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Taxing Emotional Distress Recoveries: Does Murphy Show the Way?

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TAXING EMOTIONAL DISTRESS RECOVERIES: DOES *MUPRHY* SHOW THE WAY?

by

KAUSHAL PRAKASH MAHASETH

(Under the Direction of CAMILLA E. WATSON)

ABSTRACT

The taxability of recoveries of damages on account of emotional distress remains a complicated issue under the American federal income tax law. Recent developments due to a controversial decision by the D.C. Circuit Court of Appeals have further added fuel to this debate. Even if one were to argue the justifications of exempting such recoveries from income taxation, courts do not appear to be the very appropriate kind of forum. Congress can, and in fact does tax such recoveries and the constitutional basis of such power can hardly be doubted. As a result, appropriate changes in the statute only can bring the desirable result of exempting such recoveries from income taxation.

INDEX WORDS: Federal Income Tax, Damages, Emotional Distress, Direct Taxes, Apportionment, Indirect Taxes, Non-physical Injury.

TAXING EMOTIONAL DISTRESS RECOVERIES: DOES *MURPHY* SHOW THE WAY?

by

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A Thesis Submitted to the Graduate Faculty of The University of Georgia in Partial Fulfillment
of the Requirements for the Degree

MASTER OF LAW

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2007

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by

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August 2007

DEDICATION

To

My Father,

Dr. Kapil Deo Prasad Mahaseth,

My Mother,

Mrs. Sulekha Mahaseth,

&

My Wife

Sandhya,

For their untiring love, support, and encouragement.....

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CHAPTER 1

Introduction

The Internal Revenue Code¹ (“IRC” or “Code”) is the most voluminous and complex of any set of federal statutes in America. It is through these statutes that Congress exercises its taxing power.² There are several different types of taxes covered by these statutes,³ one of which is federal income tax. Although for the average American income tax may appear as a necessary evil, most would agree that the federal government could not function without some type of tax. This leads to conflicts between taxpayers and the federal government because the government is concerned with collecting revenue and taxpayers are concerned about minimizing their tax liability. In the process of finding a common ground, the situation is made more difficult by the fact that an economist’s definition of income does not always comport with the Code’s definition of income. Thus, Albert Einstein may have been correct in saying that “[T]he hardest thing in the world to understand is the income tax.”⁴

This paper discusses one such example where a particular taxpayer felt that a certain type of award she received as damages for suffering emotional distress ought not to be taxed.⁵ Her

¹ Internal Revenue Code, 26 U.S.C. §§ 1-9833 (2007).

² See, e.g., JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION: CASES AND MATERIALS 21 (13th ed. 2004).

³ The Internal Revenue Code is further divided into various subtitles and contains a variety of taxes like Income Taxes, Estate and Gift Taxes, Employment Taxes, and Miscellaneous Excise Taxes including Excise Taxes on Alcohol and Tobacco. See FREELAND ET AL., *supra* note 2, at 6-7 (summarizing the historical evolution of different types of taxes under internal revenue taxation).

⁴ See THE MACMILLAN BOOK OF BUSINESS AND ECONOMIC QUOTATIONS 195 (Michael Jackman ed., 1984).

⁵ *Murphy v. IRS*, 362 F. Supp. 2d 206 (D.D.C. 2005), *rev’d* 460 F.3d 79 (D.C. Cir. 2006), *vacated*, *Murphy v. IRS*, Not reported in F.3d, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006) (vacating the prior opinion and scheduling oral arguments for Apr. 23, 2007)

discomfort with the taxing of such a receipt resulted in a protracted litigation that apparently is still far from over.⁶ The problem is that the IRC defines “income” in a wide and expansive fashion, allowing exclusions only for certain specifically defined items. These exclusions are matters of legislative privilege and grace and must not be treated as inherently excludible because of their character or nature. The philosophy of the tax Code is that anything that can properly fall within the catch-all definition of income is includible, whereas exclusions are defined in a more exclusive and exhaustive manner. In other words, if a taxpayer forgets or *chooses to forget* to show on a tax return a particular item of income, the taxpayer continues to be liable regardless. But, no consequences follow if the taxpayer *forgets to choose* to exclude an item to which he or she is entitled to. The taxpayer simply loses the exclusion. The reason is that if the taxpayer does not choose to take the benefit of a legislative privilege, no corresponding obligation is created on the part of the government.

Chapter 2 of this paper gives details of *Murphy v. Internal Revenue Service*,⁷ a case remarkable for the court’s interpretation of what constitutes income. This case was subject to much criticism after it initially was decided by the United States Court of Appeals, District of Columbia Circuit (“D.C. Circuit”).

⁶ *Murphy v. IRS*, Not reported in F. 3d, No. 05-5139, 2007 WL 1892238 (D.C. Cir. July 3, 2007) (rejecting Ms. Murphy’s argument in all respects upon rehearing), *see also* Jeremia Coder, *D.C. Circuit Reverses Course In Murphy Redux*, TAX NOTES, July 9, 88 (2007) (quoting Ms. Murphy’s Counsel that he will seek further review of the case).

⁷ 460 F. 3d 79 (D.C. Cir. 2006).

This case, in fact, became important not only for tax law scholars but also for constitutional law scholars.⁸ The case and the core issues it presents justify a discussion of constitutional law, tax law, tort law, and employment law. Chapter 3 discusses the case from these four perspectives.

Chapter 4 provides a general critique of the pre-rehearing and the reversal of the *Murphy* decision. The paper concludes with Chapter 5, containing recommendations for statutory changes in the tax Code for exempting income tax on damages received on account of emotional distress to the victims under whistle-blower protection statutes.

⁸ See, e.g., Stephen Bainbridge, *This One's is for the Tax Nuts*, http://www.professorbainbridge.com/2006/08/this_ones_for_t.html (last visited June 25, 2007); Ryan J. Donmoyer, *Tax Law Ruling by Court May Encourage New Challenges*, http://www.bloomberg.com/apps/news?pid=20601103&sid=azSs_FNBVDjJ8&refer=us (last visited June 25, 2007); *Tax Prof Commentary after Murphy* (2006), available at http://taxprof.typepad.com/taxprof_blog/2006/08/tax_prof_comment.html (giving a critique of *Murphy* decision by law professors) (last visited June 25, 2007).

CHAPTER 2

Background

A. The Genesis of *Murphy*

In *Murphy*, the taxpayer, Ms. Marrita Murphy, sued her former employer, the New York Air National Guard, for emotional distress and loss of reputation.⁹ She alleged that her employer both blacklisted her and gave her negative references after she disclosed environmental hazards at the air base. She brought suit under the whistleblower provisions of the environmental statutes.¹⁰ At a hearing before an Administrative Law Judge (ALJ), Ms. Murphy submitted evidence that she had suffered both mental and physical injuries as a result of her employer's wrongful actions.¹¹ She introduced testimony from a physician who stated that she had suffered both "somatic" and "emotional" injuries.¹² Upon evidence of other physical manifestations of such injuries, the ALJ awarded Ms. Murphy \$45,000 for emotional distress and \$25,000 for injury to her professional reputation.¹³ Ms. Murphy paid the requisite federal income tax on the award and thereafter filed a claim for refund in the federal district court¹⁴, after her refund claim

⁹ *Murphy*, 460 F. 3d at 81.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.* The word "somatic" means – "Corporeal; pertaining to the body as distinct from the soul, mind or psyche," see WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY 1729 (2d ed. 1967).

¹³ *Murphy*, 460 F. 3d at 81.

¹⁴ The U.S. district courts have refund jurisdiction on internal-revenue tax matters. See 28 U.S.C. § 1346(a)(1) (providing that the district courts shall have original jurisdiction of any civil action for the recovery of tax that was assessed or collected erroneously); see also 26 U.S.C. § 7422(a) (providing that no suit for a claim of refund shall be filed in any court until a claim has been administratively decided); see generally CAMILLA E. WATSON, TAX PROCEDURE AND TAX FRAUD IN A NUT SHELL (3d ed. 2006).

was denied by the Internal Revenue Service¹⁵ (IRS). She lost the case and then appealed to the D.C. Circuit.¹⁶

Section 61 of the IRC defines “gross income” in a very broad manner.¹⁷ Section 104(a)(2)¹⁸ provides that “gross income” does not include the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness.¹⁹ Since 1996²⁰ it has further provided that, for purposes of this exclusion, “emotional distress shall not be treated as physical injury or physical sickness.”²¹

B. The Arguments Advanced by Ms. Murphy

1. The “Physical Injury” Argument

Ms. Murphy first argued that her award was in fact for “personal physical injury” under Section 104(a)(2) and thus should be excludable from her gross income. In support of this argument, she primarily pointed to her physician’s testimony that she had, in fact, suffered a physical injury. She also relied upon her dental records, submitted to the IRS, to show that she had suffered permanent damage to her teeth.²² She contended that she suffered substantial physical problems that were caused by emotional distress that arose, in turn, from her employer’s

¹⁵ The IRS may assert a tax deficiency on a taxpayer in certain cases. In such situations, the taxpayer may contest and the judicial remedy is not limited to suit in the Tax Court. The taxpayer can pay the deficiency and then file an administrative claim for refund. Upon denial, the taxpayer can file suit in the District Court for a refund. Unlike Tax Court, if a refund claim is heard by a District Court then the fact issues may be determined by a jury if the taxpayer demands a jury trial. *See supra* note 14.

¹⁶ *Murphy*, 460 F.3d at 82.

¹⁷ 26 U.S.C. § 61 (2007).

¹⁸ 26 U.S.C. § 104(a)(2) (2007).

¹⁹ *Id.*

²⁰ *See infra* text accompanying notes 224-235.

²¹ 26 U.S.C. § 104(a)(2) (2007).

²² *Murphy*, 460 F.3d at 83.

wrongful conduct and that these physical manifestations must be considered physical injuries or physical sickness.²³

2. The “Sixteenth Amendment” “Income” Argument

Ms. Murphy’s second argument, a novel one, was much more interesting. This one was based on the definition of income at the time of the ratification of the Sixteenth Amendment²⁴ to the U.S. Constitution. She focused upon three sources,²⁵ all of which the U.S. Supreme Court had quoted in *O’Gilvie v. United States*:²⁶ an opinion of the U.S. Attorney General,²⁷ a decision of the Treasury Department,²⁸ and a report issued by the Ways and Means Committee of the House of Representatives.²⁹ In *O’Gilvie*, the Court had analyzed the 1918 exclusionary provision and commented that the language excluded from income those damages that are a substitution for a victim’s physical or personal well being.³⁰ Relying on this, Ms. Murphy maintained that the predecessor of Section 104(a)(2) more accurately reflected the meaning of the Sixteenth Amendment as understood by those who framed, adopted, and ratified it because the statute was enacted soon after the ratification of the Amendment. Ms. Murphy also relied on *Dotson v. United States*,³¹ a Fifth Circuit decision in which the court examined the legislative history of Section 104(a)(2) and concluded that “Congress first enacted the personal injury

²³ *Id.*

²⁴ U.S. CONST. amend. XVI, *see also infra* text accompanying notes 130-151.

²⁵ *Murphy*, 460 F.3d at 85.

²⁶ 519 U.S.79 (1996).

²⁷ *See* 31 Op. Att’y Gen. 304, 308 (1918) (expressing that accident insurance proceeds substitute human capital which is the source of future periodical incomes).

²⁸ *See* T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) (holding that an amount received by an individual as the result of a suit or compromise for personal injuries sustained in an accident is not income).

²⁹ *See* H.R. REP. No. 65-767, at 9-10 (1918) (stating that under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen’s compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income).

³⁰ *O’Gilvie*, 519 U.S. at 86 (1996).

