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TAXATION OF DAMAGES AFTER SCHLEIER — WHERE ARE WE AND WHERE DO WE GO FROM HERE?

By Douglas A. Kahn

I. INTRODUCTION

Since 1919, statutory tax law has excluded from gross income damages received on account of a personal injury or sickness. The exclusion currently is set forth in § 104(a)(2) of the Internal Revenue Code of 1986. The construction of that statutory exclusion, both by

* The author wishes to express appreciation to his colleague, Kyle Logue, for the many helpful comments and criticisms that he provided on a draft of this article.


2. The current version of I.R.C. § 104(a) reads in relevant part:

SEC. 104. COMPENSATION FOR INJURIES OR SICKNESS.

(a) IN GENERAL.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 . . . for any prior taxable year, gross income does not include— . . .

(2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sick-
the courts and by the Commissioner, has undergone a number of changes and flip-flops over its 76-year history. A few years ago, the Supreme Court addressed this issue when it decided *United States v. Burke.* The Supreme Court rested its decision in *Burke* on its construction of a long-standing regulation. The construction adopted by the Court, however, proved to be inadequate for several reasons. It created distinctions that were difficult to draw and that did not comport with the purposes of the statute. Moreover, it gave the taxpayer too much room for manipulation. While some of the fault can be attributed to the regulation itself and the Commissioner’s application of the regulation, the Supreme Court’s decision in *Burke* (as it was read by many lower courts and by the Commissioner) only made matters worse.

Less than three years after *Burke* was decided, the Supreme Court again dealt with the meaning and application of § 104(a)(2) in its 1995 decision in *Commissioner v. Schleier.* The problems created by the Court’s decision in *Burke* made subsequent litigation (or legislative action) inevitable. While the *Schleier* decision arrived at a second-best solution, it is an improvement over *Burke* and over the state of the law on this issue that existed shortly before *Burke.* *Schleier* removes most, albeit not all, of the potential for manipulation that previously existed and provides a considerable degree of certainty in what had been a chaotic corner of the tax law. In addition, *Schleier*’s construction of the statute comports more closely with the policies that underlie § 104(a)(2) than did prior judicial constructions. In any event, *Schleier* has significantly altered the construction of § 104(a)(2), and the subsequent tax treatment of damages will be controlled by that decision, even perhaps certain aspects of damages for which taxation is determined by the 1996 Amendment of § 104.

This article will examine the reasoning of the *Schleier* decision and speculate as to how taxation of pre-1996 damages will likely apply in light of *Schleier.* First, the article will set forth a very brief history of the judicial and administrative constructions of the statutory exclusion, and explore tax policy justifications for providing an exclusion from gross income for certain damages. These latter two items (set

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forth in Parts II and III of this article) are areas that have been extensively addressed previously by several commentators, including the author of this article. The reason for exploring tax policy issues is to permit the reader to judge the merits of the Schleier decision in light of the underlying policies for having an exclusion. The reader who is familiar with the historical and tax policy material, or simply isn’t interested in it, might wish to skip over Parts II and III of this article.

Part IV of this article discusses the Supreme Court’s Burke decision and explains its inadequacy. A discussion of the Schleier decision and its significance begins at Part V of this article.

II. HISTORY

Before the enactment of the antecedent to § 104(a)(2), Treasury initially took the position that damages received for a personal injury were includible in gross income. In an early regulation, Treasury analogized such damages to the proceeds of accident insurance which Treasury assumed to be taxable. However, in 1918, the Attorney General promulgated an opinion concluding that accident insurance proceeds are not taxable because they constitute a kind of conversion of human capital caused by the injury. As a consequence of the Attorney General’s opinion, Treasury promptly revoked the regulation that designated personal injury damages as taxable. Instead, Treasury held that “an amount received by an individual as result of a suit or compromise for personal injuries sustained by him through accident” is not included in gross income. Then, in 1919, when Congress adopted the predecessor of Code § 104(a)(2) as part of the Revenue Act of 1918, Congress included a provision that excluded from income: “[a]mounts received, through accident or health insurance or under workmen’s compensation


7. Treas. Reg. § 33, art. 4 (1918) stated: an “[a]mount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be accounted for as income.”

8. 31 Op. Att’y Gen. 304, 308 (1918). The Attorney General’s opinion apparently was made as a consequence of the definition of “income” that was adopted in Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918) as “the gain derived from capital, from labor or from both combined.” (citing Stratton’s Independence v. Howbert, 231 U.S. 399, 415 (1915)).

acts, as compensation for injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.\textsuperscript{10}

The subsequent history of the Service’s construction of the statutory provision reflects vacillations and sometimes total reversal of positions. Similarly, the decisions of the courts have gone in every direction.\textsuperscript{11}

One lower court decision worth noting in particular is the Tax Court’s decision in \textit{Threlkeld v. Commissioner}.\textsuperscript{12} In \textit{Threlkeld}, the Tax Court stated that § 104(a)(2) excludes from gross income compensatory damages “received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law.”\textsuperscript{13} According to the Tax Court, the crucial test is whether the injury that an individual suffered is a “personal injury.” In \textit{Threlkeld}, the Tax Court further stated, “[t]o determine whether the injury complained of is personal, we must look to the origin and character of the claim [citations omitted] and not to the consequences that result from the injury.”\textsuperscript{14} After \textit{Threlkeld} was decided, and until the Supreme Court entered the fray, it was generally believed that, with the possible exception of punitive damages, the nature of damages received by a taxpayer had little or no bearing on the question of whether the damages were excludible from gross income.

The Supreme Court’s 1992 decision in \textit{United States v. Burke}\textsuperscript{15} brought the nature of damages back into the picture to some extent by making the test of excludibility turn on the range of damages that are available for a claim. The 1995 decision of the Supreme Court in

\textsuperscript{10} Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919). The Ways and Means Committee Report on this provision stated:
Under the present law it is doubtful whether amounts received through accident or health insurance, or under workers’ 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. The proposed bill provides that such amounts shall not be included in gross income.

\textsuperscript{11} For a summary of the paths taken by the Service and by the courts, see Kahn, \textit{supra} note 6, at 330-39.

\textsuperscript{12} 87 T.C. 1294 (1986) (reviewed by the court), \textit{aff’d}, 848 F.2d 81 (6th Cir. 1988). \textit{Threlkeld} involved a recovery for injury to the taxpayer’s professional reputation that was caused by a malicious prosecution. \textit{Id.}

\textsuperscript{13} \textit{Id.} at 1308.

\textsuperscript{14} \textit{Id.} at 1299.

\textsuperscript{15} 504 U.S. 229 (1992).
Schleier makes the identification of the type of injury for which each specific recovery item is obtained a crucial factor in determining whether the receipt of that item is excluded from gross income.

III. TAX POLICY

There have been a number of different rationales suggested for the exclusion from income of personal injury damages. In a prior article of the author, the several possible policy justifications for the exclusion were examined and critiqued. This Part III consists of a brief exploration of those policy considerations that the author deems to be the most significant. For a more thorough treatment of tax policy considerations, see the author's article in the Florida Tax Review.

A. Return of Human Capital

While there is uncertainty as to precisely what considerations led Congress to adopt the antecedent to § 104(a)(2), the background history of that provision does indicate that Congress focused on the "return of human capital" theory that is described below. The human capital justification has been criticized as inadequate to support the exclusion. Even if that criticism is correct, and even if the original rationale for the adoption of the statutory exclusion could be determined with certainty, it is not necessary to accept the "return of human capital" theory as the justification for the retention of the statutory exclusion. A statute may be adopted for one reason that is later abandoned; and, yet, the statute may be retained because it is justified by quite different reasons than the one that originally spawned it.

There are a number of good reasons why the human capital theory standing alone does not justify § 104(a)(2). Firstly, for gain measurement purposes, it makes no difference whether the amount of damages received differs from the value of the rights that the taxpayer lost. Gain is measured by the difference between the amount realized and the basis that a taxpayer has in the asset for which payment is received. While it may be difficult or even impossible to determine the market

17. See discussion infra parts IV and V.
18. Kahn, supra note 6, at 340-60.
19. Id.
20. As noted later in this Part III, the author agrees that the return of human capital theory alone is not sufficient to justify the exclusion.
value of a personal right that was destroyed, it is irrelevant for gain measurement purposes what value an asset that was sold or destroyed had. For example, if X owned a rare vase in which she had a basis of only $1,000, and if the vase was destroyed by the negligence of Y, the gain that X would recognize on receiving compensation from Y would be measured by X’s $1,000 basis without regard to the actual value of the vase. Let us assume that the vase had a value of $500,000 before it was destroyed. Let us assume further that Y paid X only $28,000 as compensation for the injury. X accepted that small amount because it was the most that she believed that she could obtain from Y given the latter’s financial resources. X did not subsequently purchase any replacement property. Even though the compensation that X received is substantially less than the value of the destroyed item, X recognizes a gain of $27,000 (the difference between the amount she received and her basis in the vase). If damages for the loss of personal rights are to be treated differently, the reason does not lie exclusively in the impossibility of measuring the value of those rights.

