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The Physical Consequences of Emotional Distress: The Need for a New Test to Determine What Amounts Are Excluded from Gross Income Under § 104(a)(2)

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The Physical Consequences of Emotional Distress: The Need for a New Test to Determine What Amounts Are Excluded from Gross Income Under § 104(a)(2)

C. Anthony Wolfe IV*

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I. Introduction

Congress amended § 104(a)(2) of the Internal Revenue Code¹ in 1996, inserting the word “physical” into § 104(a)(2)’s “personal injury or sickness” exclusion from gross income.² Section 104(a)(2)’s gross income exclusion now applies to only damages received “on account of personal *physical* injuries or *physical* sickness.”³ Congress’s amendment further provided that “emotional distress shall not be treated as a physical injury or physical sickness.”⁴ Before Congress’s change, the exclusion from gross income applied to all “personal injuries,” regardless of whether they were physical, nonphysical, or emotional.⁵

Since Congress amended § 104(a)(2), courts have struggled to uniformly apply the exclusion and have begun to extend it beyond only physical injuries and physical sicknesses.⁶ Part of this struggle is due to the inherent difficulty with defining the word “physical.”⁷ Significantly, however, the struggle is mostly to do with the fact that the judicial test used to determine what amounts fall within § 104(a)(2)’s exclusion developed when the

1. I.R.C. § 104(a)(2) (2006). Unless otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended.

2. See *infra* Part IV (discussing the Small Business Job Protection Act of 1996).

3. I.R.C. § 104(a)(2) (emphasis added).

4. I.R.C. § 104(a) (flush language).

5. See *United States v. Burke*, 504 U.S. 229, 235 n.6 (1992) (noting that the exclusion’s scope had previously been limited to only physical injuries, but that it was now settled that it extended to “nonphysical injuries to the individual”).

6. See *infra* Part VI (discussing the conflicting Tax Court cases).

7. See G. Christopher Wright, Comment, *Taxation of Personal Injury Awards: Addressing the Mind/Body Dualism that Plagues § 104(a)(2) of the Tax Code*, 60 CATH. U. L. REV. 211, 211 (2010) (noting the difficulty faced when attempting to define “physical”).

exclusion applied to all “personal injuries.”⁸ Although Congress limited § 104(a)(2)’s exclusion to only physical injuries and physical sicknesses, courts have not adjusted the test used to determine what amounts fall within the exclusion.⁹ This Note proposes that courts modify the test used to exclude damage awards under § 104(a)(2) to accommodate the added “physical” requirement.¹⁰ The proposed test will allow § 104(a)(2) to be uniformly applied to only physical injuries and physical sicknesses in the way that Congress intended.

Every year taxpayers must calculate their gross income to determine the tax they must pay. To do this, taxpayers must know what amounts are included in gross income under § 61¹¹ and what amounts can be excluded from gross income under other Tax Code provisions. In 2011, disputes over what amounts are included in gross income and what amounts can be excluded were among the most litigated taxation issues.¹² Personal injury claimants—physical and nonphysical—are awarded millions of dollars each year.¹³ Thus, § 104(a)(2)’s gross income exclusion is consistently one of the most litigated exclusionary provisions.¹⁴

8. See *Comm’r v. Schleier*, 515 U.S. 323, 336–37 (1995) (determining that for a recovery to be excluded under § 104(a)(2), a taxpayer must establish that the “cause of action giving rise to the recovery [was] ‘based upon tort or tort type rights’” and that the “damages were received ‘on account of personal injuries or sickness’”).

9. See *Amos v. Comm’r*, T.C. Memo. 2003-329, at 4 (2003) (“The 1996 amendment does not otherwise change the requirements of section 104(a)(2) or the analysis set forth in *Commissioner v. Schleier*; it imposes an additional requirement for an amount to qualify for exclusion from gross income under that section.” (citation omitted)).

10. See *infra* Part VII (proposing a new test).

11. I.R.C. § 61 (2006) (providing the Tax Code’s definition of gross income).

12. See NAT’L TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS 56 (2011), www.irs.gov/pub/irs-utl/irs_tas_arc2011_exec_summary.pdf.

13. See Genny Barret, Note, *Did the Sixth Circuit Get It Right in Stadnyk? What To Do About the § 104(a)(2) Personal Injury Damages Exclusion*, 2011 BYU L. REV. 1193, 1193 (2011) (“Each year, millions of dollars are awarded to victims of physical and non-physical personal injury.”).

14. See NAT’L TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS 472 (2008), http://www.irs.gov/pub/irs-utl/08_tas_arc_mli.pdf (“Taxation of damage awards spurs litigation every year.”); see also Wright, *supra* note 7, at 211 (noting that § 104(a)(2)’s exclusion is one of the most litigated issues in federal courts).

Part II of this Note outlines the history of the “personal injury” exclusion before Congress added the word “physical.”¹⁵ Part III discusses judicial opinions limiting the scope of § 104(a)(2)’s “on account of” language.¹⁶ Congress’s amendment to § 104(a)(2) is detailed in Part IV,¹⁷ and the circuit courts’ response to the amendment is discussed in Part V.¹⁸ Part VI of this Note analyzes three Tax Court cases that illustrate the struggle in applying the amended § 104(a)(2) exclusion.¹⁹ To remedy the confusion surrounding § 104(a)(2)’s exclusion since its amendment, this Note proposes a new judicial test in Part VII.²⁰ Finally, this Note concludes in Part VIII.²¹

II. Development of the “Personal Injury” Exclusion

A. Early Development

Before the first personal injury exclusion appeared in Chapter 18, § 213(b)(6) of the Revenue Act of 1918,²² the U.S. Department of the Treasury (Treasury) indicated, in Treasury Decision 2135, that amounts received for personal injury were taxable as “gains or profits and income derived from any source whatsoever.”²³ Treasury Regulation 33, which stated, “An amount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be

15. See *infra* Part II (discussing the personal injury exclusion’s history).

16. See *infra* Part III (discussing judicial opinions interpreting “on account of”).

17. See *infra* Part IV (discussing the 1996 amendments).

18. See *infra* Part V (discussing circuit court opinions following the 1996 amendments).

19. See *infra* Part VI (discussing three conflicting Tax Court opinions).

20. See *infra* Part VII (proposing a new test).

21. See *infra* Part VIII (conclusion).

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

23. T.D. 2135, 17 Treas. Dec. Int. Rev. 39, 42 (1915) (“An amount received as a result of suit or compromise for ‘pain and suffering’ is held to be such income as would be taxable under the provision of law that includes ‘gains or profits and income derived from any source whatsoever.’”); see also Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical But Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51, 56–57 (1997) (noting Treasury’s early treatment of personal injury awards).

accounted for as income,” later confirmed Treasury’s indication.²⁴ The tax treatment of personal injury awards changed in 1918, however, when the Attorney General urged Treasury to find accident insurance proceeds nontaxable.²⁵

The Attorney General’s opinion rested on the idea that accident insurance proceeds represented a return of capital.²⁶ With tangible assets such as real property, the taxpayer’s invested capital is measured by the amount the taxpayer paid to acquire the property.²⁷ This acquisition “cost” can be subsequently adjusted.²⁸ This cost is the taxpayer’s basis in such property.²⁹ Later, when a taxpayer disposes of the property, she is only taxed on the amount in excess of her basis, or gain.³⁰ The amount she receives equaling her basis in the property is her “return of capital” and is not taxed.³¹

Applied to personal injury damages, the return of capital approach excludes from income damages equaling the taxpayer’s capital invested in oneself.³² This “human capital” theory stands for the principle that accident proceeds and damage awards

24. Treas. Reg. § 33, art. 4 (1918); *see also* Hobbs, *supra* note 23, at 57 (stating that Regulation 33 confirmed that Treasury regarded personal injury awards as taxable).

25. *See* 31 Op. Att’y Gen. 304 (1918) (urging Treasury to find accident insurance proceeds excludable from income); *see also* Hobbs, *supra* note 23, at 57 (noting that the tax treatment of personal injury awards reversed in 1918 when the Attorney General urged Treasury to find accident insurance proceeds excludable from income).

26. *See* 31 Op. Att’y Gen. at 308 (arguing that accident proceeds “merely take the place of capital in human ability which was destroyed by the accident”); *see also* Hobbs, *supra* note 23, at 63 (discussing the Attorney General’s extension of “the notion of capital value replacement to the human body”).

27. *See* I.R.C. § 1012 (2006) (defining basis in one’s property as “the cost of such property”).

28. *See id.* § 1016 (adjusting basis “for expenditures, receipts, losses, or other items, properly chargeable to [a] capital account”).

29. *See id.* § 1012 (defining basis as “the cost of such property”).

30. *See id.* § 1001 (providing that a taxpayer’s gain on such property is the difference between the “amount realized” and the basis in the property).

31. *See* Debra Cohen-Whelan, *From Injury to Income: The Taxation of Punitive Damages “On Account Of”* *United States v. Schleier*, 71 NOTRE DAME L. REV. 913, 920 (1996) (“The return of capital approach, as applied to the taxation of personal injury damages, excludes from income damages equal to the taxpayer’s capital invested in the injured item.”).

32. *Id.*

should not be taxed because the proceeds are merely a substitute for capital invested in oneself that was diminished in the accident.³³ Because the proceeds represent a “return of capital” equal to the taxpayer’s invested capital in herself, the proceeds do not increase the taxpayer’s wealth.³⁴ Instead, the accident proceeds simply return the taxpayer to her pre-injury condition.³⁵ This approach is difficult, however, because invested “human capital” in terms of cost to the owner—the owner’s basis—is often zero.³⁶ Moreover, if cost could theoretically be established, it is nearly impossible for a court to allocate accident proceeds to an abstract notion of “human capital.”³⁷

Nonetheless, Treasury accepted the Attorney General’s rationale when it issued Treasury Decision 2747.³⁸ Treasury Decision 2747 excluded personal injury awards from income, stating that “an amount received by an individual as a result of a suit or compromise for personal injuries sustained by him through accident is not income.”³⁹ Congress agreed with Treasury, and promptly codified the exclusion when it passed the Revenue Act of 1918.⁴⁰ At the time, Congress believed personal

33. See Hobbs, *supra* note 23, at 63 (“This human capital argument rests on the principle that if an ability or function of the human body, which previously allowed the taxpayer to produce income, is diminished through an accident, then the proceeds are merely a substitute for that ability or function.”).

34. See Cohen-Whelan, *supra* note 31, at 919–20 (stating that a return of capital does not increase wealth).

35. See *id.* at 919 (explaining that damages would “return the taxpayer to her pre-injury condition”).

36. See Hobbs, *supra* note 23, at 64 (explaining that often “[t]he cost to the owner of ‘human capital’ is zero”); see also *Roemer v. Comm’r*, 716 F.2d 693, 696 n.2 (9th Cir. 1983) (“[T]here is no tax basis in a person’s health and other personal interests . . .”).

37. See Gregory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis of Murphy v. Internal Revenue Service*, 60 ARK. L. REV. 185, 278 (2007) (stating that it would be “virtually impossible” for courts to determine how much of an “award compensated for the loss of one’s own consumption of human capital”).

38. T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918); see Hobbs, *supra* note 23, at 64 (noting Treasury’s acceptance of the Attorney General’s rationale).

39. T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918); see Hobbs, *supra* note 23, at 64.

40. See Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1066 (“Amounts received, through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the

injury compensation payments to be a return of human capital, and thus not constitutionally taxable “income” under the Sixteenth Amendment.⁴¹

Although the statute used the language “personal injuries or sickness,”⁴² Treasury rejected extending the exclusion to the alienation of a wife’s affections, interpreting the exclusion to apply to “physical injuries only.”⁴³ Later, however, in the wake of the now-overruled U.S. Supreme Court decision, *Eisner v. Macomber*,⁴⁴ in which the Court defined income narrowly to include “gain derived from capital, from labor, or from both combined,”⁴⁵ Treasury created an administrative exclusion for nonphysical personal injuries.⁴⁶ Treasury’s administrative exclusion became a judicial exclusion in 1927 when the Board of Tax Appeals—now the Tax Court—relied on *Eisner*’s narrow definition of income to determine that a settlement award in a defamation suit was not taxable “income.”⁴⁷ Twenty-eight years later, the Supreme Court drastically broadened its definition of income in *Commissioner v. Glenshaw Glass, Co.*⁴⁸ to include any

amount of any damages received whether by suit or agreement on account of such injuries or sickness.”).

41. See *Dotson v. United States*, 87 F.3d 682, 685 (5th Cir. 1996) (“Congress first enacted the personal injury compensation exclusion . . . when such payments were considered the return of human capital, and thus not constitutionally taxable ‘income’ under the 16th Amendment.”).

42. Revenue Act of 1918 § 213(b)(6).

43. S. 1384, 2 C.B. 71 (1920); see Hobbs, *supra* note 23, at 66 (discussing Senate Bill 1384 and that Treasury “rejected the extension of the ‘human capital’ approach to every personal injury”).

44. *Eisner v. Macomber*, 252 U.S. 189, 219 (1920) (holding that a “stock dividend” was not income).