³¹ 87 F.3d 682 (5th Cir. 1996).

compensation exclusion at a time when such payments were considered a return of human capital, and thus not constitutionally taxable “income” under the 16th Amendment.”³²

C. The Counter Arguments

The IRS attacked Ms. Murphy’s arguments on every front and also invoked the general presumption that Congress enacts laws within its constitutional limits.³³ It noted that Congress could repeal Section 104(a)(2), if it so chose thereby taxing compensation for both physical and nonphysical injuries within the provisions of the Sixteenth Amendment.³⁴ The IRS took exception to Murphy’s “human capital” argument, pointing that a human has no basis or cost, nor is it subject to depreciation, in contrast to true returns of capital in the tax sense.³⁵

D. The Opinion of the D. C. Court of Appeals

The D.C. Court of Appeals rejected Ms. Murphy’s first argument. Analyzing the ALJ’s proposed award, it noted that the damages were awarded because of Ms. Murphy’s nonphysical injuries.³⁶ Relying on *O’Gilvie*, the court concluded that the compensation was not paid “on account of” personal physical injury and thus was not entitled to the benefit of Section 104(a)(2). Nonetheless, the court agreed with Ms. Murphy’s second argument, relying on the rationale of *O’Gilvie* to determine whether the compensatory damages awarded were a substitute for a normally untaxed personal quality, good, or asset.³⁷ The *Murphy* court also relied on an Opinion issued in 1922 by the IRS.³⁸ According to this Opinion, defamation was akin to invasion of a personal right and since this right was not transferable, there could be no correct estimate of the

³² *Id.* at 685, see also Susan Kalinka, *Murphy: Is Code Sec 104(a)(2) Constitutional?*, TAXES-THE TAX MAGAZINE, Nov. 2006, at 7.

³³ *Murphy*, 460 F.3d at 84, 86-87.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Murphy*, 460 F.3d at 84.

³⁷ *Murphy*, 460 F.3d at 85.

³⁸ See Sol. Op. 132, I-1 CB 92, 93-94 (1922).

money value of the invaded right. On this reasoning, the Opinion held that damages received for invasion of such a right did not result in any gain or profit that could be taxed.³⁹ The court then concluded that if the award was “in lieu” of something normally untaxed, as had been the case with other awards similar to that of Ms. Murphy’s, then the award was not within the meaning of the Sixteenth Amendment and was not subject to tax.⁴⁰ Therefore, the court remanded the case to the district court for an order entering judgment in favor of Ms. Murphy.

The Murphy judgment came under sharp criticism from various quarters.⁴¹ Apparently in response to that criticism, the DC circuit vacated its earlier judgment and decided to rehear the matter en banc.⁴² Upon rehearing, the court rejected all the arguments of Ms. Murphy and affirmed the judgment of the district court.⁴³ It is not clear whether the taxpayer will appeal to the Supreme Court or whether on appeal the Court will agree to hear the matter. In spite of this, it is clear that *Murphy* revived an old debate that is better understood after a discussion of a few related perspectives.

³⁹ *Id.*

⁴⁰ *Murphy*, 460 F.3d at 89.

⁴¹ *See supra* note 8.

⁴² *Murphy v. IRS*, Not reported in F. 3d, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006).

⁴³ *Murphy v. IRS*, Not reported in F. 3d, No. 05-5139, 2007 WL 4005276 (D.C. Cir. July 3, 2007).

CHAPTER 3

Discussion

A. The Constitutional Law Perspective

The United States Constitution is the fundamental source of all laws enacted by Congress. Thus, Congress's lawmaking power cannot exceed constitutional limits.⁴⁴ For an understanding of such an expansive, yet not unlimited, power and a proper contextualization of the *Murphy* case, it is imperative to understand the gradual evolution of the congressional power to tax.

1. A Brief History of the Taxing Power of Congress

Beginning 1781, the Articles of Confederation, or the first American constitution, gave birth to the idea of fiscal powers to the United States.⁴⁵ This was important since, according to one leading commentator, taxation was at the very center of popular consciousness and the break with Britain was motivated largely by this issue.⁴⁶ However, on closer scrutiny it would appear

⁴⁴ See *United States v. Morrison*, 529 U.S. 598, 607 (2000) (holding that every law enacted by Congress must be based on one or more of its powers enumerated in the Constitution).

⁴⁵ See Articles of Confederation, art. VIII (1781) which provided that "All charges of war, and all other expenses that shall be incurred for the common defense or general welfare, and allowed by the United States in Congress assembled shall be defrayed out of common treasury which shall be supplied by the several States in proportion to the value of all land within each State, granted or surveyed on any person, as such land and the buildings and the improvements thereon shall be estimated according to such mode as the United States in Congress assembled, shall from time to time direct and appoint. The taxes for paying that proportion shall be laid in levied by the authority and direction of the legislatures of the several States within the time agreed upon by the United States in Congress assembled." See also Articles of Confederation, art. II (1781) which showed signs of weakness of the then Congress by reading that "Each State retains its sovereignty, freedom and independence, and every power, jurisdiction and right, which is not by the confederation expressly delegated to the United States in Congress assembled."

⁴⁶ See Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 6-7(1999) (discussing the origins of the constitutional underpinnings of the congressional power to tax).

that the Articles of Confederation did not provide the federal government with any real or enforceable power to tax. Thus the Government had to rely on the good will of its citizens to obtain the funds necessary to fulfill its obligations and basic functions.⁴⁷ This soon led to dissatisfaction among the federalists, for the taxing scheme provided the Continental Congress with the power to requisition the states for revenue but there was no mechanism to enforce the corresponding obligation upon them. The federalists indeed wanted a Constitution that would give a nearly unlimited taxing power to the central government.⁴⁸ According to Alexander Hamilton, for example, taxing power was one of the necessary powers for an energetic government.⁴⁹ He argued that the resources of the community, and not the Constitution, should limit the taxing power.⁵⁰ Anti-federalists, on the other hand, fearfully argued that the Congress could use taxation to turn a federation into a consolidated government drawing all other powers as a corollary to taxing power.⁵¹ After a near tug-of-war, the federalists eventually prevailed and their victory sign was codified as following:

Congress shall have Power to lay and collect Taxes, Duties, Imposts and
Excises. . .⁵²

⁴⁷ See Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 21 (1992) (observing that the government could not long survive under these conditions and thus the Constitution remedied this problem by giving Congress the power to tax).

⁴⁸ See Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Unconstitutional?*, 97 COLUM. L. REV. 2334, 2346 (1997).

⁴⁹ *Id.* n.61 (“[T]hey ought to exist without limitation, because it is impossible to foresee or to define the extent and variety of national exigencies, and the correspondent extent and variety of the means which may be necessary to satisfy them.” (quoting THE FEDERALIST NO. 23, at 153 (Alexander Hamilton) (Clinton Rossiter ed., 1961))).

⁵⁰ *Id.* n.62 (“Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of revenue, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution.” (quoting THE FEDERALIST NO. 30, at 188 (Alexander Hamilton) (Clinton Rossiter ed., 1961))).

⁵¹ See Calvin H. Johnson, *Homage to Clio: The Historical Continuity from the Articles of Confederation into the Constitution*, 20 CONST. COMMENT. 463, 509 nn. 222- 223 (2003-2004).

⁵² U.S. CONST. art I, §8, cl. 1. It is interesting to note, however, that neither the Articles of Confederation nor the Federal Constitution provided any justification for such taxing power. Contrast this with the Pennsylvania Constitution which in 1776 declared “[T]hat every member of society hath a right to be protected in the enjoyment of life, liberty and property, and therefore is bound to contribute his proportion towards the expense of that protection;” and the Rhode Island Constitution which in 1842 expressed: “[T]he burdens of the State ought to be

This clause consistently has been construed to mean that Congress's taxing power is "plenary."⁵³ Supreme judicial affirmation of such a congressional prowess was heard as early as 1796. In *Hylton v. United States*⁵⁴, when the Supreme Court first considered the constitutionality of taxing power,⁵⁵ Justice Paterson wrote in his concurring opinion that "[I]t was, however, obviously the intention of the framers of the Constitution, that Congress should possess full power over every species of taxable property, except exports. The term taxes, is generical, and was used to vest in Congress plenary authority in all cases of taxation."⁵⁶ In a long string of cases since then, the Supreme Court has affirmed this broad taxing power of the Congress in myriad ways. For example, in *McCulloch v. Maryland*,⁵⁷ Chief Justice Marshall owed the origin of power of taxation to the sovereign power of the national government by saying that "But, taxation is said to be an absolute power which acknowledges no other limits than those expressly prescribed in the constitution..."⁵⁸ Later, in *Veazie Bank v. Fenno*,⁵⁹ Chief Justice Chase wrote that the very purpose behind giving broad taxing powers to Congress was apparent from the terms used in the Constitution and that "[M]ore comprehensive words could not have been used. . ."⁶⁰ In *Stanton v. Baltic Mining Co.*,⁶¹ the Court gave more than a reaffirmation to its earlier stance: ". . . [T]he

fairly distributed among its citizens." See, e.g., William B. Barker, *The Three Faces of Equality: Constitutional Requirements in Taxation*, 57 CASE W. RES. L. REV. 1, 9 (2006).

⁵³ See, e.g., LOREN P. BETH, *THE DEVELOPMENT OF THE AMERICAN CONSTITUTION 1877-1917*, at 154 (Henry S. Commager & Richard B. Morris eds., 1971) (describing clause as so sweeping that it has seldom been construed as an interference with any tax measure"), quoted in Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment and the Meaning of "Incomes"*, 33 ARIZ. ST. L.J. 1057, 1059 n.2 (2001) (continuing challenge to the notion that the taxing power is plenary and in the process, assigning meaning to the term "plenary" as "without significant restriction").

⁵⁴ 3 U.S. 171 (1796).

⁵⁵ See Jensen *supra* note 48, at id.

⁵⁶ *Hylton*, 3 U.S. at 176.

⁵⁷ 17 U.S. 316 (1819).

⁵⁸ *Id.* at 427.

⁵⁹ 75 U.S. 533, 540 (1869).

⁶⁰ *Id.*

⁶¹ 240 U.S. 103, 112 (1912).

previous complete and plenary power of income taxation possessed by Congress. . . ”⁶² The same year, the Court in *Brushaber v. Union Pac. R.R. Co.*⁶³ held that the taxing authority of Congress was “an authority already possessed and never questioned,”⁶⁴ and that even the due process clause of the Fifth Amendment⁶⁵ did not impair this power.⁶⁶ Further, in *Penn Mut. Indem. Co. v. Commissioner*,⁶⁷ it was held that “[I]t did not take a constitutional amendment to entitle the United States to impose an income tax.”⁶⁸ More recently, in *United States v. Ptaynski*,⁶⁹ it was recognized that the “power to tax is virtually without limitation.”⁷⁰

2. Constitutional Limitations on Taxing Power and the Sixteenth Amendment

From the foregoing discussion, it appears clear that Article I, Section 8, clause 1 of the Constitution gives Congress wide and expansive power to tax. If no other constitutional provision affected the taxing power, this would clearly be enough to authorize the imposition of an income tax. However, Section 2, clause 3 and Section 9, clause 4 of Article I require that “direct” taxes be apportioned among the several states in accordance with their respective populations.⁷¹ Further, Article I, Section 8, clause 1 reads: “all duties, imposts and excises shall be uniform throughout the Unites States.”⁷²

⁶² *Id.*

⁶³ 240 U.S. 1 (1916).

⁶⁴ *Id.* at 17-18.

⁶⁵ U.S. CONST. amend. V.

⁶⁶ 240 U.S. at 18.

⁶⁷ 277 F.2d 16 (1960).

⁶⁸ *Id.* at 19.

⁶⁹ 462 U.S.74 (1983).

⁷⁰ *Id.* at 79.

⁷¹ U.S. CONST. art. I.

⁷² See FREELAND ET AL., supra note 2 at 15 (quoting Justice Chase: “[T]he power of Congress to tax is very extensive power. It is given in the Constitution with only . . . two qualifications. Congress must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity.”).