Secondly, it should not matter that it is not feasible to determine the basis (if any) that a taxpayer has in the body parts or personal rights that were damaged. A taxpayer has the burden of establishing the amount of basis that he has in an asset, and, if none can be established, the basis is treated as zero. But, since a person does not anticipate having the parts of his body (or personal rights) converted into cash, people do not keep records as to capital expenditures they may have had in connection therewith, and it may be deemed appropriate to accord them relief by excluding all or part of their gain. One difficulty with that approach is that it is highly unlikely that a person has any basis in his body parts or in his personal rights. It is impossible to determine what portion of expenditures that might conceivably be attributed to body parts (such as the purchase of food and clothing and medical care) should be so allocated. Moreover, to the extent that an allocation of such expenditures to body parts would be feasible, the allocated part would be in the nature of maintenance and repairs. Such expenditures cannot be capitalized and added to basis. Maintenance and

22. If X had reinvested all or part of the proceeds in replacement property, all or part of her gain would have been deferred under I.R.C. § 1033 (1994).
24. See, Dodge, supra note 6, at 152.
25. See, Dodge, supra note 6, at 152.
repairs can be deducted currently when incurred in connection with a business or profit venture.\textsuperscript{26} Such expenditures are not capital expenditures and so are not included in an asset's basis regardless of whether they were deductible when incurred.\textsuperscript{27} It therefore is highly unlikely that anyone has a meaningful basis in any of his body parts, and it would be overly generous to exclude from income damages received for such an injury solely because of the understandable failure of persons to keep records of their investment in their bodies.

Thirdly, some courts and commentators\textsuperscript{28} have suggested that the fact that § 104(a)(2) excludes from taxation damages received in substitution of lost income undercuts the possibility that the "recovery of human capital" theory is the justification for § 104(a)(2). This is a different point than the one that the author makes below in asserting that if the "recovery of human capital theory" were valid and were applied consistently throughout the tax law, the gain from the sale of a personal right would not be taxed.\textsuperscript{29}

The justification for the 1983 amendment of § 104(a)(2), which permits damages for a personal injury to be received in periodic installments without causing the recipient to recognize income because of the interest element in the deferred receipts, is problematic. If an interest element were to be segregated and taxed, it would be necessary to calculate the amount of the periodic payments that constitute interest. To do so, one would need to settle on a rate of interest and on the frequency with which interest will be compounded. The most likely reason for Congress's precluding the imputation of interest on periodic payments of damages is to relieve victims of the administrative burden of making those calculations.\textsuperscript{30} The 1983 amendment was not adopted to further the goals that are otherwise served by the other parts of § 104(a). Rather than that provision's raising doubts as to whether there is a discernable purpose underlying § 104(a)(2), the weakness of

\begin{itemize}
\item \textsuperscript{26} Treas. Reg. § 1.162-4 (1958).
\item \textsuperscript{27} I.T. 4094, 1952-2 C.B. 134.
\item \textsuperscript{28} See, e.g., Yorio, supra note 6, at 712.
\item \textsuperscript{29} See infra Subpart III D 2. The author does not share the view that the statutory exclusion from taxation of damages received for lost income is inconsistent with the "recovery of human capital" justification. The statutory treatment of damages for lost income rests on a separate and independent rationale; it is neither supported by nor inconsistent with the recovery of human capital theory. A principal reason for excluding compensation for lost income is discussed in Subpart III D 2 of this article.
\item \textsuperscript{30} See Brabson v. United States 73 F.3d 1040 n.5 (10th Cir. 1996).
\end{itemize}
the independent justification for the 1983 amendment merely raises the
question of whether the adoption of that amendment was wise.

Finally, and most significantly, the "return of human capital" rationale simply does not jibe with the tax law's treatment of the vol-
untary disposition of human capital. The exclusion from gross income
of § 104(a)(2) applies only to damages (or to a settlement obtained on
account of a claim for such damages) received on account of a personal
injury or sickness. It has no application to the voluntary sale of a part
of an individual's body or of a personal right. Currently, federal law
prohibits the sale of human organs. But, if such sales were not pro-
hibited, and if a person were to sell one of his organs (for example,
he might sell one of his kidneys to a person needing a transplant), the
entire amount received by the seller would be taxable to him. It would
not matter that the compensation he received merely replaced a part
of his human capital or that he might have had an unascertainable amount
of basis in that organ.

The prohibition against the sale of a human organ does not apply
to the sale of blood. It is well established that if an individual sells his
blood, the amount realized on the sale constitutes ordinary income to
the seller. It is clear then that not all payments that substitute a monetary
payment for a personal right or human capital are excluded from in-
come. So, neither the fact of such a substitution nor the unascertainable
basis of such items is sufficient by itself to justify an exclusion from
income. Of course, the "return of human capital" consideration might
be combined with other factors to justify the exclusion provided by
§ 104(a)(2). That possibility is examined in Subparts C and D.


32. Also, a person might go ahead and sell an organ in violation of the federal law. The
amount received for the organ would be taxable to him. The taxation of that amount does not
depend upon there being some public policy against excluding amounts received in violation of
the law. No such policy rationale is needed.

33. In Green v. Commissioner, 74 T.C. 1229, 1233-35 (1980), the Tax Court held that pay-
ments received for the sale of blood are included in gross income. The taxpayer in Green did not
dispute that such receipts are taxable. The issue that she raised concerned the question of the
deductibility of certain expenses she incurred with regard to the sale of her blood. Nevertheless,
the Tax Court passed on the issue of taxability. Id. at 1223. In Lary v. United States, 787 F.2d
1538, 1540 (11th Cir. 1986), the court denied the taxpayer a charitable deduction for the donation
of his blood because, if the taxpayer had sold his blood, he would have recognized ordinary in-
come equal to the amount he received from the sale. No charitable deduction is allowed for the
amount of a contribution that would have constituted ordinary income if the item had instead been
B. *Involuntary Conversion*

Another suggested rationale rests on the fact that the taxpayer did not voluntarily choose to dispose of the personal right or body part in question, and so it seems rapacious to tax him on the damages he received as compensation for such a personal loss. When tangible property is destroyed, the damages received in exchange therefor will cause the realization of income to the extent that the amount received exceeds the taxpayer’s basis in the destroyed item. But, the involuntarilyness of the conversion of the item into cash does arouse sympathy because of the forced recognition of previously unrealized gain that had accrued to the item in question. Accordingly, the tax law provides relief for the taxpayer who is in that predicament. If, within a specified period of time, the taxpayer invests all or part of the amount realized on the conversion to acquire an item or items of property that are similar or related in service or use to the destroyed property, all or part of the gain that the taxpayer realized on the conversion will not be taxed at that time. Instead, the taxpayer’s investment in the destroyed item will be rolled over and become part of the basis that the taxpayer acquires in the replacement property. In effect, all or part of the taxpayer’s realized gain is deferred until the taxpayer disposes of the replacement property (or until the taxpayer is allowed depreciation deductions for that property if it is a depreciable asset).

The question then is whether the involuntarilyness of the conversion of a taxpayer’s personal rights or body parts is a sufficient justification for excluding from income the damages he received. In most such cases, the taxpayer has no means of reinvesting the proceeds in something similar or related in service or use to the destroyed item. If some type of replacement can be located, its cost typically will be substantially less than the amount of damages suffered by the taxpayer, and so the application of a § 1033 deferral concept would be of little value. For example, a taxpayer who lost an arm may be able to replace it with an artificial limb, but the cost of that limb likely will be far less than the amount of damages that the taxpayer will receive for his injury. Much of what the taxpayer lost cannot be replaced.

Since a deferral of gain is not readily available, should the taxpayer be taxed on the entire amount of the gain at the time of receipt or

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should some relief be provided? For example, the taxation of a payment that is received in a lump sum in one year may cause a bunching of income that will subject the taxpayer to a large tax because of the operation of the graduated rate system that the tax law employs. At the least, one might expect some relief from the bunching effect—perhaps some form of income-averaging.

Instead, the tax law permanently excludes all such damages from income.\(^{38}\) It does not merely defer the income, nor does it provide relief from the bunching effect. It seems that involuntariness alone is not a sufficient justification for this extraordinary exclusionary treatment since the involuntary conversion of tangible property is not treated so gently.

C. *Combination of Considerations*

Given the sympathy that a personal injury engenders, perhaps the combination of the fact that a personal right or body part was destroyed (the “return of human capital” theory) and the involuntariness of the conversion is sufficient to warrant the exclusion. That is, even though neither factor alone is sufficient, the cumulative effect of the combination of those two factors may be sufficient. The whole may well be greater than the sum of its parts.

D. *The Author’s Explanation*

The author believes that there are two additional factors that color the combination of the “return of human capital” theory and the involuntariness of the conversion of a body part. The addition of that coloration makes a compelling case for the exclusion of such damages, at least when given for a physical injury.

1. *Noncommercial zone*

The tax law is aimed at commercial transactions. Of course, the gain recognized from the sale of an item that is held for personal use, such as a residence or an item of jewelry, will be taxed; but, in such cases, the taxpayer has chosen to place the item into the commercial market by putting it up for sale. Moreover, those types of property are commonly bought and sold in the market place and are properly regarded as commercial items. In contrast, noncommercial personal at-

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tributes are not traded in the market place and so lie outside of the zone of properties and activities at which the tax laws are aimed.

For example, if two persons agree to exchange their services, each will typically have to include in income an amount equal to the value of the services he received from the other.\textsuperscript{39} However, when a husband and wife agree to exchange their services by splitting the household chores between them, neither recognizes any income.\textsuperscript{40} Similarly, if several persons, who live in Manhattan and each of whom owns a small piece of land in Long Island on which vegetables are grown, were to agree to take turns traveling to Long Island and watering the gardens owned by all of them, they would be exchanging services; but they should not be taxed on that exchange. Another example of activities that fall within a noncommercial zone is the existence of babysitting clubs in which parents sit for each other's children under a kind of barter arrangement. In the author's view, those exchanges are not squarely in the commercial sphere and so should not be taxed. On the other hand, bartered exchanges can become so structured and substantial that they represent more than joint activities. In that case, the parties will have moved into the commercial sphere, and their bartered exchange will be taxable.