45. *Id.* at 207.

46. See Sol. Op. 132, 1 C.B. 92 (1922) (determining that damages received for alienation of affections, defamation, and for the surrender of child custody rights were excludable from income); see also Hobbs, *supra* note 23, at 67 (discussing Treasury’s conclusion in Solicitor’s Opinion 132 that the receipts at issue were excludable from gross income based upon the Supreme Court’s decision in *Eisner*).

47. See *Hawkins v. Comm’r*, 6 B.T.A. 1023, 1024 (1927) (relying on *Eisner* to conclude that a taxpayer’s settlement award in a defamation suit was excludable from income); see also Hobbs, *supra* note 23, at 67–68 (discussing the court’s analysis and conclusion in *Hawkins*).

48. *Comm’r v. Glenshaw Glass, Co.*, 348 U.S. 426 (1955) (holding that punitive damages fell within I.R.C. § 22(a)’s definition of income because they were “instances of undeniable accession to wealth, clearly realized, and over

“accession to wealth, clearly realized, and over which the taxpayers have complete dominion.”⁴⁹ In *Glenshaw*, the Court observed that Congress intended “to tax all gains except those specifically exempted.”⁵⁰ Despite this broad definition, the personal injury exclusion—now § 104(a)(2)—continued to be applied to nonphysical personal injuries.⁵¹

B. The “Personal Injury” Exclusion After *Glenshaw Glass*

In *Glenshaw Glass*, the Court reiterated that “personal injury recoveries [were] nontaxable on the theory that they roughly correspond to a return of capital.”⁵² The Court determined, however, that the same restoration-of-capital theory could not justify excluding punitive damages from income.⁵³

Subsequent to *Glenshaw Glass*, the Internal Revenue Service (the Service) issued a series of revenue rulings reaffirming that nonphysical personal injury receipts were excludable from income.⁵⁴ And in 1972, in *Seay v. Commissioner*,⁵⁵ the Tax Court

which the taxpayers have complete dominion”).

49. *Id.* at 432.

50. *Id.* at 430.

51. *See infra* Part II.B (discussing the exclusion after *Glenshaw Glass*).

52. *Glenshaw Glass*, 348 U.S. at 432 n.8.

53. *Id.*

54. *See* Rev. Rul. 55-132, 1955-1 C.B. 213 (holding that former World War II prisoners-of-war’s receipts for losses of personal rights were not includable in gross income); Rev. Rul. 56-462, 1956-2 C.B. 20 (determining that payments made to former Korean War captives “as compensation for the loss of their personal rights . . . [were] not includible in the gross income”); Rev. Rul. 56-518, 1956-2 C.B. 25 (“[C]ompensation paid by . . . Germany to citizens or residents of the United States . . . on account of . . . damage to life, body, health, liberty, or to professional or economic advancement, are in the nature of reimbursement for the deprivation of civil or personal rights and do not constitute taxable income”); Rev. Rul. 58-370, 1958-2 C.B. 14 (determining that, for the same reasons as in Revenue Ruling 56-518, compensation paid by the Federal Republic of Austria did not constitute taxable income); *see also* Hobbs, *supra* note 23, at 70 (discussing the Service’s rulings and their renewal of the position that nonphysical personal injury receipts were excludable).

55. *Seay v. Comm’r*, 58 T.C. 32, 37 (1972) (holding that § 104(a)(2) excluded the taxpayer’s settlement award for personal injury claims); *see* Hobbs, *supra* note 23, at 71–72 (discussing the Tax Court decision in *Seay* and noting that the decision was the first time a court addressed the “application of the statutory exclusion to nonphysical injuries”).

similarly reaffirmed that the exclusion extended to nonphysical injuries.⁵⁶ In *Seay*, the Tax Court concluded that a \$45,000 payment as “compensation for . . . personal embarrassment, mental and physical strain and injury to health and personal reputation” was excludable from income under § 104(a)(2).⁵⁷ The court cited Revenue Ruling 58-418, and its earlier decision in *Hawkins v. Commissioner*,⁵⁸ in support of its conclusion that the payment at issue fell within § 104(a)(2)’s exclusion.⁵⁹ *Hawkins* had analogized recovery for injury to personal reputation with compensation by way of life insurance proceeds, and found damages received for libel and slander to be excluded from income.⁶⁰

Eleven years later, the Ninth Circuit seemingly erased any doubt as to whether § 104(a)(2)’s personal injury exclusion applied to nonphysical personal injuries in *Roemer v. Commissioner*.⁶¹ In *Roemer*, the Ninth Circuit reversed the Tax Court’s decision below, concluding that an entire jury award in a defamation suit was excludable from income under § 104(a)(2).⁶² But shortly thereafter, the Service issued Revenue Ruling 85-143,⁶³ stating that it would follow the Tax Court’s conclusion including the defamation award in income, rather than the Ninth Circuit’s reversal.⁶⁴ Finally, however, the Tax Court ended the

56. See *Seay*, 58 T.C. at 38 (finding that § 104(a)(2) extended to the taxpayer’s nonphysical personal injuries).

57. *Id.*

58. *Hawkins v. Comm’r*, 6 B.T.A. 1023 (1927) (holding that damages received for libel and slander were excludable from income).

59. See *Seay*, 58 T.C. at 40 (stating that *Hawkins* and Revenue Ruling 54-518 supported the finding that the payment at issue was exempt from taxation under § 104(a)(2)).

60. See *Hawkins*, 6 B.T.A. at 1024–25 (analogizing a recovery for injury to personal reputation with compensation by way of life insurance proceeds, and finding the damages at issue to be excludable from income).

61. See *Roemer v. Comm’r*, 716 F.2d 693, 697 (9th Cir. 1983) (holding that a defamation award was excludable from income because “[t]he ordinary meaning of a personal injury is not limited to a physical one”).

62. See *id.* at 700–01 (concluding that the award was excludable from gross income under § 104(a)(2)).

63. Rev. Rul. 85-143, 1985-2 C.B. 55.

64. See *id.* (stating that the Service would not follow the Ninth Circuit’s decision in *Roemer* and would instead follow the Tax Court’s decision including the defamation award in income).

debate in *Threlkeld v. Commissioner*⁶⁵ when it determined that “personal injury” was not limited to a “physical injury.”⁶⁶ Congress, though, would have its voice heard on the matter before the end of the decade.⁶⁷

C. The 1989 Amendments

In 1989, the House of Representatives proposed amending § 104(a)(2) to read, “[G]ross income does not include . . . the amount of any damages received . . . on account of personal injuries or sickness in a case involving *physical* injury or *physical* sickness.”⁶⁸ According to the accompanying committee report, the House was attempting to override judicial applications of § 104(a)(2)’s exclusion to nonphysical personal injuries.⁶⁹ Congress rejected the proposed amendment, however.⁷⁰ Instead, the final amendment read, “[Section 104(a)(2)] shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.”⁷¹ The final amendment “impliedly extended § 104(a)(2) to compensatory awards for nonphysical injuries,”⁷² a result contrary to the House’s proposed

65. *Threlkeld v. Comm’r*, 87 T.C. 1294, 1305 (1986) (stating that § 104(a)(2) extended beyond physical injuries).

66. *See id.* (“A personal injury has long been understood to include nonphysical as well as physical injuries.”).

67. *See infra* Part II.C (discussing the 1989 amendments to § 104(a)(2)).

68. H.R. 3299, 101st Cong., 1st Sess., pt. 2, § 11641 (1989) (emphasis added); *see also* Hobbs, *supra* note 23, at 74 (noting that the House of Representatives proposed the amendment).

69. *See* H.R. Rep. No. 101-247, at 1344–55 (1989) (stating that courts had extended § 104(a)(2) to “awards for personal injury that do not relate to a physical injury or sickness” and that the “committee believes that such treatment is inappropriate where no physical injury or sickness is involved”); *see also* Hobbs, *supra* note 23, at 74 (“The accompanying committee report confirmed the House’s recognition that courts were interpreting § 104(a)(2) too broadly.”).

70. *See* Hobbs, *supra* note 23, at 74 (“The conference committee rejected the proposed amendment . . .”).

71. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (amending I.R.C. § 104(a)(2)); Hobbs, *supra* note 23, at 74–75.

72. Hobbs, *supra* note 23, at 75.

intentions.⁷³ All courts were now free to apply § 104(a)(2)'s exclusion to nonphysical injuries.⁷⁴ This judicial freedom led to confusion in lower courts as to how to apply § 104(a)(2) to nonphysical injuries, especially in the context of recovery for employment discrimination.⁷⁵ This confusion ultimately compelled the Supreme Court to intercede.⁷⁶

D. A Two-Part Test Emerges

In the 1990s, the U.S. Supreme Court decided two employment discrimination cases, resulting in a two-part test for damage awards to be excluded under § 104(a)(2).⁷⁷ To exclude damage awards under § 104(a)(2), a taxpayer must establish that the “cause of action giving rise to the recovery [was] ‘based upon tort or tort type rights’” and that the “damages were received ‘on account of personal injuries or sickness.’”⁷⁸ Subsequent congressional and judicial action refined the Court’s two-part test, but the framework remained applicable.⁷⁹

73. *See id.* (“This was precisely the opposite of the intent of the House provision . . .”).

74. *See id.* (noting that courts were “free to apply § 104(a)(2) to nonphysical injuries”).

75. *See id.* at 75–78 (noting that “courts struggled in determining the applicability of § 104(a)(2) to employment discrimination recoveries” and discussing the events leading up to *United States v. Burke*, 504 U.S. 229 (1992)).

76. *See id.* (noting that “courts struggled in determining the applicability of § 104(a)(2) to employment discrimination recoveries” and discussing the events leading up to *Burke*).

77. *See Comm’r v. Schleier*, 515 U.S. 323, 336–37 (1995) (determining that for a recovery to be excluded under § 104(a)(2), a taxpayer must establish that the “cause of action giving rise to the recovery [was] ‘based upon tort or tort type rights’” and that the “damages were received ‘on account of personal injuries or sickness’”); *United States v. Burke*, 504 U.S. 229, 241 (1992) (determining that damages received must redress tort or tort-like personal injury claims to be excluded under § 104(a)(2)); *see also* Hobbs, *supra* note 23, at 81 (stating that, after *Schleier*, a taxpayer must satisfy two separate requirements to exclude a damage award under § 104(a)(2)).

78. *Schleier*, 515 U.S. at 336–37.

79. *See Amos v. Comm’r*, T.C. Memo 2003-329, at 4 (2003) (finding that subsequent congressional action merely imposed additional requirements to *Schleier*’s two-part test, but did not otherwise alter *Schleier*’s framework).

1. United States v. Burke

In 1992, the U.S. Supreme Court decided *United States v. Burke*.⁸⁰ *Burke* held that the taxpayers' backpay awards received as settlement of their claims under Title VII of the Civil Rights Act of 1964⁸¹ (Title VII) were not excludable from income under § 104(a)(2).⁸² The Court's decision did not hinge on whether the claims were physical or nonphysical, however.⁸³ Instead, the Court specifically addressed whether an award of back wages redressed a "tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations."⁸⁴ Because Title VII did not allow compensatory damages and limited the available remedies to "backpay, injunctions, and other equitable relief," the Court concluded that Title VII did not redress "a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations."⁸⁵ Before concluding that Title VII backpay awards were not excludable from respondent's gross income under § 104(a)(2),⁸⁶ however, the Court acknowledged a few important precepts of both the Tax Code and § 104(a)(2)'s exclusion.

The Court first noted that the Tax Code's definition of gross income "sweeps broadly"⁸⁷ to include "all income from whatever

80. *United States v. Burke*, 504 U.S. 229, 242 (1992) (holding that "the backpay awards received by respondents in settlement of their Title VII claims [were] not excludable from gross income as 'damages received . . . on account of personal injuries' under § 104(a)(2)" (alteration in original)).

81. 42 U.S.C. § 2000e (2012).

82. *Burke*, 504 U.S. at 242.

83. *See id.* at 241 (finding that Title VII backpay awards did not redress a "tort-like personal injury" and thus could not be excluded from gross income).

84. *See id.* (concluding that the award of back wages under a Title VII claim did not redress tort-like personal injuries); *see also* I.R.C. § 104(a)(2) (2006); 26 CFR § 1.104-1(c) (1991) ("The term 'damages received (whether by suit or agreement)' means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights.").

85. *Burke*, 504 U.S. at 241.

86. *Id.* at 241-42 (concluding that the award of back wages under a Title VII claim did not redress tort or tort-like personal injuries and were thus not excludable from gross income under § 104(a)(2)).

