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## **Heads I Win, Tails You Lose: The Disparate Treatment of Similarly Situated Taxpayers Under the Personal Injury Income Tax Exclusion**

*Habib E. Hanna\**

### INTRODUCTION

Personal injury tort litigation continues to dominate the legal landscape in the United States.<sup>1</sup> Whether at the hands of a jury verdict, court order or a structured settlement agreement, tort litigation leads to the exchange of vast amounts of money.<sup>2</sup> Subsequently, whenever there is an exchange of money between two or more people, the United States Tax Code (“Code”) will likely have an impact on all the parties involved. The Code is primarily concerned with taxing income, so it tends to focus on the recipient of a tort damages money award.<sup>3</sup> The primary Internal Revenue Code (“I.R.C.”) provision that deals with money received subsequent to a personal injury tort damages award is I.R.C. § 104(a)(2) (“section 104(a)(2)”).<sup>4</sup> Since it was enacted in 1918, section 104(a)(2) has generated a considerable level of criticism, dismay and confusion over its intent, definition, and application.<sup>5</sup>

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<sup>1</sup> See generally John T. Nockleby, *How to Manufacture a Crisis: Evaluating Empirical Claims Behind 'Tort Reform,'* 86 OR. L. REV. 533 (2007).

<sup>2</sup> *Id.*

<sup>3</sup> I.R.C. § 61 (West 2009) (“[G]ross income means all income from whatever source derived.”). Unless otherwise noted, all references to the “Code” are to the Internal Revenue Code of 1986, as amended.

<sup>4</sup> I.R.C. § 104(a)(2) (West 2009) stating:

(a) In general. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include . . . (2) 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[.]

<sup>5</sup> See Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U. L. REV. 61, 79 (1997) (“For nearly eighty years, taxpayers, their advisors, and the government have wrestled with the scope of the personal injury exclusion.”). See also Renee C. Harvey, Note, *Commissioner v. Schleier: An Unfair Interpretation of Section 104(a)(2)*, 30 U.S.F. L. REV. 313, 342

Congressional intent behind the enactment of section 104(a)(2) represents a foundational theme that often dictates the method and manner in which section 104(a)(2) is applied.<sup>6</sup> Congress designed section 104(a)(2) with one primary goal in mind: to alleviate the tax burden for those who suffered a personal injury and received income as a result of tort litigation.<sup>7</sup> At its essence, section 104(a)(2) excludes from taxation any amount of money damages recovered by a taxpayer “on account of personal physical injuries or physical sickness.”<sup>8</sup> While this phrase seems relatively straightforward, it has proven difficult in real-life application.<sup>9</sup> Two of the primary issues presented by section 104(a)(2) are the definition of the word “physical” and the phrase “on account of.”<sup>10</sup> A quick example will show how section 104(a)(2) works. A person is injured in a car accident, sues for money damages and recovers an award for pain, suffering and lost wages. Because this taxpayer received money on account of a personal physical injury, that amount is fully excludable and the taxpayer owes no income tax on the amount recovered.

One of the main problems encountered under section 104(a)(2) involves a tort that causes purely emotional distress that later manifests into a physical injury.<sup>11</sup> Any damages received in such a scenario are not excluded under section 104(a)(2) because the damages are not received on account of the physical injury, rather they are received on account of the emotional distress injury.<sup>12</sup> This outcome appears to be discriminatory in that it treats similarly situated taxpayers—those who suffered physical injuries at one point or another—differently.<sup>13</sup> This disparate result is due to the fact that one physical injury occurred immediately as a result of the

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(Fall 1995) (stating that section 104(a)(2) “has caused the courts, taxpayers, and the [Internal Revenue] Service considerable consternation” since its inception); Margarita R. Karpov, Note, *To Tax or Not To Tax — That is the Question in the Midst of Murphy v. I.R.S.*, 23 AKRON TAX J. 143, 143–44 (2008) (“This code section has seen differences of opinion, amendments, and commentator mistrust on numerous occasions”); Robert J. Henry, “Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries,” 23 HOUS. L. REV. 701, 702 n.7 (1986) (stating that section 213(b)(6) of the Revenue Act of 1918 was the predecessor to the modern iteration of section 104(a)(2)).

<sup>6</sup> See Douglas K. Chapman, *No Pain — No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407, 409 (1986–1987) (discussing the intent of Congress in relation to section 104(a)(2)).

<sup>7</sup> *United States v. Burke*, 504 U.S. 229, 236 n.6 (1992).

<sup>8</sup> I.R.C. § 104(a)(2) (West 2009).

<sup>9</sup> See Doti, *supra* note 5, at 61–62 (referring to the phrase “on account of personal physical injuries or physical sickness” and stating that “there still are many uncertainties over the meaning of these terms”).

<sup>10</sup> Benjamin T. Cory, Note, *Amos v. Commissioner: The Ambiguous and Ever-Changing Definition of What Constitutes a Personal Physical Injury Under Internal Revenue Code Section 104(A)(2)*, 66 MONT. L. REV. 247, 248–49 (Winter 2005).

<sup>11</sup> See Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical but Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51, 88–89 (1997).

<sup>12</sup> See *id.*

<sup>13</sup> Nicholas M. Whittington, Note, *Against the Grain: An Interdisciplinary Examination of the 1996 Federal Statutory Changes to the Taxability of Personal Injury Awards*, 37 WASHBURN L.J. 153, 185 (Fall 1997) (concluding that the “physical” requirement leads to arbitrary application of the tax law).

tort while the other physical injury occurred at a later point in time as a consequence of the emotional distress that was immediately caused by the tort.<sup>14</sup> This comment posits that section 104(a)(2) treats similarly situated taxpayers inequitably and leads to an application of the tax code that lacks uniformity. Specifically, this comment argues that those who suffer real, verifiable physical manifestations of emotional distress injuries should receive the same favorable tax treatment received by those who suffer purely physical injuries.

This comment acknowledges and accepts the fact that Congress specifically refused to extend the benefits of section 104(a)(2) to those who suffer purely emotional distress injuries.<sup>15</sup> However, there are legitimate cases where taxpayers suffer verifiable physical manifestations of emotional distress and those individuals should be afforded the same tax treatment as those who suffer purely physical injuries.<sup>16</sup> Part I outlines the background and evolution of section 104(a)(2). Part II presents the development of section 104(a)(2) by examining the important case decisions dealing with the interpretation and application of section 104(a)(2). Part III undertakes an exhaustive analysis of the inequity that results when section 104(a)(2) is applied to individuals who suffer physical manifestations of emotional distress. Part III also discusses the treatment of physical manifestations of emotional distress by medical science and the field of tort law. Part IV suggests a viable course of action that would eliminate this disparate treatment while upholding congressional intent. Finally, this comment concludes that the totality of the circumstances presented leads to the logical deduction that section 104(a)(2) treats similarly situated taxpayers in a disparate manner and that the best course of action is through the adoption of the recommendations made in Part IV.

