Pace Law Review

Volume 16
Issue 1 *Fall 1995*
Domestic Violence and the Law Symposium

Article 8

September 1995

The Taxation of Punitive Damages: Recent Interpretation of the Section 104(a)(2) Exclusion

Wendy S. Kennedy

Recommended Citation
Wendy S. Kennedy, *The Taxation of Punitive Damages: Recent Interpretation of the Section 104(a)(2) Exclusion*, 16 Pace L. Rev. 111 (1995)
DOI: https://doi.org/10.58948/2331-3528.1338
Available at: https://digitalcommons.pace.edu/plr/vol16/iss1/8

Comment

The Taxation of Punitive Damages: Recent Interpretation of the Section 104(a)(2) Exclusion

I. Introduction

In recent years, a controversy has arisen concerning the taxation of punitive damage awards received in personal injury suits. Congress has failed to provide the guidance necessary for

the courts to decide the tax consequences of damage recoveries.[1] Courts have thus been forced to create their own law in this area through interpretation of the Internal Revenue Code[2] [hereinafter I.R.C.] and the Treasury Regulations.[3] Unfortunately, this has led to a recent split among the circuits.[4]

Courts have attempted to provide results that seem most "fair" and reasonable based on theories of taxation and the plain language of the statutes.[5] However, these attempts have led to increased controversy.[6] Congress has attempted to eliminate some of the sources of that controversy, but has only succeeded in creating new issues and renewing the old.[7]

The purpose of this Comment is to provide some guidance in the area of taxation of punitive damages. Section II provides an introduction into the controversy surrounding the taxation of punitive damage recoveries in personal injury cases. Section III explores the background of the I.R.C. § 104(a)(2) exclusion, including a thorough examination of the legislative history, Internal Revenue Service Rulings,[8] and case law interpreting the exclusion. Section IV explores recent judicial interpretation of the § 104(a)(2) exclusion. The cases discussed demonstrate the split among the circuit courts of appeals as well as the reasons for that divergence. Section V discusses the recent amendment to § 104(a)(2) and the legislative history behind this new amendment. Finally, Section VI presents the current status of the law and predicts the future of the exclusion. This section discusses the issues that are still lingering from the pre-

---

1. *See infra* notes 23-24 and accompanying text.
2. 26 U.S.C. (1994).
3. Treasury Regulations are the interpretations by the Treasury of the Internal Revenue Code. JOSEPH M. DODGE, CASES & MATERIALS ON FEDERAL INCOME TAXATION - PRINCIPLES, POLICY, PLANNING 41 (1985). These regulations are presumed to be correct and are observed by most courts to the extent that they do not conflict with the actual wording of the relevant Internal Revenue Code sections. MICHAEL D. ROSE & JOHN C. CHOMMIE, FEDERAL INCOME TAXATION 9 (3d ed. 1988).
4. *See* discussion *infra* part IV.B.
5. *See infra* parts III.C., IV.
6. *See infra* part II.
7. *See* discussion *infra* part V.
8. Internal Revenue Service Rulings are opinions issued by the Internal Revenue Service which "describe a hypothetical fact situation, state a result, and briefly provide reasons [for the result]." DODGE, *supra* note 3, at 43. These rulings are not binding upon the courts but do provide some guidance to the public and the I.R.S. staff regarding how the I.R.S. views particular legal tax issues. *Id.*

amended statute[9] as well as new issues that have arisen due to the 1989 amendment.[10]

This Comment concludes that the most reasonable interpretation of the § 104(a)(2) exclusion is that the plain meaning of the words of the statute should prevail. For cases that arose before 1989, Congress has shown no intention to exclude compensatory damages while allowing punitive damage awards to be taxed.[11] Furthermore, the recent amendment provides a basis for the belief that punitive damage awards will be given "excludable" status where the case involves physical injury or physical sickness.[12]

II. The Controversy

During the past several decades, courts have analyzed what types of damage awards should be includable in gross income[13] and what amounts are entitled to exclusion from gross income.[14] The most obvious starting point is § 61 of the Internal Revenue Code.[15] This section defines gross income as "all in-

9. I.R.C. § 104(a)(2) (1954).

10. The Amendment referred to is the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a)(2) (1994)). *See* discussion *infra* part V.

11. *See infra* notes 270-72 and accompanying text.

12. *See infra* notes 29-30 and accompanying text. *See also infra* notes 298-304 and accompanying text.

13. *See infra* note 17, discussing the Supreme Court's definition of gross income.

14. *See, e.g.*, Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 432 (1955) (holding that the punitive damages portion of a recovery was taxable gain to the taxpayer); Commissioner v. Miller, 914 F.2d 586, 591 (4th Cir. 1990) (finding that punitive damages were not excludable under § 104(a)(2) since they represented a "windfall" to the plaintiff); Roemer v. Commissioner, 716 F.2d 693, 700 (9th Cir. 1983) (holding that a lump sum recovery in a defamation suit was excludable from gross income since it was received on account of "personal injury"); Kemp v. Commissioner, 771 F. Supp. 357, 359 (N.D. Ga. 1991) (concluding that the punitive damages portion of a settlement of a 42 U.S.C. § 1983 action comprises gross income under § 104(a)(2)); Estate of Moore v. Commissioner, 67 T.C.M. (CCH) 1925 (1994) (holding that punitive damages received in settlement of a lawsuit for malicious prosecution and invasion of privacy are excludable from gross income), *rev'd*, 53 F.3d 712 (5th Cir. 1995); Threlkeld v. Commissioner, 87 T.C. 1294, 1309 (1986) (holding that damages received in settlement of a claim for malicious prosecution of a civil proceeding are received on account of "personal injuries" and are therefore excludable under § 104(a)(2)).

15. I.R.C. § 61 (1994).

come from whatever source derived."[16] By plain meaning, this section would include amounts received as a punitive damage award through a lawsuit or settlement.[17] Congress, however, has carved out certain exceptions to taxable income.[18] One such exception is I.R.C. § 104(a)(2), entitled "Compensation for Injuries or Sickness."[19] This section provides that "gross income does not include . . . the amount of any damages received (whether by suit or agreement . . .) on account of personal injuries or sickness."[20]

The § 104(a)(2) exclusion refers only to "any damages received" and does not specify any particular type of damage award.[21] Since Congress has not interpreted the parameters of

16. I.R.C. § 61(a) (1994).

17. This section of the Internal Revenue Code was intended to be applied broadly. Helvering v. Clifford, 309 U.S. 331, 334 (1940) (citing Helvering v. Midland Mutual Life Ins. Co., 300 U.S. 216 (1937)). The Supreme Court has stated that gross income includes all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Since a punitive damage award received through a lawsuit or a settlement of a lawsuit would yield an accession to wealth, such an award would be taxable under § 61. *Id.*

18. All of these exclusions are found in I.R.C. §§ 71-130 (1994). DODGE, *supra* note 3, at 1. They consist of:

(1) Non-alimony payments (e.g., child support) received by one spouse from another following a separation or divorce (§ 71).
(2) The proceeds of life insurance (§ 101(a)).
(3) Gifts and bequests received (§ 102(a)).
(4) Interest received on state and local bonds (§ 103).
(5) Insurance and damage recoveries for personal injuries and sickness (§ 104).
(6) The first $100 of dividends on aggregate corporate stock received during a year (§ 116).
(7) Scholarship and fellowship awards (§ 117).
(8) The first $125,000 of net profits from the sale of a personal residence after attaining the age of 55 (§ 121).
(9) Foreign "earned" income of Americans working abroad (§ 911).
(10) Certain (but by no means all) "fringe benefits" provided by employers to employees (see, e.g., § 79, 105, 106, 119, 125, and 132).

Id. at 1-2.

19. I.R.C. § 104(a)(2) (1994).

20. *Id.*

21. The term "any damages" has been interpreted differently by several courts. *See infra* parts III.C.2-3, IV.B. Nowhere does it differentiate between compensatory damages, punitive damages, or nominal damages received on account of personal injury. This has lead several commentators to analyze Congress' intent. *See, e.g.*, Paul C. Feinberg, *Federal Income Taxation of Punitive Damages Awarded*

this exclusion, several courts, faced with the task of interpretation, have determined that the exclusion applies to any damages—compensatory, punitive and nominal[22]—that are received on account of personal injury.[23] However, other courts have perceived the exclusion to apply only to damages that are received as compensation for personal injury.[24]

Due to the disparity in judicial interpretations of the § 104(a)(2) exclusion, Congress amended the section in 1989 by adding the sentence: "[the exclusion] shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."[25] This amendment explicitly made punitive damages received in a non-physical injury suit includable in the gross income of the taxpayer. However, the "double-negative" language of the amendment has left intact much of the controversy created by the original version of this section.[26]

---

in Personal Injury Actions, 42 CASE W. RES. L. REV. 339 (1992); James D. Egleston, *Taxation of Punitive Damage Awards From Personal Injury Actions: Should the Section 104(a)(2) Exclusion Apply?*, 20 OHIO N.U.L. REV. 117 (1993).

22. These three types of damages are distinguished as follows:

> Compensatory damages are such as will compensate the injured party for the injury sustained, and nothing more; such as will simply make good or replace the loss caused by the wrong or injury. . . .
>
> [Punitive] damages are damages on an increased scale, awarded to the plaintiff over and above what will barely compensate him for his property loss, where the wrong done to him was aggravated by circumstances of violence, oppression, malice, fraud, or wanton and wicked conduct on the part of the defendant. . . .
>
> Nominal damages are a trifling sum awarded to a plaintiff in an action, where there is no substantial loss or injury to be compensated, but still the law recognizes a technical invasion of his rights or a breach of the defendant's duty, or in cases where, although there has been a real injury, the plaintiff's evidence entirely fails to show its amount.

BLACK'S LAW DICTIONARY 390-92 (6th ed. 1990).

23. *See, e.g.*, Estate of Moore v. Commissioner, 67 T.C.M. (CCH) 1925 (1994), *rev'd*, 53 F.3d 712 (5th Cir. 1995); Robinson v. Commissioner, 102 T.C. 116 (1994); Horton v. Commissioner, 100 T.C. 93 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994).

24. *See, e.g.*, Wesson v. United States, 48 F.3d 894 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Reese v. United States, 24 F.3d 228 (D.C. Cir. 1994); Kemp v. Commissioner, 771 F. Supp. 357 (N.D. Ga. 1991).

25. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989) (codified as amended at I.R.C. § 104(a)). *See* discussion *infra* part V.

26. *See infra* text accompanying note 268.

In addition, new issues have also arisen involving the excludability of punitive damages where there is physical injury involved. First, the amendment did not settle the controversy over whether punitive damages may always be excluded in cases involving physical injury or sickness.[27] The negative language of the amendment has lead to confusion on this issue.[28] It is possible, by negative inference, that punitive damages received where there is physical injury are excludable from gross income.[29] On the other hand, it is also possible that the § 104(a)(2) exclusion must be applied as it always has been, except where there is no physical injury.[30]

Second, it is not clear whether punitive damages are excludable where there is no claim for physical injury yet there are manifestations of physical injury.[31] Solving this problem will require a thorough analysis of the word "involving" as used in the amendment.[32] Finally, courts will have to determine the

---

27. Although no cases have yet come up under the amended version of § 104(a)(2), it is clear that the controversy has not been settled by the amendment since the amendment does not explicitly state when punitive damages can or cannot be excluded from gross income, with the exception of cases that do not involve physical injury or sickness. *See infra* part VI.B.