87. *Id.* at 233.

source derived.”⁸⁸ Further, the Court acknowledged Congress’s intention to exert its full taxing power when enacting § 61(a).⁸⁹ Also, the Court noted that after its decision in *Glenshaw Glass*, it has interpreted any “accession to wealth” to be within the definition of gross income.⁹⁰ Although gross income includes any accession to wealth, exclusions from gross income must be “specifically enumerated elsewhere in the Code.”⁹¹ Additionally, these specifically enumerated exclusions from gross income are “narrowly construed.”⁹² Finally, the Court acknowledged that although courts once interpreted the personal injury exclusion to encompass only “physical” injuries, it was now well accepted that the exclusion encompassed nonphysical injuries as well.⁹³

2. Commissioner v. Schleier

The U.S. Supreme Court’s next contribution to § 104(a)(2) came three years later when it decided *Commissioner v. Schleier*.⁹⁴ Similar to the issue addressed in *Burke*, the Court considered whether § 104(a)(2) authorized the taxpayer to exclude the amount received as settlement for his claims for both backpay and liquidated damages under the Age Discrimination in Employment Act (ADEA) from his gross income.⁹⁵ Half of the taxpayer’s settlement was attributed to backpay and half to

88. *Id.* (quoting I.R.C. § 61(a) (2006)).

89. *Id.*

90. *Id.* (citations omitted) (quoting *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)).

91. *Id.*

92. *See id.* at 248 (Souter, J., concurring) (noting the “default rule of statutory interpretation that exclusions from income must be narrowly construed”).

93. *See id.* at 235 n.6 (majority opinion) (noting that the exclusion’s scope had previously been limited to only physical injuries, but that it was now settled that it extended to “nonphysical injuries to the individual”).

94. *Comm’r v. Schleier*, 515 U.S. 323 (1995) (holding that § 104(a)(2) did not exclude respondent’s recovery for back wages under the ADEA).

95. *See id.* at 324–25 (“The question presented is whether § 104(a)(2) . . . authorizes a taxpayer to exclude from his gross income the amount received in settlement of a claim for backpay and liquidated damages under the Age Discrimination in Employment Act of 1967 (ADEA).”).

liquidated damages.⁹⁶ The Tax Court determined the entire amount to be excludable, and the Fifth Circuit affirmed. The Supreme Court, however, reversed, holding that § 104(a)(2) did not exclude the taxpayer's ADEA recovery.⁹⁷

As in *Burke*, the Court emphasized the broadly sweeping definition of gross income and the corollary that exclusions must be construed narrowly.⁹⁸ And also as it did in *Burke*, the Court looked to the available remedies under the ADEA, noting that the ADEA allowed for liquidated damages “only in cases of willful violations” and that the ADEA did not permit a “separate recovery of compensatory damages for pain and suffering or emotional distress.”⁹⁹ The Court, however, did not first analyze the claim under *Burke*'s “tort or tort-type rights” standard for excludability. Instead, the Court went on to determine whether the settlement award was “on account of personal injuries.”¹⁰⁰

The Court used injuries resulting from an automobile accident as an example to illustrate its idea of what constituted a “personal injury.”¹⁰¹ In the Court's example, a taxpayer's medical expenses, lost wages, and pain, suffering, and emotional distress would all be excludable under § 104(a)(2) as being on account of personal injuries arising out of the automobile accident.¹⁰² The Court compared backpay in the present case to lost wages resulting from the hypothetical automobile accident.¹⁰³ But unlike the lost wages in the automobile accident example, the Court

96. *See id.* at 326 (“Half of respondent's award was attributed to ‘backpay’ and half to ‘liquidated damages.’”).

97. *See id.* at 327 (stating that the Tax Court and the Fifth Circuit allowed the amount to be excluded, but reversing those decisions).

98. *See id.* at 327–28 (noting the “sweeping scope” of § 61(a) and that exclusions from income are narrowly construed).

99. *Id.* at 326.

100. *See id.* at 328–32 (determining whether the backpay portion or the liquidated damages portion of respondent's settlement was “on account of personal injuries”).

101. *See id.* at 328–31 (noting potential claims and injuries arising out of a hypothetical car crash to illustrate an example of a personal injury).

102. *See id.* at 329–30 (determining that all recoveries associated with injuries arising out an automobile accident would be excludable under § 104(a)(2)).

103. *See id.* at 330–31 (comparing respondent's recovery of back wages to recovery for lost wages that hypothetically resulted from injuries sustained in a car accident).

determined that the taxpayer's backpay was not excludable.¹⁰⁴ The Court reasoned that the taxpayer's back wages were not excludable because any personal injury caused by the age discrimination was not in any way linked to the loss of wages.¹⁰⁵ Thus, age discrimination directly causes two distinct injuries, only one of which is a personal injury.¹⁰⁶ First, the employer's conduct directly causes lost wages. Second, the tortious conduct often causes a nonphysical personal injury. The lost wages, however, do not flow from the personal injury and therefore do not meet § 104(a)(2)'s on account of requirement.

After the Court concluded that the recovery of back wages under the ADEA was not on account of any personal injury, it then addressed respondent's argument that § 104(a)(2) excluded the liquidated damages portion of the award.¹⁰⁷ The Court concluded that the liquidated damages also could not be excluded.¹⁰⁸ Justice Stevens, writing for the majority, acknowledged that the liquidated damages might have come within § 104(a)(2)'s exclusion had that been Congress's intention.¹⁰⁹ Justice Stevens, however, found nothing to indicate that Congress intended the ADEA's liquidated damages to compensate "personal rather than economic" injuries.¹¹⁰ Instead,

104. *See id.* ("[Section] 104(a)(2) does not permit the exclusion of respondent's back wages because the recovery of back wages was not 'on account of' any personal injury and because no personal injury affected the amount of back wages recovered.").

105. *See id.* at 330 ("In age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other."); *see also* Hobbs, *supra* note 23, at 81–82 (stating that Justice Stevens's language, when writing for the majority in determining that a recovery under the ADEA was not a personal injury, "defie[d] logic").

106. *Cf. Banaitis v. Comm'r*, 340 F.3d 1074, 1080 (9th Cir. 2003) (explaining that employment discrimination causes two distinct injuries).

107. *See Comm'r v. Schleier*, 515 U.S. 323, 331–32 (1995) (addressing the potential excludability of respondent's liquidated damages portion).

108. *See id.* (concluding that "liquidated damages under the ADEA, like back wages under the ADEA, are not received 'on account of personal injury or sickness'").

109. *See id.* at 331 (determining that the Court's previous observation—that the liquidated damages authorized by the Fair Labor Standards Act of 1938 (FLSA), 29 U.S.C. §§ 201–219, may compensate for some "obscure" injuries—did not necessarily mean that Congress intended the ADEA's liquidated damages provision to be "personal rather than economic").

110. *Id.*

Justice Stevens found the ADEA's liquidated damages provision to be punitive in nature.¹¹¹ Accordingly, he concluded that the recovery's liquidated damages portion, along with the portion attributed to backpay, was not received "on account of personal injury of sickness."¹¹²

Next, the Court examined whether the taxpayer's ADEA recovery was "based upon 'tort or tort type rights' as that term was construed in *Burke*."¹¹³ Again the Court looked to the ADEA's remedial scheme, declared that the jury trial and liquidated damages provisions were not sufficient to bring an ADEA recovery within the ambit of § 104(a)(2), and concluded that "a recovery under the ADEA [was] not one that is 'based upon tort or tort type rights.'"¹¹⁴

Throughout its opinion, the Court seemed uncomfortable applying § 104(a)(2) to nonphysical injuries.¹¹⁵ But the Court did not go so far as to provide a rule limiting the exclusion to physical injuries.¹¹⁶ Instead, Justice Stevens articulated a two-part test for excludability under § 104(a)(2).¹¹⁷ First, a taxpayer must "demonstrate that the underlying cause of action giving rise to the recovery is 'based upon tort or tort type rights.'"¹¹⁸ Second, the taxpayer must "show that the damages were received on 'account of personal injuries or sickness.'"¹¹⁹ For a recovery to be excludable, a taxpayer must satisfy *Schleier*'s two independent requirements.¹²⁰

111. *Id.*

112. *Id.* at 332.

113. *See id.* at 334–36 (addressing respondent's argument that the recovery was excludable under *Burke*).

114. *See id.* at 335–36 (determining that neither the ADEA's jury trial provision nor its liquidated damages provision were sufficient to bring a recovery under the ADEA within the § 104(a)(2) exclusion).

115. *See Hobbs, supra* note 23, at 82 ("The Supreme Court's decisions in *Burke* and *Schleier* clearly exhibited the Court's discomfort in applying § 104(a)(2) in a nonphysical context.").

116. *See id.* (noting that the Court did not "articulate a rule limiting § 104(a)(2) to physical injuries").

117. *See Comm'r v. Schleier*, 515 U.S. 323, 337 (1995) (articulating a two-part test).

118. *Id.*

119. *Id.*

120. *See id.* at 336–37 (stating the "two independent requirements that a taxpayer must meet before a recovery may be excluded under § 104(a)(2)").

Since *Schleier*, many courts have conceded that a recovery was “based upon tort or tort type rights,”¹²¹ and Treasury has recently finalized regulations eliminating the requirement entirely.¹²² Instead, courts have focused on whether the damages were received on account of a personal injury.¹²³ *Schleier*, however, provided little detail on when a recovery is on account of a personal injury.¹²⁴ After *Schleier*, courts added more definition to the on account of requirement,¹²⁵ but *Schleier*’s framework remained the standard.¹²⁶

III. The Courts Refine § 104(a)(2)’s “On Account Of” Requirement

In *O’Gilvie v. United States*,¹²⁷ the U.S. Supreme Court addressed whether § 104(a)(2) excluded punitive damages, and provided a narrow interpretation of § 104(a)(2)’s on account of requirement.¹²⁸ The Court concluded that the petitioner’s punitive damages were not received on account of personal

121. See, e.g., *Domeny v. Comm’r*, T.C. Memo. 2010-9, at 3 (2010) (concluding summarily that the taxpayer’s action was based upon tort or tort-type rights).

122. See, *Treas. Reg. § 1.104-1(c)* (as amended in 2012) (excluding from gross income damages “on account of personal injuries or sickness”).

123. See e.g., *O’Gilvie v. United States*, 519 U.S. 79, 82–83 (1996) (holding that “on account of” required a stronger causal connection than “but for,” and that only “damages that were awarded by reason of, or because of, the personal injuries” could be excluded under § 104(a)(2)).

124. See *Hobbs*, *supra* note 23, at 81 (“The Court did not provide a test for determining when an amount was received for personal injury, in effect saying, we will know it when we see it.”).

125. See *infra* Part III (discussing court opinions interpreting “on account of”).

126. See *Amos v. Comm’r*, T.C. Memo 2003-329, at 4 (2003) (“The 1996 amendment does not otherwise change the requirements of section 104(a)(2) or the analysis set forth in *Commissioner v. Schleier*; it imposes an additional requirement for an amount to qualify for exclusion from gross income under that section.” (citation omitted)).

127. *O’Gilvie v. United States*, 519 U.S. 79, 82–83 (1996) (holding that “on account of” required a stronger causal connection than “but for,” and that only “damages that were awarded by reason of, or because of, the personal injuries” could be excluded under § 104(a)(2)).

128. See *id.* at 82 (resolving a circuit split on the proper interpretation of *Schleier*’s “on account of” requirement).

injuries and thus not excludable under § 104(a)(2).¹²⁹ The Court rejected the petitioner's argument that § 104(a)(2) only required a "but for" connection between the damages received and the underlying personal injury.¹³⁰ Instead, the Court agreed with the Government that § 104(a)(2) was "applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of" the underlying personal injury.¹³¹

Although *O'Gilvie* did not explicitly determine what damages fell within its interpretation, the Court narrowly interpreted § 104(a)(2)'s on account of requirement¹³² in accord with customary Tax Code interpretation.¹³³ After *O'Gilvie*, lower courts continued to refine § 104(a)(2)'s requirement.¹³⁴

A. The "Direct Causal Link"

In *Banaitis v. Commissioner*,¹³⁵ the U.S. Court of Appeals for the Ninth Circuit considered whether a taxpayer's economic and punitive damages recovered in his wrongful termination suit fell within § 104(a)(2)'s exclusion.¹³⁶ In *Banaitis*, the taxpayer received \$8,728,599 as settlement for his various claims against

129. See *id.* at 81 ("We conclude that the punitive damages here were not received 'on account of' personal injuries; hence [section 104(a)(2)] does not apply, and the damages are taxable.").

130. See *id.* at 82 (rejecting the petitioner's argument for "but for" causation).

131. See *id.* at 83 (agreeing with the Government's interpretation of the statute).

132. See *id.* at 82 (rejecting petitioner's broad reading of § 104(a)(2)'s "on account of" requirement).

133. See *United States v. Burke*, 504 U.S. 229, 248 (1992) (Souter, J., concurring in judgment) (noting the "default rule of statutory interpretation that exclusions from income must be narrowly construed").

134. See *infra* Part III.A (discussing the lower courts' interpretation of § 104(a)(2)'s "on account of" requirement).

135. *Banaitis v. Comm'r*, 340 F.3d 1074, 1080–81 (9th Cir. 2003) (holding that the taxpayer's economic and punitive damages recovered in his wrongful termination suit against his former employer were not "on account of" personal injuries and thus not excludable under § 104(a)(2)), *rev'd on other grounds*, *Comm'r v. Banks*, 543 U.S. 426 (2005).