#### I. BACKGROUND: TRACING THE DEVELOPMENT AND THE EVOLUTION OF SECTION 104(A)(2)

Section 61 of the Code states that, "Except as otherwise provided in this subtitle, gross income means all income from whatever source

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<sup>14</sup> *Id.* at 161:

If there is an original physical injury or physical sickness, then all damages, including emotional distress damages, that flow from that injury are treated as if they are on account of a physical personal injury or physical sickness. Recoveries for physical injuries caused by emotional distress, not linked to an original physical injury, are not excludable from income.

<sup>15</sup> J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 MONT. L. REV. 167, 177 (Winter 1997) (explaining that Congress specifically stated in I.R.C. § 104 that "emotional distress shall not be treated as a physical injury or physical sickness").

<sup>16</sup> See Kurt A. Leeper, Note, *Arguably Arbitrary: Taxation and the Physical Injury Requirement of I.R.C. Section 104(a)(2)*, 55 CASE W. RES. L. REV. 1039, 1061 (2005) ("[B]y requiring a showing of 'traditional' physical injury, [section 104(a)(2)] fails to protect taxpayers who have suffered a physical harm brought about by a nonphysical injury.").

derived . . . .”<sup>17</sup> While the word “all” implies an extraordinary level of inclusion, there are limited but significant exceptions to the rule.<sup>18</sup> Those exceptions, however, are often interpreted in a narrow manner such that the breadth of section 61 remains extremely broad.<sup>19</sup> Section 104(a)(2) represents an important exception to section 61 and addresses the exclusion of personal injury proceeds received subsequent to civil tort litigation or to a negotiated tort settlement agreement.<sup>20</sup> Section 104(a)(2) states 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.”<sup>21</sup>

Prior to 1996, section 104(a)(2) did not include the word “physical” in its language and referred only to an exclusion of income received on account of personal injuries or sickness.<sup>22</sup> However, in 1996 Congress amended section 104(a)(2) and added the word “physical” to the statutory language.<sup>23</sup> This amendment resulted from the original statute’s vague congressional intent to prevent the recipients of money damages awards from using section 104(a)(2) if the award resulted from a physical manifestation of an emotional distress injury.<sup>24</sup> This seemingly minor change to section 104(a)(2) led to increased levels of apprehension among legal professionals and academics who were already critical of the pre-amendment version for its ambiguous language.<sup>25</sup> In addition, the courts have struggled<sup>26</sup> and wavered<sup>27</sup> in their attempts to find a bright line of separation between what is obviously physical, what may be partly physical and partly emotional, and what may be purely emotional.<sup>28</sup> There are two

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17 I.R.C. § 61 (West 2009).

18 Karpov, *supra* note 5, at 146.

19 *See id.* at 146–47; *see also* Comm’r v. Schleier, 515 U.S. 323, 327 (1995) (stating that the Court has “repeatedly emphasized the sweeping scope” of I.R.C. § 61 (internal quotations omitted)).

20 *Schleier*, 515 U.S. at 328–29.

21 I.R.C. § 104(a)(2) (West 2009).

22 O’Gilvie v. United States, 519 U.S. 79, 85 (1996) (citing the Revenue Act of 1918, Ch. 18 § 213(b)(6), 40 Stat. 1066 as the predecessor to I.R.C. § 104(a)(2)).

23 Anthony C. Infanti, *Tax Equity*, 55 BUFF. L. REV. 1191, 1209 (2008).

24 Gregory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis of Murphy v. Internal Revenue Service*, 60 ARK. L. REV. 185, 200–01 (2007).

25 *See generally* Tamara Larre, *Pity the Taxpayer: The Tax Exemption for Personal Injury Damages as Disability Policy*, 33 QUEEN’S L.J. 217, 220–21 (2007). *See also* Cory, *supra* note 10, at 261 (“By inserting the word ‘physical’ into § 104(a)(2) Congress created an arbitrary and ambiguous standard.”).

26 Robert W. Wood, *Waiting to Exhale: Murphy Part Deux and Taxing Damage Awards*, SN059 A.L.I.-A.B.A. 717, 719–20 (Feb. 2008).

27 *Compare* *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (“*Murphy I*”) (holding that I.R.C. § 104(a)(2) violated the Sixteenth Amendment because it permitted the taxation of emotional damages awards which do not fall within the definition of “incomes” found in the text of the Sixteenth Amendment), *with* *Murphy v. I.R.S.*, 493 F.3d 170 (2007) (“*Murphy II*”) (reversing *Murphy I* based on the proposition that purely emotional damages and any physical injuries resulting thereafter are not within the definition of physical injuries as intended by Congress when it enacted the 1996 amendment to I.R.C. § 104(a)(2)). For an in-depth discussion of *Murphy I* and *II*, see *infra* Part III.E–F.

28 *See generally* Karpov, *supra* note 5.

lines of debate surrounding this issue. First, what are the exact parameters of the word physical.<sup>29</sup> Second, how does the nexus between physical and emotional injuries impact the excludability of income under section 104(a)(2).<sup>30</sup>

The 1996 amendment to section 104(a)(2) had a disparate impact on the applicability of the exclusion.<sup>31</sup> The amendment provided comfort for those who suffered obvious physical injuries but it also appeared to apply in a seemingly *inequitable* manner based primarily on the fact that those who suffer legitimate physical manifestations of emotional distress are forced to pay tax on every penny they receive in money damages.<sup>32</sup> This disparate treatment led many to make the argument that the first *Murphy* court was correct in its assessment that the 1996 amendment was not uniformly applied and thus constituted a violation of the Sixteenth Amendment of the United States Constitution.<sup>33</sup>

In addition, there was another aspect of the 1996 amendment to section 104(a)(2) that added even more fuel to the fire of the criticism surrounding the amended language: this involved the phrase “on account of” in section 104(a)(2).<sup>34</sup> Courts have interpreted this phrase to mean that *any* damages award that flows directly from an initial physical injury will be covered by section 104(a)(2) and thus will be deemed non-taxable to the recipient.<sup>35</sup> The Supreme Court interpreted this to mean that even purely emotional injuries that emanated from physical injuries were covered by

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<sup>29</sup> See Wood, *Waiting to Exhale*, *supra* note 26, at 723–24 (inquiring about “what is and is not physical”).

<sup>30</sup> Germain, *supra* note 24, at 202–03.

<sup>31</sup> Doti, *supra* note 5, at 62.

<sup>32</sup> See Infanti, *supra* note 23, at 1209:

In the service of bias, Congress has enacted a version of 104(a)(2) that will result in the dissimilar treatment of similarly situated persons, a violation of the widely accepted doctrine of horizontal equity in tax policy analysis. Injured individuals are not treated similarly. Those who are physically harmed may recover all damages awards tax-free. Those injured by employment bias [or other non-physical injuries] may recover nothing tax free.