Thus, each and every tax law that seeks to tax income must conform to the dual requirements of “apportionment” (if the tax is a “direct” tax) and “uniformity.” However, it is important not to lose sight of the Sixteenth Amendment for a proper understanding of income tax.

(a) The “Apportionment” Requirement for “Direct” Taxes

The Constitution contains no definition of what constitutes direct taxes. It only requires that they be apportioned among the several states. In the absence of an express definition of the term, it would be worthwhile to consider the period of history in which arose. In the original Constitutional debate, the Founders usually used the term as synonymous with “internal taxes,” meaning all taxes except taxes on imports or exports.⁷³ The reasons behind including a direct tax clause are debatable but they point to two broad sources of their origin. First, and the more obvious source, is the Federalists’ fight over a taxing regime that would allow them to circumvent the states and tax their subjects directly.⁷⁴ Such was the importance of their insistence that the very existence of the Constitution is owed to a great extent to the Federalists’ desire to have supreme authority to tax.⁷⁵ Another source, which is less obvious, is the North-South tension that prevailed at that point of time over the issue of slavery.⁷⁶ Thus, it was more likely the pragmatism of the Founders rather than the actual concrete meaning of the term “direct taxes” that led to its inclusion in the Constitution.⁷⁷ It was a coincidence that *Hylton* again was

⁷³ See Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-up in the Core of the Constitution*, 7 WM. & MARY BILL RTS. J. 1, 6-7 (1998) (giving an example to show both the necessity and absurdity of apportionment).

⁷⁴ See Jensen, *supra* note 52, at 1068 (showing that the Articles of Confederation had been a fiscal disaster with the purportedly “national” government's having absolutely no taxing power over individual citizens).

⁷⁵ See Johnson, *supra* note 73, at 21 (terming the Constitution as a pro-tax revolt).

⁷⁶ *Hylton*, 3 U.S. at 177; see also Ackerman, *supra* note 45, at 7-10.

⁷⁷ See Johnson, *supra* note 73, at 76 (attributing the definition of direct taxes and decision on apportionment to the pragmatism of the Founders).

the first case in which the Supreme Court pondered the meaning of the term direct taxes.⁷⁸ Justice Chase wrote: “I am inclined to think, but of this I do not give a judicial opinion, that the direct taxes contemplated by the Constitution, are only two, to wit, a capitation, or poll tax, simply, without regard to property, profession, or any other circumstances; and a tax on LAND. - I doubt whether a tax, by a general assessment of personal property, within the United States, is included within the term direct tax.”⁷⁹ Justice Paterson conveyed the same idea: “Whether direct taxes, in the sense of the Constitution, comprehend any other tax than a capitation tax, and tax on land, is a questionable point.”⁸⁰ After the civil war, the Supreme Court discussed this fundamental issue in five cases.⁸¹ In *Pacific Insurance Co. v. Soule*,⁸² the Court followed *Hylton* in holding that only direct taxes are those that could be easily and fairly apportioned. In the next case, *Veazie Bank v. Fenno*,⁸³ the appellant challenged the constitutionality of a ten-percent tax on currency issued by state banks. Upon a review of the historical evidence, the Court arrived at the conclusion that personal property, contracts, occupations, and the like, had never been regarded by Congress as proper subjects of direct tax.⁸⁴ The Court, while affirming that direct taxes were limited to taxes on land and appurtenances, and taxes on polls, or capitation taxes,

⁷⁸ This case presented a precise question whether a duty upon a article of personal property kept solely for the enjoyment of its owner was or was not a direct tax. Representing the defendant in error, Alexander Hamilton argued that “direct and indirect tax had no settled meanings; that by test of shiftableness this tax would be part direct and part indirect, which would be absurd; that by the prevailing political economy taxes upon land are called direct and all others indirect, because “all taxes fall ultimately upon land, and are paid out of its produce, whether laid immediately upon itself, or upon any other thing”; that a rule must be adopted which would not involve “preposterous consequences”; that this tax would in the British statutes be an excise; and that “where so important a distinction in the Constitution is to be realized, it is fair to see the meanings of terms in the statutory language of that country from which our jurisprudence is derived;” See Edward B. Whitney, *The Income Tax and the Constitution*, 20 HARV. L. REV. 280, 283 (1906-1907).

⁷⁹ *Hylton*, 3 U.S. at 174.

⁸⁰ *Id.* at 177.

⁸¹ See Whitney, *supra* note 78, at id. n.1; see *Pacific Insurance Co. v. Soule*, 74 U.S. 433 (1868); *Farmington v. Saunders* (the cotton tax case, affirmed by a divided court without opinion); *Veazie Bank v. Fenno*, 8 U.S. 533 (1870); *Scholey v. Rew*, 23 U.S. 331 (1874); *Springer v. United States*, 102 U.S. 586 (1880).

⁸² 74 U.S. 433, 446 (1868).

⁸³ 8 U.S. 533 (1870).

⁸⁴ *Id.* at 543.

held that tax on bank notes was in the nature of a duty and thus was constitutional.⁸⁵ Again, in *Scholey v. Rew*,⁸⁶ the Supreme Court upheld a Civil War Succession tax on real estate received under a will.⁸⁷ Lastly, in *Springer v. United States*,⁸⁸ the Civil War income tax was challenged on the ground that it was a direct tax requiring apportionment. The taxpayer in *Springer* filed an income tax return, but refused to pay the assessed tax. The tax collector therefore levied on the taxpayer's real estate, purchased the property at a tax lien sale, and sought to eject the taxpayer from the premises. The taxpayer then challenged the tax assessment, levy, sale, and ejectment on due process and apportionment grounds. Once again, the Supreme Court upheld the validity of the tax from constitutional challenge, relying on the lack of clarity from the constitutional debates, the notes left behind by Alexander Hamilton from the *Hylton* case, the letters of James Madison disagreeing with the *Hylton* case (but recognizing that the courts were unlikely to adopt his views), the prior practice of Congress in imposing taxes, and the recent decisions in *Veazie*, *Soule* and *Scholey*. The Court concluded: “. . . that direct taxes, within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate; and that the tax of which the plaintiff in error complains is within the category of an excise or duty.”⁸⁹

This unbroken chain of reasoning continued well past the Nineteenth century until the *Income Tax Cases (Pollock I & Pollock II)*⁹⁰ in 1895 when the Supreme Court briefly revived the

⁸⁵ *Id.* at 546-547.

⁸⁶ 90 U.S. 331 (1875).

⁸⁷ *Scholey*, 90 U.S. at 347-48 (holding that direct does not include tax on income and a succession tax in principle is similar to income tax).

⁸⁸ 102 U.S. 586 (1881).

⁸⁹ *Id.* at 599-602; see also Gergory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis of Murphy v. Internal Revenue Service*, at 29, available at <http://law.bepress.com/expresso/eps/1867/> (last visited June 25, 2007).

⁹⁰ *Pollock v. Farmers' Loan & Trust Co. (Pollock I)*, 157 U.S. 429 (1895); *Pollock v. Farmer's Loan & Trust Co. (Pollock II)*, 158 U.S. 601 (1895).

dormant direct tax clause.⁹¹ The genesis of the *Income Tax Cases* was the Tariff Act of 1894,⁹² the first non-war income tax enacted by Congress.⁹³ Charles Pollock, a shareholder in the Farmers Loan and Trust Company, sued the company to prevent it from paying taxes imposed under the 1894 Act on the income generated by the real and personal property that the corporation owned. Mr. Pollock claimed that Congress could not constitutionally tax the corporation's income from real and personal property without apportionment.⁹⁴ The Court concluded that the 1894 income tax, which because of a \$4000 exemption amount, affected only a few taxpayers in a few states, was a direct tax that had not been apportioned.⁹⁵ The Court departed from a century long tradition of *Veazie*, *Soule* and *Scholey* and held that apportionment was intended to have real effect.⁹⁶ The decisions in the *Income Tax Cases*⁹⁷ were not comfortable ones for the Supreme Court and it took two sets of hearings and opinions for the Court to strike down the entire taxing statute. On neither occasion was the Court unanimous.⁹⁸ *Pollock I* invalidated the income tax only insofar it was imposed on income from real property.⁹⁹ The Court accepted the *Hylton* dicta that a tax on real estate is a direct tax and saw no constitutionally significant difference between a tax on real estate and a tax on income from real estate.¹⁰⁰ In the opinion of Chief Justice Fuller, indirect taxes were paid by persons who either could shift the burden on someone else or were under no legal compulsion to pay. Direct taxes, on the other hand, were taxes upon property holders in respect of their real or personal property, or upon income derived from such property in a way that the payment of tax could not be avoided by the

⁹¹ See Jensen, *supra* note 53, at 1070.

⁹² 28 Stat. 509,553 (1894).

⁹³ See Germain, *supra* note 89, at 29.

⁹⁴ *Id.*

⁹⁵ See Jensen, *supra* note 53, at 1070-1071.

⁹⁶ *Id.*

⁹⁷ See *Pollock I* and *Pollock II*, *supra* note 90.

⁹⁸ See Jensen, *supra* note 53, at 1071.

⁹⁹ *Pollock I*, 157 U.S. at 558.

¹⁰⁰ *Id.*

property holders.¹⁰¹ Because it dealt only with income from real property, *Pollock I* left the status of a large part of the Tariff Act of 1894 unclear, and the Court was pressured to rehear the case.¹⁰² In *Pollock II*, heard several months later, the Court held that income from personal property should be treated the same as income from real property.¹⁰³ With income from property removed from the base of an unapportioned tax, and because the high exemption amount effectively exempted the ordinary services-provider from the scope of the law, the Tariff Act of 1894 was gutted in entirety.¹⁰⁴

The negative political reaction to the split decision in *Pollock I* and *Pollock II* led quickly to some judicial fine tuning and readjustments.¹⁰⁵ On a theory different from *Pollock I & II*,¹⁰⁶ the Supreme Court in *Knowlton v. Moore*¹⁰⁷ unanimously upheld the constitutionality of the War Revenue Act of 1898¹⁰⁸ which imposed an apportioned tax with progressive rates on legatees who received property from a deceased person's estate. Again, in *Thomas v. United States*,¹⁰⁹ the Court deviated from *Pollock I & II* by holding that a tax on a transfer of stock certificates was direct.¹¹⁰ The very same year, the Court in *Spreckels Sugar Refining Co. v. McClain*¹¹¹ upheld a tax on the gross proceeds from the sale of sugar. The Court held that the tax was not imposed upon gross annual receipts as property, but only on the carrying on the trade or business of refining sugar.¹¹² An array of cases decided afterward signaled that the tide of *Pollock I & II* was

¹⁰¹ *Id.*

¹⁰² See Jensen, *supra* note 53, at 1071.

¹⁰³ *Pollock II*, 158 U.S. at 618.

¹⁰⁴ See Jensen, *supra* note 53, at *id.*

¹⁰⁵ See Germain, *supra* note, 89 at 33.

¹⁰⁶ *Id.*

¹⁰⁷ 178 U.S. 41, 47 (1900).

¹⁰⁸ 20 Stat. 448 (1898).

¹⁰⁹ 192 U.S. 363 (1904).

¹¹⁰ *Id.* at 370.

¹¹¹ 192 U.S. 397 (1904).