136. See *id.* at 1079–81 (considering whether a taxpayer's economic and punitive damages recovered in his wrongful termination suit fell within § 104(a)(2)'s exclusion).

his former employer.¹³⁷ The taxpayer claimed that § 104(a)(2) excluded the full amount,¹³⁸ but the Ninth Circuit concluded that the entire amount was taxable.¹³⁹

Banaitis alleged that his employers' conduct resulted in a number of physical injuries.¹⁴⁰ Those injuries included "headaches, insomnia, gastrointestinal disorders, bleeding gums, and various orthopedic problems."¹⁴¹ Addressing whether the award satisfied the "on account of" requirement, the court stated that to satisfy § 104(a)(2)'s second prong, the taxpayer must show the "damage award [was] more than only proximately caused by [his employer's] tortious conduct; it must also be directly causally related to [his] personal injuries."¹⁴² Further, the court stated that the on account of requirement "can only be satisfied if there is 'a direct causal link' between the damages and the personal injuries sustained."¹⁴³ The court noted that in the ordinary personal injury tort action, it is relatively easy to discern what damages are on account of a personal injury:

The tortious act causes personal injuries which, in turn, cause further damages, such as economic loss due to physical inability to work. Thus, in the paradigmatic personal injury case, both non-pecuniary damages (such as pain and suffering) and economic damages (such as wage loss, diminished work capacity, etc.) may be excluded from gross income because the losses are "on account of" personal injury.¹⁴⁴

When damages arise from "economic or commercial tort" actions, on the other hand, it is more difficult to discern what damages are on account of personal injuries.¹⁴⁵ Put another way,

137. *See id.* at 1078 (noting the taxpayer's settlement recovery).

138. *See id.* (noting the taxpayer's argument that § 104(a)(2) excluded his award).

139. *See id.* at 1080–81 (concluding that the taxpayer's award was fully taxable).

140. *See id.* at 1076 ("Troubled by his employment situation, Banaitis apparently suffered a host of physical maladies.").

141. *Id.*

142. *Id.* at 1080 (citing *Comm'r v. Schleier*, 515 U.S. 323, 329–30 (1995)).

143. *Id.* (citing *Fabry v. Comm'r*, 223 F.3d 1261, 1270 (11th Cir. 2000)).

144. *Id.*

145. *See id.* (noting that "economic or commercial tort actions present a different circumstance," and that "the 'direct causal link' question requires a fact-specific analysis").

it is more difficult to establish the requisite “direct causal link” between the damages received and the personal injuries sustained.¹⁴⁶ The Ninth Circuit stated that “[i]n such economic or commercial tort cases, economic damages are often caused solely by the tortious action itself, rather than as a consequence of personal injury.”¹⁴⁷ The court gave the typical wrongful discharge lawsuit as an example, stating “wage loss is typically caused by the tortious employment termination, not by any physical injury that may also have been caused by the wrongful discharge.”¹⁴⁸ The court determined that Banaitis’s alleged physical injuries “did not cause his wage loss,” and that his damages “were not causally related to [his] alleged personal injuries.”¹⁴⁹ This analysis is nearly identical to *Schleier*’s analysis in which the Supreme Court determined that age discrimination caused both lost wages and a personal injury, but that the two were not linked.¹⁵⁰ Accordingly, the Ninth Circuit concluded that § 104(a)(2)’s exclusion did not apply and that Banaitis’s damages award was fully taxable.¹⁵¹

Banaitis and *O’Gilvie* illustrate that § 104(a)(2) excludes only damages directly caused by a “personal injury or sickness.” Notably, the two cases addressed § 104(a)(2)’s required causal connection between the taxpayer’s damages received and an

146. *See id.* (noting that “economic or commercial tort actions present a different circumstance,” and that “the ‘direct causal link’ question requires a fact-specific analysis”).

147. *Id.*

148. *Id.*; *cf.* *Comm’r v. Schleier*, 515 U.S. 323, 330 (1995) (“In age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other.”).

149. *See Banaitis v. Comm’r*, 340 F.3d 1074, 1080 (9th Cir. 2003) (“The personal injuries Banaitis alleges (e.g., headaches, insomnia, gastrointestinal disorders, bleeding gums, and back aches) did not cause his wage loss.”); *see also Banaitis v. Comm’r*, T.C. Memo 2002-5, at 4 (2002) (determining that Banaitis’s economic damages were not received “on account of” his alleged personal injuries because “he was not forced to leave his job because of those injuries”).

150. *Supra* note 105 and accompanying text; *see also Schleier*, 515 U.S. at 330 (“In age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other.”).

151. *See Banaitis*, 340 F.3d at 1081 (affirming that § 104(a)(2)’s exclusion did not apply and that Banaitis’s damage awards “should have been included in his gross income”).

already-established personal injury.¹⁵² When Congress amended § 104(a)(2)'s exclusion to add a "physical" requirement,¹⁵³ establishing § 104(a)(2)'s qualifying "personal *physical* injury or *physical* sickness" became a much more difficult task.

IV. *The Small Business Job Protection Act of 1996*

The Small Business Job Protection Act¹⁵⁴ (the 1996 Act) became law on August 20, 1996.¹⁵⁵ Section 1605 of the 1996 Act amended § 104(a).¹⁵⁶ Section 1605(a) specifically amended § 104(a)(2), providing that gross income does not include the "amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or *physical* sickness."¹⁵⁷ Section 1605(b) also amended § 104(a) to expressly provide that "emotional distress shall not be treated as a physical injury or physical sickness" for purposes of § 104(a)(2).¹⁵⁸

While prohibiting emotional distress from constituting a physical injury or physical sickness, § 104(a) provides that the prohibition does not apply to "damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) Section 213(d)(1)) attributable to emotional distress."¹⁵⁹

152. See *supra* Parts III.A–B (discussing *O’Gilvie* and *Banaitis*).

153. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (adding the word "physical" to § 104(a)(2)'s exclusion).

154. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.

155. See Hobbs, *supra* note 23, at 82 ("On August 20, 1996, President Clinton signed into law the Small Business Job Protection Act.").

156. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (providing amendments to § 104(a)).

157. *Id.* § 1605(a), 110 Stat. at 1838 (emphasis added).

158. See *id.* § 1605(b), 110 Stat. at 1838 ("Section 104(a) is amended by striking the last sentence and inserting the following sentence: 'For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.'").

159. See I.R.C. § 104(a) (2006) ("The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.").

Section 213(d)(1)(A) defines “medical care” to include amounts paid “for the diagnoses, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.”¹⁶⁰ And § 213(d)(1)(B) provides that “medical care” includes amounts paid “for transportation primarily for and essential to medical care referred to in subparagraph (A).”¹⁶¹ Presumably, this language permits a taxpayer to exclude damages received solely for emotional distress from gross income under § 104(a)(2) up to the amount the damages compensate for “medical care” expenses otherwise deductible under § 213(d)(1)(A) or (B).¹⁶²

In the 1996 Act’s legislative history (the House Report), Congress noted courts’ prior broad extensions of § 104(a)(2) to nonphysical personal injuries and reiterated that all punitive damages should be included in income.¹⁶³ Congress did provide, however, that punitive damages received in a wrongful death suit may be excluded from gross income if applicable state law provides that “only punitive damages may be awarded in a wrongful death action.”¹⁶⁴

Most importantly, under the heading “Include in income damage recoveries for nonphysical injuries,”¹⁶⁵ the House Report provided guidance on when damages would be excludable under § 104(a)(2), as amended. The House Report stated that “[i]f an *action* has its *origin* in a physical injury or physical sickness, *then* all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party.”¹⁶⁶ Congress’s language indicated that a taxpayer’s action must first have its “origin” in a physical injury

160. *Id.* § 213(d)(1)(A).

161. *Id.* § 213(d)(1)(B).

162. *Id.* § 213(d)(1)(A)–(B).

163. *See* H.R. REP. NO. 104-737, at 300–01, *reprinted in* 1996 U.S.C.C.A.N. 1677, 1792–93 [hereinafter HOUSE REPORT] (noting that courts have interpreted the exclusion broadly “to cover awards for personal injury that do not relate to a physical injury or sickness” and reiterating that punitive damages should be included in income).

164. *Id.* at 301.

165. *Id.*

166. *Id.* (emphasis added).

or physical sickness before proceeding to determine whether an amount is received “on account of a personal physical injury or physical sickness.”¹⁶⁷

The House Report expressly stated, however, that emotional distress, including symptoms thereof, is not considered a physical injury or physical sickness for purposes of the § 104(a)(2)’s exclusion.¹⁶⁸ As an example, the House Report provided that “the exclusion from gross income does not apply to any damages received . . . based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.”¹⁶⁹ When an action has its origin in a physical injury or physical sickness, however, and the physical injury or physical sickness causes the taxpayer to suffer emotional distress, § 104(a)(2) does exclude damages allocated to such emotional distress. The House Report explained that “[b]ecause all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.”¹⁷⁰ Lastly, the House Report stated that the gross income exclusion applies to medical care expenses attributable to emotional distress,¹⁷¹ affirming the presumption created by § 104(a)’s text.¹⁷²

167. See Robert W. Wood, *Waiting to Exhale: Murphy Part Deux and Taxing Damage Awards*, ALI-ABA COURSE OF STUDY, at 5 (Feb. 7–8, 2008) (“Congress require[s] that the action have its *origin* in a physical injury or sickness.”).

168. See HOUSE REPORT, *supra* note 163, at 301 (stating that the House bill “specifically provides that emotional distress is not considered a physical injury or physical sickness” and also that the term emotional distress includes symptoms resulting from such emotional distress).

169. *Id.*

170. *Id.*

171. See *id.* (“[T]he exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.”).

172. See *supra* notes 159–62 and accompanying text.

V. Section 104(a)(2)'s Exclusion After the 1996 Act

Because Congress prohibited emotional distress and its resulting symptoms from being excluded from gross income under § 104(a)(2), after the 1996 Act, taxpayers faced the additional burden of establishing that their personal injury or sickness was physical rather than emotional. Courts, however, continued to only apply *Schleier's* two-part test to § 104(a)(2)'s exclusion,¹⁷³ failing to accommodate the added physical requirement. Although their reasoning left open the potential for misapplication, the circuit courts, amidst allegations of physical injuries or physical sicknesses, refused to apply § 104(a)(2)'s exclusion to taxpayers' recoveries for nonphysical or emotional injuries.¹⁷⁴ Perhaps the most notable—or infamous—case to do so is one the U.S. Court of Appeals for the D.C. Circuit decided in 2007.¹⁷⁵

A. The Circuits Reach the Right Outcome

In *Murphy v. Internal Revenue Service*,¹⁷⁶ after determining the taxpayer's compensatory damages were not *income* within the Sixteenth Amendment's meaning, then *sua sponte* vacating its judgment and rehearing the case, the U.S. Court of Appeals for the D.C. Circuit held that Murphy's award could not be excluded under § 104(a)(2).¹⁷⁷ Additionally, the court held that Murphy's

173. See *Amos v. Comm'r*, T.C. Memo 2003-329, at 4 (2003) (“The 1996 amendment does not otherwise change the requirements of section 104(a)(2) or the analysis set forth in *Commissioner v. Schleier*; it imposes an additional requirement for an amount to qualify for exclusion from gross income under that section.” (citation omitted)).

174. See *infra* Part V.A (discussing circuit court cases following the 1996 Act).

175. See generally *Murphy v. Internal Revenue Serv.*, 493 F.3d 170 (D.C. Cir. 2007).

176. See *Murphy v. Internal Revenue Serv.*, 493 F.3d 170, 171 (D.C. Cir. 2007) (holding that the taxpayer's “compensation was not ‘received . . . on account of personal physical injuries’ excludable from gross income under § 104(a)(2)” and that § 61(a)'s gross income definition included the taxpayer's award (alteration in original)).

177. See *id.* (“We hold, first, that Murphy's compensation was not ‘received . . . on account of personal physical injuries’ excludable from gross income under § 104(a)(2).” (alteration in original)).

compensation fell within § 61(a)'s definition of income¹⁷⁸ and admitted that there is no constitutional impediment to taxing personal injury awards.¹⁷⁹

Murphy alleged that her former employer violated various whistleblower statutes and “blacklisted” her.¹⁸⁰ After a hearing before the Secretary of Labor, an Administrative Law Judge (ALJ) recommended compensatory damages totaling \$70,000 to Murphy.¹⁸¹ The Department of Labor Administrative Review Board (Board) affirmed the ALJ's findings and granted the award.¹⁸² \$45,000 of the damages were allocated to “past and future emotional distress” and \$25,000 of the damages were allocated to “injury to [Murphy's] vocational reputation.”¹⁸³ The court noted that “[n]one of the award was for lost wages or diminished earning capacity.”¹⁸⁴ After including the full amount in her gross income on her 2000 tax return, Murphy filed an amended return seeking a \$20,665 refund.¹⁸⁵ She argued, among other things, that § 104(a)(2) excluded her award from her gross income.¹⁸⁶ This time the D.C. Circuit rejected Murphy's argument in full.¹⁸⁷

Before the ALJ, Murphy submitted evidence that she suffered both “somatic”—relating to, or affecting, the body¹⁸⁸—and “emotional” injuries.¹⁸⁹ Her injuries included “bruxism,” or

178. *See id.* at 180 (holding that gross income under § 61(a) included Murphy's compensatory award).

