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TAXATION OF PUNITIVE DAMAGES OBTAINED IN A PERSONAL INJURY CLAIM

by Douglas A. Kahn

Since the adoption in 1919 of the Revenue Act of 1918, the statutory tax law has expressly excluded from gross income damages received on account of a personal injury or sickness. This statutory provision currently is set forth at section 104(a)(2) of the Internal Revenue Code of 1986. The exclusion from income does not apply to the extent that the payment constitutes a reimbursement for medical expenses for which the taxpayer previously had been allowed a tax deduction.

Prior to 1975, the IRS commissioner asserted that the statutory exclusion for damages received on account of a personal injury does not prevent the taxation of punitive damages even when received as part of an award or a settlement of a claim for personal injury. While the commissioner departed from that view in the period between 1975 and 1984, she returned to her original position in 1984. The Tax Court and the Sixth Circuit, however, maintain that all damages received in connection with a personal injury claim, including punitive damages, are excluded from gross income by section 104(a)(2). Three of the four circuit courts of appeals (the Fourth, Ninth, and Federal Circuits) that have passed on this issue at the date of this writing have held that punitive damages are included in gross income; but trial courts have divided on this issue. The Sixth Circuit has excluded punitive damages from income, and appeals are pending in two other circuit courts of appeals.

The question of whether punitive damages should be excluded from income will continue to be litigated in the immediate future. The issue has been fueled by the Supreme Court's 1992 decision in United States v. Burke, and by the amendment to section 104(a) that was adopted in 1989. In the soon to be published article, "Compensatory and Punitive Damages for a Personal Injury: To Tax or Not To Tax?", the author has examined the current tax treatment of both punitive and compensatory damages, has criticized the standards adopted by the Supreme Court in Burke for determining whether damages are excludable, and has made suggestions as to the proper standards for applying the statutory exclusion from income. This article addresses a more modest topic — namely, the proper construction of the last sentence of section 104(a).

The question of whether punitive damages should be excluded from income will continue to be litigated in the immediate future.

In 1989, Congress amended section 104(a) by adding the last sentence of that provision. The last sentence reads:

Paragraph (2) [i.e., section 104(a)(2)] shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.

Subject to transitional rules, punitive damages (or settlements in lieu thereof) that are received after July 10, 1989, in cases of nonphysical injuries, will be tax-

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3Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990); Hawkins v. United States, __ F.3d ___ (9th Cir. 1994) (divided decision); Reese v. Commissioner, __ F.3d ___ (Fed. Cir. 1994). Contra, Horton v. Commissioner, __ F.3d ___ (6th Cir. 1994) (divided decision).
able. Thus, punitive damages received in cases involving discriminatory practices or defamation or other dignitary torts will be taxable. That will eliminate much of the current controversy, but several important issues remain.

First, what will be the tax treatment of punitive damages that are received in a case in which there has been a physical injury? The 1989 amendment, which precludes the application of section 104(a)(2) when there is not a physical injury, creates a negative inference that section 104(a)(2) does apply to punitive damages when there is a physical injury. However, care should be taken as to whether a negative inference is warranted. As will be shown below, an examination of the legislative history of the 1989 amendment clearly establishes that Congress had no intention of passing on the proper treatment of punitive damages in any circumstance other than when there was no physical injury.

Second, does the adoption of the 1989 amendment demonstrate that Congress believed that the pre-1989 law excluded punitive damages from income when received pursuant to a claim for a personal injury? Even if the amendment does indicate that Congress held that belief, what weight should the courts accord to it?

Let us first consider the effect of the amendment on post-1989 punitive damages obtained in a case involving a physical injury. While no case has yet arisen in which punitive damages for a physical injury were received after July 10, 1989, several courts, including the Supreme Court, have assumed that the negative inference of the amendment’s language is valid. For example, in footnote 6 of the Supreme Court’s decision in United States v. Burke, the Court stated:

Congress’ 1989 amendment to section 104(a)(2) provides further support for the notion that “personal injuries” includes physical as well as nonphysical injuries. Congress rejected a bill that would have limited the section 104(a)(2) exclusion to cases involving “physical injury or physical sickness.” See H.R. Rep. No. 101-247, pp. 1354-1355 (describing proposed section 11641 of H.R. 3299, 101st Cong., 1st Sess. (1989)). At the same time, Congress amended section 104(a) to allow the exclusion of punitive damages only in cases involving “physical injury or physical sickness.” [Emphasis added.] . . . . The adoption of this limited amendment addressing only punitive damages shows that Congress assumed that other damages (i.e., compensatory) would be excluded in cases of both physical and nonphysical injury.