¹¹² *Id.* at 411.

receding fast.¹¹³ However, Congress wanted to throw the *Pollock* twins into complete oblivion by enacting a broad-based income tax.¹¹⁴ President Taft proposed a compromise in the form of a constitutional amendment which was to become reality soon in the form of the Sixteenth Amendment (discussed *infra*). After this amendment, the law seems settled and at least the Supreme Court does not appear to revert back to the rationale of *Pollock I & II*, for that would mean declaring the Sixteenth Amendment itself unconstitutional. Nevertheless, the burden of having provisions relating to apportionment of direct taxes in the Constitution will continue to haunt American jurisprudence.¹¹⁵ For example, in *Helvering v. Independent Life Ins. Co.*,¹¹⁶ the Court held that “[I]f the statute lays taxes on the part of the building occupied by the owner or upon the rental value of that space, it can not be sustained, for that would be to lay a direct tax requiring apportionment.”¹¹⁷ As one commentator summed up: “[W]e must not forget that as long as the words ‘direct taxation’ are retained in the constitution, difficulties in interpretation will arise in future, even if the income tax matter is disposed of.”¹¹⁸

¹¹³ See, e.g., *Flint v. Stone Tracey Co.*, 220 U.S. 107, 150 (1911) (challenging an excise tax upon the privilege of doing business in a corporate capacity) (“Within the category of indirect taxation, as we shall have further occasion to show, is embraced a tax upon business done in a corporate capacity, which is the subject-matter of the tax imposed in the act under consideration. The Pollock Case construed the tax there levied as direct, because it was imposed upon property simply because of its ownership. In the present case the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax, measured by the standard prescribed. The difference between the acts is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way.”); *Zonne v. Minneapolis Syndicate*, 220 U.S. 187, 190 (1911) (corporation challenging its taxability under the Corporate Tax Law of 1909) (“[T]he Corporation Tax Law . . . provides for an excise upon the carrying on or doing of business in a corporate capacity. We have held in the preceding cases that corporations organized for profit under the laws of the State, authorized to manage and rent real estate, and being so engaged, are doing business within the meaning of the law, and are therefore liable to the tax imposed.”) (citation omitted); *Stratton’s Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913) (plaintiff challenging the applicability of the Corporation Tax Law as the plaintiff was merely converting its capital asset from one form to another) (. . . “[F]or ‘income’ may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor.”).

¹¹⁴ See Germain, *supra* note 89, at 38.

¹¹⁵ See, e.g. FREELAND ET AL., *supra* note 2, at 17.

¹¹⁶ 292 U.S. 371 (1934).

¹¹⁷ *Id.* at 378.

¹¹⁸ See EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 594 (1911) *quoted in* Erik M. Jesnes *supra* note 53, at 1061-1062.

(b) The Requirement of “Uniformity”

As mentioned earlier, the Constitution provides for two important limitations on the taxing power of Congress. While the first relates to apportionment of direct taxes, the second limitation relates to the uniformity of “. . . [A]ll duties, imposts, and excises...throughout the United States.”¹¹⁹ According to noted Professor Boris Bittker, the uniformity clause is “a constitutional provision that might have dramatically influenced the structure of the federal income tax, but that has shriveled away to a mere flyspeck.”¹²⁰ To prove this point, he takes us back in history to *Pollock I*, when it was argued that the 1894 federal income tax violated the uniformity clause by taxing some corporate income at a higher rate than individual or partnership income “from precisely similar property or business” and by exempting the first \$4,000 of individual income from salaries and wages while taxing investment income regardless of amount.¹²¹ The justices were equally divided on the validity of these constitutional objections, but the uniformity clause issue got watered down in *Pollock II* when on rehearing, the Court held that the tax violated the direct tax clause because it was not apportioned among the states according to population.¹²² According to Professor Bittker, a liberal interpretation of the uniformity clause could have made exemptions and differential tax rates unconstitutional, plus it could have invalidated the distinction between capital gains and ordinary income.¹²³ The Supreme Court had perhaps heard the issue for the first time (even earlier than *Pollock I*) in *United States v. Singer*.¹²⁴ However, it is *Knowlton v. Moore*¹²⁵ that is generally credited with

¹¹⁹ U.S. CONST art. I.

¹²⁰ See Boris I. Bittker, *Constitutional Limits on the Taxing Power of the Federal Government*, 41 TAX LAW. 3, 9-10 (1987).

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ 82 U.S. 111, 121 (1872) (holding tax imposed upon a distiller in the nature of excise, and uniform in its operation since it was assessed equally upon all manufacturers of spirits wherever they were).

¹²⁵ 178 U.S. 41 (1900).

settling the law that the Constitution requires only geographical uniformity.¹²⁶ Rejecting the construction that the term uniformity related to the inherent and intrinsic character of tax, Justice White wrote: “That the words “uniform throughout the United States” do not relate to the inherent character of the tax as respects its operation on individuals, but simply requires that whatever plan or method Congress adopts for laying the tax in question, the same plan and the same method must be made operative throughout the United States; that is to say, that wherever a subject is taxed anywhere, the same must be taxed everywhere throughout the United States, and at the same rate.”¹²⁷

From the foregoing analysis, it appears clear that there are hardly any significant impediments to the taxing power of Congress. The principal message is that most taxing statutes are not vulnerable to constitutional attack.¹²⁸ Thus, it is the *practicality*, and not the *constitutionality* of a tax that is paramount.¹²⁹

(c) The Sixteenth Amendment and the Present Day Conception of Income.

In 1913, the Sixteenth Amendment eliminated any remaining constitutional requirement that taxes on income be apportioned. It provided:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.¹³⁰

¹²⁶ *Id.* at 106 (analyzing the history of the adoption of the Constitution and holding that the words “uniform throughout the United States” do not signify an intrinsic but simply a geographical uniformity).

¹²⁷ *Id.* at 84; *see also* *Edye v. Robertson*, 112 U.S. 580, 594 (1884) (“The tax is uniform when it operates with the same force and effect in every place where the subject of it is found.”); *Nicole v. Ames*, 173 U.S. 509, 521 (1898) (“Whether the word “uniform” is to be understood in what has been termed its “geographical” sense, or as meaning uniformity as to all the taxpayers similarly situated with regard to the subject-matter of the tax, we think this tax is valid . . .”).

¹²⁸ *See* FREELAND ET AL., *supra* note 2, at 20.

¹²⁹ *Nicole v. Ames*, 173 U.S. 509, 515-516 (1899) (“Taxation is eminently practical, and is in fact brought to every man’s door, and for the purpose of deciding upon its validity a tax should be regarded in its actual, practical results, rather than with reference to those theoretical or abstract ideas whose correctness is the subject of dispute and contradiction among those who are experts in the science of political economy.”).

¹³⁰ U.S. CONST. amend. XVI, *see also* *Germain*, *supra* note 89, at 39.

In reality, *Pollock I & II* had sown the seeds of the Sixteenth Amendment by overruling *Hylton*. The original intent was that Congress should have the power to lay taxes without a restraint. *Pollock I & II* went against that intent for reasons personal to the judges and not mandated by constitutional policy.¹³¹ In the years that followed, debate ensued to provide Congress with a necessary basis for a wide-based income tax scheme.¹³² This resulted into the adoption of the Sixteenth Amendment in 1913. The effect of the amendment was not to grant Congress the power to adopt income taxes for this power already existed by virtue of Article I of the Constitution.¹³³ Instead, the amendment simply eliminated the need for apportionment of any income taxes that might be viewed as direct taxes. Following adoption of the Amendment, Congress quickly imposed a broadly based income tax.¹³⁴ It is important to note that the amendment does not eliminate the apportionment requirement for direct taxes that do not involve income.¹³⁵ However, even after eliminating the difficulties of *Pollock I & II*, problems remained in determining the constitutional meaning of the term “income” since the Sixteenth Amendment nowhere defined the term.¹³⁶ The Supreme Court’s earlier pronouncements interpreted the term very strictly, limiting it to its plain or ordinary meaning.¹³⁷ In the 1918 case of *Towne v. Eisner*,¹³⁸ the Court considered the question of whether stock dividends, the source of which was earnings accumulated before the enactment of the Sixteenth Amendment, were income. While discussing the constitutional meaning of the word “income,” the Court said “A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color

¹³¹ See Johnson, *supra* note 73, at 78.

¹³² See F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725, 732 (1997).

¹³³ *Id.*; see also *Eisner v. Macomber*, 252 U.S. at 206; *Stanton v. Baltic Mining Co.*, 240 U.S. at 112-13; *Brushaber v. Union P.R. Co.*, 240 U.S. at 11-18.

¹³⁴ Tariff Act of October 3, 1913. See Pub. L. No. 63-16, S II, Ch. 16, 38 Stat. 166 (1913).

¹³⁵ See Hubbard, *supra* note 132, at id.

¹³⁶ See Kornhauser, *supra* note 47, at 3.

¹³⁷ *Id.*

¹³⁸ 245 U.S. 418 (1918).

and content according to the circumstances and the time in which it is used.”¹³⁹ The value of this case at that point of time was that it effectively determined that statutory and constitutional definitions of income coincided.¹⁴⁰ In another important case of *Eisner v. Macomber*¹⁴¹ decided two years later, the Court was confronted with the question of whether Congress could impose a tax on a stock dividend without requiring apportionment among the states. That is, is such a tax a “tax on income” (or part of a “tax on income”) exempt from the apportionment requirement that otherwise applies to direct taxes?”¹⁴² The Court, while discussing at length the meaning of income under the Amendment as well as the statute, said that the question as to what constitutes income must be decided according to “truth and substance” without regard to “form.”¹⁴³ The Court further said that in order to interpret the Sixteenth Amendment, all that was required was a clear definition of the term “income,” as used in common speech.¹⁴⁴ *Macomber* was criticized for its narrow definition of income.¹⁴⁵ This was evident in *Merchant’s Loan & Trust Co. v. Smietanka*.¹⁴⁶ when the Court departed from its own precedent and held that capital gains were income in a constitutional sense because to hold otherwise “would, in a large measure, defeat the purpose of the [Sixteenth] Amendment.”¹⁴⁷ Finally, in *Commissioner v. Glenshaw Glass Co.*¹⁴⁸ the Court further demolished *Macomber* by narrowing the holding to its facts and saying: “But it was not meant to provide a touchstone to all future gross income questions.”¹⁴⁹ In this case, the

¹³⁹ *Id.* at 425.

¹⁴⁰ *See* Jensen, *supra* note 53, at 1134.

¹⁴¹ 252 U.S. 189 (1920).

¹⁴² *See* Jensen, *supra* note 53, at 1133.

¹⁴³ *Macomber*, 252 U.S. at 193.

¹⁴⁴ *Id.*

¹⁴⁵ *See* Kornhauser, *supra* note 47, at 14-15.

¹⁴⁶ 255 U.S. 509 (1921).

¹⁴⁷ *Id.* at 521; *see also* Kornhauser, *supra* note 47, at 15.

¹⁴⁸ 348 U.S. 426 (1955).

¹⁴⁹ *Id.* at 431.

catch-all language of Section 22(a) of the Internal Revenue Code of 1939¹⁵⁰ was in dispute. Giving full deference to the intent of Congress, the Court decisively held that income may be defined as “. . .[U]ndeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”¹⁵¹ (emphasis added)

3. Constitutionality of Taxing Damages Recoveries on Account of Emotional Distress

It is a fundamental principle of constitutional democracy that lawmakers must derive their lawmaking authority from the Constitution. In the present context also, Congress must remain within the constitutional limits while attempting to tax recoveries on account of emotional distress.¹⁵² However, there is a strong presumption that Congressional statutes are constitutional and this presumption only should be overcome when Congress clearly exceeds that limit.¹⁵³ It also would be important to look for an express provision in the Constitution to determine whether such a lawmaking power had been conferred on Congress or not.¹⁵⁴ Also, when the constitutionality of a particular law or its provision is in doubt, it has to be shown that there is no conceivable constitutional basis for the same.¹⁵⁵ From the foregoing discussion, it is clear that a tax on recovery on account of emotional distress would be constitutional if two conditions are satisfied. First, the tax must not be in the nature of direct tax requiring

¹⁵⁰ 53 Stat. 9, 53 Stat. 574, 26 U.S.C. § 22(a) (1939) (predecessor of 26 U.S.C. § 61(a)(1986)).

¹⁵¹ *Glenshaw Glass*, 348 U.S. at 431.