179. *See id.* at 173 (agreeing with the Government's argument that there is no constitutional problem with taxing personal injury awards).

180. *See id.* at 171–72 (describing the taxpayer's original allegations).

181. *See id.* at 172 (“[T]he ALJ recommended compensatory damages totaling \$70,000.”).

182. *See id.* (“In 1999 the Department of Labor Administrative Review Board affirmed the ALJ's findings and recommendations.”).

183. *See id.* (describing the damages allocation) (alteration in original).

184. *Id.*

185. *See id.* (stating that Ms. Murphy originally included the amount in her gross income and then filed an amended return).

186. *See id.* at 171 (noting Ms. Murphy's arguments that her award should be excluded or that taxing her award was unconstitutional).

187. *See id.* (“We reject Murphy's argument in all aspects.”).

188. *See id.* at 174 (defining “somatic”).

189. *See id.* at 172 (“A psychologist testified that Murphy had sustained both ‘somatic’ and ‘emotional’ injuries . . .”).

teeth grinding, and “anxiety attacks, shortness of breath, and dizziness.”¹⁹⁰ Murphy argued that § 104(a)(2)’s exclusion did not require a “physical stimulus” and that “substantial physical problems caused by emotional distress” should be considered a physical injury or physical sickness.¹⁹¹ The D.C. Circuit did not agree, finding that § 104(a)(2)’s exclusion did not apply to Murphy’s award.¹⁹²

The court first cited § 104(a)(2)’s post-amble, which states that “emotional distress shall not be treated as a physical injury or physical sickness,”¹⁹³ then addressed the Government’s contentions.¹⁹⁴ The Government argued that *O’Gilvie* dictated a “strong causal connection” between Murphy’s received damages and her alleged physical injuries.¹⁹⁵ This meant Murphy had to demonstrate that her damages were awarded “because of” her physical injuries, which the Government claimed she failed to do.¹⁹⁶ Further, based on the Board’s failure to reference any of Murphy’s physical injuries—especially her bruxism—the Government argued that “there was no direct causal link between the damages award at issue and [Murphy’s] bruxism.”¹⁹⁷ The court agreed that a strong causal link was required, finding that *O’Gilvie*’s analysis of § 104(a)(2)’s on account of requirement remained controlling after the 1996 Act.¹⁹⁸

190. *See id.* (noting Murphy’s alleged injuries).

191. *See id.* at 175 (noting Murphy’s contentions as to why her award should be excluded from her gross income by § 104(a)(2)).

192. *See id.* at 176 (concluding that § 104(a)(2) did “not permit Murphy to exclude her award from gross income”).

193. *See id.* at 174 (“[F]or purposes of this exclusion, ‘emotional distress shall not be treated as a physical injury or physical sickness.’” (citing I.R.C. § 104(a) (2006))).

194. *See id.* at 175 (addressing the Government’s arguments as to why Murphy’s award should not be excluded).

195. *See id.* (noting the Government’s argument that the Supreme Court in *O’Gilvie* read § 104(a)(2)’s “on account of” language to require a “strong causal connection”).

196. *See id.* (“The Government therefore concludes Murphy must demonstrate she was awarded damages ‘because of’ her physical injuries, which the Government claims she has failed to do.”).

197. *See id.* (stating that the Board made no reference in its award to Murphy’s physical injuries and noting the Government’s argument) (alteration in original).

198. *See id.* at 176 (finding that *O’Gilvie*’s analysis of the phrase “on account

Next, the court conceded that Murphy suffered “physical *manifestations* of emotional distress,” and that the ALJ may have at best “considered her physical injuries indicative of the severity of [her] emotional distress.”¹⁹⁹ The court concluded, however, that because “her physical injuries themselves were not the reason for the award,” Murphy’s damages were not awarded “because of” her physical injuries.²⁰⁰ Thus, Murphy could not use § 104(a)(2) to exclude her award from gross income.²⁰¹

Other circuits have also refused to apply § 104(a)(2)’s exclusion to damage awards in which the taxpayers alleged to have suffered physical injuries.²⁰² The U.S. Court of Appeals for the Tenth Circuit, in *Johnson v. United States*,²⁰³ refused to exclude any portion of a taxpayer’s award under the Americans with Disabilities Act (ADA)²⁰⁴ for being unlawfully terminated.²⁰⁵ The taxpayer suffered physical injuries while working as a juvenile guard for the State of Colorado’s Department of Corrections and attempting to restrain an inmate.²⁰⁶ After the injuries, the taxpayer was unable to perform the duties of a juvenile guard.²⁰⁷ Instead of accommodating him under the ADA with another job he could perform, Colorado terminated his

of” remained controlling).

199. *See id.* (acknowledging that Murphy suffered physical injuries and that the ALJ may have considered them when recommending her award) (emphasis added).

200. *See id.* (concluding that Murphy’s “damages were not ‘awarded by reason of, or because of, . . . [physical] personal injuries’” (alterations in original) (citing *O’Gilvie v. United States*, 519 U.S. 79, 83 (1996))).

201. *See id.* (“Therefore, § 104(a)(2) does not permit Murphy to exclude her award from gross income.”).

202. *See generally, e.g.*, *Stadnyk v. Comm’r*, 367 F. App’x 586 (6th Cir. 2010); *Lindsey v. Comm’r*, 422 F.3d 684 (8th Cir. 2005); *Johnson v. United States*, 76 F. App’x 873 (10th Cir. 2003).

203. *Johnson v. United States*, 76 F. App’x 873, 877–78 (10th Cir. 2003) (holding that § 104(a)(2) did not exclude the taxpayer’s ADA damages award for front and back pay from his gross income).

204. Americans with Disabilities Act, 42 U.S.C. §§ 12101–12213 (2006).

205. *See Johnson*, 76 F. App’x at 877–78 (concluding that none of the taxpayer’s damages could be excluded from his gross income under § 104(a)(2)).

206. *See id.* at 874 (noting that the taxpayer received physical injuries while attempting to restrain a juvenile inmate).

207. *See id.* (noting that the taxpayer’s injuries prohibited him from fulfilling his duties as a guard).

employment.²⁰⁸ He sued the State of Colorado in state court and a jury returned a verdict in his favor.²⁰⁹

The taxpayer did not challenge the taxability of the portion of the jury verdict allocated to “emotional distress, pain, suffering and mental anguish.”²¹⁰ Instead, the taxpayer sought to exclude the \$293,400 amount awarded for back and front pay from his gross income.²¹¹ He argued that § 104(a)(2) excluded the damages because his physical injuries led to his unlawful termination.²¹² The court refused to apply § 104(a)(2)’s exclusion to the award, however, reasoning that because the unlawful termination caused the loss of income, and not any alleged personal physical injury,²¹³ the damages were not received “on account of personal physical injuries.”²¹⁴

When faced with similar issues, the Sixth and Eighth Circuits reached results similar to the Tenth Circuit’s.²¹⁵ In *Stadnyk v. Commissioner*,²¹⁶ the U.S. Court of Appeals for the

208. *See id.* (noting that Colorado terminated his employment).

209. *See id.* (noting that the taxpayer sued).

210. *See id.* (noting that the taxpayer only sought a refund for the “tax liability on the back and front pay portions of the award”).

211. *See id.*

212. *See id.* at 876 (noting the taxpayer’s argument that § 104(a)(2) excluded his award because his physical injuries led to his unlawful termination).

213. *See id.* at 877 (“[T]he actual cause of the loss of income and the ADA action was the unlawful termination, not the personal physical injury.”); *cf.* *Comm’r v. Schleier*, 515 U.S. 323, 330 (1995) (“In age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other.”); *Banaitis v. Comm’r*, 340 F.3d 1074, 1080 (9th Cir. 2003) (explaining that wage loss is directly caused by the employment discrimination, not by any physical injury).

214. *See Johnson v. United States*, 76 F. App’x 873, 877–78 (10th Cir. 2003) (concluding that the front and back pay damages lacked a “direct causal link” to the taxpayer’s physical injuries and were therefore not received “on account of” such injuries).

215. *See Stadnyk v. Comm’r*, 367 F. App’x 586, 594 (6th Cir. 2010) (concluding that the taxpayer’s award for false imprisonment claims could not be excluded from gross income under § 104(a)(2) because there was no “causal connection between any physical injury and the settlement award”); *Lindsey v. Comm’r*, 422 F.3d 684, 686, 689 (8th Cir. 2005) (holding that § 104(a)(2) did not exclude the taxpayer’s settlement for “claims for tortious interference with contracts, for personal injury including injury to [his] personal and professional reputation and emotional distress, [and] humiliation and embarrassment”).

216. *See Stadnyk v. Comm’r*, 367 F. App’x 586, 594 (6th Cir. 2010) (holding that the taxpayer’s award for false imprisonment claims could not be excluded

Sixth Circuit found § 104(a)(2)'s exclusion inapplicable to a \$49,000 settlement award for claims relating to false imprisonment.²¹⁷ Although the taxpayer had testified she suffered no physical injuries resulting from her arrest and detention, and nothing in the record suggested a physical injury, she nonetheless argued that her physical restraint alone constituted a personal physical injury.²¹⁸ The court disagreed.²¹⁹ The Sixth Circuit determined that false imprisonment did not necessarily involve a physical injury,²²⁰ and concluded there was no “direct causal link” between any other alleged physical injuries and the settlement award.²²¹

In *Lindsey v. Commissioner*,²²² the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's denial of § 104(a)(2)'s exclusion to the taxpayer's (Lindsey) \$2 million settlement for claims against the taxpayer's former employer.²²³ Lindsey's claims included “tortious interference with contracts, . . . personal injury including injury to [his] personal and professional reputation and emotional distress, [and] humiliation and embarrassment.”²²⁴ Lindsey alleged that he suffered physical stress-related symptoms including hypertension, periodic

from gross income under § 104(a)(2) because there was no “causal connection between any physical injury and the settlement award”).

217. *See id.* at 594 (finding § 104(a)(2) inapplicable to the taxpayer's settlement award).

218. *See id.* at 592–93 (noting that “Mrs. Stadnyk testified that she did not suffer any physical injury as a result of her arrest and detention,” that “[n]othing in the record suggests that Mrs. Stadnyk suffered physical, as opposed to emotional, injuries,” and that she argued that her physical restraint alone constituted a physical injury).

219. *See id.* at 593 (determining that a false imprisonment victim is not necessarily physically injured).

220. *See id.*

221. *See id.* at 594 (“Petitioners have failed to offer any concrete evidence demonstrating a causal connection between any physical injury and the settlement award.”).

222. *Lindsey v. Comm'r*, 422 F.3d 684, 686, 689 (8th Cir. 2005) (holding that § 104(a)(2) did not exclude the taxpayer's settlement for “claims for tortious interference with contracts, for personal injury including injury to [his] personal and professional reputation and emotional distress, [and] humiliation and embarrassment”).

223. *See id.* (“Therefore, the tax court properly denied the exclusion.”).

224. *Id.* at 685.

impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence.²²⁵ Before the Eighth Circuit, Lindsey argued that the Tax Court erroneously concluded that § 104(a)(2) did not apply to any portion of the award.²²⁶

In the Tax Court opinion under review, the court looked both to the settlement's terms and the payor's intent when analyzing whether § 104(a)(2) excluded Lindsey's settlement.²²⁷ First, the Tax Court stated that Congress explicitly excluded "emotional distress and related injuries" from the "definition of physical injuries or physical sickness."²²⁸ The court then analyzed the settlement's terms, which simply reiterated Lindsey's claims against his employer.²²⁹ The court found that "[i]njury to reputation, humiliation, and embarrassment are akin to emotional distress" and that "tortious interference with contracts is an economic injury, not a physical injury."²³⁰ Accordingly, the court found that § 104(a)(2) did not exclude damages received on account of such claims.²³¹

Next, the court considered whether Lindsey's alleged physical injuries served as the basis for any portion of the settlement agreement.²³² To do this, the court analyzed the intent of the payor.²³³ Lindsey's physician testified that he suffered physical manifestations of stress, including hypertension, fatigue, occasional indigestion, and insomnia.²³⁴ Lindsey's physician further testified that Lindsey's hypertension could lead to "strokes, heart attacks, and kidney disease."²³⁵ The court stated

225. See *id.* at 688 (noting Lindsey's alleged physical symptoms).

226. See *id.* at 687 ("Lindsey[] also contend[s] the Tax Court erred in finding the physical sickness Lindsey suffered was a type not excludable under I.R.C. § 104(a)(2).").

227. See *Lindsey v. Comm'r*, T.C. Memo 2004-113, at 5-6 (analyzing the settlement's terms and discerning the payor's intent).

228. *Id.* at 5.

229. See *id.* (analyzing the settlement's terms).

230. *Id.*

231. See *id.* (finding that § 104(a)(2) does not exclude damages received on account of such claims).

232. See *id.* at 5-6 (considering whether any portion of the settlement was intended to compensate Lindsey's physical injuries).

