disorders have an underlying physical cause.[176]

VII. CRITIQUE OF THE 1996 AMENDMENTS AND A POSSIBLE SOLUTION

The 1996 Amendments have serious flaws, including the following:

A. They Produce Inequitable Results

By denying tax relief for emotional distress, while granting it for physical injuries, the Amendments fail to recognize that emotional harm can be as hurtful—and in some cases, more so—than physical injuries.

Consider the case of Ann who ingests a medicine which subsequent epidemiological studies establish increases one's risk of cancer by 50%. In fact, Ann does not develop cancer, but for the rest of her life she lives in constant fear of that result. Her anxiety sends her into a deep depression. The depression causes her to lose sleep and have frequent stomach disorders. This in turn causes her to frequently miss work and leads to her dismissal. Ann recovers damages from the pharmaceutical manufacturer for

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[176] *See* Dawn Capp & Joan G. Esnayra, *It's All in Your Head—Defining Psychiatric Disabilities as Physical Disabilities*, 23 T. JEFFERSON L. REV. 97, 99 (2000) (stating that an "overwhelming amount of scientific data proves that psychiatric disabilities are *physical* in nature"), and Richard E. Gardner III, *Mind over Matter?: The Historical Search for Meaningful Parity Between Mental and Physical Health Care Coverage*, 49 EMORY L.J. 675, 686 (2000) (stating that "[s]cience continues to provide evidence that serious mental illnesses are actually physical diseases of the brain.").

her anxiety, medical expenses and loss of income. Because Ann did not sustain a physical injury her entire recovery is taxable.[177]

In contrast, Bill sustains a physical injury in an automobile accident caused by the negligent driving of another party. After six months, his emotional health and physical health are fully restored to their prior condition. He recovers damages for pain and suffering, loss of income and medical expenses. Because Bill sustained a physical injury, his entire recovery is tax free.

It is inequitable that Ann, who is condemned to a lifetime of anxiety and the resulting adverse consequences, must pay tax on her entire recovery, while Bill, who fully recovered after six months, escapes all tax.[178]

B. They Undercut the Rationales of Section 104(a)(2)

The rationales for the tax exclusion are: (1) at best, the recovery merely restores the taxpayer to his or her condition prior to the injury and thus, entails no gain; (2) the exclusion reflects our compassion for the injured party; (3) the exclusion avoids putting the Government in the unseemly position of profiting from the misfortune of its citizens; and (4) it is unduly harsh to tax a recovery for an injury that the taxpayer did not voluntarily incur and would have wished to avoid.[179] These reasons are equally applicable regardless of whether the recovery is for emotional distress or for a physical injury.

C. They Increase Complexity by Adding to the Number of Difficult Apportionments Required Under Section 104(a)(2)

As the bruise ruling and the "Charging Bull" hypothetical illustrate, where a course of tortious conduct begins before the physical injury, the

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[177] Ann's insomnia and her stomach disorders will almost certainly be treated as merely "physical symptoms" resulting from emotional distress and thus the damages she recovers for them will be taxable. *See* H.R. REP. NO. 104-586, at 144 n.24 (1996), *reprinted in* 1996-3 C.B. 331, at 482 n.24.

[178] For other hypotheticals illustrating how the 1996 Amendments cause inequitable differences in result, see Burke & Friel, *supra* note 59, at 182–84, and Hanna, *supra* note 131, at 180–82.

[179] *See* discussion *supra* Part I.C.

damages must be apportioned between the period preceding the physical injury and the period thereafter.[180] If a course of tortious conduct produces emotional distress that is then *intensified* by a physical injury, the damages must apparently be apportioned between the emotional distress that would have occurred anyway and the additional distress caused by the physical injury.[181] If the recovery is based on multiple claims, some involving a physical injury and others not, apportionment must be made between the different classes of claims.[182]

These apportionments are on top of those that may have already been required by prior law. Where punitive damages are included in an award, the amount received for punitive damages (which is taxable) must be sorted out from damages for the physical injury (which is not taxable).[183] If a settlement includes collateral undertakings (e.g., a commitment not to publicize the incident), the damages recovered for the undertakings (taxable) must be segregated from the amount received for the physical injury (nontaxable).[184]

Making a proper allocation requires a weighing of the relative strengths of the different claims and, because any allocation by the parties may be tax-motivated, a determination of the parties' motives. This places an undue strain on the resources of the IRS and the courts.[185]

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[180] I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000) (according tax-free treatment to damages allocable to period beginning with "First Physical injury" but taxing damages allocable to period preceding the "First Pain Incident"). A similar apportionment would be required in cases like the "Charging Bull" where the charge of the bull and the resulting terror (i.e., emotional stress) preceded the taxpayer's "physical injury," that is, his heart attack. *See supra* notes 42–44, 95–97, 140–43 and accompanying text.