¹⁵² *Marbury v. Madison*, 5 U.S. 137, 176-77 (1803) (holding that the Constitution of the United States establishes certain limits not to be transcended by the different departments of the government).

¹⁵³ *United States v. Morrison*, 529 U.S. 598, 607 (2000) (stating that due respect for the decisions of a coordinate branch of Government demands that a congressional enactment could be invalidated only upon a plain showing that Congress had exceeded its constitutional limits).

¹⁵⁴ *United States v. Harris* 106 U.S. 629, 636 (1883) (holding that every valid act of Congress must find in the Constitution some warrant for its passage).

¹⁵⁵ *Madden v. Kentucky* 309 U.S. 83, 87-88 (1940) (stating that the burden is on the one attacking the legislative arrangement to negative every conceivable basis which might support it).

apportionment; and second, the tax must be on a receipt that can properly be qualified as income and not merely a return of capital.

(a) Tax on Emotional Distress Recoveries Must Not Be a Direct Tax Requiring Apportionment

As discussed earlier, Congress's original Article I power gave it the unfettered authority to tax duties and excises without apportionment.¹⁵⁶ However, the requirement of apportioning direct taxes remains, even though most federal taxes in present times are not categorized as direct taxes because of difficulties pertaining to the requirement of apportionment, a point discussed earlier in this paper.¹⁵⁷ In the present context, therefore, it must be determined whether a tax on recoveries for emotional distress qualifies as a direct tax requiring apportionment. If the recoveries can be attributed properly to a transaction or an activity, then the tax may not be a direct tax. For example, in *Veazie Bank v. Fenno*,¹⁵⁸ the Supreme Court upheld taxes on gross proceeds from the issuance of bank notes. Again, in *Scholey v. Rew*,¹⁵⁹ taxes on gross proceeds inherited at death were upheld. Though the facts were different in these cases, one could easily see the connecting thread. The tax was not on property per se but on an activity that related to the property that generated income. Also, the historical meaning of direct taxes has been very specific and narrow.

¹⁵⁶ See Germain, *supra* note 89, at 42.

¹⁵⁷ See *supra* note 118.

¹⁵⁸ 8 U.S. 533 (1870).

¹⁵⁹ 90 U.S. 331 (1875).

**(b) Recovery of Damages for Emotional Distress Must be in the Nature of
Income and Not Merely a Return of Capital**

Though *Glenshaw Glass* broadly defined income, it could not be said that a recovery of any kind could be characterized as income in the constitutional sense. As a general proposition, the tax consequences of a recovery of damages can be determined in part, by identifying the nature of the injury.¹⁶⁰ The question was framed by the First Circuit in *Raytheon Production Corp. v. Commissioner*:¹⁶¹ “In lieu of what were the damages awarded?”¹⁶² Thus, if the recovery of damages is solely on account of capital, it can not be taxed; otherwise, it would fall within the *Glenshaw Glass* definition of income. In the context of *Murphy*, one may say that the recovery of damages for emotional distress would be tax-exempt only upon a showing that the damages were, in fact, a return of emotional capital, if this term could be properly characterized and explained. However, individuals are generally not given a basis for their investments in their own human capital.¹⁶³ In summary, one must look at a transaction’s *substance*, rather than its, in determining the appropriate tax treatment of damage recovery.¹⁶⁴

B. The Tax Law Perspective

Section 61 of the Code defines income in a broadly inclusive and non-exhaustive manner.¹⁶⁵ Exclusions, on the other hand, are limited and strictly defined. Thus, post *Glenshaw Glass*, almost any kind of receipt or gain would fall within the ambit of statutory definition of income but the exclusionary provision has to be expressly found within the Code.

¹⁶⁰ United States v Burke, 504 US 229 (1992).

¹⁶¹ 144 F.2d 110, 113 (1st Cir.1944).

¹⁶² *Id.*

¹⁶³ See Germain, *supra* note 89, at 76.

¹⁶⁴ See FREELAND ET. AL., *supra* note 2, at 185 (emphasis in original).

¹⁶⁵ 26 U.S.C. § 61.

1. Exclusion for Personal Injury

The roots of the present day Code go back to 1913, but at that time there was no exclusion for personal injury.¹⁶⁶ In 1915, the Treasury Department issued Treasury Decision 2135.¹⁶⁷ It stated that monies received by a taxpayer under an accident insurance policy were income, and that an amount received as a result of suit or compromise for “pain and suffering” would be treated as income. Although the Treasury Decision 2135 did not specifically deal with treatment of damages for personal injury, its wording was sufficiently clear to hold all damages for personal injury, compensatory as well as punitive, taxable.¹⁶⁸ A change occurred in 1918, however, when the Attorney General, responding to a letter from the Secretary of the Treasury seeking an opinion on the taxation of accident insurance proceeds, urged Treasury to find ways in which such amount could be excludable from income.¹⁶⁹ Though the Attorney General’s reasoning later was subject to criticism,¹⁷⁰ it was accepted and Congress codified the exclusion when it added Section 213(b)(6) to the Code.¹⁷¹ The new statute provided that income did not include “[A]mounts received, through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.”¹⁷² In 1927, the Board of Tax Appeals¹⁷³ held in *Hawkins v. Commissioner*,¹⁷⁴ that general or

¹⁶⁶ Income Tax Act of 1913, ch. 16, 38 Stat. 114.

¹⁶⁷ T. D. 2135, 17 Treas. Dec. Int. Rev. 39, 42 (1915) quoted in Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical But Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51, 56-57 (1997).

¹⁶⁸ *Id.*

¹⁶⁹ See 31 Op. Att’y Gen. 304 (1918).

¹⁷⁰ See, e.g., Hobbs, *supra* note 167, at 57-64.

¹⁷¹ Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1918).

¹⁷² *Id.*

¹⁷³ The Board of Tax Appeals, the forerunner to the present day United States Tax Court, was created in 1924 as an independent administrative agency in the executive branch of the government. Its name was changed in 1942 and the Tax Reform Act of 1969 gave it the status as an Article I Court. See FREEELAND ET. AL. *supra* note 2, at 29.

compensatory damages received by way of settlement for injury to personal reputation and health caused by defamatory statements constituting libel or slander are not income. The Board noted: “Even to the economist, character or reputation or other strictly personal attributes are not capital or otherwise measurable in terms of wealth, notwithstanding that all will recognize them as important factors of economic success. They are not property or goods. Such compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury.”¹⁷⁵

A turning point came in 1955 when, as noted earlier, the Supreme Court rendered its landmark decision in *Glenshaw Glass*, which had important implications for personal injury exclusion analysis, both physical and nonphysical.¹⁷⁶ The Court sanctioned the human capital rationale¹⁷⁷ for excluding personal injury recoveries.¹⁷⁸ It is interesting to note though that the IRS did not use *Glenshaw Glass* to eliminate the nonstatutory exclusion. Instead this decision was used as a tool to tax punitive damages.¹⁷⁹ Then, in *Seay v. Commissioner*,¹⁸⁰ the Tax Court had an opportunity, for the first time, to address the application of the statutory exclusion to nonphysical injuries.¹⁸¹ The Tax Court said: “Under these circumstances, we believe that the “personal embarrassment” was incidental to or in aggravation of Section 104(a)(2)¹⁸² personal injuries and that the entire \$ 45,000 payment is, therefore, excludable under Section 104(a)(2). In reaching this conclusion, we have found it unnecessary to decide whether damages received in settlement

¹⁷⁴ 6 B.T.A. 1023 (1927).

¹⁷⁵ *Id.* at 1025.

¹⁷⁶ See Hobbs, *supra* note 167, at 70.

¹⁷⁷ See *infra* notes 194-198.

¹⁷⁸ See Hobbs, *supra* note 167, at 70.

¹⁷⁹ *Id.* at 71.

¹⁸⁰ 58 T.C. 32 (1972).

¹⁸¹ See Hobbs, *supra* note 167, at 71.

¹⁸² The present day Section 104(a)(2) is a successor to Section 22(b)(5) of the Internal Revenue Code of 1939, which in turn owes its origin to Section 213(b)(6) of the Revenue Act of 1918. The earlier versions took shape of Section 104 of the Internal Revenue Code during its major reorganization in 1954.

of a claim based solely upon personal embarrassment would be excludable under Section 104(a)(2).”¹⁸³ Though not a decision that had a convincing reasoning for its judgment, it certainly had the effect of merging the statutory physical injury exclusion and the non-statutory nonphysical injury exclusion.¹⁸⁴ Later, the Ninth Circuit’s decision in *Roemer v. Commissioner*¹⁸⁵ provided more clarification. In this case, the taxpayer sued a credit company for issuing a defamatory report that resulted in his being denied several agency licenses. He was awarded compensatory and punitive damages which he sought to exclude under Section 104(a)(2). The Tax Court held the entire award taxable drawing a distinction between damages to personal reputation and damages to business reputation.¹⁸⁶ Reversing the Tax Court, the Ninth Circuit held that for tax treatment of damages, the relevant distinction should be made between personal and nonpersonal injuries, and not between physical and nonphysical injuries.¹⁸⁷ In 1986, the Tax Court reconsidered its holding on damages to professional reputation. In *Threlkeld v. Commissioner*,¹⁸⁸ the Tax Court followed the *Roemer* approach, allowing exclusion of the settlement amount allocated to damages to professional reputation.¹⁸⁹ The Tax Court expressly found no distinction between physical and emotional injuries or between injury to personal reputation and injury to professional reputation. The Tax Court held that the proper inquiry has to be the “origin and character of the claim,” and not “the consequences of the injury.”¹⁹⁰ According to the court, even if lost income is the best measure of damages, that does not change the character of the claim. To characterize the claim in that case, the court focused on the

¹⁸³ *Seay*, 58 T.C. at 40.

¹⁸⁴ *See Hobbs supra* note 167, at 72.

¹⁸⁵ 79 T.C. 398, (1982).

¹⁸⁶ *Id.* at 405.

¹⁸⁷ 716 F.2d 693, 697 (9th Cir. 1983).

¹⁸⁸ 87 T.C. 1294 (1986); *see also* Leandra L. Gassenheimer, *The Excludability of Employment Discrimination Awards under Code Section 104(a)(2) after Burke v. United States and Commissioner v. Schleier*, 28 ARIZ. ST. L.J. 315, 318-319 (1996).

¹⁸⁹ *Threlkeld*, 87 T.C. at 1298.

¹⁹⁰ *Id.* at 1299.

taxpayer's complaint and found that the cause of action was malicious prosecution, which would be classified as a personal injury cause of action under applicable state law. On appeal, the Sixth Circuit affirmed the Tax Court, adopting the *Roemer* reasoning.¹⁹¹

2. The Justifications of Exclusion

The most common policy explanations for Section 104(a)(2) are: (1) the return of capital theory; (2) the involuntary nature of transaction theory; (3) the compassion or humanitarianism theory; (4) the imputed income theory; and (5) the bunching of income theory¹⁹² or the administrative concerns theory.¹⁹³

The return of capital theory is powerful in its simplicity and intuitive logic¹⁹⁴ and happens to be the most common explanation for the Section 104 exclusion.¹⁹⁵ Return of capital is a payment received that equals, or does not exceed, a taxpayer's investment or basis in an item. Under this approach, damage awards are considered a return of capital. When a taxpayer's mental or physical health is injured, a damage award compensates a taxpayer for the injury and, in doing so, returns the lost capital. This mirrors a traditional principle in tort law that the purpose of compensatory damages is to put the injured party in the position that he or she would have been had the party not been injured. Thus, the damages make the injured party whole.¹⁹⁶ This theory is not without criticism though. In order to have a return of capital, a taxpayer must first have a basis or investment in his or her body. However, a taxpayer cannot be said to have a basis in his or her body because human bodies are not purchased. Furthermore, a person's basis in his or her

¹⁹¹ See Grassheimer, *supra* note 188, at id.