See also Karpov, *supra* note 5, at 151; Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 708–10 (2007) (arguing that inequitable treatment under 104(a)(2) may lead people to fabricate physical injuries to avoid paying taxes. This could lead to enforceability and verifiability issues for the I.R.S. and, ultimately, to “higher taxes or reduced spending” by the federal government).

<sup>33</sup> See Wood, *Waiting to Exhale*, *supra* note 26, at 720, 724–25 (stating that “most people read Judge Ginsburg’s first *Murphy* opinion as a statement that the 1996 amendments to section 104 (imposing the “physical” requirements) were invalid.” Wood goes on to describe how the *Murphy* II court did an “about-face” to avoid the constitutional question when it reversed its previous *Murphy* I decision).

<sup>34</sup> See Germain, *supra* note 24, at 197.

<sup>35</sup> O’Gilvie v. United States, 519 U.S. 79, 84 (1996) (stating that “pain and suffering damages, medical expenses, and lost wages . . . are covered by the statute and hence excluded from income not simply because the taxpayer received a tort settlement, but rather because each element . . . satisfies the requirement . . . that the damages were received *on account of* personal injuries or sickness” (quoting *Comm’r v. Schleier*, 515 U.S. 323, 330 (1995)) (internal quotations omitted) (emphasis added)).

the exclusion.<sup>36</sup> However, to the dismay of some critics of the 1996 amendment to section 104(a)(2), the exclusion did not apply in the converse situation.<sup>37</sup> That is to say, if someone suffered latent physical injuries that manifested themselves as a result of a purely emotional injury, then that person is not covered by the exclusion and is subject to taxation on any and all money damages received for either the emotional or the physical manifestations of those emotional injuries.<sup>38</sup>

In addition to the criticism of the way section 104(a)(2) treated people who suffered purely emotional injuries or physical manifestations of purely emotional injuries there is another central concern regarding the applicability of the language added in the 1996 Amendments. This concern has to do with the definition of the word “physical” and the extent to which any non-visible physical injuries would be covered by the exclusion.<sup>39</sup> The Internal Revenue Service (“I.R.S.”) has not specifically addressed the issue. However, the I.R.S. has made one notable statement regarding the definition of “physical.”<sup>40</sup> In October 2007, the I.R.S. issued a Private Letter Ruling in which it stated that a physical injury had to involve touching that causes a bruise, cut, swelling or bleeding in order to qualify for exclusion under section 104(a)(2).<sup>41</sup> This language projects the self-interested nature of the I.R.S.’s position on the matter, a position that naturally lends itself to interpreting the breadth of section 104(a)(2) as narrowly as possible.<sup>42</sup>

However, the congressional intent behind the 1996 amendment to section 104(a)(2) tends to show that the legislators who penned the amendment may have envisioned a broader scope for the word “physical.”<sup>43</sup> The problem with defining the word “physical” as narrowly as the I.R.S. has in its Private Letter Ruling is that purely internal injuries

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<sup>36</sup> *Schleier*, 515 U.S. at 329.

<sup>37</sup> See Germain, *supra* note 24, at 200–06.

<sup>38</sup> See Robert W. Wood, *Tax Treatment of Settlements and Judgments*, SN059 A.L.I.-A.B.A. 665, 669–70 (Feb. 2008) (asking the question “[w]hat if the defendant’s conduct did not involve physical touching, but did produce physical injury, particularly physical injury caused by intentional infliction of emotional distress?” and cautioning that the I.R.S.’s emphasis on physical touching places an “undue emphasis on the original harm” without taking into account the real possibility that purely emotional distress can lead to what may be classified as verifiable physical manifestation). See also Germain, *supra* note 24, at 204 (arguing that the “clear purpose of the new physical injury or physical sickness requirement was to make all amounts received for emotional distress damages, including amounts received on account of physical manifestations arising out of that emotional distress, includible in income”).

<sup>39</sup> See Doti, *supra* note 5, at 75.

<sup>40</sup> See Karpov, *supra* note 5, at 172 (stating that “[e]ven ten years after the 1996 amendment changes, many questions remain in the interpretation of ‘physical’ in § 104(a)(2)” and arguing that section 104(a)(2) “has not been applied consistently” by the courts or the I.R.S.).

<sup>41</sup> I.R.S. Priv. Ltr. Rul. 200041022 (July 17, 2000).

<sup>42</sup> See Wood, *Tax Treatment of Settlements*, *supra* note 38, at 672 (criticizing I.R.S. Private Letter Ruling 200041022 by stating that “[a] distinction between a case in which the plaintiff is touched and then injured as a result, compared with the plaintiff who is *not* touched but injured in the same way, seems artificial”).

<sup>43</sup> See Doti, *supra* note 5, at 73–74.

and pain are apparently not physical enough to qualify.<sup>44</sup> Critics of the narrow I.R.S. interpretation have posited that the approach is too simplistic in that it relies on obvious, visible signs of injury and disregards the very real possibility that personal injury litigants could suffer from physical injuries that do not necessarily manifest themselves in such visible ways.<sup>45</sup>

So, who suffers as a result of the addition of the word “physical” in the 1996 amendment to section 104(a)(2)? Primarily those who are victims of purely emotional distress injuries and those who are victims of emotional distress injuries that lead to a manifestation of subsequent physical injuries.<sup>46</sup> Examples include victims of sexual harassment, wrongful termination, employment discrimination, unlawful arrest, wrongful incarceration, and sexual molestation, just to name a few.<sup>47</sup> These emotional distress victims often have a serious medically and psychologically documented impact on their physical and mental well-being.<sup>48</sup>

Unfortunately, the applicability of section 104(a)(2) forces these emotional distress victims to pay taxes on any amount of damages they recover while someone who suffers a minor injury that bruises for a couple of days and then goes away is treated with proverbial “kid gloves” and escapes all or most of the tax liability associated with that injury.<sup>49</sup> While the background of section 104(a)(2) highlights its ambiguities and shortcomings, the next section considers various cases that illustrate how the courts have struggled to define workable parameters for the application of section 104(a)(2).

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<sup>44</sup> See Wood, *Tax Treatment of Settlements*, *supra* note 38, at 671. Wood states that he is not sure the I.R.S. got it right in Letter Ruling 200041022 when they tried to:

draw a line between the various incidents of sexual harassment and touching that left no ‘observable bodily harm,’ and the various assaults (that they term beginning with the ‘First Pain Incident’). Although the [ruling] seems cogent enough, the truth is that very often it is difficult to separate exactly what causes trauma (and what [type] of trauma) and what does not.

<sup>45</sup> See *id.* See also Marianna G. Dyson, *Hot Topics in Fringe Benefits*, SG003 A.L.I.-A.B.A. 1, 9 (2001) (arguing that the narrow interpretation made by the Internal Revenue Service in Private Letter Ruling 200041022 is unworkable as a practical matter because “there can be [an] adverse impact on the physical being of an individual, whether or not physical symptoms are manifested”).

<sup>46</sup> See Infanti, *supra* note 23, at 1209 (“[T]he physical/non-physical dichotomy adopted in amended section 104(a)(2) guarantees disparate and disadvantageous treatment of recoveries for the physical and emotional harms to workers in job bias cases.”).