28. Many commentators have come to different conclusions in their interpretation of the amendment. *See, e.g.*, Feinberg, *supra* note 21; Egleston, *supra* note 21; Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 TAX LAW. 783 (1992); Day, *Taxation of Punitive Damages: Interpreting Section 104(a)(2) after the Revenue Reconciliation Act of 1989*, 66 WASH. L. REV. 1019 (1991); Jaeger, *Taxation of Punitive Damage Awards After the Revenue Reconciliation Act of 1989*, 68 TAXES 368 (1990).

29. Although no judicial interpretation of the amendment has yet occurred, some commentators have found that the amendment requires exclusion of punitive damages where there is physical injury or sickness. *See* David G. Jaeger, *Taxation of Punitive Damage Awards: The Continuing Controversy*, 57 TAX NOTES 109 (1992).

30. At least one commentator has adopted this second viewpoint. Egleston, *supra* note 21, at 119. This view requires the assumption that Congress did not intend punitive damages from physical injury actions to ever be covered by the 104(a)(2) exclusion. Thus, the courts are free to interpret the exclusion as they always have, as if there were no amendment. *Id.*

31. An example of this problem would be a defamation suit. The tort of defamation itself is not a physical injury cause of action; rather, it involves injury to reputation. However, there may be physical manifestations of injury such as pain and suffering, emotional distress, or physical symptoms which result from emotional distress. *See* Jaeger, *supra* note 29, at 115.

32. Courts should resolve whether a case "involving" physical injury requires that the claim itself be one for physical injury, or that there simply be some physi-

effects of the amendment on liquidated damage[33] awards resulting from discrimination suits.[34]

Although the 1989 amendment did settle some of the controversy, the courts will still have to deal with many of the pre-amendment issues since cases under the pre-amended § 104(a)(2) are still being adjudicated.[35] The courts therefore must rely on their own reasoning and the reasoning of the courts that have already interpreted the pre-amended section. Thus, the controversy involving the pre-amended section remains.

III. History of the § 104(a)(2) Exclusion

This section discusses the history behind the § 104(a)(2) exclusion from gross income. First to be addressed is the legislative history of the statute from the first internal revenue acts until the present status of the exclusion. Various Internal Revenue Service rulings that have been relevant to this issue are also explored. Finally, the case law in this area will be

---

cal injury accompanying the claim. Since no cases have been brought thus far dealing with this issue, courts will have to rely on their own judgment.

33. Liquidated damages is the term applicable when

> the amount of damages has been ascertained by the judgment in the action, or when a specific sum of money has been expressly stipulated by the parties to a bond or other contract as the amount of damages to be recovered by either party for a breach of the agreement by the other.

BLACK'S LAW DICTIONARY 391 (6th ed. 1990). In the context of a discrimination suit, liquidated damages are available in cases of willful discrimination. Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994).

34. In the past, liquidated damage awards have been a source of controversy. Some courts have found that liquidated damages serve a compensatory function and are therefore excludable from income under § 104(a)(2). *See, e.g.*, Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994); Downey v. Commissioner, 97 T.C. 150 (1991), *rev'd*, 33 F.3d 836 (7th Cir. 1994).

Other courts, however, have found that liquidated damages serve as a punishment to the tortfeasor and are therefore not excludable from gross income. *See, e.g.*, Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994).

35. Although the amendment was passed in 1989, the cases that have appeared thus far still require the application of the pre-amended statute. The reason for this seemingly confusing treatment is the second section of the amendment which gives the amendment future effect only. *See* Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(b), 103 Stat. 2106, 2379 (1989). This section states that "the amendment . . . shall apply to amounts received after July 10, 1989." *Id.* Since the cases that have been brought thus far involved amounts received prior to July 10, 1989, the amended section 104(a)(2) has not been analyzed.

presented in order to provide a basis for the present rulings on the issue.

A. *The Statutory History of I.R.C. § 104(a)(2)*

Although the statutory history in this area is scarce, Congress has provided some guidance in dealing with the exclusion of damages from gross income. Congress first addressed the exclusion in the Revenue Act of 1918.[36] This statute stated that "gross income . . . does not include . . . amounts received . . . as compensation for personal injury or sickness . . . [or] any damages received . . . on account of such injuries or sickness."[37] Although Congress provided some interpretive guidance merely by creating the Act, this section of the Act was, nevertheless, still filled with many ambiguities. Most obvious was the Act's failure to address punitive damages. In fact, only the first part of this section refers to damages received as *compensation* for injury or sickness.[38] The statute did not explicitly state whether the term "any damages" in the second part of the section included punitive damages. It was therefore unclear whether those damages had to be compensatory in nature. Furthermore, the "on account of" language received no explanation and so constituted a source of further confusion. This language was retained in later versions of the statute and the confusion has therefore persisted until the present time.[39]

This first statutory interpretation was subsequently codified in 1939[40] without revision. The statute was recodified in 1954 as § 104(a) of the Internal Revenue Code.[41] This version actually split section 213(b)(6) of the 1918 Act into two separate sections of § 104(a).[42] Section 104(a)(1) incorporated the first part of § 213(b)(6) regarding amounts received under work-

36. Revenue Act of 1918, Pub. L. No. 254, § 213(b)(6), 40 Stat. 1057, 1065-66 (1918).

37. *Id.*

38. *Id.*

39. The present version of the statute is codified in I.R.C. § 104(a)(2) (1994). Although the statute has changed somewhat from its original version, the "on account of" language has remained as it was in the Revenue Act of 1918. *See* I.R.C. § 104(a)(2) (1994).

40. I.R.C. § 22(b)(5) (1939).

41. I.R.C. § 104(a) (1954).

42. *Id.* The 1954 version of this exclusion is virtually identical to the present I.R.C. § 104. *See supra* text accompanying note 20.

men's compensation acts,[43] while § 104(a)(2) incorporated the second part regarding receipt of damages on account of personal injury.[44] The 1954 version, however, eliminated the "compensation" language of § 213(b)(6) and left the courts to determine the meaning of "any damages" and "on account of." Unfortunately, this new version did little to settle the controversy surrounding the exclusion.[45] On the contrary, it created even greater controversy over whether punitive damages should be excluded from gross income under the new statute.[46]

The statute has been recodified several times since 1954 but the language remained unchanged until the 1989 amendment.[47] The new amendment was part of the Omnibus Budget Reconciliation Act of 1989.[48] Congress amended § 104(a)(2) to read: "[this section] shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."[49]

B. *Relevant Internal Revenue Service Rulings*

The Internal Revenue Service has made several Revenue Rulings concerning the § 104(a)(2) gross income exclusion.[50] Although the I.R.S. has "flip-flopped" on its approach to this is-

43. I.R.C. § 104(a)(1) (1954).

44. I.R.C. § 104(a)(2) (1954).

45. Since the 1954 codification merely split § 22(b)(5) of the 1939 code into two subsections of § 104, the 1954 version had little effect on the statute itself.

46. Due to the use of the word "compensation," it is not clear whether the 1939 version limited the exclusion to compensatory damages in the first part of § 22(b)(5). There is no relevant interpretation of the exclusion that explains whether it was intended to encompass punitive damage recoveries.

However, when the 1954 code was created, § 104(a)(2) did not include the word "compensation." The word "compensation" only appeared in § 104(a)(1). Congress thus increased the ambiguity of the exclusion for damages received for injuries or sickness by eliminating wording that might have provided some guidance in this area. If the word "compensation" had appeared in § 104(a)(2) also, the present controversy might have been avoided.

47. The Amendment referred to is the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a)(2) (1994)). *See infra* part V for further discussion of the Act.

48. Omnibus Budget Reconciliation Act § 7641(a), 103 Stat. at 2379.

49. *Id.* Since the present focus is on the historical background of the § 104(a)(2) exclusion, this amendment will be thoroughly discussed in part V of this article.

50. *See supra* note 8 for a discussion of the significance of Revenue Rulings.

sue over the years, its analysis provides some guidance in this area.[51]

The first such ruling was made in 1975.[52] In Revenue Ruling 75-45, the I.R.S. addressed the issue of whether an amount received from an insurance company by the executor of the estate of a decedent was excludable from the gross income of the estate under § 104(a)(2) of the 1954 I.R.C.[53] This case concerned a decedent who was killed in a plane crash and whose estate received a settlement from the carrier's liability insurance.[54] In deciding whether this amount was excludable from the taxpayer's gross income, the Service found that § 104(a)(2) referred to "any damages received . . . *on account of* personal injuries or sickness."[55] Therefore, any damages, "whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income."[56] The Service's determination was based upon Revenue Ruling 58-578[57] which explained that:

> Where a contract between an insurance company and the owner of an airplane provides for the payment of specified amounts to a person injured in such plane or to such person's beneficiary . . . upon the execution of a release of all claims for damages against the insured, such amounts are damages under § 104(a)(2) of the Code, and, as such, are excludable from gross income of the recipient.[58]

The Service concluded that the amount received was excludable from the estate's gross income under § 104(a)(2).[59]

---

51. *See infra* note 211 and accompanying text.

52. Rev. Rul. 75-45, 1975-1 C.B. 47. Although this ruling was later revoked by Revenue Ruling 84-108, 1984-2 C.B. 32, it is instructive in that it allowed for the exclusion of punitive damages from gross income. *See infra* text accompanying notes 60-70.

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

54. *Id.* The liability insurance required that the decedent's beneficiary execute a full release of all claims for wrongful death against the insured. *Id.*

55. *Id.*

56. *Id.*

57. Rev. Rul. 58-578, 1958-2 C.B. 38.

58. Rev. Rul. 75-45, 1975-1 C.B. at 47 (citing Rev. Rul. 58-578, 1958-2 C.B. 38).

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

Nine years later, the I.R.S. reversed its position, revoking Revenue Ruling 75-45.[60] In Revenue Ruling 84-108, the I.R.S. found that amounts received by a surviving spouse and child in consideration of the release from liability under a wrongful death act, which provided exclusively for payment of punitive damages, are includable in their gross incomes.[61]

This ruling also involved a death caused by a plane crash for which the decedent's spouse and child received a sum from the aircraft liability insurance policy.[62] This policy required the estate to release all claims for wrongful death.[63] In determining whether this sum was taxable, the I.R.S. first looked to the nature of a wrongful death claim under applicable state law[64] and found that it was purely punitive in nature.[65] The Service then looked to the Supreme Court's decision in *Commissioner v. Glenshaw Glass Co.*[66] which held that punitive damages received in an antitrust case and in a fraud case represented accessions to wealth and, as such, were includable in gross income.[67]

The Service also looked to the Ninth Circuit's decision in *Starrels v. Commissioner*[68] in determining that punitive dam-

60. Rev. Rul. 84-108, 1984-2 C.B. at 32. The most probable explanation for the Service's reversal on this issue is the Supreme Court's decision in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). *See* discussion *infra* text accompanying notes 66-67 and part III.C.1.

61. Rev. Rul. 84-108, 1984-2 C.B. at 34.

62. *Id.* at 33.

63. *Id.*

64. *Id.* Treasury Regulations require that the Service examine the nature of the state law since payments made under a policy in lieu of prosecution of a suit for damages constitute damages received within the meaning of § 104(a)(2). *Id. See* Treas. Reg. § 1.104-1(c) (1994).

65. Rev. Rul. 84-108, 1984-2 at 33. The wrongful death act in Alabama provides exclusively for the payment of punitive damages. ALA. CODE § 6-5-410, ¶ IV (1993). Thus, the damages are determined according to the degree of fault of the tortfeasor, rather than according to the amount necessary to compensate the survivors for loss sustained. Rev. Rul. 84-108, 1984-2 C.B. at 33.