¹⁹² See Sharon E. Stedman, *Congress's Amendment to Section 104 of the Tax Code will Not Clarify the Tax Treatment of Damages and will Lead to Arbitrary Distinctions*, 21 SEATTLE U. L. REV. 387, 389 (1997).

¹⁹³ See Robert C. Illig, Note, *Tort Reform and the Tax Code: An Opportunity to Narrow the Personal Injuries Exemption*, 48 VAND. L. REV. 1459, 1466 (1995).

¹⁹⁴ *Id.* at 1464.

¹⁹⁵ See Stedman, *supra* note 189, at 389-390.

¹⁹⁶ *Id.*

body cannot be the cost to maintain that body because a taxpayer deducts those costs in the annual personal exemption. Accordingly, the return of capital theory alone cannot adequately explain the policy underlying the Section 104(a)(2) exclusion.¹⁹⁷ This theory was rejected in *Horton v. Commissioner*¹⁹⁸ and thus is no longer very relevant.

Second is the involuntary transaction theory which simply states that a plaintiff does not ask to be injured and thus is not liable for the consequences of injury, including recovery of damages.¹⁹⁹ Therefore, under this theory, Section 104 is analogous to other sections of the tax code that afford special tax treatment to involuntary transactions.²⁰⁰ For example, Section 1033²⁰¹ allows a taxpayer to postpone gain after an involuntary conversion of property. Under this section, if a taxpayer's property is destroyed, the taxpayer can exclude any gain received from insurance, but only if the taxpayer reinvests the money in a replacement property.²⁰² However, Sections 104 and 1033 are not completely analogous. Even though Section 1033 allows for a postponement of gain, Section 1033, unlike Section 104, does not create an exclusion from income but rather, provides a postponement of income recognition. Consequently, this theory is also inadequate for explaining the exclusion under Section 104.²⁰³

The third theory is the compassion or humanitarianism theory. Many believe that the very origin of Section 104(a)(2) is congressional compassion and concern for the injured.²⁰⁴ If part of a damage award is used for paying tax then the injured taxpayer may not be able to cover the entire expenses needed for complete medical care. And this would defeat the primary goal of tort

¹⁹⁷ See Stedman, *supra* note 192, at 390.

¹⁹⁸ 100 T.C. 93, 96 (1993), *aff'd* 33 F.2d 625 (6th Cir. 1994).

¹⁹⁹ See Stedman, *supra* note 192, at 390-391.

²⁰⁰ *Id.*

²⁰¹ 26 U.S.C. § 1033.

²⁰² See Stedman, *supra* note 192, at *id.* Section 104(a)(2) is somewhat similar in that Section 213 allows an offsetting deduction to the extent of an inclusion of a recovery for personal injury where the injured party suffers actual damages for medical treatment that is not reimbursed by an insurance company.

²⁰³ *Id.*

²⁰⁴ See Stedman, *supra* note 192, at 391.

law which is compensation of victims for personal injuries and look as if the government is engaging, by taxing, in a “vulturous behavior”.²⁰⁵ It also leads to greater damage awards in order to cover the tax, attorney’s fees and other costs. Thus, under this theory, Section 104(a)(2) is comparable to Section 101 of the Code²⁰⁶ which provide exclusion for amounts received under life insurance contracts.²⁰⁷

A fourth possible explanation is the imputed income theory.²⁰⁸ The concept of imputed income is further subdivided into two types. The first type is derived from the use of “household durables.” In other words, the owner of a house saves in rent which he or she would have to pay to a landlord had he or she been living in a rented house. This saving in rent is considered imputed income. The second type is derived by using one’s own labor. A taxpayer grows vegetables in his or her garden and the resulting saving is imputed income to the taxpayer. However, in both cases, the IRS does not include this amount in gross income.²⁰⁹ The imputed income theory may be used to explain the exclusion of damages from gross income.

A fifth justification is based on the bunching of income theory.²¹⁰ The gist of this theory is that it would be unfair to tax damages because the recovery would artificially place a taxpayer in a higher progressive rate bracket. In other words, if a taxpayer would have received a fraction of damages each year spread over a long period, this would decrease or even eliminate his or her tax liability. But because of lump sum payment, the taxpayer might be paying a considerable amount of tax at a much higher rate in the year of receipt.²¹¹ However, this theory has been criticized because Congress can easily set this problem right by averaging the damage award

²⁰⁵ See Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 349 (1995).

²⁰⁶ 26 U.S.C. § 101.

²⁰⁷ See Stedman, *supra* note 192, at 391-392.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ See Stedman, *supra* note 192, at 392-393.

²¹¹ *Id.*

over the relevant period. This way, the taxpayer would not have to report the entire award as income in one particular year.²¹² Moreover, difficulties with the allocation of awards, for example between taxable and exempt income, have also been cited as potential justifications for the current system.²¹³

3. The Amendments in Section 104(a)(2)

(a) Congress's 1989 Amendment

Throughout the period of the judicial and administrative expansion phase of Section 104(a)(2) marked by *Hawkins*, *Seay*, and *Roemer*, Congress remained silent.²¹⁴ Then, in 1989, the House of Representatives proposed an amendment to Section 104(a)(2), repudiating the courts' expansive reading. The proposed amendment read: "[G]ross income does not include . . . the amount of any damages received . . . on account of personal injuries or sickness in a case involving physical injury or physical sickness . . ." The accompanying committee report confirmed the House's recognition that courts were interpreting Section 104(a)(2) too broadly. The Report stated that "some courts have held that the exclusion applies to damages in cases involving employment discrimination and injury to reputation where there is no physical injury or sickness," but that the committee believed this "inappropriate where no physical injury or sickness is involved."²¹⁵ The conference committee rejected the proposed amendment, however, in favor of a substitute amendment which, in effect, gave congressional approval to the extension of Section 104(a)(2) to nonphysical injuries: "Paragraph [Section 104(a)(2)] shall not apply to any punitive damages in connection with a case not involving physical injury or physical

²¹² *Id.*

²¹³ *See Illig, supra* note 193, at 1466.

²¹⁴ *See Hobbs, supra* note 167, at 74.

²¹⁵ *Id.*

sickness.” The proposal was signed into law as part of the Omnibus Budget Reconciliation Act of 1989.²¹⁶ Unfortunately, the 1989 amendment achieved expansion by contraction.²¹⁷ Congress did not realize that by declaring only punitive damages for nonphysical injuries taxable, it was impliedly allowing the exclusion of Section 104(a)(2) to apply to compensatory awards for nonphysical injuries. This was not the intention of the House and gave courts the freedom to apply Section 104(a)(2) to nonphysical injuries.²¹⁸ In 1992, the Supreme Court, in *Burke v. United State*,²¹⁹ reaffirmed the statutory requirement that for damages to be within the scope of Section 104(a)(2), the claim on which the damages were based must be tort or tort-type.²²⁰ The principal contribution of the *Burke* decision was to set criteria for determining whether a claim is a tort or tort-type.²²¹ Three years later, in *Commissioner v. Schlier*,²²² the Court added another requirement to that enunciated by *Burke*. It was held that the damages must have been received on account of personal injuries and sickness.²²³

(b) The 1996 Amendment

Following the Supreme Court’s decisions in *Burke* and *Schlier*, the House of Representatives proposed to limit the exclusion in Section 104(a)(2) once again.²²⁴ However, even the amended Code Section 104(a)(2) did not define what “personal injury” or “personal sickness” meant.²²⁵ For an understanding of these two terms one may look at the House

²¹⁶ See Hobbs, *supra* note 167, at 74-75.

²¹⁷ See Hobbs, *supra* note 167, at 75.

²¹⁸ *Id.*

²¹⁹ 504 U.S. 229 (1992).

²²⁰ See Douglas A. Kahn, *Taxation of Damages after Schleier – Where are We and Where Do We Go From Here*, 15 QUINNIPAC L. REV. 305, 319(1995).

²²¹ *Id.*

²²² 515 U.S. 323 (1995).

²²³ *Id.* at 336.

²²⁴ See Germain, *supra* note 89, at 11.

²²⁵ 26 U.S.C. § 104(a)(2).

Committee Report that contains an explanation of the requirement of physical injury or physical sickness.²²⁶ The Committee believed that substantial litigation had resulted in an attempt to attribute the reason for the award.²²⁷ The Report provided that the exclusion from gross income was not intended to apply to any damages received based on a claim of employment discrimination or emotional distress. It also noted that since all damages received on account of physical injury or physical sickness were allowed to be excluded from gross income, the exclusion from gross income applied to any damages received on a claim of emotional distress attributable to a physical injury or physical sickness.²²⁸ Moreover, footnote 24 of the Report expressed the Committee's intention that the term "emotional distress" include physical symptoms (e.g. insomnia, headaches, stomach disorders) which may result from such emotional distress.²²⁹ Thus, the Report specifically intended that physical manifestations of emotional distress should not be treated as a "physical injury or physical sickness." In other words, it wanted to ensure a proximate physical impact that produced an immediate physical injury or sickness (although not necessarily to the plaintiff) in order to have a "physical injury or physical sickness" from which excludible damages could flow.²³⁰ However, the exclusion from gross income specifically applied to the amount of damages received that were not in excess of the amount paid for medical care attributable to emotional distress.²³¹ So, if emotional distress resulted in physical symptoms for which the injured party sought treatment and incurred expenses, the recovery was excludable up to the amount of the expenses.

²²⁶ See House Committee Report on Small Business Job Protection Act, 1996 H.R. REP. No. 104-586, at 143 (1996), 1996-3 C.B. 331, 481.

²²⁷ *Id.*

²²⁸ See H. R. REP. *supra* note 226, at 143-144.

²²⁹ *Id.*

²³⁰ See Germain, *supra* note 89, at 12.

²³¹ *Id.*; see also Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U. L. REV. 61, 73-74 (1997).

Unlike in 1989, when the Senate had not initially accepted the House version of the bill, this time the Conference Committee agreed to the House version.²³² The Conference Committee report quoted much of the language from the House Report as the reason why the damages arising from emotional distress were being excluded.²³³ The flush language added to Section 104(a)(2) made it very clear that emotional distress shall not be treated as a “physical injury or physical sickness.”²³⁴ Thus, the clear purpose of the new “physical injury or physical sickness” requirement was to make all amounts received for emotional distress damages, including amounts received on account of physical manifestations arising out of that emotional distress, includible in income.²³⁵

C. The Tort Law Perspective

Damage recoveries for personal injuries are as old as tort law.²³⁶ One of the principal functions of tort law is to make the victim whole again through compensatory damages.²³⁷ In the case of pecuniary damage, the emphasis is on putting the injured party back in the same economic position that party would have been in if no loss had occurred.²³⁸ Though punitive damages are an important part of tort law, the present discussion is confined to compensatory damages. In tort law the term “compensatory damages” encompasses recoveries for both economic harms (such as medical expenses, lost wages, and earning capacity) and noneconomic

²³² See H.R. CONF. REP. No. 104-737 at 300 (1996).

²³³ See Small Business Job Protection Act of 1996, Conference Report to accompany H.R. 3448, *see supra* note 228, at *id.*; *see also* Germain, *supra* note 89, at 12.

²³⁴ 26 U.S.C. § 104(a)(2); *see also* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1838 (1996).

²³⁵ See Germain, *supra* note 89, at 13.

²³⁶ See Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 701 (1986).

²³⁷ RESTATEMENT (SECOND) OF TORTS § 903 (1979).