When a part of an individual's body is damaged or destroyed, what has been taken from that individual is something that is predominantly of a noncommercial nature. It is true that an individual can use his arms, legs, eyes, ears etc. in commercial ventures, but body parts themselves are universally regarded as personal and noncommercial. Since humans are engaged in commercial activities, their bodies and their personal attributes will be inexorably entwined with those activities. But, an individual's body and personal attributes are merely \textit{used} in commercial activities; they are not detached and sold in the market place. It would be a rare person that would contemplate the sale of his body parts to be removed from him while he is still alive. If such a transaction were to take place, then the individual will have committed the sale of that body part to a commercial venture, and there is no reason for the tax law to exempt the gain from taxation, and it does not

\textsuperscript{39} Treas. Reg. § 1.61-2(d) (as amended in 1989).

\textsuperscript{40} There is no statute or regulation that provides for the exclusion from taxation of spousal exchange of services. 26 U.S.C. § 1041, which was added to the Code in 1984, precludes the recognition of gain or loss on an interspousal transfer of \textit{property}, it does not address the tax consequences of exchanging services. Unlike property exchanges, the Commissioner has never sought to tax interspousal exchanges of services, and the exclusion of such exchanges is part of the common law of taxation.
do so. However, if a body part is destroyed or injured, the compensation that the victim receives is not the product of his having voluntarily committed that part to a commercial sale. It is true that the victim must actively seek reparations in order to be compensated; but, that is a consequence of the injury and does not represent a voluntary entrance into the commercial market.

2. Vulturous behavior

Perhaps the most important consideration that weighs against taxing such damages is the heartlessness of the government's profiting from the tort law's attempt to soften the injury that a victim has suffered. The dollar damages that a victim receives are not truly substitutes for what was lost but, at most, constitute some mitigation of it. Much of the victim's loss is not monetary, but only monetary damages can be given because no substitute is available to replace what was lost. If the government were to tax damages received for the loss of a body part (or for the death of a relative), it would seem to many to have engaged in a vulturous act—analogous to feeding off of the flesh of a dismembered arm or leg or off of the corpse of a recently departed.

The compassionate motivation for the exclusion has much greater force when the victim suffers a physical injury (and possibly an injury to mental health). But, even as to physical injuries, not all of them are severe, and a minor injury (such as a sprained ankle) does not create so much sympathy that it makes the taxation of damages received for that injury unpalatable. Nevertheless, the exclusion of damages received for minor physical injuries detracts very little from the validity of the theory that avoiding the appearance of vulturous behavior is a major justification for the exclusion. While having no empirical data, the author's intuition is that most of the dollars obtained as damages and settlements for physical injuries involve a serious harm. The cost of obtaining damages for a minor injury will preclude many persons from prosecuting their claim, and those who do pursue the matter will obtain a small amount. Since the amount of damages that a taxpayer will receive for a minor injury will be small, it is not worth the administrative hassle to establish and enforce criteria that would attempt to distinguish

between major and minor physical injuries. Consequently, the sympathy that is aroused for major physical injuries spills over to provide relief for the sufferer of a minor injury. It is not uncommon that the compelling concerns that cause the adoption of a relief provision also will benefit a limited number of persons who fall within the scope of the remedial provision even though their plight is not the one that triggered its adoption. Taxation is a practical enterprise, and it is not practical to seek to operate the tax system so as to have every provision apply only to those on whose behalf it was passed.

The "compassionate" justification and the "return of human capital" justification for the exclusion apply more readily to damages for noneconomic injuries than to damages for lost income. Perhaps the most compelling reason for excluding lost income damages is that such damages should not be separated from the general damages provided for the victim because the total sum of such damages merely mitigate the victim's personal loss and do not fully compensate him for it. The fact that, as part of the effort to arrive at a just figure of dollar compensation, the courts utilize an estimate of the amount of income lost by the victim, does not change the nature of the total compensation package. When a victim suffers a physical injury, there is no way to measure the dollar amount of his loss, and the courts can do no more than resort to some conventional devices to arrive at a reasonable amount of mitigation. One of the devices utilized for that purpose is to estimate the amount of income that the victim has lost. The measurement of lost income lends respectability to the enterprise in that it suggests a greater amount of mathematical precision than otherwise exists. Also, income loss is one of the few aspects of the victim's loss (medical expenses being another) that relate to money. Since money is all that can be granted to the victim, it is understandable that tort law would seize on a money loss as a measure of part of what must be paid to the victim. This fact should not obscure what damage awards are all about.

3. Author's conclusions

In the author's view, the noncommercial and nonmonetary nature of a body part that was destroyed or injured, and the vulturous portrait that the government's profiting from a personal tragedy would paint,

42. Kahn, supra note 6. The justification for excluding damages for lost income is discussed in Subpart III H of the author's Florida Tax Review article.
explain why a suggestion that the damages for such an injury be taxed typically is met with a vigorous renunciation. A body part is not perceived as a commercial item; the taxpayer never sought to commercialize its value by selling it, and the damages paid to the taxpayer mitigate the loss of a personal attribute the appreciated value of which never would have been taxed if the injury had not occurred. The damages received for the loss of a body part are widely viewed as mitigation of the victim’s loss. A diversion of a portion of those damages to the Government would impair that mitigation. While a strict application of such tax concepts as “basis” and the “measurement of gain” lead to the taxation of such receipts, the countervailing considerations are very strong. As with many tax law provisions, the appropriateness of retaining them depends upon value judgments.

On the other hand, the case for excluding damages received for nonphysical injuries (other perhaps than for mental damage) is less compelling. The plight of a person who suffers exclusively nonphysical injuries does not arouse the same degree of sympathy that attaches to a victim who suffers a serious physical injury. A nonphysical injury appears far less “tragic” than does a serious physical injury. The taxation of damages received for nonphysical injuries, therefore, does not create the rapacious image that characterizes a tax on damages received for a serious physical injury. Nevertheless, despite the Commissioner’s original contention to the contrary, it has been established for some 23 years that § 104(a)(2) excludes from income damages received for nonphysical injuries as well as those for physical injuries. However, a recently adopted statute limits § 104(a)(2) to damages (other than punitive damages) received pursuant to a claim that had its origin in a physical injury or physical sickness.

IV. THE BURKE DECISION

One issue that was the subject of frequent litigation (but which was resolved by the 1996 Act) is whether damages received by the vic-

43. The Internal Revenue Service initially ruled that the statutory exclusion applied only to damages received for physical injuries. E.g., Sol. Mem. 1384, 2 C.B. 71 (1920) (holding that damages for alienation of affection, although a personal injury, are taxable; Sol. Mem. 957, 1 C.B. 65 (1919) (holding that damages for defamation are taxable). Since 1972, the statute has been construed as applying to damages received for nonphysical injuries. See Seay v. Commissioner, 58 T.C. 32 (1972), acq., 1972-2 C.B. 3. Any question concerning the statute’s application to pre-1996 non-physical injuries was laid to rest by the Supreme Court in United States v. Burke, 504 U.S. 229 (1992).

44. Section 1605(a) of the SMALL BUSINESS JOB PROTECTION ACT OF 1996.
tims of discrimination are excluded from income by § 104(a)(2). The Supreme Court cast a new light on that issue, albeit not a very helpful one, in its 1992 decision in *Burke*. Since then, the issue was totally restructured as a consequence of the Court's decision in *Schleier* and finally resolved by the 1996 Act. Before discussing *Schleier*, let us examine the *Burke* decision, the significance of which extends far beyond discrimination damages.

In *United States v. Burke*, the Court addressed the question of whether damages received under Title VII of the Civil Rights Act of 1964 (as it read prior to the 1991 amendment) because of sex discrimination were excluded from gross income by § 104(a)(2). The damages at issue in *Burke* were for back wages that the taxpayers had failed to earn because of the discriminatory acts of the employer.

For purposes of § 104(a)(2), Treasury’s regulations provide that the term “'damages received'... means an amount received... through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.” Only damages (or settlements) received pursuant to a claim that qualifies as a tort or a tort-type right can be excluded under § 104(a)(2). For that reason, a number of courts, including the Supreme Court, have held that a crucial test for § 104(a)(2) exclusion is to determine the nature of the claim underlying the taxpayer’s receipt of damages or a settlement.

In *Burke*, the Supreme Court reaffirmed the regulatory requirement that for damages to be within the scope of the statutory exclusion, the claim on which the damages were obtained must be tort or tort-type. The principal contribution of the *Burke* decision was to set forth criteria for determining whether a claim is tort or tort-type. The Court held that the characterization of a claim as tort or tort-type depends upon the breadth of the remedies that the applicable law provides for such claims. The Court noted that common law (and current state laws) permit a wide range of remedies for victims of torts. A recovery is

47. Treas. Reg. § 1.104-1(c) (as amended in 1970).
49. *Burke*, 504 U.S. at 234; *Threlkeld*, 87 T.C. at 1299.
51. *Id.*
52. *Id.* at 235-37.
permitted for lost wages or profits, medical expenses, and diminished future earning capacity. In addition to allowing recovery for pecuniary losses, tort laws also permit a recovery for such nonpecuniary items as: pain and suffering, emotional or mental distress, personal humiliation, mental anguish, and suffering. The Court also noted that punitive or exemplary damages are generally available if the wrongdoer's conduct was intentional or reckless. The Court held that if the remedies provided for a specific violation of an individual's rights are significantly narrower than those typically made available to victims of torts, the damages or settlement obtained by a victim whose rights of that type were violated are not based on a tort or tort-type claim; and, so, the amounts received thereunder are taxable.