[181] *See supra* Part IV.

[182] *See* Burke & Friel, *supra* note 59, 190–93.

[183] I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000) (holding that amount allocable to punitive damages is taxable).

[184] *See* Amos v. Comm'r, 86 T.C.M. (CCH) 663, 667, 2003 T.C.M. (RIA) ¶ 2003-329 (2003).

[185] Burke & Friel, *supra* note 59, at 190–93.

D. They Require the IRS, Taxpayers and the Courts to Make Sophisticated Determinations of Medical Causation That They Are Ill-Suited to Make

As the discussion of PTSD shows, whether a condition is caused by a physical injury sometimes involves very sophisticated and often unsettled issues of medical causation which the courts and the other parties are ill-equipped to decide.[186] Putting courts in this position seems to serve little purpose when little, if any, reason for making tax consequences turns on the distinction between injury to one's body and one's mind has been given—let alone justified.

E. The Lack of a Coherent and Intelligible Policy Justification for the 1996 Amendments Impedes Rational Application and Development of the Law

Since Congress's reasons for according tax-free treatment to damages received for physical injuries while taxing other damages are obscure at best, it is difficult to decide whether a given harm should qualify for tax-exempt status based on the statute's purposes and policy. Rather the decision maker is left grasping at dictionary definitions and cryptic statements in an incomplete and murky Committee Report. This impedes rational application and extension of the law to new and unforeseen situations.[187]

Below I make a proposal that I believe will significantly improve the current law. I am not trying to resolve the long-standing philosophical debate between those who believe that litigation damages, at least in some cases, should be tax free and those who believe that such damages should be taxed. In general, I accept the current status of the law for one pragmatic reason: I believe any attempt to make a wholesale revision in the law is doomed to failure. My objective is more modest: I want to reduce the deficiencies created by the 1996 Amendments and yet address some of the concerns raised by the proponents of the Amendments.

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[186] *See* discussion *supra* Part VI.

[187] *See* HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW 145–52 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994) (arguing that a statute should be interpreted through a process of "reasoned elaboration" based on its purposes and policies).

Each of the flaws listed above results from, or is significantly aggravated by, the need to distinguish between physical injury or sickness and emotional distress. Consequently, each can be eliminated, or substantially reduced, if that distinction is eliminated. Can this be done while satisfying, at least in part, the proponents' reason for enacting the 1996 Amendments?

Answering this question is difficult since the legislative history gives so little insight into the reasons for their enactment. However, as discussed above, the best surmise is that Congress was concerned that amounts that would otherwise be taxed in the absence of an injury (i.e., lost income) would escape tax when received as damages. Congress specifically noted that "[d]amages received on a claim not involving physical injury or physical sickness are generally to compensate the claimant for lost profits or lost wages that *would otherwise be included in taxable income*."[188] The Supreme Court itself acknowledged in *Ogilvie* that the law went beyond what was required to restore the taxpayer's human capital:

> 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. . . . [since 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.[189]

Indeed, some commentators believe that the Court's restrictive interpretation and application of § 104(a)(2) in *Burke*, *Schleier* and *O'Gilvie* reflected its unease over this anomalous result.[190] It is reasonable to conclude that Congress was motivated, at least in significant part, by a desire to make sure that income, which would be taxed in the absence of an injury, would still be taxable when recovered as damages.

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[188] H.R. REP. NO. 104-586, at 143 (1996), *reprinted in* 1996-3 C.B. 331, at 481 (emphasis added).

[189] O'Gilvie v. Comm'r, 519 U.S. 79, 86 (1996).

[190] *See*, *e.g.*, Doti, *supra* note 70, at 70 (stating author's belief that Court held the recovery in *Schleier* taxable because it "could not accept the fact that Congress intended such a loophole to exist for lost wages—a classic form of taxable income.").