The Internal Revenue Service pointed out that a different situation would arise where the state wrongful death statute provides for purely compensatory damages. *Id.* Amounts received due to wrongful death in these states would be excluded from gross income under § 104(a)(2) because they serve to compensate the survivors for their actual loss sustained by reason of the wrongful death. *Id.*

66. 348 U.S. 426 (1955). *See infra* part III.C.I.

67. Rev. Rul. 84-108, 1984-2 C.B. at 33-34 (citing *Glenshaw Glass*, 348 U.S. at 431).

68. 304 F.2d 574 (9th Cir. 1962). *See infra* note 124.

ages are not awarded "on account of personal injury" because they do not restore loss of capital and are determined with reference to the defendant's degree of fault.[69] Based upon these court decisions, the I.R.S. concluded that the damages awarded in this case were punitive in nature and therefore not excludable from gross income under § 104(a)(2).[70]

The Service revised the compensatory/punitive damages distinction in Revenue Ruling 85-98.[71] In this case, the taxpayer received a lump-sum settlement of a libel suit for injury to personal reputation.[72] The Service confirmed that the portion of a settlement which represented compensatory damages was excludable from gross income under § 104(a)(2), while the portion considered to be punitive damages was includable in the taxpayer's gross income under § 61 of the Internal Revenue Code.[73]

The Internal Revenue Service has thus made clear its view that punitive damages are "accessions to wealth" under *Glenshaw Glass* and are therefore not excludable from gross income under § 104(a)(2). However, the I.R.S.'s absolute reversal in its approach towards the taxation of punitive damage awards may be indicative of its future indecisiveness regarding this issue.

C. *Cases Interpreting the Personal Injury Damages Exclusion*

Over the years, several courts have interpreted the § 104(a)(2) exclusion.[74] Rather than achieving a consistent approach to the exclusion, these decisions have created even greater controversy. However, the reasoning employed in these cases is instructive in determining the present status of the exclusion.

---

69. Rev. Rul. 84-108, 1984-2 C.B. at 34.

70. *Id.*

71. Rev. Rul. 85-98, 1985-2 C.B. 51.

72. *Id.* at 51.

73. *Id.* at 52. Section 61 of the Internal Revenue Code states that "gross income means all income from whatever source derived." I.R.C. § 61(a) (1994). Any such income is considered to be gross income unless an exception is specifically provided for elsewhere in the Code. Commissioner v. Glenshaw Glass, 348 U.S. 426, 430 (1955). *See also supra* notes 15-18 and accompanying text.

74. *See, e.g.*, Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990); Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983); O'Gilvie v. United States, No. CIV.A.90-1075-B, 1992 U.S. Dist. LEXIS 13307 (D. Kan. Aug. 26, 1992).

1. Commissioner v. Glenshaw Glass Co.[75]

The Supreme Court first addressed the taxation of punitive damages in *Commissioner v. Glenshaw Glass Co.*[76] The issue before the Court was "whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income under § 22(a) of the Internal Revenue Code of 1939."[77]

In *Glenshaw*, the Glenshaw Glass Company asserted claims against Hartford-Empire Company for exemplary damages for fraud and treble damages for injury to its business due to Hartford's violation of the federal antitrust laws.[78] The parties settled for approximately $800,000.[79] Glenshaw did not report this amount as gross income and the Commissioner determined a deficiency.[80] The Commissioner then instituted suit.[81]

---

75. 348 U.S. 426 (1955).

76. *Id.* This case is actually a consolidation of two cases, Glenshaw Glass Co. v. Commissioner, 18 T.C. 860 (1952), *aff'd*, 211 F.2d 928 (3rd Cir. 1954), *rev'd*, 348 U.S. 426 (1955), and William Goldwin Theatres, Inc. v. Commissioner, 19 T.C. 637 (1953), *aff'd sub nom.* Commissioner v. Glenshaw Glass Co., 211 F.2d 928 (1954), *rev'd*, 348 U.S. 426 (1955). Since these cases have similar factual backgrounds, only the facts of *Glenshaw Glass*, 18 T.C. 860 (1952) will be discussed here.

77. 348 U.S. at 427. Section 22(a) of the Internal Revenue Code of 1939, I.R.C. § 22(a) (1939), is equivalent to the present Internal Revenue Code § 61(a). *See supra* notes 15-17. Both state in relevant part that "gross income includes income derived from any source whatever." I.R.C. § 61(a) (1994). *See* I.R.C. § 22(a) (1939).

78. 348 U.S. at 427-28.

79. *Id.* at 428.

80. *Id.* There are two methods by which a suit may come to the tax court to be resolved. JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION, at 28-29 (8th ed. 1994). The first is that which is represented in this case: a taxpayer may fail to report a certain amount on his income tax return. *Id.* at 28. The Commissioner may then determine a deficiency and bring suit in the Tax Court to collect the deficient amount. *Id.*

The second method occurs when a taxpayer reports an amount as income on his tax return, or pays an amount asserted as a deficiency by the Commissioner. *Id.* at 29. He may then later file an administrative claim for a refund for an amount he deems to have been overpayment. *Id.* If the Commissioner disallows this refund, the taxpayer may then bring suit in the Tax Court or the district court in order to recover that amount. *Id.*

81. 348 U.S. at 428.

The Tax Court determined that $324,529.94 represented punitive damages.[82] Both the Tax Court and the Court of Appeals determined that the entire settlement amount was excludable by the taxpayer.[83] To resolve recent controversy that had developed in this area, the Supreme Court granted certiorari.[84]

The Court noted that the language used in section 22(a) "was used by Congress to exert . . . the 'full measure of its taxing power.' "[85] Also, the Court noted that Congress intended "to tax all gains except those specifically exempted."[86] The Court found that in this case there were "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients."[87]

The Court also determined that the amount of the settlement representing punitive damages could not be considered a gift and did not fall within any of the other exceptions set forth in the Internal Revenue Code.[88] The Court concluded that the punitive damages portion of the recovery was therefore taxable income to the taxpayer.[89]

The most noticeable omission from this case was a discussion of the exclusion for damages received on account of personal injury. Although the exclusion for damages received due to personal injury or sickness had already been codified by 1955,[90] the Court did not consider the exclusion in this case. Still, the analysis by the Court in *Glenshaw* provides useful in-

82. *Id.*
83. *Id.* at 427-28.
84. 348 U.S. 813 (1954).
85. 348 U.S. at 429 (citation omitted). *See supra* note 77.
86. 348 U.S. at 430 (citing Commissioner v. Jacobson, 336 U.S. 28, 49 (1949)).
87. *Id.* at 431.
88. *Id.* at 432. Punitive damages cannot be considered gifts. The Supreme Court has stated that "a gift . . . proceeds from a detached and disinterested generosity." Commissioner v. Duberstein, 363 U.S. 278, 285 (1960) (citation omitted). Certainly, punitive damages are not given through disinterested generosity on the part of the payor. *See also supra* note 18 for discussion of other exclusions from gross income.
89. 348 U.S. at 432.
90. *See supra* note 41 and accompanying text.

sight into the theories of taxation and also provides the basis for many later court decisions regarding the taxation of punitive damages.

2. Roemer v. Commissioner[91]

In *Roemer v. Commissioner*, the Court of Appeals for the Ninth Circuit was presented with the issue of whether the lump sum recovery under a defamation suit, which included both compensatory and punitive damages, was excludable from gross income under § 104(a)(2).[92] The taxpayer, Paul Roemer, owned an insurance business.[93] After the Retail Credit Company issued a defamatory credit report which caused Roemer to be denied an insurance license, Roemer brought suit for libel in California.[94] The jury awarded both compensatory and punitive damages.[95] Roemer reported only a portion of the damage award as income on his 1975 tax return and the Commissioner determined a deficiency.[96]

The Tax Court found that the compensatory damages were includable in gross income because they were not received due to personal injury.[97] The court also found that the punitive damages were includable as "accessions to wealth" since the compensatory damages were intended to reimburse the taxpayer for injury to his professional reputation.[98] Thus the Tax Court concluded that the entire recovery was taxable and did not fall within the § 104(a)(2) exclusion.[99]

The Court of Appeals for the Ninth Circuit reversed the decision of the Tax Court.[100] The court first looked to the nature of the underlying tort action to determine if the award should be included in gross income.[101] It stated that "[t]he relevant distinction that should be made is between personal and nonper-

91. 716 F.2d 693 (9th Cir. 1983).
92. *Id.* at 696.
93. *Id.* at 694.
94. *Id.* at 695.
95. *Id.*
96. *Id.*
97. Roemer v. Commissioner, 79 T.C. 398, 407 (1982).
98. *Id.* at 408.
99. *Id.* at 407-08.
100. *Roemer*, 716 F.2d at 701.
101. *Id.* at 697.

sonal injuries, not between physical and nonphysical injuries."[102] The court found that "[s]ince . . . the defamation of an individual is a personal injury under California law, the compensatory damages received . . . are excludable from gross income under § 104(a)(2), as would be the compensatory damages received on account of any personal injury."[103]

The court stated that normally punitive damages are not excludable from gross income under the analysis of *Commissioner v. Glenshaw Glass*.[104] However, the court looked to Revenue Ruling 75-45[105] and stated that "the Commissioner liberally interprets § 104(a)(2) to exclude punitive damages as well as all compensatory damages where there has been a personal injury."[106] The court therefore concluded that the punitive damages received by Roemer on account of his "personal injury" in this case were excludable from gross income under § 104(a)(2).[107]

3. Commissioner v. Miller[108]

In *Commissioner v. Miller*, the Court of Appeals for the Fourth Circuit was faced with the issue of whether the punitive damages portion of a defamation suit settlement is excludable from gross income under § 104(a)(2).[109] In this case, the taxpayer "obtain[ed] a large settlement of two lawsuits brought for defamation and intentional infliction of emotional distress."[110]

102. *Id.*

103. *Id.* at 700. The court was referring to section 45 of the California Civil Code which provides that: "Libel is a false and unprivileged publication by writing, printing, picture, effigy, or other fixed representation to the eye, which exposes any person to hatred, contempt, ridicule, or obloquy, or which causes him to be shunned or avoided, or which has a tendency to injure him in his occupation." CAL. CIV. CODE § 45 (West 1982).

104. 716 F.2d at 700. *See supra* part III.C.1.

105. Rev. Rul. 75-45, 1975-1 C.B. 47. *See supra* text accompanying notes 52-59.

106. 716 F.2d at 700. The court here actually steers around stare decisis by distinguishing the Supreme Court's holding in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). The court did note that the Supreme Court found punitive damages includable in gross income, but nonetheless distinguished *Glenshaw Glass* and chose to follow the Internal Revenue Service's ruling in Revenue Ruling 75-45, 1975-1 C.B. 47. *Roemer*, 716 F.2d at 700.

107. 716 F.2d at 700.

108. 914 F.2d 586 (4th Cir. 1990).

109. *Id.* at 587.