At the time that the facts of Burke arose, the remedies provided for Title VII violations were exclusively to compensate for lost wages and to permit equitable relief for reinstatement or elevation to a job. The Court held that the range of damages that was then available to a claimant under Title VII rights was too restricted to qualify the taxpayers' claims as ones for tort or tort-type rights. Accordingly, although the taxpayers did suffer an injury, the range of available remedies permitted by Title VII was insufficient to qualify a victim's rights under that provision as a claim for damages for a "personal injury" within the meaning of § 104(a)(2). Hence, the Court held that the damages that the taxpayers received are taxable. The Court contrasted the remedies provided at that time by Title VII with the broad range of remedies provided by other antidiscrimination statutes. For example, 42 U.S.C. § 1981 provides a broad range of remedies for victims of race-based employment discrimination. While the Court noted that Title VII was amended in 1991 to provide a broad range of remedies for certain types of violations, the facts of the Burke case arose prior to the effective date of that amendment, and so the Court did not pass upon

53. Id. at 235.
54. Burke, 504 U.S. at 236-37.
55. Id. at 237. The Court listed the right to a jury trial as usually being made available to victims of torts. Id. However, the presence or absence of a right to a jury trial is not a significant factor, and the availability of a jury trial was given little or no weight in the Court's decision in Schleier. Schleier, 115 S. Ct. at 2166.
56. Burke, 504 U.S. at 241-42.
57. Id. at 238-39.
58. Id. at 241-42.
59. Id. at 242.
60. Burke, 504 U.S. at 240.
the effect that the amendment has on the treatment of such damages that are received after the amendment. The state of the excludibility of Title VII damages under the Burke doctrine, but before Schleier and the 1996 Amendment changed it, is discussed below.

There are two different types of discrimination that are proscribed by Title VII of the Civil Right Act of 1964. One type is the disparate treatment of employees where the employer has the intent to discriminate against an individual, with respect to compensation or other employment terms, because of the individual's race, color, religion, sex or national origin (a "disparate treatment" violation). The second type (the "disparate impact" violation) is facially neutral employment practices that are not necessary for business purposes and that have a disparate impact on persons within a protected classification (for example, persons within a group classified by race or gender). A violation of the second type occurs when a practice of the employer has no bona fide business justification and has a disparate impact on members of a protected group. There is no requirement that the employer have intended that result.

The Civil Rights Act of 1991 added a new section (section 1981a) to Title VII that expanded the range of relief that can be granted for violations of the disparate treatment type of prohibited discrimination — i.e., it applies to intentional acts of discrimination by an employer. In such cases, compensatory damages can be awarded for nonpecuniary injuries, and punitive damages can be awarded in certain cases. But, this provision does not apply to disparate impact cases; the exclusive relief available in those cases, back pay and equitable relief, remains unchanged.

The Court did not state in Burke that a determination that a claim was tort or tort-type is sufficient to exclude damages received thereunder from income. What the Court did hold was that a tort or tort-type claim is a necessary condition to excludibility. However, subject to a few exceptions, a number of courts and the Commissioner concluded

61. Id. at 241 n.12.
63. For a discussion of the Title VII provisions that apply to employment discrimination and of the remedies that are permitted to be granted to victims of violations of those provisions, see Arthur W. Andrews, The Taxation of Title VII Victims After the Civil Rights Act of 1991, 46 TAX LAW. 755, 768-70 (1993).
64. Burke, 504 U.S. at 242.
that *Burke* made the existence of a tort or tort-type claim sufficient for exclusion as well as being a necessary element.\(^5\)

What then became of the statutory requirement that damages be received on account of a personal injury or sickness to be excludible? That requirement was not entirely stricken by *Burke*, but its significance was reduced. At a minimum, unless the *act* for which damages were received caused a personal injury, the exclusion would not apply. This means that damages received for an injury to taxpayer’s property is not excluded. Even if the same act of the wrongdoer caused both personal injury and property damage, the damages received for the loss of property are not excluded. So, to that extent, the post-*Burke* and pre-*Schleier* construction of the statute required that an examination be made of the type of injury for which the damage was received. However, property damage was not the only instance in which such an examination was necessary. The courts divided over the question of whether punitive damages could be excluded if they were given in connection with a personal injury.\(^6\) As we shall see, a majority of the federal courts of appeals held that punitive damages are taxable; but, one court of appeals excluded punitive damages from gross income.\(^7\) According to the majority view, the noncompensatory nature of the damage meant that it was not received on account of a personal injury and so was not excluded by the statute. The post-*Burke* decisions that excluded punitive damages from income relied in part on a reading of *Burke* that made the nature of the damage award irrelevant so long as it stemmed from a claim based on a personal injury.\(^8\) Prior to *Schleier*, the courts also divided over the question of whether a damage award for prejudgment interest was excludible, but it now appears to be settled that prejudgment interest is taxable.\(^9\)

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5. Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994); Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994).

6. Compare Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990); Wesson v. United States, 48 F.3d 894 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994) (2-1 decision), *cert. denied*, 115 S. Ct. 648 (1994); Reese v. Commissioner, 24 F.3d 228 (Fed. Cir. 1994) (holding punitive damages to be taxable) with Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994) (divided decision) (holding punitive damages to be excluded from income). Subsequent to *Schleier*, the courts have uniformly held that punitive damages are taxable, and the issue currently is pending before the Supreme Court. *E.g.*, Bagley v. Commissioner, 105 T.C. 396 (1995) (reviewed by the court); O’Gilvie v. United States, 66 F.3d 1550 (10th Cir. 1995), *cert. granted*, 116 S. Ct. 1316 (1996).

7. See cases cited supra note 66.


Apart from those several exceptions described above, after Burke was decided and prior to Schleier, courts and the Commissioner ignored the type or nature of the damage that a taxpayer received and instead made the nature of the taxpayer’s claim the exclusive focus of their decisions.

For example, in McKay v. Commissioner,70 the taxpayer had been an officer of a corporation, and his employer terminated his employment.71 Taxpayer sued his former employer for wrongful discharge and for a breach of the employment contract.72 After a trial and a jury verdict for the taxpayer, the parties settled the dispute.73 Under the settlement agreement, the employer agreed to pay taxpayer $16,744,300, of which: more than $12,000,000 was for the claim for wrongful discharge, more than $2,000,000 was for the breach of contract claim, and the balance was partial reimbursement of various legal and litigation costs.74 Relying on Burke, the Tax Court held that the more than $12,000,000 that taxpayer received for his wrongful discharge claim is excluded from income because wrongful discharge constitutes a tort claim.75 It is difficult to see how an injury incurred because of a wrongful discharge can be classified as a “personal injury or sickness,” but the Tax Court’s decision ignored that statutory requirement on the apparent assumption that Burke had subsumed that requirement in its determination that damages received on a tort or tort-type claim are excludible. As we will see, the Supreme Court’s subsequent decision in Schleier vitiates the approach taken by the Tax Court in McKay, and the Fifth Circuit vacated the Tax Court’s decision on the basis that it was contrary to Schleier.76

Another striking example of the assumption that the tort or tort-type claim requirement is sufficient for excludibility is the two deci-
sions of the district court of Kansas in *O'Gilvie v. United States (O'Gilvie I)*\(^7\) and *O'Gilvie v. United States (O'Gilvie II).*\(^8\)

The first decision of the United States District Court for the District of Kansas in *O'Gilvie I* granted the Government’s motion for summary judgment and held that punitive damages obtained in a wrongful death action are taxable.\(^7\) The court held that, even though the taxpayer’s underlying claim was in tort, punitive damages serve no compensatory purpose and so are not received “on account of personal injury”\(^8\) and, therefore, are not excluded from income by §104(a)(2). *O'Gilvie I* was decided the same day that the Supreme Court promulgated its *Burke* decision, and so the district court did not have that decision before it when the court granted the Government’s summary judgment.

The taxpayer in *O'Gilvie* moved for reconsideration so that the district court could consider the relevance of the Supreme Court’s decision in *Burke.*\(^8\) In *O'Gilvie II*, the district court granted the motion for reconsideration and changed its decision entirely.\(^8\) Relying on its reading of *Burke*, the district court determined that it had erred in its prior ruling by focusing on the nature of the punitive damage award rather than on the nature of the underlying claim. Since the underlying claim was tort-type, the court stated that “the court believes its previous order is contrary to *Burke* and must be reversed.”\(^9\) The court granted summary judgment for the taxpayer.\(^8\) On appeal, in what might be called *O'Gilvie III*, the Tenth Circuit (in a decision made subsequent to *Schleier*) reversed the district court and held that punitive damages are taxable.\(^8\) It now appears that there will be an *O'Gilvie IV* since the Supreme Court has granted *certiorari* in that case.\(^8\)


\(^9\) *O'Gilvie I*, 70 AFTR 2d at 92-5072.

\(^8\) Id.