Solution of this problem therefore lies in making *all* damages received for lost income taxable.[191] At the same time, the existing dichotomy between "physical injuries or physical sickness" and "emotional distress" should be eliminated. This change would eliminate, or substantially reduce, the defects in the current law identified above. Making all damages for lost income taxable would carry out in a more consistent and thorough manner the intent that a compensated victim's tax situation not be improved over what it would have been if no injury occurred.[192] Under the proposal, damages for lost income in the cases involving emotional distress will be taxed as under current law, *and* damages for lost income in cases involving physical injuries will likewise be taxed.

This proposal entails its own problems.[193] Perhaps the most serious is the need to determine the amount of a recovery attributable to lost income.

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[191] Numerous commentators have advocated taxing recoveries for lost income in personal injury cases: Mark W. Cochran, *Should Personal Injury Damages Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43 (1987); Burke & Friel, *supra* note 39, at 46; Lawrence A. Frolik, *Personal Injury Taxation as a Tax Preference*, 37 ME. L. REV. 1, 36–37 (1985).

[192] Professor Dodge agrees that § 104(a)(2) of the Code, as presently applied, often has the effect of overcompensating taxpayers in the case of lost income awards, since he or she pays no tax on income that would have been taxed if no injury had occurred. Dodge, *supra* note 38, at 146. However, he would retain § 104(a)(2) but deal with the problem by limiting the tax exclusion to two types of recoveries: (1) periodic payments where the each payment is reduced to reflect the tax that would have been paid if no injury had occurred; and (2) lump sum awards provided the taxpayer places the award in an annuity that is structured and taxed to put the taxpayer in same after-tax position as if the injury had not occurred. *Id.* at 156–59, 166–67.

My concerns with this approach are pragmatic. Professor Dodge's analysis is complex and the rules needed to implement his proposal would likewise be complex (e.g., varying rules for taxing annuity payments based on how award is computed). *See id*. at 159. Explaining the rationale and the rules and then selling them to Congress and the states would at best be a long, drawn-out process. I doubt if Congress would adopt them. Certainly Congress made no move in this direction in the 20 years since Professor Dodge made his proposal, and Congress did not adopt his approach in 1996 when it made recoveries of lost income taxable when no physical injury takes place. Note also that th*e* federal government would receive no tax revenue under some of his proposed scenarios. For example, in the case of periodic payments, the payments by the defendant are to be reduced to reflect the tax that would have otherwise been payable on them. *Id*. at 169. Under this proposal, the Government collects no tax; rather the reduction in the payment serves as an "implicit" tax. For Professor Dodge's defense of this result, see *id*. at 169–70. However, if the award is viewed as a replacement of, or substitute for, lost taxable income, it seems the Government should be entitled to collect the tax that would be payable on it.

[193] Professor Dodge notes that if § 302(a)(2) is amended to make awards for lost income taxable, an *after-tax rate of return* should be used as the discount rate in computing the defendant's lump sum payment for plaintiff's loss of future income. The after-tax rate of return is the rate of return normally used for present value computations (generally the rate of return on a safe investment like government

However, as shown above, the 1996 Amendments created their own set of hard-to-make apportionments.[194] The need for those extremely difficult apportionments would disappear if, as proposed here, the need to distinguish between physical injury and emotional distress were eliminated. Thus, adoption of this proposal is unlikely to increase apportionment problems. Indeed, an apportionment is frequently required under current law to determine the amount of employment taxes payable on the portion of a recovery that is attributable to back pay and to the loss of future pay.[195]

The apportionment problem would be eased if juries (and courts that determine damages) were required to specify in tort cases any amount awarded for lost income. Such a requirement would be a proper exercise of Congress's power to assure compliance with federal tax law. Such allocations should, as under current law, be respected by the federal courts since they result from an adversarial, arms-length process. Manipulation to achieve a desirable tax result is unlikely, since the attorneys representing claimants will attempt to maximize each component of the verdict: the taxable components as well as the nontaxable ones.

Settlements are admittedly a more difficult problem. The payor of the damages may be indifferent as to the allocation of the damages, since the entire amount of the payment, no matter how allocated, will often be deductible.[196] Sometimes the interests of the parties will even coincide. For

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bonds) less the taxpayer's anticipated tax rate on such return. Otherwise, the plaintiff will incur a duplication of tax: an implicit tax caused by using the before-tax rate of return as the discount rate and the actual tax the plaintiff pays with respect to the recovery. Therefore, Professor Dodge urges that if Congress were to amend the law in this fashion, it should send "a clear signal to states that plaintiff equity can be achieved only by figuring lump sum damage recoveries on a before-tax basis using an *after-tax* discount rate." Dodge, *supra* note 38, at 177.