<sup>47</sup> See Stephen Cohen, *Why Civil Rights Lawyers Should Study Tax*, 22 HARV. BLACKLETTER L.J. 1, 2 (2006) (“It seems arbitrary and unfair, for example, that damages for sexual harassment are taxed if damages for a broken leg are tax-exempt.”).

<sup>48</sup> See *infra* Part III.B.

<sup>49</sup> See Cory, *supra* note 10, at 258 (discussing the fact that the petitioner in *Amos v. Commissioner* suffered what was labeled a minor injury at best and that “[d]espite the fact that Mr. Amos had no observable injury . . . the Tax Court concluded that Mr. Amos had suffered a physical injury”).



## II. CASE HISTORY: KEY DECISIONS ILLUSTRATE THE JUDICIARY'S ATTEMPTS TO SET THE BOUNDARIES OF I.R.C. § 104(a)(2)

There are only three Supreme Court decisions dealing directly with section 104(a)(2).<sup>50</sup> However, there are also numerous federal and tax court cases dealing with the interpretation of section 104(a)(2).<sup>51</sup> Most of these decisions, with the exception of one important outlier,<sup>52</sup> demonstrate the growing trend that the courts should defer to Congress and the I.R.S. in matters requiring statutory interpretation of the Code and federal tax legislation.<sup>53</sup>

### A. *United States v. Burke*

One of the first Supreme Court cases dealing with section 104(a)(2) was *United States v. Burke* decided in 1992.<sup>54</sup> In *Burke*, the Court looked at the taxability of a money damages award received for violation of Title VII of the Civil Rights Act of 1964.<sup>55</sup> The taxpayer believed that the back pay portion of the settlement—received for a sex discrimination claim under Title VII of the Civil Rights Act of 1964—was not taxable because it was received on account of a personal injury.<sup>56</sup> The Court, however, held that the award was not excludable under section 104(a)(2) because there was no tort-like personal injury redressed by the suit.<sup>57</sup>

The Court came to this conclusion based on the reasoning that the employees were awarded damages in the form of back pay which did not fall within the rubric of tort-like personal injury envisioned by the original drafters of section 104(a)(2).<sup>58</sup> More importantly, the *Burke* Court

<sup>50</sup> See *infra* Part II.A–C. Other than the primary cases discussed in this comment, there are a handful of other Supreme Court cases that dealt tangentially with I.R.C. § 104(a)(2).

<sup>51</sup> See *infra* Part II.D–F.

<sup>52</sup> See *infra* Part II.E. See also cases cited, *supra* note 27.

<sup>53</sup> See Myron C. Grauer, *Justice O'Connor's Approach to Tax Cases: Could She Have Led the Court Toward a More Collaborative Role for the Judiciary in the Development of Tax Law?*, 39 ARIZ. ST. L.J. 69, (Spring 2007) (discussing Justice O'Connor's influence over the Court's deferential approach to Congress in tax law matters). See also T. James Lee, Jr., *Section 104(a)(2) After Commissioner v. Schleier: Litigating the Excludability of Statutory Damages 'Received on Account of Personal Injuries'*, 1996 BYU L. REV. 531, 543 n.86 (1996) (examining Justice O'Connor's dissenting opinion in *Schleier* where "[s]he asserted that even though the interpretive rulings of the [Internal Revenue] Service do not rise to the authoritative level of regulations, the Court must give substantial deference to the Service's reasonable interpretations") (emphasis added).

<sup>54</sup> *United States v. Burke*, 504 U.S. 229 (1992). This case was decided before the 1996 amendments to section 104(a)(2), however, it remains an important decision because it established one of the first boundary lines between what is and what is not a personal injury.

<sup>55</sup> *Id.* at 230.

<sup>56</sup> *Id.* at 229.

<sup>57</sup> *Id.* at 241 ("[W]e cannot say that a statute such as Title VII, whose sole remedial focus is the award of back wages, redresses a tort-like personal injury within the meaning of § 104(a)(2).").

<sup>58</sup> *Id.* at 234 (citing 26 C.F.R. § 1.104-1(c) (1991) and stating that:

Neither the text nor the legislative history of § 104(a)(2) offers any explanation of the term personal injuries. Since 1960, however, IRS regulations formally have linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles: The term 'damages received (whether by suit or agreement)' means an amount received . . . through

interpreted section 104(a)(2) as applying to both physical and non-physical injuries.<sup>59</sup> The Court based this reasoning on the fact that Congress amended section 104(a)(2) in 1989 to specifically preclude punitive damages from the exclusion, thus implying that both physical and non-physical injuries should be covered by the exclusion.<sup>60</sup> The *Burke* decision set the foundation for the requirement of tort or tort-like damages in a section 104(a)(2) analysis.<sup>61</sup>

#### B. Commissioner v. Schleier

The Court followed *Burke* with the ground-breaking 1995 decision in *Commissioner v. Schleier*.<sup>62</sup> This decision involved money damages awarded for back wages and liquidated damages in an age discrimination suit filed under the Age Discrimination in Employment Act of 1967 (“ADEA”).<sup>63</sup> In *Schleier*, the taxpayer—with the *Burke* decision likely in mind—included the amount received for back wages in his federal income tax return.<sup>64</sup> However, the taxpayer excluded the portion received for liquidated damages because he claimed that the liquidated damages were received on account of personal injuries under section 104(a)(2).<sup>65</sup> Using logic similar to that in *Burke*, the Court declared: “Our consideration of the plain language of [I.R.C. §] 104(a), the text of the regulation implementing [I.R.C. §] 104(a)(2), and our reasoning in *Burke* convince us that a recovery under the ADEA is not excludable from gross income.”<sup>66</sup>

The *Schleier* Court reasoned “that Congress intended the ADEA’s liquidated damages to be punitive in nature; thus, they serve no compensatory function and cannot be described as being ‘on account of personal injuries.’”<sup>67</sup> *Schleier* is significant because the Court annunciated a two-prong test for use in analyzing section 104(a)(2) exclusions.<sup>68</sup> The test requires that, in order to be excludable under section 104(a)(2), the money damages award (i) must be received through prosecution or

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prosecution of a *legal suit or action based upon tort or tort type rights*, or through a settlement agreement entered into in lieu of such prosecution. (emphasis added) (some internal quotations omitted)).

<sup>59</sup> *Id.* at 235–36 n.6.

<sup>60</sup> *Id.* (“The enactment of this limited amendment addressing only punitive damages shows that Congress assumed that other damages (i.e., compensatory) would be excluded in cases of both physical and nonphysical injury.”).

<sup>61</sup> See Leeper, *supra* note 16, at 1052 (stating that *United States v. Burke* established the “tort-like” requirement).

<sup>62</sup> *Comm’r v. Schleier*, 515 U.S. 323 (1995). Like *Burke*, the *Schleier* decision also predated the 1996 amendments to section 104(a)(2) when Congress added the “physical” requirement to personal injuries. However, this case remains important and applicable because the two-prong test it established continues as the threshold test in applying section 104(a)(2).