²³⁸ See Bretram Harnett, *Torts and Taxes*, 27. N.Y.U.L. REV. 614,617 (1952).

harms (such as pain and suffering, and humiliation).²³⁹ The fundamental aim of tort law is to create disincentives to socially harmful conduct.²⁴⁰ The interconnection between tax law and tort law is important since the *Burke* judgment effectively limited the Section 104(a)(2) exclusion to damages received on account of a claim that redresses a tort-like personal injury.²⁴¹ This was contrasted with legal injury of an economic character.²⁴²

As noted earlier, through successive amendments in Section 104(a)(2), its scope has been narrowed to a great extent.²⁴³ In the present day context, this section provides that only recoveries for compensatory damages received as a result of physical injury of physical sickness are excludible.²⁴⁴

1. Tort Law Physical Injury and Section 104(a)(2)

Under Section 104(a)(2), interpretive difficulties exist with regard to the words “physical injury or physical sickness.”²⁴⁵ Congress failed to stipulate whether physical contact is required or whether physical manifestations of a nonphysical injury would suffice.²⁴⁶ Also, the conference report was silent with respect to the presence of physical sickness when the origin of the action is a nonphysical injury, i.e., sexual harassment resulting in an ulcer or intentional infliction of emotional distress resulting in suicide.²⁴⁷ Since the amended statute provides an exclusion for amounts paid for physical injury “or” physical sickness, presumably some portion

²³⁹ See Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 145 (1992).

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Burke*, 504 U.S. at 238-239.

²⁴³ See *supra* text accompanying notes 214-235.

²⁴⁴ 26 U.S.C. § 104(a)(2).

²⁴⁵ See Hobbs, *supra* note 167, at 88.

²⁴⁶ *Id.*

²⁴⁷ See Hobbs, *supra* note 167, at 89.

of such awards should be excludable.²⁴⁸ The IRS's guidance on this issue is limited to a single private letter ruling.²⁴⁹ The ruling (sometimes referred to as the "Job from Hell" ruling)²⁵⁰ describes a "slow progression" of affronts and injuries suffered by the plaintiff on the job.²⁵¹ As per this ruling the plaintiff's relationship with her employer at first had been friendly, but later came to include lewd remarks and unwanted attempts to make sexual contact, then progressed to unwanted physical touching without "observable bodily harm." Later, the employer "assaulted" the plaintiff, causing "what [she] represent[ed] was extreme pain," although her doctors found nothing "physically wrong" with her. During a subsequent road trip, the employer assaulted her again, "cutting her and biting her." Later assaults resulted in "skin discoloration and swelling." The IRS ruled that the employer's assaults produced physical injury (exempt from taxation when compensated by damages) only when they reached the cutting and biting stage. The ruling describes the standard for "physical" injury as "uninvited physical contacts resulting in observable bodily harm such as bruises, cuts, swelling, and bleeding." While this is a non-precedent²⁵² position taken by the IRS, it provides a window into the Service's thinking on the subject.²⁵³

2. The Tort Law Emotional Distress and Section 104(a)(2)

The statutory language contained in Section 104(a)(2) reasonably produces two very different interpretations.²⁵⁴ First, the section might mean that a recovery solely for emotional

²⁴⁸ *Id.*

²⁴⁹ See I.R.S. Priv. Ltr. Rul. 200041022 (July 7, 2000).

²⁵⁰ See J. Thomas Price, *Settlement and Judgments: Taxing Issues Remain*, 50 BOSTON B. J. 20, 20 (Nov./Dec. 2006).

²⁵¹ *Id.*

²⁵² See 26 U.S.C. 6110(k)(3) (providing that a "written determination", which includes a private letter ruling, may not be used or cited as precedent).

²⁵³ *Id.*

²⁵⁴ See Hobbs, *supra* note 167, at 87.

distress unaccompanied by a physical injury is to be treated as a taxable nonphysical injury award, except to the extent of medical costs incurred in treating the emotional distress.²⁵⁵ Under this reading, Section 104(a)(2) contains a limited nonphysical injury exclusion for claims of emotional distress.²⁵⁶ But the language might instead limit the exclusion for physical injury and physical sickness.²⁵⁷ Under this reading, when a claim of physical injury or physical sickness includes damages for emotional distress, the only portion of the emotional distress recovery that may be excluded is the amount received for medical cost reimbursement.²⁵⁸

In tort law there is a common law rule that physical injury or physical impact is a prerequisite to the recovery of damages for negligent infliction of emotional distress.²⁵⁹ At common law, the physical injury/physical impact rule barred recovery for purely psychological injuries.²⁶⁰ A plaintiff could only recover damages for emotional distress which flowed from physical injuries caused by a tortfeasor's negligence.²⁶¹ The common law rule is based on judges' skepticism about the reliability of evidence regarding the plaintiff's mental state and the possibility that plaintiffs may be faking emotional distress.²⁶² Because it is usually harder to fake physical injuries, the physical injury/physical impact requirement was interposed in an attempt to avoid the problem of proof of injury.²⁶³ It is very possible that Congress may have the same concerns that judges have had with respect to emotional distress that is not attributable to physical injury or physical sickness.²⁶⁴ Hence, Congress imposed the requirement of physical

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ *See* Doti, *supra* note 231, at 76.

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² *Id.*

²⁶³ *Id.*

²⁶⁴ *Id.*

injury or physical sickness for the personal injury exclusion to apply.²⁶⁵ Furthermore, in its conference report, Congress allows tax-free treatment for emotional distress only if the award is attributable to a physical injury or physical sickness.²⁶⁶ This position mirrors the common law rule that allows damages for negligent infliction of emotional distress only if the emotional distress is attributable to physical injury.²⁶⁷

3. The Tort Law Defamation and Section 104(a)(2)

It is interesting to note that the common law physical injury/physical impact rule of negligent infliction of emotional distress has an exception. Recovery is possible for emotional distress attributable to defamation.²⁶⁸ The conference report, however, provided that the exclusion does not apply to injury to reputation accompanied by a claim of emotional distress, thus departing from the common law tort rule in the case of defamation.²⁶⁹

D. The Employment Law Perspective

1. Wrongful Discharge

Damages for wrongful discharge from employment can be recovered under both tort and contract law.²⁷⁰ In *Byrne v. Commissioner*,²⁷¹ the taxpayer was fired by her employer under the suspicion that she had cooperated with the Equal Employment Opportunity Commission (EEOC), which was investigating the employer for possible wage disparity.²⁷² The EEOC

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ *Id.*

²⁶⁸ See Doti *supra* note 231, at 76-77.

²⁶⁹ See *supra* note 232, at *id.*

²⁷⁰ See Lisa A. Chun, *United States v. Burke and Internal Revenue Section 104(a)(2): When Will Personal Injury Damages be Taxed?* 16 HAWAII L. REV. 263, 292 (1994).

²⁷¹ 883 F.2d 211 (3d Cir. 1989).

²⁷² *Id.* at 212-213.

concluded that the taxpayer's discharge of Byrne was calculated to discourage other employees from cooperating with the EEOC investigation.²⁷³ Upon the EEOC's complaint and resulting compromise with the employer, the taxpayer eventually settled for a lump-sum payment in lieu of reinstatement and for not suing her employer under the Fair Labor Standards Act.²⁷⁴ The Tax Court estimated that the claims settled were tort-like claims to the extent of fifty percent (the other fifty percent being attributed to contract claims) and therefore half of the payment was treated as taxable.²⁷⁵ The Third Circuit, reversed the Tax Court, holding that the statutory claim sought to remedy a statutory violation that was defined as wrongful and thus, the claim was more tort-like than contract-like.²⁷⁶

If we apply *Burke* to *Byrne*, it seems that damage awards based on wrongful discharge claims received under the Fair Labor Standards Act should be tax-exempt²⁷⁷ because a wrongful discharge claim provides relief through compensatory and punitive damages, and thus redresses a tort or tort-like right.²⁷⁸ Also, it may be necessary to separate the damages based on contract rights from those based on tort rights.²⁷⁹ Moreover, an employer's tort liability is fixed if his discharge of an at-will employee violates a clear mandate of public policy.²⁸⁰ For instance, in

²⁷³ *Id.*

²⁷⁴ Section 215(a)(3) of the Fair Labor Standards Act states that it shall be unlawful for any person -- (3) to discharge or in any other manner discriminate against any employee because such employee has filed any complaint or instituted or caused to be instituted any proceeding under or related to this chapter, or has testified or is about to testify in any such proceeding, or has served or is about to serve on an industry committee. . . .; A willful violation of this provision subjects the offender to criminal sanction. *See* 29 U.S.C. § 216(a) ("Any person who willfully violates any of the provisions of section 215 of this title shall upon conviction thereof be subject to a fine of not more than \$ 10,000, or to imprisonment for not more than six months, or both."); The Act also provides for the following civil remedy: Any employer who violates the provisions of section 215(a)(3) of this title shall be liable for such legal or equitable relief as may be appropriate to effectuate the purposes of section 215(a)(3) of this title, including without limitation employment, reinstatement, promotion, and the payment of wages lost and an additional equal amount as liquidated damages.

²⁷⁵ 90 T.C. 1000, 1011 (1988).

²⁷⁶ *Byrne*, 883 F.2d at 215-216.

²⁷⁷ *See Chun*, *supra* note 270, at 293.

²⁷⁸ *Id.*

²⁷⁹ *Id.*

²⁸⁰ *See, e.g., Parnar v. American Hotels Inc.* 652 P.2d 625 (1973) (employee sought damages from her former employer for retaliatory discharge, alleging that her discharge was made in an attempt to prevent her from testifying

Norris v. Hawaiian Airlines Inc.,²⁸¹ the issue of employer liability arose under the Hawaii Whistleblower's Protection Act (HWP).²⁸² The HWP provides, in relevant parts:

An employer shall not discharge, threaten, or otherwise discriminate against an employee regarding the employee's compensation, terms, conditions, location, or privileges of employment because:

(1) The employee . . . reports or is about to report to a public body, verbally or in writing, a violation or a suspected violation of a law or rule adopted pursuant to law of this State, a political subdivision of this State, or the United States, unless the employee knows that the report is false[.]²⁸³

After reviewing the legislative history of HWP, the court held that the legislature intended to safeguard the general public by giving certain protections to individual employees who “blow the whistle” for the public good.²⁸⁴ Thus, wrongful discharge actions under similar whistleblower's protection statutes should be deemed tort or tort-like under the *Burke* test.

2. Employment Discrimination

*Threlkeld v. Commissioner*²⁸⁵ became the flag bearer for employment discrimination damages cases.²⁸⁶ First, *Threlkeld* noted that lost income was not the sole “measure” of damages, thus disagreeing with the argument that the damages replaced otherwise includable income. Second, *Threlkeld* saw no difference between physical and nonphysical injuries, or

in an antitrust investigation. The Hawaii Supreme Court held: “an employer may be held liable in tort where his discharge of an employee violates a clear mandate of public policy. In determining whether a clear mandate of public policy is violated, courts should inquire whether the employer's conduct contravenes the letter or purpose of a constitutional, statutory, or regulatory provision or scheme. Prior judicial decisions may also establish the relevant public policy. However, courts should proceed cautiously if called upon to declare public policy absent some prior legislative or judicial expression on the subject. Of course, the plaintiff alleging a retaliatory discharge bears the burden of proving that the discharge violates a clear mandate of public policy.” (foot note omitted).

²⁸¹ 842 P.2d 634 (1992).

²⁸² HAW. REV. STAT. §§ 378-61 to 378-69 (Supp. 1992).

²⁸³ *Norris*, 842P.2d at 646.

²⁸⁴ *Id.*

²⁸⁵ 87 T.C. 1294 (1986).

²⁸⁶ *See Gassenheimer, supra* note 188, at 319.

between professional and nonprofessional injuries. Third, *Threlkeld* focused on the “character” of the claim, an amorphous test. This enabled courts to decide employment discrimination cases in favor of taxpayers, despite the fact that large components of most employment discrimination awards confiscated back pay.²⁸⁷ However, judicial concern about back pay awards continued.²⁸⁸ In some cases²⁸⁹ where taxpayers had recovered back wages and other damages under a single anti-discrimination statute, courts bifurcated the damages into a taxable “contractual” component (back pay) and a nontaxable “tortuous” component (often the portion the underlying statute termed “liquidated damages”).²⁹⁰

Damages from some, but not all, employment discrimination claims may be said to have been received on account of personal injury or sickness and thus qualify in their own right for the Code Section 104(a)(2) exemption.²⁹¹ Some of them are discussed briefly.