110. *Id.*

She did not include any of the settlement proceeds in her gross income and the Internal Revenue Service determined a deficiency for the entire amount.[111]

The Tax Court found the whole settlement to be excludable from gross income.[112] The court refused to draw distinctions between the kinds of personal injuries or the kinds of harm flowing from those injuries.[113] The court concluded that the "plain meaning" of § 104(a)(2) indicated that the exclusion applied to "any damages" and therefore that punitive damages should be excluded.[114] The court also interpreted the phrase "on account of" to suggest causation.[115] Since the punitive damages were on account of the personal injury, they were excludable under § 104(a)(2).[116]

The Court of Appeals for the Fourth Circuit, however, reversed the Tax Court's decision.[117] The court found that "[a] punitive damages award 'does not attempt to compensate the plaintiff for harm suffered by him, but rather is exemplary in nature and is over and above any award of compensatory damages.' "[118] The court also found the "on account of" language of § 104(a)(2) to be ambiguous since it could mean either "but-for" causation or "sufficient causation."[119]

Because of the ambiguous nature of the statute, the court looked to extrinsic aids for interpretation.[120] First, it noted that "exclusions to income are to be construed narrowly."[121] Therefore, "[g]iven that § 104(a)(2)'s language is not plain . . . [a] more restrictive view of what kinds of damages are excludable from gross income under the section [must be adopted]."[122]

---

111. *Id.*

112. Miller v. Commissioner, 93 T.C. 330, 341 (1989).

113. *Id.* at 334-37.

114. *Id.* at 338.

115. *Id.* at 339.

116. *Id.* at 340-41.

117. 914 F.2d at 592.

118. *Id.* at 589 (citing Exxon Corp. v. Yarema, 516 A.2d 990, 997 (Md. Ct. Spec. App. 1986), *cert. denied*, 522 A.2d 392 (Md. 1987)).

119. *Id.* at 589-90. The distinction drawn between "but-for" and "sufficient" causation did not affect the court's holding, but merely provided a means by which the court could bring in extrinsic aids to interpretation.

120. *Id.* at 590.

121. *Id.* (citing Commissioner v. Jacobson, 336 U.S. 28, 49 (1949)).

122. *Id.*

Second, the court found that interpreting the § 104(a)(2) exclusion to apply only to compensatory damages comports better with the statute's underlying purpose.[123] The court observed that damages are only excludable from gross income because they restore a loss of capital.[124] Since punitive damages do not serve to make the plaintiff whole, § 104(a)(2) does not extend to this type of damages.[125] Thus, the court concluded that the punitive damages portion of the plaintiff's recovery was not excludable under § 104(a)(2) since it represented pure "windfall" to the plaintiff.[126]

IV. Recent Judicial Interpretation of the § 104(a)(2) Exclusion

In the past several years, courts have tried to define the parameters of the § 104(a)(2) exclusion. These courts have dealt with the excludability of punitive damages,[127] ADEA liqui-

---

123. *Id.*

124. *Id.* The court was referring to the Ninth Circuit's decision in Starrels v. Commissioner, 304 F.2d 574 (9th Cir. 1962). The Ninth Circuit found that "[d]amages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights—because, in effect, they restore a loss to capital." *Id.* at 576.

The "return of capital" theory was discussed by dissenting Justice Trott in Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 132 L. Ed. 2d (1995). He equated the theory to the concept of basis in tax law. *Id.* at 1087 (Trott, J., dissenting). "If I buy a property for $100 and sell it for $150, my $50 gain is taxable. My $100 basis, or return of capital, is not." *Id.* In applying this theory to punitive damage recoveries, punitive damages are not deemed to be a "return of capital" since they make a plaintiff more than whole. *Id.* Only damages received that serve to make the plaintiff whole are excludable from gross income. *Id.*

125. 914 F.2d at 590. The court referred to the Supreme Court's holding that "[p]unitive damages . . . cannot be considered a restoration of capital for taxation purposes." Commissioner v. Glenshaw Glass, 348 U.S. 426, 432 n.8 (1955). *See supra* part III.C.1.

126. 914 F.2d at 591. When this case again reached the Fourth Circuit on appeal (after being remanded), the court adhered to its prior ruling that "the portion of the settlement proceeds representing punitive damages was not entitled to the exclusion from gross income under 26 U.S.C. § 104(a)(2) . . . ." Miller v. Commissioner, No. 94-1383, 1995 U.S. App. LEXIS 16111, at *1 (4th Cir. Jun. 30, 1995). The court noted that it gave careful consideration to the Supreme Court's holding in United States v. Burke, 504 U.S. 229 (1992), in making its decision. *Id.* at *2.

127. *See, e.g.*, Wesson v. United States, 48 F.3d 894, 902 (5th Cir. 1995) (holding that "§ 104(a)(2) does not exclude noncompensatory punitive damages from gross income"); Horton v. Commissioner, 33 F.3d 625, 630 (6th Cir. 1994) (holding that where the underlying claim is one for personal injury, the full recovery is

dated damages,[128] and prejudgment interest.[129] Although these decisions are helpful in determining the excludability of damages in general, they will not be fully explored because the focus of this Comment is on the excludability of punitive damages. Presently there is no consensus among the courts on the excludability of punitive damages, but recent judicial decisions are instructive in predicting the future of the § 104(a)(2) exclusion.

A. United States v. Burke[130]

Although this case did not explicitly deal with the excludability of punitive damages, it gives meaningful insight into the treatment of the § 104(a)(2) exclusion. In *United States v. Burke*,[131] the Supreme Court determined whether payment received in settlement of a backpay claim under Title VII is excludable from gross income under § 104(a)(2) as "damages received . . . on account of personal injuries."[132] The taxpayers in *Burke* sought backpay and injunctive relief due to their employer's unlawful discrimination in the payment of salaries on the basis of sex.[133] The parties reached a settlement and federal income taxes were withheld from the amount of the award.[134]

---

excludable, including the punitive damages); Hawkins v. United States, 30 F.3d 1077, 1084 (9th Cir. 1994) (concluding that § 104(a)(2) does not exclude noncompensatory punitive damages), *cert. denied*, 115 S. Ct. 2576 (1995); Reese v. United States, 24 F.3d 228, 231 (D.C. Cir. 1994) (reasoning that Congress did not intend § 104(a)(2) to exclude noncompensatory punitive damages from gross income).

128. *See, e.g.*, Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994); Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994).

ADEA is the abbreviation for the Age Discrimination in Employment Act, 29 U.S.C. §§ 621-634 (1988).

129. *See, e.g.*, Brabson v. United States, 859 F. Supp. 1360 (D. Colo. 1994).

130. 504 U.S. 229 (1992).

131. *Id.*

132. *Id.* at 230. "Title VII of the Civil Rights Act of 1964 makes it an unlawful employment practice for an employer 'to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin.'" *Id.* at 237-38 (citing 42 U.S.C. § 2000e-2(a)(1) (1988)). If a violation was found, the Court could enjoin the discriminatory practice or award either reinstatement, backpay or other equitable relief. *Id.* at 238.

Title VII was later amended in 1991 to allow recovery of both compensatory and punitive damages in certain circumstances. Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071.

133. 504 U.S. at 231.

134. *Id.*

The plaintiffs brought a refund action for the amount withheld, claiming that the amount was excludable from gross income under § 104(a)(2).[135] The district court found that since the taxpayers obtained only backpay rather than compensatory or other damages, settlement proceeds were not excludable under § 104(a)(2).[136]

The Court of Appeals for the Sixth Circuit reversed.[137] The court stated that the exclusion under § 104(a)(2) turns on "whether the injury and claim are personal and tort-like in nature . . . ."[138] "If the answer is in the affirmative, then that is 'the beginning and end of the inquiry.' "[139] The court concluded that gender discrimination constituted a "tort-like, personal injury" and damages received for such injury were therefore excludable under § 104(a)(2).[140] It "rejected the Government's attempt to distinguish Title VII, which authorizes no compensatory or punitive damages, from other statutes thought to redress personal injuries."[141] The Supreme Court granted certiorari to "resolve [the] conflict among the [c]ourts of [a]ppeals concerning the exclusion of Title VII backpay awards from gross income under § 104(a)(2)."[142]

The Court, accepting the Sixth Circuit's approach to the issue, held that the backpay awards were not excludable under § 104(a)(2) since Title VII is not a tort-like cause of action.[143] In reaching this conclusion, the Court noted that Congress intended section 61(a)[144] to exert the full measure of its taxing

---

135. *Id.* at 232.

136. *Id.*

137. Burke v. United States, 929 F.2d 1119, 1124 (6th Cir. 1991).

138. *Id.* at 1121.

139. *Id.* at 1123. The court here relied on the Tax Court's ruling in Threlkeld v. Commissioner, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988). The court stated in *Threlkeld*:

> [W]hether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim and not to the consequences that result from the injury.

Id. at 1299 (citation omitted).

140. 929 F.2d at 1122.

141. 504 U.S. at 232 (citing United States v. Burke, 929 F.2d 1119, 1121-23 (6th Cir. 1991)).

142. *Id.* at 233.

143. *Id.* at 239-41.

144. I.R.C. § 61(a) (1992).

power and to bring within the definition of income any accession to wealth.[145] The question presented was whether Title VII discrimination constituted a "personal injury" under § 104(a)(2).[146] The Court agreed with the Sixth Circuit "insofar as it focused . . . on the nature of the claim underlying [the] damages award."[147] In order to come within the § 104(a)(2) exclusion, it must be shown that the legal basis for recovery was tort-like.[148]

The Court looked to the types of damages available in a Title VII claim to determine if the claim was tort-like.[149] It stated that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff 'fairly for injuries caused by the violation of his legal rights.' "[150] Thus, the availability of compensatory or punitive damages is an indication that a claim is tort-like.[151]

Applying this test, the Court found that since neither punitive nor compensatory damages were available under Title VII,[152] the claim was not tort-like.[153] Furthermore, "[n]othing in [the] remedial scheme [of Title VII] purports to recompense . . . the plaintiff for any of the other traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages."[154] Thus, the Court concluded, that since the claim did not redress a tort-like personal injury within the meaning of § 104(a)(2), the entire settlement was includable in gross income.[155]

---

145. 504 U.S. at 233. The Court looked to Helvering v. Clifford, 309 U.S. 331, 334 (1940), and Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

146. 504 U.S. at 237.

147. *Id.*

148. *Id. See also* Treas. Reg. § 1.104-1(c) (1994) (stating that "the term 'damages received' . . . means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights . . . .").

149. 504 U.S. at 237 n.7.

150. *Id.* at 235 (citing Carey v. Piphus, 435 U.S. 247, 257 (1978)).

151. *Id.* at 240.

152. At the time of the *Burke* decision, only backpay and equitable relief were available under Title VII. 42 U.S.C. § 2000e-5(g) (1988) (amended 1991). *See supra* note 132 for text of Title VII.

153. 504 U.S. at 241.

154. *Id.* at 239.

155. *Id.* at 241-42. The Court did note, however, that "discrimination could constitute a 'personal injury' . . . if the relevant cause of action evidenced a tort-like conception of injury and remedy." *Id.* at 239. The Court provided the example of 42 U.S.C. § 1981 (1991), which "permits victims of race-based employment discrimination to obtain a jury trial at which 'both equitable and legal relief, including

The *Burke* case has provided a test to be used in Title VII cases. However, the Supreme Court did not expressly address punitive damages in its decision. This has led to confusion in the interpretation of the *Burke* decision and its applicability to other cases.

B. *The Recent Circuit Split in Cases Involving Purely Punitive Damages*

There is currently a split among the courts of appeals regarding the exclusion of punitive damages under § 104(a)(2).[156] Although the pre-amended version of § 104(a)(2) applied[157] in all of these cases, the decisions are instructive in determining the future of the recently amended § 104(a)(2) exclusion and its interpretation.