<sup>63</sup> *Schleier*, 515 U.S. at 324–25.

<sup>64</sup> *Id.* at 327.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 323.

<sup>68</sup> See Harvey, *supra* note 5, at 341.

settlement of an action “based upon tort or tort type rights” and (ii) received “on account of personal injuries or sickness.”<sup>69</sup> However, in adopting the “on account of personal injuries” language, the Court added to the confusion surrounding section 104(a)(2) when it failed to provide any guidelines as to what constitutes a personal injury or sickness.<sup>70</sup>

C. *O’Gilvie v. United States*

Following the trend it established in *Burke* and *Schleier*, the Court placed another boundary line on the section 104(a)(2) exclusion in the 1996 *O’Gilvie* decision.<sup>71</sup> This case dealt with punitive damages received in a wrongful death cause of action based on products liability tort law.<sup>72</sup> The taxpayer claimed that the punitive damages were excludable under section 104(a)(2) because the damages award was received on account of a personal injury, specifically death.<sup>73</sup> The Court disagreed and held that the “punitive damages received here were not received ‘on account of’ personal injuries; hence the provision does not apply, and the damages are taxable.”<sup>74</sup>

The *O’Gilvie* Court’s reasoning mirrored that in *Burke* and *Schleier* in that it relied heavily on congressional intent, and the I.R.S.’s interpretation of section 104(a)(2), in making its decision.<sup>75</sup> The *O’Gilvie* Court first conceded that the damages received were indeed based on tort or tort-type injuries, thus satisfying the first prong of the *Schleier* test.<sup>76</sup> However, the Court agreed with the Government’s position that “such [punitive] damages were not ‘received . . . on account of’ the personal injuries, but rather were awarded ‘on account of’ a defendant’s reprehensible conduct and the jury’s need to punish and to deter it.”<sup>77</sup> The Court, in deciding *Burke*, *Schleier*, and *O’Gilvie*, limited the reach of section 104(a)(2) but failed to provide a clear directive as to what is or is not a personal injury.<sup>78</sup> As a result, the

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<sup>69</sup> *Schleier*, 515 U.S. at 337.

<sup>70</sup> See Harvey, *supra* note 5, at 341–42 (arguing that the Court erred when it failed to clearly define the term “on account of personal injuries or sickness,” and when it avoided “the ambiguity of the statute, which since its inception has caused the courts, taxpayers, and the [Internal Revenue] Service considerable consternation”) (emphasis added).

<sup>71</sup> *O’Gilvie v. United States*, 519 U.S. 79 (1996).

<sup>72</sup> *Id.* at 79.

<sup>73</sup> *Id.* at 81.

<sup>74</sup> *Id.*

<sup>75</sup> See *id.* at 86–90. See also F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725, 742 (1997) (discussing congressional intent—as well as the *O’Gilvie* Court’s view of punitive damages vis-à-vis section 104(a)(2)—and concluding that there is “no evidence that congressional generosity or concern for administrative convenience provide a reason for exempting these noncompensatory [i.e. punitive] damages”) (internal quotations omitted).

<sup>76</sup> *O’Gilvie*, 519 U.S. at 82.

<sup>77</sup> *Id.* at 83.

<sup>78</sup> See Hobbs, *supra* note 11, at 53–54. See also Lee, *supra* note 53, at 551 (“Though the Court provided an appropriate grounding in the plain language of the Code, it failed to provide additional guidance as to the scope of the term ‘personal injuries’ for purposes of s[ection] 104(a)(2).”); Donald J. Zahn, *Personal Injury Exclusion: Is the Slashing of Wrists Necessary?*, 13 AKRON TAX J. 129, 148–49

perception that emanated from cases dealing with section 104(a)(2) is that a tort-based money damages award—received for personal physical *and* non-physical injuries—is excludable as long as the damages award was compensatory in nature, that is, not for liquidated or punitive damages.<sup>79</sup>

D. *Amos v. Commissioner*

After Congress amended section 104(a)(2) in 1996 and added the “physical” requirement, the courts continued to struggle in setting the boundary lines between what is and what is not a personal injury.<sup>80</sup> In the 2003 *Amos* decision, the United States Tax Court addressed the severity required in order for an injury to qualify as “physical” within the meaning intended by Congress when it amended section 104(a)(2).<sup>81</sup> In *Amos*, the taxpayer claimed that the entire award of damages received for an intentional kick to the groin was for physical injuries.<sup>82</sup> The I.R.S. argued that none of the award should be excludable because the taxpayer’s physical injuries were minimal and because the authenticity of the injury was questionable.<sup>83</sup> The *Amos* court held that the taxpayer did suffer a physical injury as is required by section 104(a)(2).<sup>84</sup>

The *Amos* court reasoned that “it is the nature and character of the claim settled, and *not its validity*, that determines whether the settlement payment is excludable from gross income under section 104(a)(2).”<sup>85</sup> The court also found that the defendant’s “dominant reason in paying the settlement amount at issue was petitioner’s claimed physical injuries as a result of the incident.”<sup>86</sup> In coming to its conclusion the court pointed to congressional intent behind the 1996 amendment where House members indicated that purely emotional distress injuries do not fall within the ambit of the amended section 104(a)(2) exclusion.<sup>87</sup> While the *Amos* court

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(1997) (discussing the *Schleier* decision and stating that “[t]he Court, in effect, broke from traditional notions of personal injuries and many years of precedent. The Court indicated that even though tort litigation allows for liquidated damages, personal injuries of a legal character are not sufficient to bring the claim within the regulation.” Zahn goes on to discuss the negative impact of the three major Supreme Court decisions on section 104(a)(2)—*Burke*, *Schleier* and *O’Gilvie*—and concludes that “[a]s [federal trial and tax] courts diverted their focus from legal precedent to flights of fancy, the state of the personal injury award exclusion deteriorated”) (emphasis added).

<sup>79</sup> See Cory, *supra* note 10, at 251 (“Relying on a broad definition of ‘personal injury,’ many rulings and court decisions during the 1970’s and 1980’s allowed exclusion for damages arising from both physical and non-physical personal injuries.”).

<sup>80</sup> See *Burke & Friel*, *supra* note 15, at 168 (“[T]he remedy chosen to limit an overbroad statute, the drawing of a line between physical and nonphysical injuries, has introduced its own difficulties and is not supportable from a tax policy standpoint.”). See also Doti, *supra* note 5, at 62 (“Most of the confusion and controversy surrounding the personal injury exclusion would have been avoided if Congress had carefully considered the scope of the exclusion from its inception.”).

<sup>81</sup> *Amos v. Comm’r*, T.C. Memo 2003-329 (2003).

<sup>82</sup> *Id.* at 1, 5.

<sup>83</sup> *Id.* at 5.

<sup>84</sup> *Id.* at 6.