\(^9\) *O'Gilvie II*, 71 AFTR 2d at 93-547.

\(^8\) Id. at 93-548.

\(^9\) Id.

\(^8\) Id.

\(^8\) Id.


The federal courts of appeals divided over the question of whether punitive damages can be excluded by § 104(a)(2). Prior to Schleier, four courts of appeals held that they are taxable, and the Sixth Circuit excluded them.\(^87\) Two issues raised by the question of whether punitive damages can be excluded are whether such damages are obtained on account of a personal injury or sickness, and whether that is a requirement of excludibility. We will address those issues and the effect that Schleier has on their resolution later in this article.

As a consequence of Burke, the Commissioner acknowledged in Revenue Ruling 93-88 that compensatory damages obtained for race-based discrimination under 42 U.S.C. § 1981, and compensatory damages received under the amended version of Title VII for disparate treatment type of discrimination will be excluded from income.\(^88\) However, even in that ruling, the Commissioner noted that damages received under Title VII for a disparate impact type of violation are taxable because of the limited range of remedies available for those claims.\(^89\) Like the several cases discussed above, in promulgating that revenue ruling, the Commissioner read Burke as establishing that the satisfaction of the tort or tort-type requirement is sufficient to provide excludibility. In Schleier, the Supreme Court was critical of that revenue ruling and effectively repudiated it.\(^90\) We will explore the status of damages received because of discrimination later in this article.

As can be seen from the discussion above, the standard established by Burke led to incongruous distinctions and results. Damages received because of a wrongful discharge were held to be excludible if the claim was treated as a tort but not if it was treated as a contract claim. Damages received for some types of discrimination claims were excludible and others were not.

Moreover, the Burke standards encouraged manipulative settlements to obtain advantageous tax treatment. For example, if an em-

\(^87\) Compare Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990); Wesson v. United States, 48 F.3d 894 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994) (2-1 decision), cert. denied, 115 S. Ct. 648 (1994); Reese v. Commissioner, 24 F.3d 228 (Fed. Cir. 1994) (holding punitive damages to be taxable) with Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994) (divided decision) (holding punitive damages to be excluded from income).


ployer wished to pay a senior employee to retire, the employee might instead sue for alleged discrimination on some ground or another and then settle that suit for a tax-free payment of damages. While the author has no data that this has occurred,91 accounts of such occurrences did circulate among some law firms. Regardless of whether those accounts were accurate, the availability of that course of action was too tempting to doubt that it would take place. Having set the stage as it existed at the time that Schleier reached the Supreme Court, let us now turn to that case.

V. THE SCHLEIER DECISION

Commissioner v. Schleier92 involved the question of the excludi- bility of damages received in settlement of a claim under the Age Discrimination in Employment Act of 196793 (hereinafter often referred to as the “ADEA”). The ADEA permits an award for lost wages.94 The ADEA also permits an award for an equal amount as liquidated damages but only in the case of willful violations.95 The ADEA does not permit an award to be made for pain and suffering or for emotional distress.96 The ADEA does provide for a jury trial.97

The taxpayer in Schleier obtained a settlement from his former employer for his discharge based on his age.98 One-half of the taxpayer’s settlement was for lost wages, and the other half was for liquidated damages.99 The Supreme Court had previously determined in Trans World Airlines, Inc. v. Thurston100 that the liquidated damages provision in the ADEA constitutes punitive damages, and the Court adhered to that determination in Schleier. The Supreme Court (in

91. But, see, the facts of the recent case of Taggi v. United States, 35 F.3d 93 (2d Cir. 1994), that lend credibility to the suggestion that this was taking place. See also, Loren C. Rosenzweig, Careful Planning May Establish Excludability of Damages Awarded For Age Discrimination, 81 J. TAX’N 254 (1994) for the suggestion (made prior to Schleier) that settlements for the termination of employment should be structured to have the maximum amount that is feasible characterized as a settlement of a tort claim.
95. Id.
96. Schleier, 115 S. Ct. at 2167.
98. Schleier, 115 S. Ct. at 2162.
99. Id.
100. 469 U.S. 111 (1985).
a 6-3 decision) concluded that all of the damages that the taxpayer received are included in his gross income and are taxable.\textsuperscript{101}

There are several important features of the Court's decision in \textit{Schleier}. One of these is the Court's adherence to and application of the \textit{Burke} standard for determining whether a claim is tort or tort-type. Two more important features of the case are: (1) the Court's determination that the "tort or tort-type" requirement\textsuperscript{102} is merely one of two requisites for excludibility under the statute, and (2) the Court's establishment and description of the second requisite for excludibility.\textsuperscript{103} Before examining the second requisite that the Court established, let us consider the Court's application of the \textit{Burke} requisite.\textsuperscript{104}

In \textit{Schleier}, the Supreme Court adhered to the views that it promulgated in \textit{Burke} that a claim must be tort or tort-type for damages to be excluded and that a claim does not so qualify unless the applicable law provides a broad range of remedies for the claimant.\textsuperscript{105} The Court held that the remedies provided by the ADEA are not sufficiently broad to qualify claims thereunder as tort or tort-type, and so the taxpayer's case failed under the \textit{Burke} standard.\textsuperscript{106} The ADEA's provision allowing an award for back pay is the same type of remedy that the Court had previously found in \textit{Burke} to be insufficient to classify a claim as tort or tort-type.\textsuperscript{107} The principal difference from the facts of \textit{Burke} is that the ADEA allowed punitive damages (described in the Act as "liquidated damages") for willful violations and permitted a jury trial. The Court held that the addition of a punitive damage remedy and of a jury trial (together with allowing back pay) was not a broad enough range of remedies to qualify an ADEA claim as tort or tort-type.\textsuperscript{108} This holding is significant in that it indicates that the range of available remedies must be extensive for a claim to qualify for § 104(a)(2) treatment.

The Court's application of the \textit{Burke} standard was sufficient to defeat the taxpayer's claim for exclusion. But, the Court went much

\begin{itemize}
  \item \textsuperscript{101} \textit{Schleier}, 115 S. Ct. at 2167.
  \item \textsuperscript{102} This requirement is set forth in Treas. Reg. § 1.104-1(c) and was adopted in \textit{Burke} where the Supreme Court elaborated on the standard to be applied in determining whether a claim is tort or tort-type.
  \item \textsuperscript{103} \textit{Schleier}, 115 S. Ct. at 2166.
  \item \textsuperscript{104} See supra note 101.
  \item \textsuperscript{105} \textit{Schleier}, 115 S. Ct. at 2167.
  \item \textsuperscript{106} \textit{Id.}
  \item \textsuperscript{107} \textit{Burke}, 504 U.S. at 241.
  \item \textsuperscript{108} \textit{Schleier}, 115 S. Ct. at 2166-67.
\end{itemize}
further than that and made the application of the *Burke* standard merely an alternative holding. Obviously displeased with the assumption that compliance with the *Burke* standard was sufficient to invoke the exclusion provided by § 104(a)(2), the Court expressly repudiated that view.\textsuperscript{109} The Court held that the tort or tort-type claim requirement is merely one of two conditions that must be satisfied for damages to be excluded.\textsuperscript{110} In addition to there being a tort claim, a damage will not be excluded unless it is obtained on account of a personal injury.\textsuperscript{111} Let us now turn to this second requirement and examine what it is and how it operates.

*Schleier* holds that the receipt of a damage payment cannot be excluded unless the loss or injury for which the payment is made is attributable to a personal injury. A single wrongful act can cause multiple injuries. Only those damages that are received as compensation for losses that are attributable to a personal injury can be excluded.

The Court utilized the following hypothetical example to illustrate this concept.\textsuperscript{112} An individual suffers a physical injury in an automobile accident that is caused by another’s negligence. In settlement of the resulting lawsuit, the individual receives $X for medical expenses, $Y for lost wages (both past wages and reduced future earnings), and $Z for pain and suffering. The individual had not previously claimed a tax deduction for the medical expenses. The $X that the individual received for medical expenses and the $Z that the individual received for pain and suffering are attributable to the personal injury that the individual suffered—i.e., absent a personal injury, the individual would not have incurred the medical expenses or incurred pain and suffering, and so the damages for those items are received on account of the personal injury. Consequently, those amounts are excluded from gross income by § 104(a)(2). If the $Y that the individual received for lost income (including reduced future earnings) are attributable to the personal injury that the individual suffered, that amount also will be excluded. For example, if the individual were a surgeon who lost fingers in the accident, the individual’s lost income (both past and future) is a consequence of the loss of his fingers, and so the damages received therefore is received on account of the individual’s personal injury.

\textsuperscript{109} Id. at 2166.
\textsuperscript{110} Id. at 2167.
\textsuperscript{111} Id.
\textsuperscript{112} Schleier, 115 S. Ct. at 2163-64.
In contrast, consider the case of the taxpayer in *Schleier* who was fired because of his age in contravention of the ADEA. The improper action of taxpayer's employer in firing the taxpayer caused multiple injuries. One injury that the taxpayer suffered was the humiliation and emotional pain from being stigmatized as unfit.\(^{113}\) That was a personal injury. A second injury he suffered was the loss of the income that he would have earned had he been allowed to continue his employment.\(^{114}\) That loss constitutes an improper termination of an economic relationship; therefore, it is an economic injury, *not* a personal injury. The damages paid to taxpayer for back wages that he was prevented from earning were not attributable to his personal injury. Even if the taxpayer had not felt any humiliation or emotional pain because of the firing, he would have been entitled to precisely the same amount of damages he received for back wages. The personal injury that taxpayer suffered was a product of the same act that caused his economic loss, but it was a separate and distinct injury.\(^{115}\) The circumstance of the injured surgeon in the hypothetical discussed in the paragraph above was quite different. The surgeon would not have lost any income if he had not suffered a personal injury in the accident. The lost income is directly attributable to that personal injury. When a personal injury is caused by a wrongful act, any damages resulting *from that personal injury* may be excluded. But when a wrongful act causes both a personal injury and an economic injury that is separate and distinct from the personal injury, then damages received for the latter cannot be excluded under § 104(a)(2).