The Supreme Court construed the amendment as having both an inclusionary and an exclusionary direction. By stating the rule as allowing an exclusion for punitive damages only when there was a physical injury, the Court adopted the view that the amendment allows an exclusion for a physical injury and denies an exclusion for a nonphysical injury. In fact, the language of the amendment addresses only the circumstances in which there is no physical injury and makes no express statement concerning the treatment of damages when a physical injury is present. The Court did not analyze the amendment; it simply assumed that the denial of an exclusion for nonphysical injuries amounted to allowing one for physical injuries. The statement was made by the Court in the middle of a lengthy footnote that dealt with the question of whether compensatory damages for nonphysical injuries are excluded from income by section 104(a)(2). The Court’s comment concerning the amendment’s authorization of an exclusion of punitive damages when there was a physical injury is dictum and does not appear to be the product of any serious thought, much less a consideration of the legislative history. For the point that the Court made in that footnote (i.e., that the amendment’s precluding an exclusion when the injury is nonphysical supposedly shows that section 104(a)(2) otherwise applies to compensatory damages for nonphysical injuries), it makes no difference whether the amendment permits an exclusion for punitive damages when a physical injury is present. There was no reason for the Court to focus on the question of the applicability of the amendment to physical injury claims, and it does not appear to have done so. The Court’s remarks concerning the application of the amendment to physical injury cases appear to be the product of a casual reading of the statute and are not worthy of any weight.

Several courts have referred to the Supreme Court’s statement in Burke as support for the view that the 1989 amendment allows for the exclusion of punitive damages in cases involving physical injuries.

Nevertheless, several courts have referred to the Supreme Court’s statement in Burke as support for the view that the 1989 amendment allows for the exclusion of punitive damages in cases involving physical injuries. For example, the Supreme Court’s comment on the amendment was cited with approval by the Sixth Circuit in its affirmation of the Tax Court’s decision that punitive damages are excluded from income by section 104(a)(2). In addition, at least two commentators concluded that the amendment implicitly permits the exclusion of punitive damages received after 1989 in a case involving physical injuries. Let us now consider whether those conclusions are warranted.

4Burke, note 4 supra.
The House bill (H.R. 3299) that ultimately became the Omnibus Budget Reconciliation Act of 1989 contained a proposed amendment to section 104(a)(2). Section 11641 of that bill would have amended section 104(a)(2) to permit the exclusion of personal injury damages only in a case involving physical injury or physical sickness. The bill, with that provision intact, was passed by the House on October 5, 1989. The committee report on that bill reflects that the principal focus of the House in adopting section 11641 was to preclude the exclusion of damages obtained in cases involving employment discrimination and defamation.9

The Senate's bill, however, made no mention of section 104 or the treatment of damages. The Conference Committee did not adopt the restriction that had passed the House, but the committee did adopt an amendment to section 104(a) that added the last sentence to that provision. The amendment is set forth in section 7641 of the Omnibus Budget Reconciliation Act of 1989.10 That amendment barred the application of section 104(a)(2) to exclude from income punitive damages received in a case involving nonphysical injuries. If the legislative history is ignored, there are several possible inferences that might be drawn as to the purpose of including that provision in the final act. An examination of the legislative history removes any doubt as to the purpose of that provision.

The Conference Committee reported the bill on November 21, 1989.11 Two months earlier, on September 13, 1989, the Tax Court promulgated its reviewed decision in Miller v. Commissioner12 in which a majority of that court held that punitive damages can be excluded under section 104(a)(2). The Fourth Circuit's reversal of the Tax Court's decision did not take place until almost one year later, on September 21, 1990. Consequently, at the time that the Conference Committee (and then the whole Congress) acted, the principal case on the question of the excludability of punitive damages was a recent Tax Court decision, in which only two judges dissented, holding that they are excluded.

The Senate refused to adopt the limitation on section 104(a)(2) that the House had passed. The Senate was not willing to make taxable all damages obtained for nonphysical injuries. At the Conference Committee, a compromise was reached. The Senate agreed to prevent the application of section 104(a)(2) to punitive damages received in a case involving only nonphysical injuries. The Senate thereby provided the supporters of the House bill with the assurance that there would be no exclusion of punitive damages in such cases. The Conference Committee did not necessarily believe that punitive damages would be excluded in the absence of the amendment. They could well have intended no more than to assure that punitive damages will not be excluded when there was no physical injury, regardless of how the courts might otherwise resolve the question of the excludability of punitive damages under the pre-1989 version of section 104. Even if the Conference Committee believed that punitive damages would be excludable without the amendment, that would be because of the presence of a reviewed Tax Court decision to that effect. The committee could not know that that decision would be reversed on appeal.

There is no indication that the committee, or Congress as a whole, desired that punitive damages be excluded when there was a physical injury. To the contrary, the history of the forms that the bill took as it passed through the legislative process makes it abundantly clear that Congress deliberately chose not to pass on that issue and instead chose to leave that question to be resolved by the courts.