<sup>85</sup> *Id.* at 6 (emphasis added).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 4.

indicated that there had to be some physical injury, it failed to address lingering questions about the veracity of the underlying claim and the severity of the injury.<sup>88</sup> The court's decision left open the question of whether the physical injury, no matter how slight, had to take place as an immediate consequence of the tort or whether the physical injury could result from a manifestation of an emotional distress injury.<sup>89</sup>

E. *Murphy v. Internal Revenue Service* (2006) (*Murphy I*)

*Murphy I* is a case that sent shock waves throughout the tax world.<sup>90</sup> In *Murphy I*, the Circuit Court of Appeals for the District of Columbia addressed the applicability of the amended section 104(a)(2)—and the “physical” injury requirement—to purely emotional distress tort damages awards.<sup>91</sup> The *Murphy* taxpayer suffered emotional distress after she was “blacklisted” by her employer for filing a complaint against the employer with state authorities.<sup>92</sup> The taxpayer subsequently filed a tort claim and received compensatory damages for emotional distress and injury to professional reputation.<sup>93</sup> The taxpayer then claimed that this money damages award was not taxable because it was received on account of physical injury because she had suffered some physical manifestations of her emotional injury, including “teeth grinding . . . which may cause permanent tooth damage[,] . . . shortness of breath, and dizziness.”<sup>94</sup> The taxpayer also claimed that section 104(a)(2) was unconstitutional because it failed to exclude revenue that is not income under the Sixteenth Amendment.<sup>95</sup>

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<sup>88</sup> See Cory, *supra* note 10, at 257–58 (arguing that the *Amos* court interpreted section 104(a)(2)'s physical injury requirement in a broader manner than that put forth by the IRS and concluding that “[i]n accordance with *Amos*, it can be argued that the minimum requirements of §104(a)(2) are that an individual must experience (1) a physical touching, and (2) that as a result of the touching the individual experiences pain”).

<sup>89</sup> See Doti, *supra* note 5, at 75 (“It is not clear, however, whether more serious physical manifestations of emotional distress, such as a nervous breakdown or heart attack, will constitute physical injury.”). See also Sharon E. Stedman, Note, *Congress's Amendment to Section 104 of the Tax Code Will Not Clarify the Tax Treatment of Damages and Will Lead to Arbitrary Distinctions*, 21 SEATTLE U. L. REV. 387, 405 (1997) (arguing that “the tax treatment of damages should not depend on the arbitrary distinction of whether the taxpayer is fortunate (or unfortunate) enough to have sustained a physical injury”).

<sup>90</sup> *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (“*Murphy I*”). See Germain, *supra* note 24, at 186 (declaring that “[a] unanimous panel of the Circuit Court of Appeals for the District of Columbia recently dropped a bombshell on federal income tax jurisprudence by holding in *Murphy v. I.R.S.* [(*Murphy I*)] that Congress violated the United States Constitution”) (emphasis added); Karpov, *supra* note 5, at 144 (stating that the *Murphy I* court “rendered a monumental decision that could change the course of damages taxation”); Wood, *Waiting to Exhale*, *supra* note 26, at 719 (stating that “in the wake of the first iteration of *Murphy*, many observers had feared that once one domino in the unconstitutionality chain toppled, virtually no tax would be safe from constitutional attack” and that because of *Murphy I* “there was near hysteria in some sectors about undermining the scope of congressional taxing powers”) (emphasis added).

<sup>91</sup> *Murphy I*, 460 F.3d at 80–81.

<sup>92</sup> *Id.* at 81.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* at 84–85.

The court disagreed with the taxpayer on the first point and decided that—despite the fact that the taxpayer “suffered from certain physical manifestations of emotional distress”—the written record indicated that the award she received was for “mental pain and anguish” and, therefore, was not received on account of a physical injury or sickness.<sup>96</sup> However, the court also held that section 104(a)(2) was unconstitutional because Congress was barred by the Sixteenth Amendment from taxing tort compensation that was deemed not income.<sup>97</sup> The court argued that the damages awarded to the taxpayer “were awarded to make Murphy emotionally and reputationally ‘whole’ and not to compensate her for lost wages or taxable earnings of any kind.”<sup>98</sup> This decision is important for two reasons. First, the court acknowledged that the word “physical” is ambiguous and that the possibility exists that some physical manifestations of emotional distress may rise to the level of the “physical” injury requirement of section 104(a)(2).<sup>99</sup> Second, the court concluded that section 104(a)(2)’s disparate treatment of similarly situated taxpayers is a violation of the Constitution because it excluded revenue that is deemed not income—such as that received for a physical injury—while it taxed other revenue that is similarly not income—such as that received for a physical manifestation of a non-physical injury.<sup>100</sup> The serious constitutional implications of *Murphy I* meant that its staying power was doubtful as is evidenced by the next episode in the *Murphy* saga.

F. *Murphy v. Internal Revenue Service (2007) (Murphy II)*

Less than one year after the *Murphy I* decision, the same Circuit Court of Appeals for the District of Columbia reversed itself in the *Murphy II* decision.<sup>101</sup> Looking at the same facts and essentially the same arguments as in *Murphy I*, the court came to a remarkably different conclusion.<sup>102</sup> Similar to its previous decision, the court first reasoned that the taxpayer’s

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<sup>96</sup> *Id.* at 84.

<sup>97</sup> *Id.* at 88.

<sup>98</sup> *Id.*

<sup>99</sup> *See id.* at 84; Wood, *Waiting to Exhale*, *supra* note 26, at 721 (“At least *Murphy I* noted that the question [of what is a “physical” injury] was confusing and that the IRS has done little to remedy that posture.”). *See also* Karpov, *supra* note 5, at 149 (suggesting that the *Murphy I* court simply followed the Internal Revenue Service’s early interpretations of the predecessor to section 104(a)(2) where the Service determined that “compensation for a nonphysical tort . . . constituted a replacement, and not a gain, of human capital, and thus was not within the definition of income”).

<sup>100</sup> *Murphy I*, 460 F.3d at 89:

That emotional distress and loss of reputation were both actionable in tort when the Sixteenth Amendment was adopted supports the view that compensation for these nonphysical injuries was not regarded differently than was compensation for physical injuries and, therefore, was not considered income by the framers of the Amendment and the state legislatures that ratified it.

<sup>101</sup> *Murphy v. I.R.S.*, 493 F.3d 170 (2007) (“*Murphy II*”). The court—acting on its own and without any prompting from either of the parties—vacated the *Murphy I* decision and ordered a rehearing where it ultimately overturned the *Murphy I* decision.