As previously noted, the Court characterized the liquidated damages that the taxpayer in *Schleier* received as punitive damages.\(^{116}\) Accordingly, the Court held that the liquidated damages were not received on account of a personal injury and so are not excluded.\(^{117}\) The Court

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113. *Id.* at 2164.
114. *Id.* at 2164-65.
115. The Court stated in *Schleier*:

> Whether one treats respondent's attaining the age of 60 or his being laid off on account of his age as the proximate cause of respondent's loss of income, neither the birthday nor the discharge can fairly be described as a 'personal injury' or 'sickness.' Moreover, though respondent's unlawful termination may have caused some psychological or 'personal' injury comparable to the intangible pain and suffering caused by an automobile accident, it is clear that no part of respondent's recovery of back wages is attributable to that injury.

*Id.* at 2164.

117. *Id.*
did state that if the liquidated damages had been intended by Congress to compensate for personal injuries that were difficult to prove, they "might well come within § 104(a)(2)’s exclusion." One might question the desirability of having the tax treatment of a damage award rest on a determination of the legislative purpose for providing that remedy; but that is one of the less attractive elements of the Court’s decision. The proper treatment of liquidated damages is discussed in Part VI.

If the ADEA had allowed damages to be awarded for pain and suffering, and if that added item were deemed sufficient to make a claim under the ADEA a tort or tort-type claim, then damages received by the taxpayer for pain and suffering would be received on account of a personal injury, and so would be excluded from income. However, even in that case, the damages received for back pay and the liquidated damages would be taxable because neither of those were received for a personal injury.

While Schleier is an extremely significant decision that sets a new and clearer path for determining the tax treatment of damages, it does not constitute a radical departure from prior law, including the Burke decision. As noted previously, even after Burke was decided, there were circumstances in which the nature of a damage payment had to be examined to determine whether it was excludible even when the underlying claim was a tort or tort-type. The clearest example of this is where a wrongful act caused both a property damage and a personal injury. For example, consider an automobile accident in which the victim suffered both a personal injury and damage to his vehicle. Even though the same wrongful act caused both injuries, the damages obtained for the property loss are not excluded by § 104(a)(2), but the damages obtained for the personal injury are excluded. Another example is where the victim of a personal injury obtains both compensatory and punitive damages. While the courts divided on the issue, the clear trend favored taxing the punitive damages. This again requires an examination of the nature of the damage award rather than relying exclusively on the nature of the underlying claim. The post-Schleier status of punitive damages is discussed in Part VI of this article.

118. Id. Of course, to be excludable, the claim on which the damage is payable must qualify as a tort or tort-type claim.

119. Id. The tort or tort-type claim classification is necessary to satisfy that requirement (the Burke requirement) of the statute.

120. See cases cited supra note 66.
In *Schleier*, the Court substantially expanded the requirement that the nature of a damage payment must be examined. However, the concept of tying the tax treatment of a damage payment to the question of whether it was attributable to a personal injury existed long before *Schleier* was decided.

Justice O'Connor's dissent in *Schleier* is divided into two parts.121 The first part, which is not a model of clarity, seems to be based on the contention that if an act causes a personal injury, then all compensatory damages obtained because of that act constitute damages received on account of a personal injury. Justice O'Connor simply passes over the fact that one act can cause more than one injury, and that the majority's holding requires that the damage received be characterized by the injury that caused the loss for which compensation is obtained. Justice O'Connor expresses bewilderment over the majority's distinction of damages incurred in a car accident from those incurred by the taxpayer, and she suggests that the only basis on which those two can be taxed differently is if the majority implicitly treats nonphysical injuries differently from physical injuries.122 Whatever the merits might be of providing different tax treatment for damages received for physical and nonphysical injuries, the majority's decision does not do so and does not establish standards that will prevent an exclusion of damages for nonphysical injuries. As shown in Part VI, the *Schleier* decision excludes from income certain types of damages (such as pain and suffering) that are obtained in claims based on dignitary torts (including discrimination claims based on a tort or tort-type claim). Even damages for lost income that are obtained on a defamation claim are excludible under the majority's standard. This first part of Justice O'Connor's dissent was joined by only one other Justice (Justice Thomas).123 Justice Souter joined only in the second part of that dissent.124

The second part of Justice O'Connor's dissent concludes that the ADEA provides for a tort or tort-type claim and that the *Burke* decision and a 35-year consistent administrative construction of § 104(a)(2) made the tort or tort-type character of a claim decisive in determining the excludibility of damages.125 Justices Thomas and Souter joined in

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122. *Id.* at 2169-70.
123. *Id.* at 2167.
124. *Id.*
that part of the dissent.\textsuperscript{126} In addition to urging the adoption of a broader construction of what constitutes a tort, this part of the dissent rests on a plea for an application of stare decisis and for upholding the administrative position that purportedly has been followed in the most recent period. The dissent fails to give the majority credit for making a desirable modification to a judicially created standard\textsuperscript{127} that was proving to be unworkable and highly unsatisfactory from a tax policy viewpoint. As previously observed, using the \textit{Burke} standard as the sole requirement for exclusion led to the drawing of arbitrary distinctions and led to the exclusion of certain items when there was no tax policy justification for not taxing them. The \textit{Schleier} decision represents a movement in the right direction in that the tax results it generates are more consistent with tax policy considerations than are prior rules.

Moreover, the historical pattern of the tax treatment of damages is not as consistent as the dissent pictures it. There have been a number of vacillations and reversals of position. For example, the Service has contended that punitive damages are taxable (although, even as to that, there was a period of some nine years, from 1975 to 1984, in which the Service excluded punitive damages from income).\textsuperscript{128} That administrative position (which has been adopted by a majority of the courts of appeal\textsuperscript{129} that have faced the issue) contravenes the view that the nature of damages is irrelevant to the determination of its excludibility. Over the years, the Service and the courts have changed their positions concerning the excludibility of a number of different types of damages.

\textsuperscript{126} \textit{Id.} at 2167.

\textsuperscript{127} While Treas. Reg. § 1.104-1(c) created the "tort or tort-type" standard, that regulation does not make that standard the exclusive test for applying § 104(a)(2). The regulation uses that standard to define the meaning of "damages received (whether by suit or agreement)." The regulation is silent as to the meaning of the statutory requirement that the damages be received "on account of personal injuries or sickness." The elevation of the "tort or tort-type" requisite to an exclusive status is attributable to some (but not all) judicial decisions construing § 104(a)(2). Although, in Rev. Rul. 93-88, 1993-2 C.B. 61, the Internal Revenue Service granted a much greater role to the "tort or tort-type" requirement than it had done previously, that construction was based on the Internal Revenue Service's reading of the Supreme Court's decision in \textit{Burke}. The majority opinion in \textit{Schleier} explicitly repudiated the broad reading of \textit{Burke} that the Internal Revenue Service had adopted in that 1993 ruling. \textit{Schleier}, 115 S. Ct. at 2167.

\textsuperscript{128} Rev. Rul. 75-45, 1975-1 C.B. 47 reversed the Service's prior position and ruled that punitive damages are excluded from income. Rev. Rul. 84-108, 1984-2 C.B. 32 revoked the 1975 ruling and determined that punitive damages are taxable, and that has been the Service's position ever since. It is noteworthy that even the discredited Rev. Rul. 93-88, 1993-2 C.B. 61 ruled only that \textit{compensatory} damages received under certain federal statutes barring discrimination were excludible.

\textsuperscript{129} See cases cited supra note 66.
For example, the tax treatment of damages received because of discrimination has gone through a number of changes.130

VI. THE POST-SCHLEIER PRE-1996 STATE OF THE LAW

As a consequence of Schleier, it is much easier to predict whether pre-1996 damages will be taxable. Let us now consider the likely treatment of different types of damages for several different types of injuries.

A. Compensatory Damages for Physical Injuries

Schleier will have little effect (if any) on the treatment of compensatory damages obtained for a physical injury. There will be few, if any, cases of that sort in which the victim's claim will not qualify as a tort under the Burke and Schleier standards. And, in virtually all such cases, the damages obtained by the victim (whether by suit or by agreement) will be attributable to the victim's physical injury and so will be received on account of a personal injury. The damages covered by § 104(a)(2) include: lost income (both past and future), pain and suffering, mental anguish, inconvenience, and medical expenses (except to the extent previously taken as deductions by the victim). The tax treatment of punitive damages is discussed in Subpart F, below.