1. Horton v. Commissioner[158]

In *Horton v. Commissioner*, the taxpayers suffered personal injuries when a gas leak caused their home to explode.[159] The jury awarded the taxpayers both compensatory and punitive damages.[160] The taxpayers excluded the punitive damage award from their gross income on their 1985 tax return and the Commissioner determined a deficiency.[161] They filed a petition with the Tax Court for a redetermination of the deficiency.[162]

---

compensatory and, under certain circumstances, punitive damages' may be awarded." *Id.* at 240 (citing Johnson v. Railway Express Agency, Inc., 421 U.S. 454, 460 (1975)).

156. On one side of the split, the Sixth Circuit in Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994), has found punitive damages to be excludable from gross income under § 104(a)(2). The only other circuits to decide this issue have found punitive damages to be includable in the taxpayer's gross income. *See* Wesson v. United States, 48 F.3d 894 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Reese v. United States, 24 F.3d 228 (D.C. Cir. 1994); Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990).

157. The 1989 amendment to § 104(a)(2) was not applicable because the cases dealt with amounts received prior to July 10, 1989. In the amendment, Congress provided that "[t]he amendment . . . shall apply to amounts received after July 10, 1989, in taxable years ending after such date." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(b)(1), 103 Stat. 2106, 2379 (1989). *See infra* part V for discussion of the Act.

158. 33 F.3d 625 (6th Cir. 1994).

159. *Id.* at 626.

160. *Id.*

161. *Id.*

162. *Id.*

The Tax Court determined that the punitive damages were excludable under § 104(a)(2).[163] The court reaffirmed its holding in *Miller v. Commissioner*[164] that "[t]he plain meaning of the broad statutory language [of § 104(a)(2)] simply does not permit a distinction between punitive and compensatory damages."[165] Therefore, the court held that the "any damages" language in § 104(a)(2) includes punitive damages.[166] In addition, the court stated that:

> The beginning and end of the inquiry should be whether the damages were paid on account of "personal injuries." This inquiry is answered by determining the nature of the underlying claim. Once the nature of the underlying claim is established as one for personal injury, any damages received on account of that claim, including punitive damages, are excludable.[167]

The Tax Court also noted that the Supreme Court's analysis in *Burke*[168] established that "punitive damages are not merely an incidental result of a personal injury claim . . . . [since] they are 'inextricably bound up' with the concept of tort type rights."[169] "As one of the hallmarks of traditional tort claims, it is logical to conclude that punitive damages are received 'on account of' such claims."[170] Applying this analysis, the court concluded that the claim was tort-like and therefore, that the punitive damages should be excluded from gross income under § 104(a)(2).[171]

The Tax Court "rejected the concept that § 104(a)(2) excludes only amounts that restore lost capital as opposed to amounts that would otherwise constitute gains or accessions to

163. Horton v. Commissioner, 100 T.C. 93, 101 (1993).

164. Miller v. Commissioner, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990). *See supra* text accompanying notes 108-24.

165. 100 T.C. at 95 (citing *Miller*, 93 T.C. at 338).

166. *Id.*

167. *Id.* at 96. The court relied on the Supreme Court's analysis in *Burke*, 504 U.S. 229 (1992). *See supra* part IV.A.

168. 504 U.S. 229 (1992).

169. 100 T.C. at 99. The Supreme Court in *Burke*, 504 U.S. 229 (1992), looked to the remedies available in order to determine whether the claim was tort-like. *Id.* at 234-35. The Court found that punitive damages were an indicia of a traditional tort claim. *Id.* at 240. *See supra* part IV.A.

170. 100 T.C. at 99.

171. *Id.* at 101.

wealth."[172] The court justified its finding by noting that, in Kentucky, punitive damages are awarded " 'because the *injury* has been *increased* by the *manner* [in which] it was inflicted.' "[173] Therefore, punitive damages are partially compensatory in nature and "are allowed by way of remuneration for the aggravated wrong done."[174]

The Court of Appeals for the Sixth Circuit affirmed.[175] It agreed with the Tax Court that "[a]lthough [*Burke's*] . . . holding is not applicable, . . . its method of assessing whether a claim is excludable . . . is instructive."[176] The court focused on whether the injury was personal and if the underlying claim was tort-like in nature.[177] In this case, the underlying claim was one for personal injury, and therefore the full recovery was excludable, including the punitive damages.[178]

The court stated that its holding was consistent with the 1989 Amendment which allowed punitive damages in physical injury cases to be excluded.[179] The court criticized the Commissioner's view that punitive damages should not be excluded because they do not represent a return of capital.[180] It stated that

172. *Id.* at 96. The Tax Court followed its prior decision in Downey v. Commissioner, 97 T.C. 150 (1991). In *Downey*, the court stated that:

> Whether the damages paid to the tort victim reflect a substitute for amounts or items otherwise taxable or a substitute for amounts or items to be enjoyed without a tax consequence is irrelevant . . . . [Section 104(a)(2)] permits the exclusion of damages that are a substitute for . . . amounts or items that otherwise would be taxable or would potentially produce taxable benefit . . . . In sum, under section 104(a)(2), we will focus on whether the injury is personal and on whether the claim resulting in payment of damages is . . . tort-like, not on the consequences of the personal injury or the actual damages suffered.

Id. at 163-64.

173. Horton v. Union Light, Heat and Power Co., 690 S.W.2d 382, 390 (Ky. 1985) (holding that punitive damages serve both a compensatory and punitive function)).

174. 100 T.C. 100 (citing *Horton*, 690 S.W.2d at 390).

175. Horton v. Commissioner, 33 F.3d 625, 626 (6th Cir. 1994).

176. *Id.* at 629.

177. *Id.* at 630.

178. *Id.*

179. *Id.* at 631. The court refers to the 1989 amendment created by Congress in the Omnibus Budget Reconciliation Act of 1989. *See supra* note 25 and accompanying text and *infra* part V. Although the amendment does not apply to this case since the recovery occurred before July 10, 1989, the court pointed out that its holding is consistent with the amendment. 33 F.3d at 631. *See also supra* note 35.

180. 33 F.3d at 632.

the "return to capital" theory[181] is a false dichotomy since the theory "[t]hat money damages make the injured person whole is merely a legal fiction."[182]

2. Hawkins v. United States[183]

In *Hawkins v. United States*, the taxpayers received a punitive damage award due to the defendant's breach of his duty of good faith and fair dealing.[184] The Hawkinses reported the punitive damages on their tax return but later filed for a refund.[185] The Commissioner denied the refund and the Hawkinses filed suit in the district court.[186] The District Court for the District of Arizona found that the Hawkins' punitive damages were excludable from gross income.[187] The court reasoned that the plain meaning of § 104(a)(2) compels exclusion of punitive damages.[188]

The Court of Appeals for the Ninth Circuit reversed, concluding that § 104(a)(2) does not exclude noncompensatory punitive damages.[189] It agreed with the Fourth Circuit in *Miller*[190] that § 104(a)(2) is ambiguous and there is no "plain meaning."[191] The court also noted that "punitive damages . . . which do not purport to compensate the taxpayer for personal injuries and which bear no relation to the severity of the taxpayer's injuries, are not necessarily awarded 'on account of' personal injury; rather, they are awarded 'on account of' the tortfeasor's egregious conduct."[192]

Thus, the Ninth Circuit added another step to the *Burke* analysis.[193] In addition to having a "tort-like" cause of action,

---

181. *See supra* note 124.
182. 33 F.3d at 632.
183. 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995).
184. *Id.* at 1079.
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.* at 1080.
189. *Id.* at 1084.
190. 914 F.2d 589-90. *See* discussion *supra* part III.C.3.
191. *Hawkins*, 30 F.3d at 1080. *See supra* notes 115-24 and accompanying text.
192. *Hawkins*, 30 F.3d at 1080.
193. United States v. Burke, 504 U.S. 229 (1992). The Supreme Court in *Burke* had simply looked at the underlying claim to see if it was tort-like in nature. *Id.* at 237. When it found that the claim was not tort-like (since traditional tort

the damages must also be received "on account of" personal injury.[194] In other words, simply finding a tort-like cause of action is not the end of the inquiry.[195]

The court also found that excluding punitive damages is inconsistent with § 104(a)(2)'s title and purpose.[196] First, the court pointed to the title of the statute, "Compensation for Sickness and Injury."[197] Second, the court reasoned that the "return to capital" rationale justified including punitive damages in gross income since they do not purport to compensate the victim for injuries suffered.[198] Awarding punitive damages does not restore lost capital, "but rather . . . punish[es] the tort-feasor whose wrongful action was intentional or malicious, and . . . deter[s] him and others from similar extreme conduct."[199]

In sum, the court concluded that a punitive damage award is a pure windfall to the plaintiff and should be included in gross income.[200] This is consistent with the view that exclusions from gross income, such as § 104(a)(2), should be construed narrowly.[201]

Judge Trott provided a strong dissent.[202] Trott stated that the "any damages" language suggests "all damages."[203] He further noted that "[t]he language [is] unambiguous, permitting no distinction between punitive and compensatory damages."[204] "If Congress intended to exclude only compensatory damages from gross income, it certainly could have made that distinction ex-

---

damages were not available), the Court ended its inquiry. *Id.* at 239-41. *See supra* part IV.A.

The Supreme Court did not indicate that "if the underlying cause of action is tort-like, all damages, regardless of their purpose, are excludable." *Hawkins*, 30 F.3d at 1081. "The [Supreme] Court did not state that courts should look exclusively at the nature of the claim underlying the damage award." *Id.*

194. *Hawkins*, 30 F.3d at 1081.

195. *Id.*

196. *Id.* at 1082 n.7.

197. *Id.* at 1083. This is the title for the entirety of § 104. I.R.C. § 104 (1994).

198. *Hawkins*, 30 F.3d at 1083-84.

199. *Id.* at 1083 (citing City of Newport v. Fact Concert Inc., 453 U.S. 247, 266 (1981)).

200. *Id.* at 1083-84.

201. *Id.* at 1080. *See supra* text accompanying notes 85-86.

202. *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting).

203. *Id.* (citing Miller v. Commissioner, 93 T.C. 330, 338 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990)).

204. *Id.*

plicit."[205] Furthermore, "punitive damages are received on account of personal injury because punitive damages are not available unless a personal injury has occurred."[206]

Trott criticized the majority for "glossing over" the Ninth Circuit's decision in *Roemer*,[207] which relied on Revenue Ruling 75-45[208] to find that punitive damages were excludable from gross income.[209] He further pointed out that the Internal Revenue Service has "flip-flopped" on this issue, therefore undermining the idea that Revenue Ruling 84-108[210] is the final and correct decision.[211]

Judge Trott also disagreed with the two-part test expounded by the majority. He urged the court to adopt the holding of the Tax Court in *Horton*, which stated: "The beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.' "[212] Criticizing the majority, he pointed out that "[t]he *Burke* Court did not mention any additional requirements for exclusion under § 104(a)(2)."[213] Relying on the *Burke* analysis, he reasoned that since "punitive damages are one of the primary indicia of a personal injury claim . . . it follows that punitive damages are received 'on account of personal injury.' "[214]

Furthermore, Judge Trott pointed out that the 1989 amendment to § 104(a)(2)[215] suggests that all punitive damages

---

205. *Id.*

206. *Id.* at 1085.

207. Roemer v. Commissioner, 716 F.2d 693 (6th Cir. 1983). *See supra* part III.C.2.

208. Rev. Rul. 75-45, 1975-1 C.B. 47. *See supra* notes 52-57 and accompanying text.

209. *Hawkins*, 30 F.3d at 1084-85 (Trott, J., dissenting). Judge Trott points out that the *Roemer* court also interpreted the statute and did not blindly rely on Revenue Ruling 75-45. *Id.*

210. Rev. Rul. 84-108, 1984-2 C.B. 32. *See supra* notes 59-68 and accompanying text.

211. *Hawkins*, 30 F.3d at 1085 (Trott, J., dissenting).