<sup>102</sup> *Id.* at 171.

recovery was intended as recompense for emotional distress suffered and not for physical injury or physical manifestations of emotional distress.<sup>103</sup> Next, the court concluded that the imposition of tax on a tort damages award for non-physical personal injury did indeed fall within Congress' tax powers as prescribed by the Constitution and by the Supreme Court's interpretation of what constitutes income.<sup>104</sup> The court reached this conclusion by applying the sweeping definition of income conveyed by the Supreme Court in *Glenshaw Glass*.<sup>105</sup>

The *Murphy II* court's sudden reversal led some scholars to speculate that the court was under considerable external pressure to reconsider its earlier position.<sup>106</sup> This speculation is bolstered by the reasoning and ease with which the *Murphy II* court dismissed the Sixteenth Amendment argument it applied in *Murphy I*.<sup>107</sup> It is important to note that the issue of what is a "physical" injury—and whether physical manifestations of emotional distress fall within the rubric of section 104(a)(2)—was not fully addressed in either opinion, leaving little judicial guidance on the meaning of "physical."<sup>108</sup> However, the court implied, in both cases, that the definition of "physical" and the applicability of the "on account of" phrasing of section 104(a)(2) remained questionable.<sup>109</sup> This section has highlighted the difficulty the courts have experienced in applying section 104(a)(2). The next section analyzes some of the underlying principles, as well as the tort law, medical science, ethical, and prudential reasons that make section 104(a)(2) an inequitable tax provision.

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<sup>103</sup> *Id.* at 176.

<sup>104</sup> *Id.* at 179 ("[A]lthough the Congress cannot make a thing income which is not so in fact, . . . it can label a thing income and tax it, so long as it acts within its constitutional authority.").

<sup>105</sup> *Id.* (stating that I.R.C. § 61(a) defines gross income as "all income from whatever source derived" and citing *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955), where the Supreme Court defined income to include all instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. This supported the Court's conclusion that Murphy's tort recovery is included in both the statutory and the interpretational definitions of income).

<sup>106</sup> See Germain, *supra* note 24, at 187–88 n.8; Karpov, *supra* note 5, at 182; Wood, *Waiting to Exhale*, *supra* note 26, at 724.

<sup>107</sup> See Wood, *Waiting to Exhale*, *supra* note 26, at 724–25:

The about-face, the court says, is attributable to a new and novel argument the IRS raised for the first time in its petition for rehearing en banc (of course, the court denied that motion). This new and novel argument, says the court, is that while Murphy's recovery may not be income within the meaning of the 16th Amendment, Congress can still tax it without violating the Constitution.

<sup>108</sup> See *id.* at 721 (stating that "[t]he first Murphy opinion did not answer the question of just what constitutes physical injuries" and that "the court doesn't offer any comments about this issue in the second go-round [in *Murphy II*]").

<sup>109</sup> Karpov, *supra* note 5, at 184 ("The *Murphy II* decision has not given an acceptable answer to the taxability of nonphysical personal injury awards because the court's reasoning was noticeably result-driven and weaved in and out of arguments with a motive to end with a taxable result.").

III. ANALYSIS: HOW THE “ON ACCOUNT OF” REQUIREMENT OF I.R.C.  
§ 104(a)(2) LEADS TO THE DISPARATE TREATMENT OF SIMILARLY  
SITUATED TAXPAYERS

The problem at the heart of the current iteration of section 104(a)(2) is in the seemingly arbitrary, one-way direction in which the exclusion applies.<sup>110</sup> The three words “on account of” are interpreted to mean that *any* consequence stemming from an initial physical injury may be excludable regardless of how indirect the connection.<sup>111</sup> For example, a young girl is injured in an accident at a negligently supervised swimming pool and is partially paralyzed as a result. The child rightfully recovers for her injuries based on a tort claim against the owner of the pool.<sup>112</sup> Clearly, any damages—except for punitives—recovered by the young girl are fully excludable.<sup>113</sup> However, the child’s parents also suffer purely emotional distress both from witnessing the accident and from dealing with the subsequent condition of their daughter. If the parents sue and recover damages for their purely emotional injuries, then, according to the *Schleier* decision, the parents are also allowed to exclude the recovered damages under section 104(a)(2).<sup>114</sup> It is important to note that the parents’ money damages recovery is *not based on any physical injury or sickness* to either of the parents themselves. Rather, this seemingly counterintuitive result is based solely on the notion that section 104(a)(2) applies in a forward-looking manner. Any injury or harm that results after the initial physical injury—including a subsequent purely emotional distress injury to a different person, such as a parent—may be excludable because that subsequent injury was suffered “on account of” the initial personal physical injury to the child.<sup>115</sup>

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<sup>110</sup> See *id.* at 149–52 (explaining that prior to the addition of the “physical” injury requirement, section 104(a)(2) applied to people who suffered physical manifestations of emotional distress). See also Stedman, *supra* note 89, at 387–89 (stating that Congress slightly over-reacted when it added the “physical” requirement in the 1996 amendment and that this over-reaction was likely due to the fact that Congress wanted to clarify the terms of the exclusion. Congress also acted out of fear that the tax code might be abused by people who filed and recovered tort damages based on fraudulent emotional distress claims. Stedman argues that the addition of the “physical” requirement swung the pendulum too far in the other direction thus leading to the disparate treatment of people who recover tort damages for legitimate, verifiable physical manifestations of emotional distress by denying them the benefits of the exclusion. Stedman concludes that “[t]he ambiguous term ‘personal injury’ has been replaced by ‘personal physical injury,’ a term that is equally ambiguous”).

<sup>111</sup> See Wood, *Waiting to Exhale*, *supra* note 26, at 722 (explaining that “[a] payment can be ‘on account of’ physical injuries or sickness even if the plaintiff is not injured but recovers on behalf of an injured party” and stating that “[e]xamples include recoveries for loss of consortium (based on physical injury to a spouse) and wrongful death”).

<sup>112</sup> The relevant tort claim would likely be based in negligence and/or products liability.

<sup>113</sup> See *supra* Part II.B. The young girl’s recovery would qualify for the section 104(a)(2) exclusion because—under the *Schleier* test—her claim is a tort or tort-like claim and she suffered a significant physical injury. In addition, the 1989 amendment to section 104(a)(2) prohibited punitive damages from excludability.

<sup>114</sup> Wood, *Waiting to Exhale*, *supra* note 26, at 722–23.