B. Damages Obtained Because of Defamation

Schleier also will have little effect on the tax treatment of pre-1996 compensatory damages obtained in a defamation claim. A claim based on defamation will be a tort claim. The injury that is incurred because of defamatory statements is damage to the victim's reputation, and that is a personal injury. Compensatory damages obtained because of the defamation, including damages obtained for loss of past and future income, are directly attributable to the personal injury that the victim suffered (i.e., the damage to the individual's reputation). Therefore, all compensatory damages obtained by the victim will be excluded from gross income by § 104(a)(2). Punitive damages obtained

130. Compare, Hodge v. Commissioner, 64 T.C. 616 (1975); and Coats v. Commissioner, 36 T.C.M. (CCH) 1650 (1977), aff'd by court order, 626 F.2d 865 (9th Cir. 1980) (holding such damages to be taxable); with Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990); Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990); Downey v. Commissioner, 97 T.C. 150 (1991) [hereinafter Downey I], aff'd on reconsideration, 100 T.C. 634 (1993) (reviewed by the court) [hereinafter Downey II], rev'd, 33 F.3d 836 (7th Cir. 1994); Rev. Rul. 93-88, 1993-2 C.B. 61 (holding certain damages for discrimination to be excludible and certain types to be taxable).
in connection with a defamation claim will be taxable because of the express provision in § 104 making that taxable.

C. Damages Obtained Because of Discrimination

Some types of discrimination claims will not qualify as tort or tort-type, and damages received thereunder are not excluded by § 104(a)(2). For example, discriminatory impact claims under Title VII and claims for age discrimination under the ADEA are outside of the scope of § 104(a)(2). But, the remedies provided for a number of types of discriminatory claims will qualify those claims as torts. For example, claims for race based discrimination under 42 U.S.C. § 1981, disparate treatment type of discrimination under Title VII, and discrimination under the Americans with Disabilities Act all qualify as tort or tort-type claims. Once past the tort requirement, the question arises whether the receipt of a damage payment satisfies the second requirement described in Schleier. Some types of damages will satisfy that second requirement, and some will not.

Damages obtained for lost income that is attributable to a discrimination violation will be taxable. The loss of income will not be attributable to the personal injury that the victim suffered — i.e., humiliation, damage to personal dignity etc. As was determined to be the case in Schleier, the economic injuries (other than medical expenses) that a victim of discrimination incurs are attributable to violations of commercial interests; and, so, the damages therefor are not received on account of a personal injury. However, damages obtained for pain and suffering, mental anguish, and similar items, and for medical expenses incurred because of those injuries, are attributable to a personal injury and so can be excluded under § 104(a)(2). The same discriminatory act can cause both the loss of income and personal injuries, but only the damages obtained for pain and suffering and for mental anguish and the like are attributable to the personal injury.

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133. Rev. Rul. 93-88, 1993-2 C.B. 61, suspended by I.R.S. Notice 95-45, 1995-34 I.R.B. 20. While Schleier invalidates the part of that ruling that determined that compensatory damages received under those claims is excluded from income by § 104(a)(2), there is no question to reason the validity of the part of the ruling that determines that claims under those provisions are tort or tort-type claims.
134. Schleier, 115 S. Ct. at 2164.
135. Id. at 2164-65.
Any punitive damages that are obtained as a consequence of a discrimination claim are taxable. Even prior to the 1996 Amendment, § 104 explicitly precluded the exclusion of punitive damages received as a consequence of a claim in which the victim suffered no physical injury or sickness.

D. Damages for Wrongful Discharge or for Intentional Infliction of Emotional Harm

Depending upon the remedies provided by the applicable local law, some claims based on a wrongful discharge will constitute a tort claim and some will not. If the claim does not qualify as a tort claim, the damages obtained thereunder are taxable. Even when the claim does satisfy the tort requirement, compensatory damages received for lost income will be taxable for the same reasons as were explained above in connection with the receipt of damages for lost income in a discrimination case. Any punitive damages will be taxable. Frequently, a claim for damages for a wrongful discharge will be coupled with a claim for damages for intentional infliction of emotional harm. Any pre-1996 damages obtained for emotional harm are attributable to a personal injury. Therefore, if the tort claim requirement is satisfied, pre-1996 damages obtained for emotional harm or like injuries, whether such damages are allowed pursuant to a wrongful discharge claim or pursuant to an intentional infliction of emotional harm claim, will be excluded by § 104(a)(2). The extent to which Schleier permits the exclusion of such damages constitutes one of the flaws of the Schleier approach. It was cured by the 1996 Amendment.

E. Sexual Harassment

A claim for damages based on sexual harassment is a tort claim, and any compensatory damages acquired thereby are received on account of a personal injury. All such pre-1996 compensatory damages, including damages compensating for lost income, will be excluded by § 104(a)(2). Compensatory damages received after the 1996 Amendment generally will be taxable. But see the discussion in Subpart F below. The question of whether punitive damages obtained in such cases will be excluded from income is also discussed in Subpart F, below.

136. See, McKay v. Commissioner, 84 F.3d 433 (5th Cir. 1996).
F. Punitive Damages

In 1989, Congress amended § 104(a)(2). That amendment precludes the application of § 104(a)(2) to punitive damages obtained in connection with a case in which no physical injury or sickness occurred. Subject to transition rules, the amendment applies to punitive damages received after July 10, 1989. So, there is no issue concerning the taxability of punitive damages received after that date when the claim is based on a dignitary tort or some other tort in which the victim did not incur a physical injury. With one minor exception, all punitive damages obtained after the 1996 Amendment are taxable.

Unresolved at this time is whether the 1989 Limitation of § 104(a) applies if the victim suffered only a very minor amount of physical injury. Is any physical injury sufficient to remove punitive damages from the prohibition of that 1989 Amendment? Consider a sexual harassment case in which the victim was pinched and incurred a small bruise thereby. The bruise would constitute a minuscule part of the injury suffered by the victim. The question is whether the presence of some physical injury, no matter how small, is sufficient to remove a punitive damage award from the statutory prohibition. This question becomes irrelevant if all punitive damages are taxable, regardless of whether the last sentence of § 104(a) is applicable. Since, as explained below, the author has concluded that that is the case, he deems the applicability of the 1989 Amendment to be irrelevant.

The question of whether punitive damages are taxable has two separate aspects to be examined. First is the question of whether the Schleier construction of § 104(a)(2) prevents its application to pre-1996 punitive damages in the absence of other statutory provisions making it applicable. The second question is whether the 1989 amendment impliedly excludes from income punitive damages received before 1996, when the victim suffered a physical injury. We will consider both of those aspects of the issue.

Even a casual reading of Schleier makes it clear that § 104(a)(2) does not apply to pre-1996 punitive damages. Such damages are given to punish a wrongdoer for willful or wantonly wrongful behavior. While the severity of the victim’s injury often can be taken into account in determining the size of punitive damages to be awarded, it is used as a means of measuring the degree of the wrongdoer’s culpability. Even criminal sanctions, clearly punitive in nature, take the extent of the victim’s injury into account in assessing the severity of the crime and the amount of punishment to be inflicted.
Punitive damages are awarded to the injured party, rather than to the state, in order to make the victim a kind of private attorney general by encouraging the victim to enforce the policies of the state by inflicting punishment on the wrongdoer.\textsuperscript{137} Even if the legislative purpose for permitting a punitive damage award has some compensatory objective,\textsuperscript{138} it will constitute a minor aspect of the legislative purpose, which virtually always will be predominately punitive. A possible exception is where a state permits only punitive damages to be awarded for a wrongful death. In that case, damages would reflect a substantial compensatory objective.

Typically, punitive damages are not provided on account of a personal injury. Rather, they are provided on account of an excessively wrongful act. In \textit{Schleier} itself, the Court held that the liquidated damage provision of the ADEA served as a punitive damage provision and so was not received "on account of personal injury or sickness." The decision in \textit{Schleier} reflects the Court's view that only compensatory damages can be excluded under § 104(a)(2).

In one respect, punitive damages can be said to be received on account of a personal injury. A victim cannot obtain punitive damages unless the victim suffered an injury. If the injury is personal, can the punitive damages therefore be viewed as attributable to (i.e., received "on account of") the personal injury? The Fourth Circuit, in a pre-\textit{Schleier} decision, rejected that view;\textsuperscript{139} but the Sixth Circuit felt differently.\textsuperscript{140} At this date, five circuit courts of appeals (the Fourth, Fifth, Ninth, Tenth, and Federal Circuits) have held punitive damages to be taxable, and only the Sixth Circuit disagreed.\textsuperscript{141} In a reviewed decision in \textit{Bagley v. Commissioner},\textsuperscript{142} the Tax Court unanimously overruled its prior decision in \textit{Horton} and held that \textit{Schleier} requires a determination that punitive damages are taxable. It seems to the author that any doubts concerning the taxability of punitive damages are laid to rest by the majority opinion of the Supreme Court in \textit{Schleier}.\textsuperscript{143} In


\textsuperscript{138} See, e.g., \textit{Horton v. Commissioner}, 33 F.3d 625, 631 (6th Cir. 1994) (2-1 decision) finding a compensatory element in the punitive damage provision there-involved.

\textsuperscript{139} \textit{Commissioner v. Miller}, 914 F.2d 586 (4th Cir. 1990).

\textsuperscript{140} \textit{Horton v. Commissioner}, 33 F.3d 625 (6th Cir. 1994) (2-1 decision).

\textsuperscript{141} See cases cited supra note 66. In addition to those cases, the Tenth Circuit held in \textit{O'Gilvie III} that punitive damages are taxable. \textit{O'Gilvie v. United States}, 66 F.3d 1550 (10th Cir. 1995).

\textsuperscript{142} 105 T.C. 396 (1995) (reviewed by the court).