212. *Id.* (citing *Horton*, 100 T.C. at 96). The Supreme Court adopted this analysis in *Burke*, 504 U.S. at 232.

213. 30 F.3d at 1085 (Trott, J., dissenting).

214. *Id.* at 1086.

215. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a)(2)). *See* discussion *supra* notes 46-48 and *infra* part V.

received before 1989 are not taxable.[216] He stated that the majority's view that all punitive damages are taxable would mean that the amendment serves to broaden the § 104(a)(2) exclusion rather than narrow it.[217] Also, Trott believed that the majority's interpretation renders the amendment meaningless if all punitive damages are taxable.[218]

Finally, Judge Trott pointed out that the "return to capital" theory does not explain the § 104(a)(2) exclusion because "compensatory damages, like punitive damages, can represent a windfall in addition to a return to capital."[219] Money damages can serve to more than compensate for the injury suffered and therefore make the injured party "more than whole."[220] Furthermore, this theory does not explain why punitive damages received in physical injury cases after 1989 are excludable.[221]

3. Reese v. United States[222]

In *Reese v. United States*, Elizabeth Reese sued her employer for termination of employment based on gender discrimination and sexual harassment.[223] Following a jury trial, she was awarded both compensatory and punitive damages.[224] Reese included the punitive damages as gross income in her 1987 federal income tax return.[225] She later filed an amended return for a refund which was disallowed by the Internal Reve-

---

216. *Hawkins*, 30 F.3d at 1086 (Trott, J., dissenting). Judge Trott stated that such a view is the only method of harmonizing the original statute with the amended statute. *Id.* He pointed out that the amendment served to narrow the § 104(a)(2) exclusion by not allowing punitive damages to be excluded where no physical injury or sickness was involved. *Id.* If the amendment were to accomplish this goal, punitive damages must have been excludable from gross income in all personal injury cases prior to the amendment. *Id.* at 1086-87.

217. *Id.*

218. *Id.*

219. *Id.* at 1087.

220. *Id.*

221. *Id.*

222. 24 F.3d 228 (D.C. Cir. 1994).

223. *Id.* at 229. Although these facts appear to be similar to those in *Burke*, 504 U.S. 229 (1992), they are distinguishable since this suit was not brought under Title VII. Rather, Reese brought suit under the District of Columbia Human Rights Act, D.C. CODE ANN. § 1-2501 (1981). 24 F.3d at 229.

224. *Id.*

225. *Id.*

nue Service.[226] Reese then filed suit for refund in the Court of Federal Claims.[227]

The Court of Federal Claims granted summary judgment for the Government.[228] The court found that § 104(a)(2) is ambiguous.[229] It "adher[ed] to the general tenet that the language 'gross income' is to be construed broadly and exemptions to gross income are to be construed narrowly."[230] "The court . . . concluded that the exclusion . . . does not encompass punitive damages because the title and subject matter of section 104 are limited to payments received as 'compensation' for injuries or sickness."[231]

The Court of Appeals for the Federal Circuit affirmed, reasoning that "Congress did not intend section 104(a)(2) to exclude from gross income noncompensatory damages such as punitive damages."[232] It determined that the "on account of" language of the statute is ambiguous and susceptible to at least two conflicting interpretations.[233] The court must therefore "look . . . to the design of the statute as a whole and to its object and policy."[234] First, the court noted that the title of the statute is "Compensation for Injuries or Sickness."[235] Second, "section 104's enumerated categories encompass only the replacement of losses resulting from injury or sickness."[236] The court also stated that "taxable income" should be broadly construed with the purpose to tax income comprehensively.[237] "Exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy."[238]

226. *Id.* at 229-30.

227. *Id.* at 230.

228. Reese v. United States, 28 Fed. Cl. 702, 703 (1993).

229. *Id.* at 705.

230. 24 F.3d at 230.

231. *Id.*

232. *Id.* at 231.

233. *Id.* at 230. *See supra* note 119 and accompanying text.

234. 24 F.3d at 231 (citing Crandon v. United States, 494 U.S. 152, 158 (1990)).

235. *Id.* (referring to the title of I.R.C. § 104 (1994)).

236. *Id. See* I.R.C. § 104(a)(1)-(5) (1994).

237. 24 F.3d at 231 (citing Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955)).

238. *Id.* (citing Commissioner v. Jacobson, 336 U.S. 28, 49 (1949)).

In addition, punitive damages are not intended to compensate the injured party, but are to punish the tortfeasor for his wrongful conduct.[239] They are "damages above and beyond the amount which you may award for compensatory and nominal damages."[240] In sum, punitive damages "in no way resemble a return of capital."[241] In light of all of these factors, the court concluded that "punitive damages are not excludable from gross income pursuant to 26 U.S.C. § 104(a)(2) (1987) because such damages are not received on account of personal injury within the meaning of the Code."[242]

4. Wesson v. United States[243]

In *Wesson v. United States*, the Fifth Circuit Court of Appeals joined the Ninth, Federal, and Fourth Circuits in holding that noncompensatory punitive damages are not excludable from gross income under § 104(a)(2).[244] In *Wesson*, the taxpayers received a jury award of $ 1.5 million in punitive damages in a bad-faith action against Mutual Life Insurance Company.[245] Initially, they reported the punitive damage award in their 1988 tax return, but later requested a refund.[246] The Internal Revenue Service denied the request and the taxpayers subsequently filed suit in district court.[247]

The District Court for the Southern District of Mississippi ruled against the taxpayers, holding that the punitive damages recovered in the bad-faith cause of action were not awarded "on account of personal injuries."[248] The court stated that the action "simply involved a breach of insurance contract" and "the bene-

239. *Id.* (citing *City of Newport*, 453 U.S. at 266).
240. *Id.* at 232.
241. *Id.* at 233.
242. *Id.* at 235.
243. 48 F.3d 894 (5th Cir. 1995).
244. *Id.* at 896. The Fifth Circuit enforced its holding in *Wesson* in Moore v. Commissioner, 53 F.3d 712 (5th Cir. 1995). In *Moore*, the court held that the punitive damages awarded under Texas law are not compensatory in any way and are therefore not excludable from gross income under § 104(a)(2). *Id.* at 713.
245. Wesson v. United States, 843 F. Supp. 1119, 1120 (S.D. Miss. 1994). The taxpayers were originally awarded $8 million in punitive damages, but this amount was reduced to $1.5 million through remittitur. *Id.*
246. *Id.*
247. *Id.*
248. *Id.* at 1123.

ficiaries [could not] seriously contend that they received the punitive-damages award 'on account of personal injuries' as required under section 104(a)(2) for purposes of exclusion from taxation."[249] In other words, the award was "deemed a taxable accession of wealth."[250]

The Fifth Circuit Court of Appeals affirmed the district court's ruling that the punitive damage award was not exempted from taxation under § 104(a)(2).[251] In its analysis, the court first looked to the language of the statute.[252] It agreed with the Ninth, Federal, and Fourth Circuits that the "on account of" language in § 104(a)(2) was ambiguous.[253] The court also found ambiguity in the term "personal injury."[254] However, the court noted that the Supreme Court in *Burke*[255] eliminated that ambiguity by "link[ing] identification of a personal injury to traditional tort principles."[256]

With *Burke* in mind, the court looked to Mississippi law to determine whether a bad faith cause of action is one that redresses a personal injury.[257] Since "punitive damages are not allowed [under Mississippi law] absent such malicious, reckless, willful or gross disregard for the rights of the insured as to constitute an independent tort," the court concluded that the bad faith cause of action sounded in tort and was therefore one redressing a personal injury.[258]

Establishing this "threshold inquiry," the court of appeals went on to determine whether the punitive damages were re-

---

249. *Id.*

250. *Id.*

251. Wesson v. United States, 48 F.3d 894, 902 (5th Cir. 1995).

252. *Id.* at 896.

253. *Id.* at 897. The court believed that § 104(a)(2) was subject to at least two conflicting interpretations. *Id.* "[It] could mean that all damages recovered in a personal injury suit are excluded, or it could mean that only those damages that purport to compensate the plaintiff for the personal injury suffered are received on account of personal injury." *Id.* *See supra* text accompanying notes 117-20, 189, 255-58.

254. 48 F.3d at 897.

255. *See supra* part IV.A.

256. *Wesson*, 48 F.3d at 897. The *Burke* Court found that where traditional tort law remedies were available, the legal action is based upon tort and therefore involves personal injury. *Id.* (citing *Burke*, 504 U.S. at 259).

257. *Id.*

258. *Id.* at 898.

ceived on account of that personal injury.[259] Since the "on account of" language in § 104(a)(2) was deemed ambiguous, the court looked to "the design of the statute as a whole and to its object and policy."[260] It noted that § 104 is titled "Compensation for Injuries or Sickness"[261] and that punitive damages do not serve to compensate the plaintiff, but to punish the tortfeasor.[262] Furthermore, the underlying purpose behind excluding damages from gross income under § 104 is that "they restore a loss of capital."[263] Taking both these points into consideration, the court found that punitive damages are not awarded on account of personal injuries.[264] It concluded that "the class of damages that may be excluded are those that *compensate* an individual for some loss"[265] and that " 'Congress did not intend section 104(a)(2) to exclude from gross income non-compensatory damages such as punitive damages.' "[266]

V. *The Omnibus Budget Reconciliation Act of 1989*[267]

Until 1989, Congress had not specifically addressed the exclusion of punitive damages under § 104(a)(2). In 1989, Congress amended § 104(a)(2) to read: "[Section 104(a)(2)] shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."[268] Thus, if a taxpayer recovers punitive damages in a case *not* involving physical injury, this amount will be includable in gross income under the amended § 104(a)(2). However, due to the double-negative language of the amendment, it is not clear whether punitive

---

259. *Id.* The court stated that "[u]nder *Burke* the threshold inquiry in determining whether a damage award is excludable from gross income pursuant to § 104(a)(2) is to determine if the underlying cause of action seeks to redress a personal injury." *Id.* at 897.

260. *Id.* at 898 (citing *Reese*, 24 F.3d at 231 (quoting Crandon v. United States, 494 U.S. 152, 158 (1990))).

261. *Id.*

262. *Id.* at 899.

263. *Id.* (quoting *Hawkins*, 30 F.3d at 1083). For a discussion of the "return to capital" theory, *see supra* notes 198-99 and accompanying text.

264. 48 F.3d at 900.

265. *Id.* at 899 (emphasis in original).

266. *Id.* (quoting *Reese*, 24 F.3d at 231).

267. Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a) (1994)).

268. *Id.*

damages received for a claim involving physical injury would be excludable.

Furthermore, one commentator has stated that "while this change could be viewed as expressing congressional intent regarding punitive damages, the legislative history indicates that the real focus of the amendment was damages received for nonphysical injuries."[269] The committee report accompanying the bill indicates that the amendment was in response to recent judicial decisions which allowed the exclusion of punitive damages in cases that *did not* involve physical injury or physical sickness.[270] In enacting the amendment, the House Ways and Means Committee stated that the "[exclusion of punitive damages from gross income] is inappropriate where no physical injury or sickness is involved."[271]

The Committee report would have limited the application of the income exclusion "to damages received on account of personal injuries or sickness in a case involving physical injury or physical sickness."[272] Although its report would have explicitly made both compensatory and punitive damages excludable in cases involving physical injury or sickness,[273] the amendment as passed did not go that far.[274]

Although it appears that Congress has finally spoken on the subject of punitive damages, it is still unclear how the amendment should be interpreted. For instance, it remains uncertain whether punitive damages can be excluded where there *is* physical injury, as opposed to cases "not involving physical injury or sickness."[275] Furthermore, the amendment does not explain the meaning of "in connection with a case involving physical injury or physical sickness."[276] This could refer either to a claim of physical injury, or to a claim for nonphysical personal injury where there have been physical manifestations of injury, such as pain and suffering or emotional distress.