The bill (H.R. 3299) that the Senate agreed to adopt on November 21, 1989, contains inked changes in the printed copy of the bill. Section 7641 of that bill contains the amendment to section 104(a). Four words of the printed copy of section 7641 were deleted in ink, and one word was added in ink.13 The altered version is the one that was adopted and is now part of section 104(a).

The unaltered copy of section 7641 read as follows:

Sec. 7641. Limitation on Section 104 Exclusion.

(a) General Rule. -- Section 104(a) (relating to compensation for injuries or sickness) is amended by adding at the end thereof the following new sentence: "Paragraph (2) shall not apply to any punitive damages unless such damages are in connection with a case involving physical injury or physical sickness."

The language of the bill was altered in ink by drawing a line with a deletion symbol through the words "unless such damages are" and by inserting in ink the word "not" between the words "case" and "invoking." As altered, the amendment read, "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." As reported by the committee, the amendment appeared something like this:

"Paragraph (2) shall not apply to any punitive damages unless such damages are in connection with a not case involving physical injury or physical sickness."

12 Miller, note 2 supra. The taxpayer in Miller had received both compensatory and punitive damages in the settlement of a defamation claim.
13 The Conference Committee's version of the amendment is set forth in DTR No. 224, Special Supplement, p. S-81 (November 22, 1989). The inked changes are marked on the bill as reproduced therein. The Conference Committee's bill, with those inked changes shown on the bill, also is reproduced in a bulletin of Prentice Hall that was published at that time; the bulletin is titled: Revenue Provisions of the Omnibus Budget Reconciliation Act of 1989 (Title VII), and was published as Bulletin 47 Extra on November 28, 1989.
The original printed version of the amendment would have made both a positive and a negative statement. It would have provided that punitive damages received in connection with a physical injury are excluded from income and that punitive damages that are not connected with a physical injury are included in income. The handwritten alteration that was made on the printed text changed the provision to make only a negative statement; it provides that punitive damages that are not connected with a physical injury are not excluded from income by section 104.

Congress did not inadvertently fail to make an explicit statement that punitive damages connected with a physical injury are excluded. To the contrary, when the draft contained that statement, Congress deliberately deleted it so as not to take a position on that issue. It is clear, then, that the 1989 amendment has no bearing on the question of the excludability of punitive damages that are connected with a physical injury.

It is clear that the 1989 amendment has no bearing on the question of the excludability of punitive damages that are connected with a physical injury.

A second issue is whether the adoption of the 1989 amendment implies that Congress believed that section 104(a)(2), as it existed before the amendment, excluded punitive damages from income. As shown above, it is by no means clear that Congress believed that section 104(a)(2) applied to punitive damages. Congress may have merely wished to assure that the courts would not apply the exclusion when nonphysical injuries are involved. At the time that Congress acted, the Miller case had been decided by the Tax Court. With only two judges dissenting, the court had held that punitive damages are excluded by section 104(a)(2). While the Tax Court's decision was reversed a year later, Congress would at least have believed that the courts might follow the Tax Court's lead and hold that punitive damages are excluded from income. On the other hand, the courts might not adopt the Tax Court's view. Congress chose to take a position on that issue only as it relates to punitive damages that are received when there are no physical injuries. It is highly unlikely that Congress deliberately struck from the bill any reference to punitive damages acquired in connection with a physical injury claim because it considered that issue settled and wished to avoid a redundancy. It is far more likely that Congress, having more pressing matters before it, chose not to deal with that issue and leave it for the courts to resolve.

Even if, in 1989, Congress did believe that punitive damages are excluded by section 104(a)(2), that belief would have little or no significance. In the discussion of this issue in Hawkins, the Ninth Circuit quoted the Supreme Court's statement that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." That is especially true here, since there is every reason to doubt that Congress held that opinion.

In sum, the 1989 amendment sheds no light on whether punitive damages received prior to that year are excluded from income or on whether punitive damages received after that year in connection with a physical injury are excluded.

One more question needs to be discussed. The last sentence of section 104(a) refers to "physical injury or physical sickness." If the victim of a dignitary tort has a mental breakdown as a consequence of the humiliation he suffered, could punitive damages acquired because of that tort be excluded from income by section 104(a)(2) because the victim incurred a "physical sickness"? In such a case, the injury inflicted by the wrongdoer would not be physical, but one of the consequences of that injury would be a physical reaction. Given the legislative history of the 1989 amendment, it seems that Congress intended to bar the exclusion of punitive damages when the tort itself did not constitute a physical intrusion to the person of the injured party. The principal focus of the 1989 House bill was to prevent the exclusion of damages received in discrimination and defamation cases. The final bill was a compromise that limited that bar to punitive damages received in such cases. The purpose of the amendment would be frustrated if the exclusion were extended to punitive damages received in connection with discrimination and defamation cases when the victim became ill as a consequence of the wrongful act.

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13Miller, note 2 supra.

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