\textsuperscript{143} Every decision on this issue that was made since \textit{Schleier} came down has held that puni-
that opinion, the Court emphasized that the statutory exclusion is aimed at compensatory remedies.\textsuperscript{144} The Court went on to point out that the ADEA provision for liquidated damages "serve no compensatory function."\textsuperscript{145} Moreover, when the tax policy justifications for the statutory exclusion of certain damages are examined,\textsuperscript{146} there is no possible justification for excluding punitive damages; and so the statute should not be read expansively to cover those damages. Also, note that the title to § 104 reads "Compensation For Injuries or Sickness" (emphasis added), and the items listed in § 104(a)(1) and in (a)(3)-(5) all apply to compensatory receipts. The meaning of § 104(a)(2) is illuminated by the title of that statute and by the nature of the subsections that surround § 104 (a)(2).

Perhaps, if it could be shown that the legislative purpose of permitting a specific damage award that is designated as "punitive" was primarily compensatory, and so the statute was misidentified by the legislature in labeling it punitive, the receipt of such a damage might qualify for the exclusion. Even if that is so, there should be an extremely heavy burden on the taxpayer to show that the damage item was mislabelled by the legislature. In the view of the author, it will virtually never be possible to demonstrate that a designated "punitive" provision does not have punishment as its predominant purpose (except possibly for certain wrongful death damages as described above).

The second question concerning the treatment of punitive damages is whether Congress, by its 1989 amendment, impliedly authorized the exclusion of punitive damages when the victim suffered a physical injury. The express statement in the 1989 Amendment of the statute that punitive damages are not excludible when no physical injury occurred creates a negative inference that punitive damages are excludible when a physical injury did occur. In footnote 6 of the \textit{Burke} opinion, the Court stated in dictum that Congress amended the statute in 1989 to allow the exclusion of punitive damages in cases where there was a physical injury or sickness.\textsuperscript{147} The question of whether Congress's 1989 amendment authorized the exclusion of punitive damages when there is a physical injury was not before the Court in \textit{Burke}, and there is no indication that the Court examined the legislative history of that

\textsuperscript{144} Schleier, 115 S. Ct. at 2166-67.
\textsuperscript{145} Id. at 2167.
\textsuperscript{146} See supra part III.
\textsuperscript{147} Burke, 504 U.S. at 237 n.6.
provision or even subjected the provision to scrutiny. A careful reading of the legislative history of the 1989 amendment makes abundantly clear that Congress had no intention of making such punitive damages excludible.

At the time that the amendment was passed, the Tax Court had just held that punitive damages are excluded from income; and while that decision was reversed, the reversal took place after the amendment had been adopted.\textsuperscript{148} The original proposal for the 1989 amendment of § 104(a) would have restricted the statutory exclusion of § 104(a)(2) to damages obtained in cases where there was a physical injury. That version was not then adopted by Congress. Instead, the Conference Committee chose to preclude the application of the exclusion to punitive damages in cases in which there was no physical injury. This amendment apparently was made to provide assurance that, even if the Tax Court’s view, as announced in \textit{Miller}, was sustained, at least the punitive damages obtained for nonphysical injuries would be taxable. The original version of the Conference Committee’s bill would have expressly allowed an exclusion for punitive damages when there was a physical injury and have denied it to punitive damages only when there was not a physical injury.\textsuperscript{149} That draft of the bill was corrected by marking changes in ink on the bill itself. As altered, and as finally adopted, the bill merely precludes an exclusion for punitive damages obtained when there is no physical injury. The bill and the current statute is silent as to the treatment of punitive damages when there is a physical injury. The deliberate striking from the bill of the provision allowing an exclusion for punitive damages when there is a physical injury demonstrates beyond cavil that the silence on that topic in the statute is deliberate, and that Congress had no wish to make any provisio concerning that issue.\textsuperscript{150}

The Supreme Court has granted certiorari in \textit{O'Gilvie}.\textsuperscript{151} \textit{O'Gilvie} involves punitive damages received in a case where the victim

\begin{itemize}
\item \textsuperscript{148} Miller v. Commissioner, 93 T.C. 330 (1989) (reviewed by the court) was decided before the amendment was adopted, \textit{rev'd}, 914 F.2d 586 (4th Cir. 1990) after the amendment had been adopted.
\item \textsuperscript{150} For a more thorough explanation of the evidence that the 1989 amendment does not permit the exclusion of punitive damages obtained when there is a physical injury, and for a more thorough discussion of the correct tax treatment of punitive damages, \textit{see} Kahn, \textit{supra} note 6, at 366-78.
\item \textsuperscript{151} O'Gilvie v. United States, 116 S. Ct. 1316 (1996).
\end{itemize}
incurred a physical injury. The damages obtained in *O'Gilvie* were received prior to the effective date of the 1989 Amendment to § 104(a)(2). Perhaps, the Court wishes to reconsider the position it adopted in *Schleier*, or perhaps it merely wishes to examine the significance of the 1989 Amendment.

G. Liquidated Damages

Liquidated damages can be provided to compensate an injured party for intangible injuries, the amount and existence of which are difficult to prove. If that is the function of a liquidated damage provision, and if the injury for which the damage is provided constitutes a personal injury, and if the claim on which that damage is based is a tort or tort-type claim, the liquidated damage should be excluded from gross income by § 104(a)(2). That is a lot of "ifs" to be satisfied, but it shows that it is possible for a liquidated damage to be excluded. However, if the provision primarily serves a punitive purpose, it will not be excludible. If the provision requires a showing that the wrongdoer knew that his action was unlawful or a showing that the wrongdoer's action was especially egregious in some other respect, the *Schleier* decision indicates that such a liquidated damage provision will be characterized as punitive for purposes of § 104(a)(2).

If the characterization of a liquidated damage provision can be determined by objective facts, such as whether the damage is allowed only when the wrongdoer commits an especially bad act, the fact that distinctions will be made between those provisions that are punitive and those that are compensatory is not overly troublesome. But, if the distinction is to be made by resort to language employed in the legislative history to determine the legislative purpose for enacting the provision, that is a much less satisfactory basis for arriving at different tax consequences.

VII. CONCLUSION

As previously mentioned, the author views *Schleier* as making a substantial improvement in the law as it appeared immediately after *Burke* was decided. While the standards adopted by the Supreme Court

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152. In *Schleier*, the Court stated: "[I]f liquidated damages were designed to compensate ADEA victims, we see no reason why the employer's knowledge of the unlawfulness of his conduct should be the determinative factor in the award of liquidated damages." *Schleier*, 115 S. Ct. at 2165. There will be no exclusion of post-1996 damages unless there was a physical injury.
in *Schleier* are not optimum, they may be as good as a court could do
given the tortuous and unfortunate history of the manner in which the
doctrine for excluding certain damages had developed before the issue
reached the *Schleier* Court. The current state of the law on this issue
(especially after the 1996 amendment) appears manageable and roughly
conforms to tax policy considerations.

*Schleier* did not eliminate the availability of manipulation, but it
does reduce the scope of such actions. For example, it will no longer
be sufficient to obtain tax exclusion to cloak an employee’s severance
pay in the guise of a tort settlement. However, to the extent that a pre-
1996 severance payment can successfully be disguised as a payment for
pain and suffering or for mental anguish of some type of tort (such as
intentional discrimination or an intentional infliction of emotional
harm), the payment may escape taxation. But, it will be difficult to es-

tablish that a payment truly is received in settlement of a legitimate
claim for such damages pursuant to a tort. In this regard, note that the
Tax Court has repudiated an allocation of damages made by parties and
approved by a court when the allocation was patently unreasonable and
when the payor had no reason to care how the payment was character-
ized.\footnote{153. Robinson v. Commissioner, 102 T.C. 116 (1994), *aff’d* on
issue, *rev’d* on different issue, 70 F.3d 34 (5th Cir. 1995), *petition for
cert. filed*, 65 U.S.L.W. 3002 (U.S. Mar. 4, 1996) (No. 95-
2067).}

Under *Schleier*, damages cannot be excluded unless they are re-
ceived as compensation for a personal injury.\footnote{154. *Schleier*, 115 S. Ct. at
2167.} Economic losses that
accompany, but are not attributable to a personal injury, are no longer
excludible.\footnote{155. *Id.* at 2165.} The author believes that the justification for excluding
any damage from income rests on a view that it would be rapacious (or
at least unseemly) of the government to take from a victim part of the
compensation the victim received for the involuntary destruction of part
of his human capital. The restriction of the exclusion to damages that
are received in compensation of a personal loss (however the value of
that loss may be measured) comports with the policy justification for
the statutory provision to a much better extent than did the prior con-
struction of the statutory exclusion.

A better solution, was recently adopted. Section 1605 of the
*Small Business Job Protection Act* of 1996 amended § 104 to re-
strict the exclusion of damages to those received on account of physical
injury or physical sickness.156 The statute expressly provides that emotional distress is not deemed to be a physical injury or physical sickness.157 Punitive damages are made taxable except for certain wrongful death damages awarded in a state where only punitive damages are permitted to be awarded for a wrongful death.158 When punitive damages are the exclusive remedy that is permitted for a wrongful death, a substantial amount of such damages serves a compensatory purpose. Presumably, Congress deemed the compensatory element in many such cases to be sufficient to justify excluding the damages from income.

This statutory provision should cure most of the remaining ills in the treatment of damages, but some questions remain — for example, whether a minor physical injury is truly the source of the claim.

157. Id.
158. Id.