233. See *id.* (analyzing the intent of the payor).

234. See *id.* at 5 (excerpting the physician's testimony).

235. *Id.*

that Congress intended Lindsey's injuries to be "within the definition of emotional distress," citing the House Report's statement that emotional distress included symptoms.²³⁶ Finally, the court found that even if Lindsey had suffered a "personal physical injury within the meaning of section 104(a)(2), such injury could not have been the basis for settlement" because there was no evidence that Lindsey communicated such injuries to the payor.²³⁷

On review, the Eighth Circuit mostly confirmed the Tax Court's findings and reasoning.²³⁸ Notably, though, the Eighth Circuit implied that § 104(a)(2) might have excluded Lindsey's settlement had he done two things.²³⁹ First, the court noted the importance of Lindsey's failure to make the payor aware of his physical injury or physical sickness.²⁴⁰ Second, the court stated that Lindsey failed to meet the on account of requirement because he did not demonstrate "what percentage of the settlement damages [was] allocable to physical injury or physical sickness," and because the record's evidence failed to do the same.²⁴¹ The Eighth Circuit's implications provide a blueprint for a taxpayer to exclude physical symptoms of emotional distress if his award is not expressly allocated to nonphysical or emotional injuries.

Without focusing on whether the taxpayer's action against the defendant had its origin in a physical injury or physical sickness, the circuit courts still refused to apply § 104(a)(2)'s exclusion amidst allegations of physical injuries. This result was

236. *See id.* (noting that Lindsey's injuries fell "within the definition of emotional distress" and citing the House Report).

237. *See id.* at 6 ("Even if petitioner had suffered a personal physical injury within the meaning of section 104(a)(2), such injury could not have been the basis for settlement because, as the parties stipulated, petitioner did not communicate any physical injury to [the payor] during the settlement negotiations.")

238. *See Lindsey v. Comm'r*, 422 F.3d 684, 689 (8th Cir. 2005) ("We affirm the well-reasoned decision of the Tax Court.")

239. *See id.* at 688–89 (implying that § 104(a)(2) might have excluded Lindsey's award had he made the defendant aware of the injuries and been able to prove that a portion of the settlement was allocated to such injuries).

240. *See id.* (noting the importance of Lindsey's failure to communicate his physical injuries to the defendant).

241. *Id.* at 689.

possible because the damages at issue were expressly allocated to nonphysical injuries. Because of this allocation, the taxpayers were unable to prove that any portion of their award was intended to compensate their alleged physical injury. Thus, focusing on whether the received damages were “on account of a personal physical injury or sickness” was sufficient to reach the right outcome. As three conflicting Tax Court cases indicate, the correct result is not as readily ascertainable when the damages are not so neatly allocated.²⁴²

VI. *The Tax Court Reaches Conflicting Results*

A. *Sanford v. Commissioner*

In 2008, the U.S. Tax Court decided *Sanford v. Commissioner*.²⁴³ *Sanford* held that § 104(a)(2) did not exclude the taxpayer’s damages received from a legal action against her employer for employment discrimination and sexual harassment.²⁴⁴ The taxpayer filed complaints with the U.S. Equal Employment Opportunity Commission (EEOC) against her employer, the U.S. Postal Service (USPS).²⁴⁵ She alleged that the USPS discriminated against her and that “she was retaliated against for previously participating in EEOC activity.”²⁴⁶

242. Compare *Sanford v. Comm’r*, T.C. Memo. 2008-158, at 1 (2008) (holding that § 104(a)(2) did not exclude the taxpayer’s damages received from a legal action against her employer for employment discrimination and sexual harassment that caused emotional distress manifested by physical symptoms), with *Domeny v. Comm’r*, T.C. Memo. 2010-9, at 5 (2010) (holding that § 104(a)(2) excluded the taxpayer’s settlement award from her employer where she alleged that the employer’s conduct caused emotional distress manifested by physical symptoms), and *Parkinson v. Comm’r*, T.C. Memo. 2010-142, at 7 (2010) (holding that § 104(a)(2) excluded the taxpayer’s settlement award for his intentional infliction of emotional distress claim when his emotional distress was manifested by a second heart attack).

243. *Sanford v. Comm’r*, T.C. Memo. 2008-158, at 1 (holding that § 104(a)(2) did not exclude the taxpayer’s damages received from a legal action against her employer for employment discrimination and sexual harassment that caused emotional distress manifested by physical symptoms).

244. *See id.*

245. *See id.* (detailing the taxpayer’s claims against the USPS).

246. *Id.*

Additionally, she alleged that a USPS coworker sexually harassed her.²⁴⁷

The EEOC found the taxpayer was discriminated against because of her sex, and that she was sexually harassed.²⁴⁸ The USPS Final Agency Decision awarded the taxpayer “compensatory damages of \$7,662 in past medical expenses and transportation, \$14,033 for past benefits lost (leave without pay), and \$12,000 in nonpecuniary compensatory damages.”²⁴⁹ In 2003, the USPS paid the taxpayer the total damages of \$33,695.²⁵⁰ The taxpayer then appealed the USPS Final Agency Decision to the EEOC.²⁵¹ On appeal, the EEOC “noted that [the taxpayer] had provided sufficient documentation to substantiate or justify her request for additional compensatory damages,” with documentation consisting of statements from her friends, coworkers, and psychologist.²⁵² The EEOC also noted that the documentation showed the taxpayer “experienced physical symptoms” due to the emotional distress and psychiatric problems that the long-term harassment created.²⁵³ These physical symptoms included “intensification of petitioner’s asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression.”²⁵⁴ Accordingly, the EEOC modified the USPS Final Agency Decision, determining that “USPS should pay [the taxpayer] a total of \$115,000 in nonpecuniary damages, \$33,542 in future pecuniary losses, \$7,662 for medical expenses, and \$14,033 for use of annual leave.”²⁵⁵ In 2004, the USPS paid the taxpayer the damages.²⁵⁶

The taxpayer failed to report any of the damages received in the legal action as income on her 2003 and 2004 tax returns,²⁵⁷

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.*

251. *See id.* at 2 (“Petitioner appealed the \$33,695 USPS Final Agency Decision to the EEOC.”).

252. *Id.*

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

and the Service determined a deficiency.²⁵⁸ The Tax Court considered whether § 104(a)(2) excluded the taxpayer's received compensation for "nonpecuniary damages and future pecuniary losses."²⁵⁹ The court's analysis began by noting that "gross income is broad in scope, while exclusions from income are narrowly construed."²⁶⁰ Then, the court reiterated § 104(a)(2)'s text, specifically stating that "emotional distress is not treated as a personal physical injury or physical sickness."²⁶¹ Because the Service conceded the taxpayer's underlying cause of action was "based in tort or tort-type rights," the court proceeded to determine whether the taxpayer's damages were received on account of her physical injuries or physical sickness.²⁶²

The court concluded that the taxpayer's nonpecuniary damages and future pecuniary losses "were not received on account of personal physical injury or physical sickness" and thus not excluded from her gross income under § 104(a)(2).²⁶³ Because the taxpayer did not meet the requirements for "medical care" deductions under § 213, the court also concluded the taxpayer could not exclude the portion of the award attributed to medical expenses.²⁶⁴ When analyzing the nonpecuniary damages and future pecuniary losses portion, the court looked to the EEOC and USPS decisions, which noted that the taxpayer's sexual harassment "caused her emotional distress."²⁶⁵ Further, the court acknowledged that the taxpayer's "emotional distress manifested

258. *Id.*

259. *See id.* at 3 ("We now consider whether petitioner must include in income the portion of the award for nonpecuniary damages and future pecuniary losses.").

260. *Id.* (citing *Comm'r v. Schleier*, 515 U.S. 323, 328 (1995)).

261. *See id.* ("Emotional distress is not treated as a personal physical injury or physical sickness." (citing I.R.C. § 104(a) (2006))).

262. *See id.* (noting that the Service conceded that the taxpayers met the "tort or tort-type rights" requirement and proceeding to determine whether the damages were received "on account of" her physical injuries or physical sickness).

263. *See id.* at 4 ("We conclude that the [damages] awarded to [the taxpayer] as a result of the legal action were not received on account of personal physical injury or physical sickness. [The taxpayer] therefore must include these damages in her income under section 104(a)(2).").

264. *See id.* (concluding that § 104(a)(2) did not exclude taxpayer's portion of the award for "past medical expenses and transportation").

265. *Id.* at 3.

itself in [the] physical symptoms” noted in the EEOC decision but found that “[t]hese physical symptoms were not the basis of the award.”²⁶⁶ Instead, the taxpayer was awarded relief for sexual harassment and sex-based discrimination, and was “compensated . . . for the emotional distress she suffered because of the sexual harassment.”²⁶⁷ Importantly, the Tax Court stated that “[d]amages received on account of emotional distress, even when resultant physical symptoms occur, are not excludable from income under section 104(a)(2).”²⁶⁸ This statement is entirely consistent with § 104(a)(2)’s legislative history in which Congress provided that the term “emotional distress” included symptoms.

B. *Domeny v. Commissioner*

Less than two years later, in *Domeny v. Commissioner*,²⁶⁹ the Tax Court reached a conclusion directly contrary to *Sanford*.²⁷⁰ After being terminated, the taxpayer complained that her pre-existing multiple sclerosis (MS) “spik[ed],” and that she suffered “shooting pain up her legs, fatigue, burning eyes, spinning head, vertigo, and lightheadedness.”²⁷¹ Before filing suit, however, the taxpayer’s attorney negotiated a settlement agreement with her former employer.²⁷² In the settlement agreement, the taxpayer released potential claims under the ADA, the ADEA, and potential claims for invasion of privacy, defamation and misrepresentation, and infliction of emotional distress.²⁷³ The

266. *Id.*

267. *Id.*

268. *Id.* (citing *Hawkins v. Comm’r*, T.C. Memo. 2005-149 (2005)).

269. *Domeny v. Comm’r*, T.C. Memo. 2010-9, at 5 (2010) (holding that § 104(a)(2) excluded the taxpayer’s settlement award from her employer where she alleged that the employer’s conduct caused emotional distress manifested by physical symptoms).

270. *See id.* at 5 (concluding § 104(a)(2) excluded the taxpayer’s settlement award because her work environment exacerbated her physical illness).

271. *Id.* at 2.

272. *See id.* (noting that a settlement agreement was reached before any suit was filed).

273. *See id.* (listing the causes of action that the taxpayer released pursuant to the settlement agreement).

settlement agreement made no mention of the taxpayer's alleged physical symptoms.²⁷⁴

The taxpayer's employer paid a total of \$33,308 under the agreement.²⁷⁵ Of the total, \$16,375 was sent directly to the taxpayer's attorney.²⁷⁶ The Tax Court addressed the sole question of whether § 104(a)(2) excluded the settlement agreement's remaining \$16,933, which was sent directly to the taxpayer and not included as income on her tax return.²⁷⁷

The court began by noting that the taxpayer believed she was being compensated "for physical injuries that occurred in a hostile work environment."²⁷⁸ Next, the court noted § 104(a)(2)'s text, including the post-amble, which states that "emotional distress shall not be treated as physical injury or physical sickness."²⁷⁹ After summarily concluding the settlement agreement was ambiguous, the court proceeded to analyze the payor's intent.²⁸⁰ The court also concluded that the taxpayer's claim against her employer was based on tort or tort-type rights.²⁸¹ Finally, the court analyzed whether there was a "direct causal link" between the damages and the taxpayer's alleged physical injuries.²⁸²

The taxpayer's employer did not withhold taxes on the \$16,933 at issue and labeled the amount as "[n]onemployee compensation."²⁸³ Based on this fact alone, the Tax Court inferred that the taxpayer's employer "was aware that at least part of [the taxpayer's] recovery may not have been subject to tax; i.e., was due to physical illness."²⁸⁴ The court then coupled that inference

274. *See id.* at 3 (noting that the settlement agreement contained only a list of "numerous possible causes of action that [the taxpayer] was releasing").

275. *Id.* at 2.

276. *Id.* Half of the \$16,375 was compensation due to the taxpayer and the taxpayer reported that as income on her 2005 tax return. *Id.* The taxpayer was not issued any tax forms on the other half sent to her attorney and did not report it as income. *Id.*

277. *Id.* at 3.

278. *Id.*

279. *Id.*

280. *Id.*

281. *Id.*

282. *Id.* (citing *Banaitis v. Comm'r*, 340 F.3d 1074, 1080 (9th Cir. 2003)).

283. *Id.* at 4.

284. *Id.*

with the “likelihood that [the taxpayer’s] attorney represented [the taxpayer’s] circumstances to [her employer] in the course of the settlement negotiations.”²⁸⁵ Based solely on these bare inferences—and ignoring the settlement agreement’s terms—the Tax Court found that the taxpayer’s employer intended to compensate her for “her acute physical illness caused by her hostile and stressful work environment.”²⁸⁶ Thus, because the taxpayer had “shown that her work environment exacerbated her existing physical illness,” she had “shown that the only reason for the \$16,933 payment was to compensate her for her physical injuries.”²⁸⁷

Domeny’s conclusion cannot be squared with *Sanford*. In *Sanford*, the EEOC and the court explicitly noted that the taxpayer’s emotional distress caused physical symptoms, including intensifying her preexisting asthma.²⁸⁸ In *Domeny*, the taxpayer’s emotional distress caused physical symptoms, including intensifying her preexisting MS.²⁸⁹ Yet § 104(a)(2) was applied to the award in *Domeny* and not in *Sanford*.²⁹⁰ A Tax Court case decided later in 2010 is further indicative of this inconsistent application.