(a) The Age Discrimination in Employment Act Claims

The Age Discrimination in Employment Act²⁹² (“ADEA”) prohibits age-based discriminatory practices involving hiring, firing, and compensation.²⁹³ ADEA is an example of a statute offering both back pay and liquidated damages.²⁹⁴ Under this, a victim of willful discrimination is entitled to “liquidated damages” in an amount equal to the back pay awarded.²⁹⁵

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ *See, e.g.,* Redfield v. Ins Co. of N. Am., 940 F.2d 542 (9th Cir. 1991) (addressing a claim based on ADEA); Pistillo v. Comm, 912 F.2d 145 (6th Cir. 1990) (similarly addressing an ADEA claim); Rickel v. Comm, 900 F.2d 655 (3d Cir. 1990) (also addressing an ADEA claim).

²⁹⁰ *See* Gassenheimer, *supra* note 188, at 319-320.

²⁹¹ *See* Chun, *supra* note 270, at 294.

²⁹² 29 U.S.C 623.

²⁹³ *See* Chun, *supra* note 270, at 295.

²⁹⁴ *See* Gassenheimer *supra* note 188, at 320.

²⁹⁵ *Id.*

*Rickel v. Commissioner*²⁹⁶ was the first ADEA case heard by the Tax Court. Following earlier cases involving other anti-discrimination statutes, the Tax Court distinguished between the two types of damages awarded and held only the wage-related damages taxable. The court found that liquidated damages were excludable from income under Section 104(a)(2) as damages received for personal injuries. On appeal, the Third Circuit reversed, allowing exclusion of all of the damages on the theory that the nature of an age discrimination claim is personal injury.²⁹⁷ In *Downey v. Commissioner*²⁹⁸ an airline pilot sued his employer for wrongful discharge and violations of ADEA. The Tax Court held that the entire settlement payment was excluded under Section 104(a)(2).²⁹⁹ While holding so, the court overruled its own conclusion in *Rickel* that that back pay or nonliquidated damages based on back pay received on account of claim under the ADEA are not excludable under Section 104(a)(2)³⁰⁰ and stated that:

[The] petitioner's claim . . . arose *not* because [the employer] allegedly breached some contractual obligation to petitioner *but* because [the employer] allegedly breached its duty under the ADEA not to discriminate on the basis of age. [The employer's] duty under the ADEA not to discriminate does not depend on a contractual relationship with petitioner. . .³⁰¹

Thus, the ADEA compensation scheme evidences a tort-like conception of injury remedy.³⁰²

(b) Title VII Claims under the Civil Rights Act of 1964

In *Burke*, the United States Supreme Court ruled that sexual discrimination claims brought under pre-1991 Title VII³⁰³ were not tort or tort-like claims.³⁰⁴ Since the remedies for

²⁹⁶ *Id.*

²⁹⁷ *Id.*

²⁹⁸ 97 T.C. 150 (1991).

²⁹⁹ *Id.* at 173.

³⁰⁰ *Id.*

³⁰¹ *Id.*; see also *Chun*, *supra* note 270, at 296.

³⁰² See *Chun*, *supra* note 270, at 287 *citing* the supplemental opinion in *Downey v. Comm'r*, 100 T.C. 634, 635 (1993).

pre-1991 Title VII claims were limited to back pay awards and injunctive relief, the claims were deemed not to redress tort or tort-type rights. Therefore, the settlement payments awarded to the claimants were not excludible from gross income. Decisions following the *Burke* opinion also ruled that pre-amendment Title VII claims are not qualified tort or tort-like claims for the Section 104(a)(2) exclusion.³⁰⁵ *Burke* can be viewed as a limitation on the favorable tax treatment of Title VII actions. However, certain post-amendment Title VII claims will most likely qualify as tort or tort-like claims.

(c) Equal Pay Act Claims

The Equal Pay Act³⁰⁶ (EPA) amended the Fair Labor Standards Act and outlaws discrimination in pay on the basis of sex. Damages available under the EPA include back wages and liquidated damages. The Court of Appeals for the District of Columbia Circuit determined that these liquidated damages were intended to compensate for nonpecuniary harms such as pain and suffering and for pecuniary losses that are too difficult to measure.³⁰⁷ In *Thompson v. Commissioner*,³⁰⁸ the taxpayer was an employee in the government printing press, and she brought a claim of sexual discrimination under Title VII and the EPA.³⁰⁹ The Court of Appeals for the Fourth Circuit affirmed the judgment of the Tax Court, ruling that while liquidated damages were excluded from gross income, an award of back pay under the EPA would not qualify for the Section 104(a)(2) exclusion. The court distinguished an award received as

³⁰³ *Id.*

³⁰⁴ *Id.*

³⁰⁵ *See, e.g.,* Robinson v. Southeastern Pa. Transp. Auth., 982 F.2d 892 (3d Cir. 1993); Hubbard v. Administrator, Envtl. Protection Agency, 982 F.2d 531 (D.C. Cir. 1992).

³⁰⁶ Equal Pay Act of 1963, Pub. L. No. 88-38, § 3, 77 Stat. 56, 56-57 (1963) (codified as amended at 29 U.S.C. § 206(d)(3) (1988)).

³⁰⁷ *Thompson v. Sawyer*, 678 F.2d 257, 281 (D.C. Cir. 1982).

³⁰⁸ 866 F.2d 709 (4th Cir. 1989).

³⁰⁹ *Id.* at 710.

compensation for services rendered from compensation for the inability to earn an income due to the tortious action of a defendant. The court said:

The back pay award was simply recovery for earned, but unpaid, wages which distinguishes her award of back pay from awards for lost wages or lost income in traditional personal injury/tort actions. [Thompson] received compensation for services rendered whereas a tort plaintiff receives compensation for the inability to earn an income due to the tortious action of a defendant.³¹⁰

However, the Tax Court later rejected similar reasoning when it analyzed the ADEA claim in *Downey*. *Downey* concluded that the ADEA created a statutory duty on the employer to not discriminate based upon age. The court recognized that the EPA creates a similar statutory duty involving sex discrimination. Therefore, the Tax Court is likely to rule that back pay awards under the EPA are excluded from taxable income. If the EPA claims for back pay are deemed similar to the ADEA claims and conclusions of the Tax Court and the Fourth Circuit in *Thompson* are rejected, the entire award from an EPA claim will be excluded from gross income. The Fourth Circuit concluded in *Thompson* that liquidated damages serve as a deterrent to ensure compliance with the Act and as compensation for injuries too obscure or difficult to prove. Applying the *Burke* test, damage awards under EPA claims will be excluded from taxable income due to their punitive and compensatory functions.

³¹⁰ *Id.* at 712.

CHAPTER 4

A Critique of Pre-hearing *Murphy* Decision

Shortly after it was delivered, the *Murphy* decision came under sharp criticism due to court's inability to see issues in a proper frame of reference.

The court first considered the applicability of Section 104(a)(2) and decided that Section 104(a)(2) was inapplicable since Ms. Murphy's damages were not awarded by reason of, or because of, physical personal injury. However, for its reasoning, the court's reliance on the 1922 IRS opinion³¹¹ was not proper as this was issued in the light of *Stratton's Independence v. Howbert*³¹² and *Macomber*. The opinion made sense in the light of both cases since they took a limited approach to the definition of income.³¹³ In view of the expanded definition of income as given by *Glenshaw Glass*, the applicability of such an opinion is highly doubtful. After this, the court questioned the constitutionality of Section 104(a)(2). Ideally, the court should have explored the Code to see if the damages could be included under some other provision, notably Section 61. Section 104(a)(2) does not trigger a tax liability.³¹⁴ Instead Section 61 requires that amounts not specifically excluded by other provisions of the Code should be included in the income of a taxpayer.³¹⁵ Even if Section 104(a)(2) was unconstitutional, it does not mean that the damages which Ms. Murphy received could not be included in her income.³¹⁶ Thus, the D.C.

³¹¹ *Murphy*, 460 F.3d at 91; see *supra* note 38.

³¹² 231 U.S. 399, 415 (1913).

³¹³ See *Kalinka*, *supra* note 32, at 9.

³¹⁴ *Id.* at 10.

³¹⁵ *Id.*

³¹⁶ *Id.*

Circuit should have held that Section 61, as applicable to the damages in question, and as amended in 1996 was unconstitutional.³¹⁷

The court's constitutional law analysis was not flawless either. The court was mistaken when it believed that the Sixteenth Amendment constitutes the sole source of Congress's taxing power. Congress's taxing power instead comes from Article I of the Constitution. Also, the court erred by not properly considering the expanded definition of income as propounded by the Supreme Court in *Glenshaw Glass*.

³¹⁷ *Id*; see also Germain supra note 89, at 75.

CHAPTER 5

Conclusions

Upon close scrutiny, one might say that the D.C. Circuit should not have reached the constitutional question when initially deciding the *Murphy* case (*Murphy I*). If Section 104(a)(2) appeared constitutionally problematic, Section 61 and *Glenshaw Glass* should have provided some clues about the problem faced by the court. Even if Section 104(a)(2) failed to provide the justification to extend an exclusion to Ms. Murphy's award, it did not follow that Section 61 also failed. By disbodying Section 61 from its constitutional framework, the D.C. Circuit fell short of declaring it unconstitutional. If an item of income should fall within the ambit of Section 61, a decision otherwise would undermine the principles of the Sixteenth Amendment. Thus, it was in this vein that the D.C. Circuit decided to rehear the case. From a statutory and a constitutional perspective, the D.C. Circuit's judgment in *Murphy II* is better reasoned.

Applying *Glenshaw Glass* principles, the award received by Ms. Murphy appears to be income, particularly since there is practically no restriction on Congress's power to tax. The only sticking point to this proposition is the human capital theory, but that is problematic for two reasons. First, it is administratively impractical to measure human capital. Insurmountable difficulties quickly arise in attempting to do so. If a taxpayer has human capital investment in his or her own body, the day may not be far behind when a depreciation allowance will be sought on this capital asset. Second, how does one determine that Ms. Murphy had a return of capital when she had no capital investment in the first place? For example, can it be said that she extended a

loan of human capital to her employer when she started to work? Advancing the human capital theory may not take one very far since Congress can always trump the theory, because direct taxes, by their definition and explanation, have never included taxes on human capital.

The issue then becomes political. Does Congress want this exclusion to extend to damages received on account of emotional distress? If it does, it can. Not all taxes are justifiable and not all of them are based on solid logic or perfect reasoning. Taxing is a blunt function of government and to expect sophistication or perfectly rational and scientific theories to support it would be a fallacy. Having said this, Congress has much leeway to address the issue decisively, in a victim-friendly manner, especially under the whistle-blower statutes. Congress has the legitimate power to tax recoveries received on account of emotional distress, but it needs to find the fine balance between that power and the responsibility that comes with it. The issue is one of policy, and Congress should take policy considerations of this type into account.³¹⁸ *Murphy II* might rightly be seen as a corrective course of action undertaken by the D.C. Circuit in the wake of wide ranging criticism of *Murphy I*. This will, however, not undermine the importance of *Murphy I* in showing to Congress the policy concerns on the basis of which any changes in law might be desirable. Courts may not be the right kind of forums to address this concern but Congress certainly is. Thus, the issue would be removed from the “docket” to the “ballot box,” and the issue would be decided once and for all.

³¹⁸ See Debrah Cohen-Whelan, *From Injury to Income: The Taxation of Punitive Damages "on Account of" United States v. Schleier*, 71 NOTRE DAME L. REV. 913, 941(1996).

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