269. Jaeger, *supra* note 29, at 111.

270. H.R. REP. No. 247, 101st Cong., 1st Sess. 1354-55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2825.

271. *Id.*

272. *Id.*

273. *Id.*

274. Omnibus Budget Reconciliation Act § 7641.

275. *Id.*

276. *See supra* note 268 and accompanying text.

By enacting the amendment, Congress has given the courts limited guidelines in which to view the § 104(a)(2) exclusion. Unfortunately, cases will continue to face the courts in which the pre-amended statute still applies.[277] This is because the amendment has only prospective effect.[278] For these cases, the courts must continue to interpret when and if punitive damages are excludable from gross income under § 104(a)(2).

VI. The Present and Future Status of the § 104(a)(2) Exclusion

A. *The Status of Pre-Amended § 104(a)(2)*

As noted previously, cases continue to come down under the pre-amended version of the statute.[279] However, there is still no consensus on the treatment of punitive damages.[280] Thus, courts must continue to interpret the exclusion and determine whether to exclude punitive damages from gross income. The most plausible interpretation of the pre-amended section is that it excludes punitive damages from gross income.

The plain language of the statute should be given deference. The language clearly indicates that the exemption applies to "any damages," without distinguishing between punitive and compensatory damages. If Congress had intended to exclude only compensatory damages, it could have done so explicitly in the statute.

Furthermore, the "on account of" language lacks the ambiguity that many courts have sought to find in it. Punitive damages are "inextricably bound up"[281] with a claim for personal injury and therefore cannot be said to be entirely separated from it. Punitive damages are not awarded unless injury is shown.[282] It logically follows that they are received on account of that injury.

---

277. *See, e.g.*, Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994); Estate of Wesson v. United States, 843 F. Supp. 1119 (S.D. Miss. 1994), *aff'd*, 48 F.3d 894 (5th Cir. 1995); Kemp v. Commissioner, 771 F. Supp. 357 (N.D. Ga. 1991).

278. Omnibus Budget Reconciliation Act § 7641(b). *See supra* note 35.

279. *See supra* note 277.

280. For a discussion of *Horton*, *Hawkins*, and *Reese*, *see supra* part IV.B. 1-3.

281. *Horton*, 100 T.C. at 99 (citing *United States v. Burke*, 504 U.S. 229, 237 n.7 (1992)). *See supra* note 169 and accompanying text.

282. *See supra* note 22.

The reasoning of courts which have found punitive damages to be includable in gross income may appear to be sound at first glance, yet it is inconsistent with the language of the statute.[283] First, the plain meaning of the statute clearly indicates otherwise. As noted above, the plain language of the statute indicates that "all damages" should be excludable, not just those that compensate the victim for the injury suffered. Second, the Supreme Court's decision in *Burke* states that the beginning and *end* of the inquiry should be whether the underlying claim is tort-like.[284] Once it is determined that the claim is tort-like, and therefore one for personal injury, all damages resulting therefrom should be excludable from gross income under § 104(a)(2) as "damages received on account of personal injury or sickness."

Finally, courts have arbitrarily created new steps in the analysis that clearly contradict the *Burke* Court's ruling on the issue.[285] The Supreme Court explicitly stated that the only determination to be made was whether the claim was tort-like.[286] That was meant to be the beginning and end of the inquiry.[287] If the Court had intended for there to be a second step to the analysis, it would have said so. To create a second step in the analysis of the exclusion is an impermissible supplementation of the Supreme Court's ruling, as it changes the focus of the analysis.

The "return to capital" theory used by many courts to justify including punitive damages in gross income is not really determinative.[288] Courts that use this theory hold that only compensatory damages serve to make a person whole.[289] They

283. *Compare Wesson*, 48 F.3d at 894, *Hawkins*, 30 F.3d at 1077 and *Reese*, 24 F.3d at 228.

284. *Burke*, 504 U.S. at 237.

285. *See, e.g.*, *Hawkins*, 30 F.3d 1077 (stating that the analysis also requires the court to determine whether the damages were received on account of personal injury).

286. *Burke*, 504 U.S. at 237. *See supra* note 148.

287. *Burke*, 929 F.2d at 1123. The Supreme Court agreed with this portion of the Sixth Circuit's opinion. *Burke*, 504 U.S. at 237. *See supra* text accompanying notes 147-48.

288. *See Wesson*, 48 F.3d at 894; *Hawkins*, 30 F.3d at 1077; *Reese*, 24 F.3d at 228; *Miller*, 914 F.2d at 586.

289. *Hawkins*, 30 F.3d at 1083-84; *Reese*, 24 F.3d at 231-32; *Miller*, 914 F.2d at 589.

reason that punitive damages are over and above the amount needed to compensate the plaintiff and are therefore a clear accession to wealth.[290] However, compensatory damages, like punitive damages, can also represent a windfall to the plaintiff and, in essence, make him more than "whole." Often, an injured plaintiff receives more than is required to compensate him for his injury.[291] This is because it can be difficult to put a dollar value on an injury.[292]

Furthermore, it is hard to determine what a person's basis[293] is in his own body. It is, therefore, difficult to ascertain whether the taxpayer has realized a clear gain under the I.R.C. For that reason, compensatory damages often provide the plaintiff with a clear accession to wealth that, nevertheless, is not taxable under § 104(a)(2).

Furthermore, the "return to capital" theory does not explain why punitive damages are excludable from gross income in physical injury cases after the 1989 amendment.[294] It follows

290. *Hawkins*, 30 F.3d at 1080, 1083-84; *Reese*, 24 F.3d at 231-32; *Miller*, 914 F.2d at 589-90.

291. *Hawkins*, 30 F.3d at 1087 (Trott, J., dissenting).

292. *Horton*, 33 F.3d at 632.

293. "Basis" is the term used in I.R.C. § 1011 (1994). It is defined as the "total amount of capital expenditures with respect to an asset (in most cases the cost of purchase plus the cost of 'improvements' on the asset) . . . ." DODGE, *supra* note 3, at 3.

Basis is used to calculate taxable gain or deductible loss to the taxpayer. I.R.C. § 1001 (1994). This is done by subtracting the taxpayer's basis from the amount realized in a transaction. *Id.* Amount realized is "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b).

In the scenario of a damage recovery, compensatory damages are meant to make the taxpayer whole so that he realizes no gain or loss on the transaction. This requires that the amount realized equal the taxpayer's basis. Amount realized is easily determined as the amount of the damage award received by the taxpayer in a suit or by settlement. However, a taxpayer's basis cannot be determined when a damage recovery is meant to compensate for physical injuries since it is impossible to put a precise dollar value on a person's health and body parts.

The court's inability to determine basis in this situation renders the calculation of gain or loss a virtual impossibility. Thus, there is great risk that the taxpayer will be either overcompensated or undercompensated for his injury. Where overcompensation occurs, the amount over and above the basis should be taxable gain but will not be recognized as such. Likewise, where undercompensation occurs, the difference between the taxpayer's basis and the actual amount received should be a deduction from gross income but will fail to be recognized as such.

294. *See supra* part V.

logically that if punitive damages are a windfall to the plaintiff in all situations, they should not be excludable where there is physical injury. The "return to capital" theory does not provide an explanation for this apparent contradiction. The only conclusion is that the "return to capital" theory is not the true basis on which to determine the excludability of damages received for personal injury or sickness.

Even if the circuit courts of appeals were not presently split on this issue, it appears that the Tax Court would continue to follow its reasoning in cases such as *Miller*[295] and *Horton*[296] and find that punitive damages are excludable where the underlying claim is tort-like. Thus far, the Tax Court has refused to follow the Fourth and the District of Columbia Circuits.[297] Instead, it has consistently held that punitive damages are excludable from gross income due to the plain language of the statute.[298] It is unlikely that the Tax Court will change its stance on the issue since the entire panel of the Tax Court reviewed *Miller* and found punitive damages excludable.[299]

Unfortunately, it is unlikely that Congress will provide further guidance in this area, since these cases will not be appearing for much longer. As noted earlier, the pre-amended version of the statute only applies to award amounts received before July 10, 1989.[300] As time passes, fewer cases will fall under the pre-amended statute, despite the present backlog in the court system. Congress will therefore have little incentive to take a definite stance on this highly controversial matter.

B. *Probable Effects of the 1989 Amendment*

While the 1989 Amendment to § 104(a)(2)[301] provides some clarification on the excludability of punitive damage recoveries, it still leaves much of the controversy intact. The amendment also creates several new issues for the courts to decide.

---

295. *Miller*, 93 T.C. at 330. *See supra* text accompanying notes 112-14.

296. *Horton*, 100 T.C. at 93. *See supra* text accompanying notes 163-72.

297. The Tax Court has not followed *Miller*, 914 F.2d at 586, or *Reese*, 24 F.3d at 228.

298. *See, e.g.*, *Horton*, 100 T.C. at 93; *Miller*, 93 T.C. at 330.

299. *Miller*, 93 T.C. at 341-42.

300. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(b), 103 Stat. 2106, 2379 (1989).

301. *Id.* § 7641(a). *See* discussion *supra* part V.

First, it is not clear whether punitive damages are excludable where the case does involve physical injury or sickness.[302] If, by negative implication, the amendment excludes punitive damages in physical injury cases, several of the courts that have found punitive damages to always be includable in gross income[303] will have to adjust their analysis. These courts have found under the pre-amended statute that punitive damage recoveries are always taxable because they represent accessions to wealth that do not serve to make the plaintiff whole.[304]

If the pre-amended section did not exclude punitive damages, the amendment actually serves to broaden the § 104(a)(2) exclusion by allowing punitive damages to be excluded from gross income where there is physical injury or sickness. Such a broadening of the scope of § 104(a)(2) is clearly inconsistent with the Congressional intent behind the amendment.[305] Congress only intended to clarify the exclusion and eliminate the situation where courts were allowing damages to be excluded in cases that did not involve physical injury.[306] Thus, Congress was actually limiting the scope of the exclusion. Any interpretation that the amendment served to broaden the exclusion clearly contradicts Congress' actual intent, and is therefore invalid.

Additionally, if courts continue to follow the rationale that all punitive damages are includable in gross income regardless of whether physical injury is involved, they essentially render the amendment meaningless. Those courts which have held that punitive damages should be included in income because they are not "on account of" personal injury or sickness,[307] have utilized a rationale that clearly contradicts the plain language of the amendment. The amendment obviously must allow for

---

302. *See supra* notes 29-30 and accompanying text.

303. *See Hawkins*, 30 F.3d at 1077; *Reese*, 24 F.3d at 228; Kemp v. Commissioner, 771 F. Supp. 357 (N.D. Ga. 1991).

304. *See Wesson*, 48 F.3d at 898; *Hawkins*, 30 F.3d at 1083-84; *Miller*, 914 F.2d at 590.

305. *See supra* text accompanying notes 270-73.

306. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1354-55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2825; *see also supra* text accompanying notes 270-71.