[194] *See supra* notes 95–102, 162–67 and accompanying text.

[195] *See supra* note 101 and accompanying text.

[196] *See, e.g.*, Robinson v. Comm'r, 102 T.C. 116 (1994), *aff'd in part and rev'd in part*, 70 F.3d 34 (5th Cir. 1995), where court disregarded allocations of damages in settlement because it found that payor was indifferent to the allocations (presumably because it would be able to deduct entire amount in any event) and taxpayers had unilaterally determined allocation to minimize their Federal income tax liability. *Id.* at 129–34. *See also* Lafleur v. Comm'r, 74 T.C.M. (CCH) 37, 42, 1997 T.C.M. 1997-312 (1997) (refusing to follow allocations in settlement agreement where defendant indifferent to them); FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAX: CASES AND MATERIALS 196–97 (16th ed. 2011).

example, neither party will want to designate any portion of the award as punitive damages: the recipient because such damages are taxable, and the payor to avoid the ignominy of that label.[197] The best answer is probably to leave the law as it currently is: allocations in a settlement agreement will be respected if they are "entered into by the parties in an adversarial context at arm's length and in good faith."[198] Otherwise, the court will attempt, by looking at all the facts and circumstances, to determine "in lieu of what was the settlement amount paid."[199] If the taxpayer fails to present evidence establishing, or at least enabling the court to make, an allocation of the damages, the taxpayer will be taxed on the entire recovery.[200]

The important point, though, is that, unlike some of the speculative allocations that may be required by the 1996 Amendments, determining what portion of a settlement payment constitutes reimbursement of lost income comes well within the expertise of the IRS and courts that adjudicate tax issues. Indeed, it is exactly the type of determination they are frequently called upon to make when, for example, they must determine what portion of a taxpayer's purported salary in fact constitutes "reasonable" compensation and what portion, if any, is actually a disguised dividend or gift.[201]

Some may be concerned that an award for lost income that would have otherwise been earned over an extended time period (e.g., over the taxpayer's lifetime) would result in an improper "bunching" of income in a single year, pushing the taxpayer into an abnormally high income tax

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[197] FREELAND, *supra* note 196, at 196–97; Bagley v. Comm'r, 105 T.C. 396, 403, 409–10 (1995).

[198] *Bagley*, 105 T.C. at 407.

[199] *Id.* at 406. For a general discussion of how courts treat allocations in settlement agreements in § 104(a)(2) cases, see Jon O. Shields, *Exclusion of Damages Derived from Personal Injury Settlements: Tax-Planning Considerations in Light of* McKay v. Commissioner, 56 MONT. L. REV. 603 (1995).

[200] *See, e.g.*, Pipitone v. United States, 180 F.3d 859, 895 (7th Cir. 1999). For cases where the courts made their own allocations of damages based on the evidence presented by the parties, see Gerard v. Commissioner, 86 T.C.M. (CCH) 604, 2003 T.C.M. (RIA) ¶ 2003-320 (2003) and Parkinson v. Comm'r, 99 T.C.M. (CCH) 1583, 2010 T.C.M. (RIA) ¶ 2010-142 (2010).

[201] Courts are required to make these determinations because § 162(a)(1) of the Code limits deduction for payments for personal services to a "reasonable allowance." *See* Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 835 (7th Cir. 1999) (stating that "primary purpose of section 162(a)(1) . . . is to prevent dividends (or in some cases gifts), which are not deductible from corporate income, from being disguised as salary, which is.").

bracket. However, this problem can be satisfactorily resolved by enacting an income averaging provision. Congress has adopted such provisions in the past when the tax brackets were more steeply progressive than today.[202]

In short the potential problems arising from the proposal are manageable. Once resolved, the proposed reform will result in a more equitable, rational and administrable law.

[202] *See* I.R.C. §§ 1301–1305, *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117. *See also* S. REP. NO. 99-313, at 45 (1986), *reprinted in* 1986-3 C.B. 45 (stating that reason for repeal of the income averaging provisions was the "significantly flatter rate structure" under the Tax Reform Act).