C. Parkinson v. Commissioner

In *Parkinson v. Commissioner*,²⁹¹ the taxpayer asserted claims of intentional infliction of emotional distress and invasion of privacy against his former employer (medical center) and two

285. *Id.*

286. *Id.*

287. *Id.* at 5.

288. *See* *Sanford v. Comm’r*, T.C. Memo. 2008-158, at 3 (2008) (“We further acknowledge, as did the EEOC, that the emotional distress manifested itself in physical symptoms such as asthma.”).

289. *See* *Domeny v. Comm’r*, T.C. Memo. 2010-9, at 2 (2010) (noting that the taxpayer suffered physical symptoms of her emotional distress, including exacerbating her preexisting MS).

290. *See supra* Parts VI.A–B (discussing *Sanford* and *Domeny*).

291. *See* *Parkinson v. Comm’r*, T.C. Memo. 2010-142, at 7 (2010) (holding that § 104(a)(2) excluded the taxpayer’s settlement award for his intentional infliction of emotional distress claim when his emotional distress was manifested by a second heart attack).

named coworkers.²⁹² The taxpayer's complaint alleged that the two named coworkers "harassed and harangued" him, causing him to suffer "severe emotional distress, *manifested* by permanent, irreparable physical harm in the form of his second heart attack."²⁹³ For both claims, the "complaint sought \$500,000 in compensatory damages, \$500,000 in punitive damages, attorney's fees, and costs."²⁹⁴ The day after a jury trial began, the "medical center agree[d] to pay [the taxpayer] \$350,000 'as noneconomic damages and not as wages or other income,'"²⁹⁵ and the taxpayer agreed to drop all claims.²⁹⁶ In 2005, the taxpayer received a \$34,000 payment pursuant to the settlement agreement but failed to report this amount on his 2005 federal income tax return.²⁹⁷

After considering the settlement agreement's terms and the payor's intent, the court first concluded that "the entire settlement payment [wa]s allocable to [the taxpayer's] cause of action for intentional infliction of emotional distress."²⁹⁸ Then, the Tax Court concluded that § 104(a)(2) excluded one-half of the taxpayer's 2005 settlement payment because it "was made on account of [the taxpayer's] physical injuries."²⁹⁹ In support of its conclusion, the court looked to the 1996 Act's House Report.³⁰⁰

First, the Tax Court acknowledged the House Report provided that the term "emotional distress" included symptoms.³⁰¹ Next, the court quoted the portion of the House Report that stated that "[b]ecause all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion . . . applies to any damages received based on a claim of emotional distress that is

292. *See id.* at 1–2 (detailing the taxpayer's complaint).

293. *Id.* at 2.

294. *Id.*

295. *Id.*

296. *See id.* ("Pursuant to the settlement agreement [the taxpayer] agreed to drop all his claims.").

297. *Id.*

298. *Id.*

299. *See id.* at 6 (finding one-half of the settlement amount excluded).

300. *Id.* at 5.

301. *Id.*

attributable to a physical injury or physical sickness.”³⁰² The court stated that this language, with respect to a claim for emotional distress, indicated Congress’s intent to distinguish “damages attributable to physical injury or physical sickness, which are excludable, from damages attributable to emotional distress or ‘symptoms’ thereof, which are not excludable.”³⁰³ The court took the House Report’s language out of context and read it incorrectly.

Parkinson dropped the origin of the action portion of the House Report, focusing instead only on the end result. The House Report provided that damages for emotional distress qualified for § 104(a)(2)’s exclusion only when a personal physical injury or physical sickness caused emotional distress.³⁰⁴ In other words, when a taxpayer’s personal physical injury or physical sickness causes the taxpayer to suffer emotional distress, then the damages allocated to such emotional distress will be on account of the personal physical injury or physical sickness. As *Parkinson* reads the House Report, damages allocated to a physical symptom of emotional distress would fall within § 104(a)(2)’s exclusion because they are on account of the physical symptom. Under that reading, damages allocated to emotional distress caused by a physical injury or physical sickness would be on account of emotional distress. This is directly contrary to the statute’s text and its legislative history. Section 104(a) explicitly states that damages on account of emotional distress should be included in income.³⁰⁵ Congress intended for damages allocable to emotional distress caused by a physical injury to fall within § 104(a)(2)’s exclusion only because all of those damages have their “origin in a physical injury or physical sickness.”³⁰⁶

302. *Id.*

303. *Id.*

304. See HOUSE REPORT, *supra* note 163, at 301 (providing that § 104(a)(2) excluded damages allocated to emotional distress “on account of” a physical injury or physical sickness).

305. See I.R.C. § 104(a) (2006) (“[E]motional distress shall not be treated as a physical injury or physical sickness.”).

306. See HOUSE REPORT, *supra* note 163, at 301 (providing that § 104(a)(2) excluded damages allocated to emotional distress “on account of” a physical injury or physical sickness).

Next, the Tax Court stated it was “self-evident that a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress.”³⁰⁷ A heart attack is undoubtedly a “severe” physical symptom, but it is a “symptom” nonetheless. In fact, the taxpayer stated in his complaint that he “suffered severe emotional distress, *manifested* by permanent, irreparable physical harm in the form of his second heart attack.”³⁰⁸ Because the taxpayer’s emotional distress manifested itself with such a severe physical symptom, he received a large sum as settlement for his claim.³⁰⁹ This does not mean, however, that the taxpayer’s larger sum should not be taxed, while someone suffering a “milder” physical symptom—and consequently receiving a smaller settlement—should be taxed.³¹⁰

Lastly, the Tax Court relied on treatise excerpts, stating that when a plaintiff is compensated for emotional distress that is evidenced by physical symptoms, both the mental and physical elements have been compensated.³¹¹ The Tax Court is correct that the medical center compensated the taxpayer for both elements of his emotional distress. But simply because both the mental and the physical elements have been compensated for does not mean each element should be taxed separately rather than taxed as one recovery for emotional distress. Under *Parkinson’s* reasoning, every taxpayer suffering a physical symptom of emotional distress would be entitled to exclude a court-determined amount of any potential recovery under § 104(a)(2). The analytical difficulties of drawing a line between the emotional and the physical elements would make judicial determinations, at best,

307. *Parkinson v. Comm’r*, T.C. Memo. 2010-142, at 5 (2010).

308. *Id.* at 2.

309. The taxpayer received \$350,000. *Id.*

310. *See, e.g.,* *Murphy v. Internal Revenue Serv.*, 493 F.3d 170, 176 (D.C. Cir. 2007) (concluding that § 104(a)(2) did not exclude the taxpayer’s \$70,000 award for emotional injuries manifested by physical symptoms, such as “bruxism”).

311. *See Parkinson*, T.C. Memo. 2010-142, at 5–6 (stating that, when a plaintiff is compensated for emotional distress accompanied by physical symptoms, both the physical and the mental elements have been compensated (citing the RESTATEMENT (SECOND) OF TORTS § 46(1) (1965); W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS, § 12, at 64 (5th ed. 1984)).

wildly speculative. As a result, the tax consequences of emotional distress recoveries would be entirely unpredictable.

Moreover, when Congress stated that the term emotional distress includes symptoms that may result from such emotional distress,³¹² it indicated that § 104(a)(2)'s exclusion does not consider emotional distress's physical symptoms as a stand-alone physical injury or physical sickness. Instead, a recovery for "emotional distress" encompasses its physical symptoms, no matter their severity. As the Tax Court previously stated, "[d]amages received on account of emotional distress, even when resultant physical symptoms occur, are not excludable from income under section 104(a)(2)."³¹³

VII. Proposal: A New Test

Before the 1996 Act, the "origin" of the "personal injury" giving rise to damages was a nonissue for a few reasons. First, *Burke's* "tort or tort-type rights" test ensured that § 104(a)(2) excluded only damages compensating for personal-injury torts, or for personal injuries where the full range of tort-type remedies were available.³¹⁴ The test intended to "distinguish damages for personal injuries from, for example, damages for breach of contract."³¹⁵ Second, § 104(a)(2) excluded *all* personal injuries, physical, nonphysical, and emotional.³¹⁶

312. See HOUSE REPORT, *supra* note 163, at 301 n.56 (stating that the term emotional distress includes symptoms that may result from such emotional distress).

313. *Sanford v. Comm'r*, T.C. Memo. 2008-158, at 3 (2008) (citing *Hawkins v. Comm'r*, T.C. Memo. 2005-149 (2005)).

314. See *Damages Received on Account of Personal Physical Injuries or Physical Sickness*, 74 Fed. Reg. 47,152, 47,153 (proposed Sept. 15, 2009) (to be codified at 26 C.F.R. § 1.104-1) [hereinafter Proposed Regulation] (stating that the "tort or tort type rights" requirement "intended to ensure that only damages compensating for torts and similar personal injuries qualif[ied] for exclusion under § 104(a)(2)").

315. See *Damages Received on Account of Personal Physical Injuries or Physical Sickness*, 77 Fed. Reg. 3106, 3107 (Jan. 23, 2012) (to be codified at 26 C.F.R. § 1.104-1) [hereinafter Final Regulation] ("The tort-type rights test was intended to distinguish damages for personal injuries from, for example, damages for breach of contract.").

316. See *United States v. Burke*, 504 U.S. 229, 235 n.6 (1992) (noting that the exclusion's scope had previously been limited to only physical injuries, but

After the 1996 Act, on the other hand, Treasury amended its § 104(a)(2) regulations that served as the basis for *Burke's* requirement, thus eliminating *Burke's* tort or tort-type rights test.³¹⁷ In the amendment's proposal, Treasury stated that judicial and legislative developments—including the 1996 Act—have “eliminated the need to base the section 104(a)(2) exclusion on tort and remedies concepts.”³¹⁸ The amended regulations extend § 104(a)(2)'s exclusion to “personal physical injuries or physical sickness not defined as torts under state and common law,” and to no-fault statutes.³¹⁹ Section 104(a)(2)'s exclusion no longer “depend[s] on the scope of remedies available under state or common law.”³²⁰ Replacing the tort or tort-type rights requirement, the amended regulations define § 104(a)(2) “damages” as “an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.”³²¹

Additionally, § 104(a)(2) now excludes only damages received “on account of personal *physical* injuries or *physical* sickness.”³²² Because of the added “physical” requirement, defendants can be liable for “personal injury” compensatory damages that § 104(a)(2) no longer excludes. For example, a defendant's conduct may directly cause a taxpayer to suffer emotional distress. Before the 1996 Act, the taxpayer's emotional distress would have qualified as a “personal injury” for purposes of § 104(a)(2)'s exclusion. If the defendant then paid the taxpayer damages on account of such emotional distress, § 104(a)(2) would exclude those damages as being on account of a personal injury. Now, however, because § 104(a) prohibits emotional distress from being treated as a physical injury or physical sickness, § 104(a)(2)

that it was now settled that it extended to “nonphysical injuries to the individual”).

317. See Treas. Reg. § 1.104-1(c) (as amended in 2012) (eliminating the “tort or tort type rights” requirement).

318. Proposed Regulation, *supra* note 314, at 47,153.

319. *Id.*

320. *Id.*

321. Treas. Reg. § 1.104-1(c) (as amended in 2012).

322. I.R.C. § 104(a)(2) (2006) (emphasis added); see *supra* Part IV (discussing the Small Business Job Protection Act of 1996).

does not exclude damages received on account of the “personal injury” of emotional distress. Thus, defendants can be liable for “personal injury” compensatory damages—damages that would have been excluded before the 1996 Act—without directly causing a “physical injury or physical sickness.”

This creates the problem that was illustrated in *Domeny* and in *Parkinson*. According to *Domeny* and *Parkinson*, damages allocated to a physical symptom of emotional distress may be excluded if the taxpayer could show that the damages compensated for, or were “on account of,” the physical symptom.³²³ In *Lindsey*, the Eighth Circuit implied that to do so, a taxpayer simply has to alert the defendant to the taxpayer’s physical symptom and then prove that at least a portion of the award is intended to compensate for the physical symptom.³²⁴ This result directly contradicts the exclusion’s text, however, which states that “emotional distress shall not be treated as a physical injury or physical sickness” for purposes of § 104(a)(2)’s exclusion,³²⁵ and the House Report, which states that “emotional distress” includes resulting symptoms.³²⁶ To remedy this contradiction, it is necessary to focus on whether the taxpayer’s action against the defendant has its *origin* in a physical injury or physical sickness.