307. *See Wesson*, 48 F.3d at 894; *Hawkins*, 30 F.3d at 1077; *Reese*, 24 F.3d at 228; *Miller*, 914 F.2d at 586.

the exclusion of punitive damages in at least some cases involving physical injury or sickness.

The 1989 amendment states that § 104(a)(2) does not apply to punitive damages received in connection with a case not involving physical injury or physical sickness.[308] Congress must have intended for punitive damages to either always be excludable where they are received in a case involving physical injury or sickness, or, at least be excludable in some cases involving physical injury or sickness. If Congress wanted punitive damages never to be excluded from gross income, it could have explicitly expressed that intent in the statute. Furthermore, the legislative history indicates that Congress was only concerned with the situation where punitive damages were excluded when there was no physical injury.[309] There is no indication that Congress wanted to tax punitive damages in all cases.

If courts continue to rule that all punitive damages are excludable from income, they will be rendering the amendment meaningless. Although the amendment does not explicitly state that punitive damages in physical injury cases should always be excluded from gross income, it is apparent they must be excludable in at least some, if not all, situations. Otherwise, Congress would have affirmatively made punitive damages includable in gross income in all cases. The courts will therefore have to develop a new analysis for deciding whether or not to exclude punitive damages in physical injury cases. Certainly, their present blanket rule that never allows for exclusion will not suffice.

Furthermore, courts that do not allow the exclusion of punitive damages will also have difficulty explaining why punitive damages may be excluded in physical injury cases after the amendment and not in nonphysical injury cases. In either case, those courts would presumably deem punitive damages to be a windfall to the plaintiff, serving no compensatory purpose, and therefore includable in gross income. This blanket analysis is not consistent with the present amended statute. Those courts might argue that the amendment's double-negative nature allows them to render all punitive damages includable in income.

308. I.R.C. § 104(a) (1994).

309. *See supra* part V.

However, that statutory analysis would also render the amendment ineffective.

Although the amendment does not serve to overrule any of the recent court decisions to include punitive damages in gross income (since they did not involve physical injury), it may impact the Internal Revenue Service's approach to this issue. At least in part, the amendment may overrule Internal Revenue Service ruling 84-108.[310]

The Revenue Ruling stated that punitive damages are not excludable in the settlement of a wrongful death claim.[311] Clearly, if the amendment is taken to exclude punitive damages where there is physical injury or sickness, punitive damages would be excludable in the settlement of a wrongful death action. This directly contradicts the Internal Revenue Service's ruling in 84-108. Even if the amendment only excludes some punitive damages in physical injury cases, the Service will have to revise its analysis in the future since it cannot render all punitive damages includable in gross income without rendering the amendment meaningless.

Both the courts and the Internal Revenue Service will therefore have to adopt a new analysis in dealing with this issue. The most obvious answer is for them to apply the Supreme Court's analysis in *United States v. Burke*.[312] Once it is determined that the underlying claim is for physical injury, obviously a tort-like cause of action, all punitive damages resulting therefrom should be excluded from gross income under § 104(a)(2). Such an approach is consistent with the Court's ruling and the amendment. This way only punitive damages awarded in connection with a physical injury case can be excluded. All other punitive damages, not passing this test, would therefore be included in gross income.

Second, the amendment is unclear as to whether punitive damages should be excluded from gross income where the claim itself is not one for physical injury or sickness, but where the tortfeasor's conduct has resulted in physical injury sickness. Such a situation can arise where a plaintiff in a nonphysical

310. Rev. Rul. 84-108, 1984-2 C.B. 32. *See supra* text accompanying notes 60-70.

311. Rev. Rul. 84-108, 1984-2 C.B. 32.

312. 504 U.S. 229 (1992). *See supra* part IV.A.

injury suit seeks to recover for emotional distress or pain and suffering. The most logical approach to this issue would be for punitive damages to be excluded whenever physical injury or sickness manifests itself in the suit, regardless of the nature of the claim.

To draw a distinction between the two situations would create an absolute contradiction. Obviously, in both situations, the tort-like claim *involves* physical injury. The only difference is that, in one, the claim itself is for physical injury, while, in the other, it is not. This approach will eliminate the inquiry into what is meant by "involves," and therefore curb future controversy over this issue.

Also, the plain meaning of the amendment suggests that all punitive damages are to be excluded if *any* part of the underlying claim relates to physical injuries. The most logical interpretation of "involving physical injury or sickness" is that the cases must include some manifestation of physical injury. It would be illogical to conclude that a defamation suit does not involve physical injury or sickness where the plaintiff has suffered emotional distress or pain and suffering.

Furthermore, the legislative history of the statute indicates that the "involving" language of the amendment is meant as "originating with."[313] Therefore, whenever the case "originates with" physical injury or sickness, despite whether the claim itself is for such physical injury, the punitive damages awarded should be excluded from gross income under § 104(a)(2).

Finally, it is unclear how broadly courts should define what constitutes physical injury or physical sickness under the amended section § 104(a)(2). It is apparent that defamation and employment discrimination are not physical injuries. However, what other causes of action are non-physical injury claims under the amendment?[314] Since Congress has not yet provided

313. *See* H.R. REP. No. 247, 101st Cong., 1st Sess. 1354-55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2825. The House Report stated that "if an action has its origin in a physical injury or physical sickness, then all damages that flow therefrom are treated as payments involving physical injury or physical sickness." *Id.*

314. Other possible examples of non-physical injury claims are: claims for economic loss due to property damage; claims under the antitrust laws; and claims for breach of contract.

a workable definition for the terms, the interpretation will be left for the courts to determine.

Until these complex issues are resolved by Congress or until courts reach a consensus, the controversy surrounding the § 104(a)(2) exclusion will persist. However, it is possible to formulate some conclusions as to the effect the amendment will have on future cases that will soon face the courts.

In states where punitive damages are deemed to have some compensatory purpose,[315] the punitive damage awards will probably still be excluded in cases that do not involve physical injury or sickness. In some states, the law provides that punitive damages serve to compensate the plaintiff for injuries that cannot be specifically ascertained.[316] Because, in these circumstances, a punitive damage award is not purely punitive, the rationale for including them in gross income does not apply. However, the individual states must decide how their punitive damage awards should be defined in order for the courts to determine whether they should be excluded from gross income.[317]

The amendment may also create new problems with the allocation of damage awards. In the case of settlement, it may be difficult for the court to determine which portion of the settlement is attributable to punitive damages and should therefore be includable.[318] In the past, courts have looked to the amount of punitive damages requested in the complaint to determine what portion of the settlement proceeds should be allocated to punitive damages.[319] However, in the future, attorneys will rec-

315. *See, e.g., Horton*, 100 T.C. at 100 ("[I]n Kentucky, punitive damages serve both to compensate the injured party and punish the wrongdoer.").

316. *See Horton*, 100 T.C. at 93. The Tax Court noted in *Horton* that the Kentucky Supreme Court explicitly found that the punitive damages were awarded since injury had been increased by the manner in which it was inflicted. *Id.* at 100 (citing Chiles v. Drake, 59 Ky. (2 Met.) 146, 74 (1859)). The damages were "allowed by way of remuneration for the aggravated wrong done." *Id.* (quoting Louisville & N.R. Co. v. Roth, 114 S.W. 264, 266 (Ky. 1908)).

317. This approach was adopted by the Fourth Circuit in *Miller*, 914 F.2d 586. The court found that "under Maryland law, 'punitive damages are inherently different from compensatory damages and the reasons for the award of each differ sharply.'" *Id.* at 589 (citing Exxon Corp. v. Yarema, 516 A.2d 990, 997 (Md. App. 1986), *cert. denied*, 522 A.2d 392 (Md. 1987)).

318. Jaeger, *supra* note 29, at 114.

319. *See* Robinson v. Commissioner, 102 T.C. 116 (1994). The court stated that normally the allocation in a settlement agreement will be binding for tax purposes. *Id.* at 127. However, if such allocation is clearly contrary to the amounts

ognize the possible risks associated with settlement and will therefore request more compensatory damages in the complaint itself. This will have the effect of allowing the plaintiff to exclude more than he would be able to otherwise, thereby counteracting the amendment. Courts will have to develop some means by which to remedy this situation. This could be accomplished by thoroughly examining the facts of the case and determining exactly what amount is necessary to compensate the plaintiff for harm suffered. However, this method would force courts to make factual determinations that were never made at trial due to settlement. Furthermore, it is often difficult to ascertain the exact amount necessary to compensate an injured plaintiff, since many injuries are intangible.[320] Ultimately, courts will be confronted with more complex allocation issues than they faced in the past.

The 1989 amendment may also create new problems in employment discrimination cases. For example, only liquidated damages are recoverable under the Age Discrimination in Employment Act.[321] Recent cases have shown that the courts may be willing to classify liquidated damages as compensatory and therefore excludable from gross income under § 104(a)(2).[322] However, the circuits are presently split on this issue.[323]

Under the amendment, the determination of whether liquidated damages are compensatory or punitive in nature becomes more significant. If they are punitive, they cannot be excluded

---

sought in the complaint, then the court will determine the payor's intent from all facts and circumstances of the case at issue. *Id.*

320. *Horton*, 33 F.3d at 632.

321. 29 U.S.C. § 626(b) (1988). Liquidated damages as referred to in the Age Discrimination in Employment Act "is the sum which a party to a contract agrees to pay if he breaks some promise and, which having been arrived at by good faith effort to estimate actual damage that will probably ensue from breach, is recoverable as agreed damages if breach occurs." BLACK'S LAW DICTIONARY 391 (6th ed. 1990). Under the Act, liquidated damages can be recovered when the employer has willfully violated the statute. 29 U.S.C. § 626(b) (1988).

322. *See, e.g.*, Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994); Downey v. Commissioner, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994). It is well beyond the scope of this article to explore this issue. For further discussion, *see* Carolyn F. Kolks, *United States v. Burke - Does it Definitively Resolve the Analytical Confusion Created by the Section 104(a)(2) Personal Injury Exclusion?* 45 ARK. L. REV. 657 (1993).

323. *See* Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994); Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994).

under § 104(a)(2) because discrimination does not involve physical injury or sickness. If they are compensatory, they are excludable under the statute. Therefore plaintiffs must argue that liquidated damages are more compensatory than punitive in nature.

VII. Conclusion

The controversy surrounding the exclusion of punitive damages from gross income has survived despite legislative and judicial attempts to provide a rational interpretation of § 104(a)(2). Courts will continue to be faced with issues surrounding the exclusion. Unfortunately, they lack the explicit guidance that is needed in this highly controversial area of tax law. Until Congress takes further action, courts will have to develop an appropriate method with which to deal with these issues.

Although cases will continue to confront the courts under the pre-amended statute, there is little chance that Congress will speak on the issue. However, there is still adequate opportunity for the Legislature to clarify the present statute. It appears logical that punitive damages are excluded from gross income where there is some manifestation of personal injury in the case, but many courts will inevitably disagree with this rationale. For this reason, the legislature should define its stance and amend the statute.

The present "double-negative" nature of the amendment perpetuates the confusion. Congress would be prudent to amend the statute to affirmatively state that punitive damages are excludable from gross income where the case involves physical injury or sickness. Furthermore, it should provide explicit definitions of "involving" and "physical injury or physical sickness." Only by amending the statute will Congress finally end the controversy surrounding the § 104(a)(2) exclusion.

*Wendy S. Kennedy**

* This comment is dedicated to my parents. Without the loving support of my family and Michael Venoit, this comment could not have been written.