As Treasury noted when it proposed amending its regulations, judicial and legislative developments have affected § 104(a)(2)’s exclusion.³²⁷ Most importantly, the 1996 Act added the requirement that a taxpayer’s “personal injury or sickness” must be “physical.”³²⁸ To accommodate that added requirement, a new test needs to be implemented to prevent results—such as

323. See *supra* Parts VI.B–C (discussing *Domeny* and *Parkinson*).

324. *Supra* notes 239–41 and accompanying text.

325. I.R.C. § 104(a).

326. See HOUSE REPORT, *supra* note 163, at 301 n.56 (stating that the term emotional distress includes symptoms that may result from such emotional distress).

327. See Proposed Regulation, *supra* note 314, at 47, 152–53 (noting that judicial and legislative developments have affected § 104(a)(2)’s exclusion that Treasury’s proposed regulations reflect the statutory developments).

328. *Amos v. Comm’r*, T.C. Memo 2003-329, at 4 (2003) (“The 1996 amendment . . . imposes an additional requirement for an amount to qualify for exclusion from gross income under that section.”).

Domeny and *Parkinson*—that contradict § 104(a)(2)’s text and legislative history.

Under the new test, to be excluded from gross income under § 104(a)(2): (1) an amount must be received (other than workers’ compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution; (2) such legal suit or action must have its origin in a physical injury or physical sickness; and (3) the amount must be received on account of such physical injury or physical sickness.

The test’s three requirements must each be satisfied independently. The first requirement is taken from § 104(a)(2)’s text and Treasury’s proposed regulations. As Treasury intended, it replaces the tort or tort-type rights requirement and defines § 104(a)(2) “damages.” The requirement functions as Treasury detailed in its proposed regulations above³²⁹ and thus needs no additional explanation here. The test’s third requirement derives from § 104(a)(2)’s on account of text and incorporates all the case law interpreting that language. The cases interpreting on account of are detailed earlier in Part III of this Note.³³⁰ Accordingly, the third requirement also requires no further explanation here. The test’s second requirement derives from § 104(a)(2)’s text combined with Congress’s language in the House Report. The test’s second requirement works in unity with the first and needs additional explanation.

A. The “Origin” Requirement

When a statute is ambiguous on its face—as § 104(a)(2)’s language has always been³³¹—courts should view the legislative history to determine Congress’s intent.³³² Appropriately, then, the test’s second requirement is drawn from the House Report that

329. *Supra* notes 318–21 and accompanying text.

330. *See supra* Part III (discussing the case law refining § 104(a)(2)’s “on account of” text).

331. *See O’Gilvie v. United States*, 519 U.S. 79, 79 (1996) (acknowledging that the “on account of” phrase in § 104(a)(2) is ambiguous).

332. *See Middlesex Cnty. Sewerage Auth. v. Nat’l Sea Clammers Ass’n*, 453 U.S. 1, 13 (1981) (stating that the Court first looks to the statutory text and then reviews the legislative history to determine congressional intent).

gave guidance on how to apply the amended § 104(a)(2) exclusion.³³³ According to the House Report, to qualify for § 104(a)(2)'s exclusion, the taxpayer's "action" against the defendant must have its "origin in a physical injury or physical sickness."³³⁴ This requirement, combined with the regulations' use of "legal suit or action," forms the test's second component.

The word "origin" is commonly defined as "the point at which something begins or rises" or as "something that creates, causes, or gives rise to another."³³⁵ Thus, to qualify for § 104(a)(2)'s exclusion, a physical injury or physical sickness must create, cause, or give rise to the taxpayer's "legal suit or action" against the defendant. Except in the context of a wrongful death or survival suit, this origin requirement will be satisfied only when the defendant's conduct directly causes the taxpayer's personal physical injury or physical sickness, thus giving rise to the taxpayer's action against the defendant. This requires that there be a "direct causal link" between the defendant's conduct and the taxpayer's personal physical injury or physical sickness.

For example, in *Schleier's* automobile accident illustration, the taxpayer's personal physical injuries suffered in the automobile accident gave rise to the taxpayer's negligence action against the defendant.³³⁶ Without an intervening emotional injury, the defendant's negligent conduct directly caused the taxpayer's personal physical injuries, including bruises, cuts, or broken bones. Because the defendant directly caused the taxpayer's personal physical injuries, the defendant was liable for damages on account of the taxpayer's personal physical injuries. Thus, the taxpayer's "legal suit or action" against the defendant—that may have resulted in other claims such as lost wages, or

333. See HOUSE REPORT, *supra* note 163, at 301 (providing the "origin" requirement).

334. See *id.* ("If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness . . ."); see also Wood, *supra* note 167, at 5 ("Congress require[s] that the action have its *origin* in a physical injury or sickness.").

335. *Origin Definition*, MERRIAM-WEBSTER.COM, <http://merriam-webster.com/dictionary/origin> (last visited Nov. 14, 2012) (defining origin) (on file with the Washington and Lee Law Review).

336. See *supra* note 101 and accompanying text (using an automobile accident example to illustrate a personal injury).

pain, suffering, and emotional distress—had its origin in a physical injury or physical sickness.

In the context of a wrongful death or survival suit, the taxpayer's action against the defendant has its origin in a physical injury or physical sickness because the taxpayer's action originated out of the decedent's death, which the defendant directly caused. Because the taxpayer could not have prosecuted the action against the defendant absent the decedent's personal physical injury of death, the decedent's death gave rise to the spouse's action. Therefore, the decedent's death was the origin of the spouse's wrongful death or survival action against the defendant. The taxpayer's action may then include claims for loss of consortium and pain, suffering, and emotional distress, but the action's origin was in a physical injury or physical sickness.³³⁷

On the other hand, the origin requirement will not be satisfied when the defendant's conduct directly causes the taxpayer to suffer emotional distress manifested by a physical symptom, even if the physical symptom alone could be considered a physical injury or physical sickness. With employment discrimination or wrongful termination, the defendant's conduct directly causes lost wages and nonphysical personal injuries, such as emotional distress, but does not directly cause a physical injury or physical sickness.³³⁸ Because the defendant's conduct only directly causes the taxpayer's emotional distress, there is no direct causal link between the defendant's conduct and the taxpayer's physical symptom. The taxpayer can still bring an action against the defendant for infliction of emotional distress and lost wages, but the action would not have its origin in a physical injury or physical sickness. Thus, the taxpayer would fail to meet the test's second requirement.

In *Parkinson*, for example, the defendant's conduct directly caused the taxpayer's emotional distress.³³⁹ The taxpayer's emotional distress then manifested itself with the severe physical

337. Cf. HOUSE REPORT, *supra* note 163, at 301 (noting that a taxpayer's claim for loss of consortium due to his spouse's physical injury or physical sickness would be excluded from gross income).

338. See *supra* note 101 and accompanying text (using an automobile accident example to illustrate a personal injury).

339. See *supra* Part VI.C (discussing *Parkinson v. Comm'r*, T.C. Memo. 2010-142 (2010)).

symptom of a heart attack. The taxpayer's emotional distress severed the direct causal link between the defendant's conduct and the physical symptom. Thus, the taxpayer's heart attack was not the origin of his action against the defendant. Rather, the taxpayer's severe emotional distress was the origin of his action against the defendant and the emotional distress then gave rise to his physical injury.

Importantly, the immediacy of the physical symptom's onset does not affect this result. Consider a taxpayer-employee that is deathly afraid of snakes.³⁴⁰ If her employer places a rubber snake in her office and she immediately suffers a heart attack upon seeing the snake, her heart attack will not be the origin of her action against her employer. Instead, her cause of action for infliction of emotional distress will have its origin in her severe emotional distress, which was manifested by a heart attack.³⁴¹ These consequential physical symptoms may, of course, indicate the severity of the defendant-inflicted emotional distress and thus increase the total damages sum.³⁴² But this does not mean that a taxpayer suffering physical consequences of emotional distress should be better off from a tax perspective than a taxpayer whose emotional distress does not have physical consequences.

Admittedly, there can be confusion when the defendant simultaneously inflicts separate emotional and physical injuries. This scenario is best illustrated in the sexual harassment and false imprisonment contexts. As the Service explained in a private letter ruling in 2000, when sexual harassment takes the form of an "unwanted or uninvited physical contact[] resulting in observable bodily harms," then § 104(a)(2) excludes damages allocable to such injuries.³⁴³ But when the sexual harassment is

340. This example was provided by Professor Brant J. Hellwig.

341. If the employee died as a result of her heart attack and her husband brought a wrongful death action against her employer, then the husband's action would have its origin in the physical injury of death. Thus, § 104(a)(2) would exclude damages that he received "on account of" his wife's death.

342. *Cf.* *Murphy v. Internal Revenue Serv.*, 493 F.3d 170, 176 (D.C. Cir. 2007) (noting that the Administrative Law Judge may have considered the taxpayer's physical injuries "indicative of the severity of [her] emotional distress").

343. *See* I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000) (providing that § 104(a)(2) would exclude damages allocated to "unwanted or uninvited physical

nonphysical and causes the taxpayer to suffer emotional distress § 104(a)(2) does not exclude any damages attributable to the emotional distress, even if accompanied by physical symptoms.³⁴⁴ Similarly, as the Sixth Circuit explained in *Stadnyk*, false imprisonment does not necessarily involve a physical injury.³⁴⁵ Presumably, if the false imprisonment took the form of an “unwanted or uninvited physical contact[] resulting in observable bodily harms,” then § 104(a)(2) would exclude damages attributable to such injuries.³⁴⁶ But § 104(a)(2) would not exclude damages attributable to emotional distress resulting from the false imprisonment’s nonphysical aspects, such as confinement alone.³⁴⁷

In these scenarios, the physical injury or physical sickness does not have to be the action’s *sole* origin. Because the defendant directly caused the taxpayer’s personal physical injury, and that personal physical injury is one of the origins of the taxpayer’s action against the defendant, the test’s second requirement would be met. A court would then have to determine what portion of the damages is on account of the taxpayer’s personal physical injuries, and thus excluded by § 104(a)(2). Section 104(a)(2) would not, however, exclude the portion of damages flowing from, or directly caused by, the taxpayer’s emotional distress, except in the amount not exceeding qualifying medical care under § 213.

contacts resulting in observable bodily harms”).

344. *See id.* (providing that § 104(a)(2) would exclude *only* damages allocated to “unwanted or uninvited physical contacts resulting in observable bodily harms”); *see also* Sanford v. Comm’r, T.C. Memo. 2008-158, at 1 (2008) (holding that § 104(a)(2) did not exclude the taxpayer’s damages received from a legal action against her employer for sexual harassment that caused emotional distress manifested by physical symptoms).

345. *See* Stadnyk v. Comm’r, 367 F. App’x 586, 593 (6th Cir. 2010) (determining that a false imprisonment victim is not necessarily physically injured).

346. *Cf.* I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000) (sexual harassment).

347. *Cf.* Stadnyk, 367 F. App’x at 594 (holding that the taxpayer’s award for false imprisonment claims could not be excluded from gross income under § 104(a)(2) because there was no “causal connection between any physical injury and the settlement award”).

VIII. Conclusion

Of course, it still remains difficult to draw the line between *physical* and *nonphysical*. Some commentators have suggested that § 104(a)(2)'s exclusion be repealed due to the difficulty with drawing such a line.³⁴⁸ Others have suggested rewriting the exclusion to apply only to damages attributable to lost human capital,³⁴⁹ or that the Service adopt definitions from the *Restatement (Third) of Torts*.³⁵⁰ No matter where the line is drawn between *physical* and *nonphysical*, however, some taxpayers will be better off than others.

Although Congress did not explicitly define physical when it amended § 104(a)(2),³⁵¹ it stated both in the statutory text and the House Report that “emotional distress shall not be treated as a physical injury or physical sickness” for purposes of the exclusion.³⁵² Importantly, the House Report provided that the term *emotional distress* includes symptoms that may result from such emotional distress.³⁵³ By providing that emotional distress and its resulting symptoms are not to be treated as a physical injury or physical sickness, Congress excluded emotional distress from its definition of physical. Section 104(a)(2) does not exclude a taxpayer's recovery for emotional distress, unless an originating physical injury or physical sickness causes the taxpayer's emotional distress. To prevent the inconsistency of having § 104(a)(2)'s gross income exclusion extended to some physical symptoms of emotional distress, but not others, it is necessary to focus on whether the taxpayer's action has its origin in a physical injury or physical sickness.

348. See Barret, *supra* note 13, at 1194 (“In order to promote predictability and consistency, the exclusion should be eliminated.”).

349. See Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U. L. REV. 61, 62 (1997) (proposing that § 104(a)(2) should be redrafted and only encompass “damages attributable to lost human capital and not lost wages and earning power”).

350. See Wright, *supra* note 7, at 215 (proposing that the *Restatement (Third) of Torts*' definition be adopted).

351. See HOUSE REPORT, *supra* note 163, at 300–01 (failing to define “physical injury or physical sickness”); see also I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000) (“The term ‘personal physical injuries’ is not defined in either § 104(a)(2) or the legislative history of the 1996 Act.”).

352. See *supra* Part III (discussing the Small Business Job Protection Act of 1996).

353. See HOUSE REPORT, *supra* note 163, at 301 n.56 (stating that the term “emotional distress” includes symptoms).