<sup>115</sup> *Id.*



The converse situation is where the real problem arises.<sup>116</sup> If a person suffers a purely emotional injury that later causes or leads to the manifestation of a *verifiable* physical injury, then any recovery that person receives, whether for the emotional or the physical injury, is *not* excludable under section 104(a)(2) and, thus, is fully taxable.<sup>117</sup> For example, an employee is fired for acting as a whistle-blower and revealing fraudulent business practices to a regulatory agency. As a result of the increased stress caused by the firing, the employee cannot find another job and subsequently files suit for wrongful termination. The employee continues to suffer emotional problems and is soon diagnosed with Post Traumatic Stress Disorder (“PTSD”) and severe depression. Within six months of being fired, the employee begins to suffer serious physical manifestations of emotional distress. These physical manifestations include serious weight loss, hypertension, and stomach ulcers. The employee eventually wins the wrongful termination lawsuit and recovers money damages for the emotional and physical injuries, as well as for lost wages and punitive damages. However, because the *initial* injury was purely emotional the wrongfully terminated employee will have to pay tax on the *total* recovery.<sup>118</sup>

When Congress enacted the 1996 amendments to section 104(a)(2) and added the word “physical,” its primary intention was to eliminate the exclusion for purely emotional injuries and to narrow the exclusion to those who suffered real, verifiable physical injuries.<sup>119</sup> This change in direction was based largely on Congress’ distrust of tort claimants who could “easily” falsify or exaggerate an emotional injury in order to recover money damages.<sup>120</sup> However, Congress left the issue of the origin of the physical injury in question.<sup>121</sup> If the intent of Congress was to provide tax relief for people who suffered physical injuries, then the way the physical injury came about should be, in theory, secondary to the fact that there is

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<sup>116</sup> See Hubbard, *supra* note 75, at 745 (questioning the motive and propriety of Congress’s actions in limiting the applicability of section 104(a)(2) to those situations where the tort recovery is on account of a physical injury while physical manifestations of emotional distress are not excludable).

<sup>117</sup> See Whittington, *supra* note 13, at 176 (“The tax code also does not allow a taxpayer to exclude amounts received for physical injuries that flow from an emotional injury.”).

<sup>118</sup> See generally Wood, *Tax Treatment of Settlements*, *supra* note 38.

<sup>119</sup> Doti, *supra* note 5, at 72–74 (discussing Congress’ intent to narrow the scope of section 104(a)(2) as the major driving force behind the 1996 amendments).

<sup>120</sup> See Leeper, *supra* note 16, at 1057 (arguing that, in enacting the 1996 amendments to section 104(a)(2), “Congress [may have] feared a flood of frivolous claims (i.e., suits alleging that a large portion of damages came from emotional distress and other difficult-to-prove, nonphysical injuries) were it to allow the exclusion to encompass all types of harms”). See also Hobbs, *supra* note 11, at 88 (“A variety of reasons were given [as the intent behind the 1996 amendments to section 104(a)(2)], including concerns over proof and valuation, the fear of fraudulent claims, and a flood of litigation.”).

<sup>121</sup> See Cory, *supra* note 10, at 248 (stating that “[d]ue to the vague nature of §104(a)(2), the courts have had difficulty limiting the scope of, as well as defining, ‘personal injuries’ under §104(a)(2)” and that “deciphering what constitutes a ‘personal physical injury’ has remained largely ambiguous”).

indeed a physical injury.<sup>122</sup> The intent of Congress would be satisfied as long as there is a provable causal link between the initial incident and the subsequent physical injury thus making the recovery excludable under section 104(a)(2).<sup>123</sup>

The United States Tax Court addressed the issue of verifiability and the possibility of fraud in the *Amos* case.<sup>124</sup> The *Amos* court made a rather revealing statement when it declared: “[w]hether the settlement payment is excludable from gross income under section 104(a)(2) depends on the nature and character of the claim asserted, *and not upon the validity of that claim.*”<sup>125</sup> So, a physically injured individual whose claim may or may not be valid is fully entitled to reap the benefits of the section 104(a)(2) exclusion.<sup>126</sup> However, an individual who has suffered a legitimate, verifiable physical manifestation of an emotional distress injury is not entitled to any favorable tax treatment regardless of the validity of that person’s claim.<sup>127</sup> The absurdity of these highly disparate outcomes is self-evident.<sup>128</sup> If the issue of verifiability was Congress’ main reason for adding the “physical” injury requirement, then the fact that *invalid* claims can and do exist in both purely physical and purely emotional injury claims shows that this was not likely the predominant reason why Congress added the “physical” requirement.<sup>129</sup>

If two equally legitimate tort claims arise, one stemming from an initial physical injury, the other emotional at first and physical later, then both claimants should be entitled to the same treatment under the tax law. If the intent of Congress was to provide tax relief for people who suffered physical injuries, then it should not matter how the physical injury came about. As long as there is a provable causal link between the initial tort for which money damages were obtained and the subsequent physical injury.<sup>130</sup>

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<sup>122</sup> Stedman, *supra* note 89, at 408–09 (discussing the absurdity of distinguishing between different types of physical injuries).

<sup>123</sup> See Leeper, *supra* note 16, at 1065 (arguing that a causal link between the tort and the injury was the primary method used before the 1996 amendment and concluding that “by requiring courts to distinguish between physical and nonphysical injury and examine sometimes unclear chains of causation, the ambiguity of the physical injury requirement of section 104(a)(2) creates the possibility of arbitrariness in application”).

<sup>124</sup> *Amos*, T.C. Memo 2003-329 at 5–6. The petitioner in *Amos* suffered an internal injury to the groin, however, there were no visible signs of injury and the severity of the injury was highly questionable. For a detailed analysis of *Amos*, see *supra* Part II.D.

<sup>125</sup> *Id.* at 5 (emphasis added).

<sup>126</sup> *Id.*

<sup>127</sup> See Whittington, *supra* note 13, at 176–77.

<sup>128</sup> See e.g. Stedman, *supra* note 89, at 405 (stating that “[a] victim of . . . sexual harassment has suffered no less of an injury than a taxpayer who broke a leg in a car accident” and concluding that “Congress should not treat a taxpayer who is a victim of sexual harassment differently from a taxpayer who is a victim of a car accident”).

<sup>129</sup> See Leeper, *supra* note 16, at 1071 (“Whatever the validity of such claims, requiring a showing of a physical injury for tax exclusion can only create the potential for disputes and differing treatment of taxpayers who have suffered similar harms.”).

<sup>130</sup> See generally Hobbs, *supra* note 11, at 55–56 (discussing the motives and the intent of Congress in adding the “physical” injury requirement and concluding that section 104(a)(2)’s disparate

However, section 104(a)(2) essentially discriminates between similarly situated taxpayers and leads to inequitable treatment in a system founded on principles of uniformity.<sup>131</sup> While several courts have faced the question of whether section 104(a)(2) should apply to tort damages awarded for a physical manifestation of an emotional distress injury, to date, in *all* of these decisions these courts have declined to extend the application of section 104(a)(2) to physical manifestations of emotional distress.<sup>132</sup> It is worth noting, however, that none of these cases dealt with a relatively serious form of physical manifestation caused by emotional distress. The unidirectional—and inherently inequitable—impact of section 104(a)(2) is best illustrated through the real-life examples presented in the next section.

A. Hypothetical Situations: Two Detailed Scenarios that Illustrate the Inequity of Section 104(a)(2)

Elena is a 42 year old single woman. She is a full-time employee at a leading biotech company where she is a clinical data manager. Elena's immediate supervisor, Richard, has repeatedly made unwelcome sexual advances toward her. Richard has frequently touched Elena despite her constant refusal to submit to his advances. Richard's non-consensual

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treatment of similarly situated taxpayers may only be resolved via a complete repeal of section 104(a)(2)).

<sup>131</sup> See *Infanti supra* note 23, at 1198–201 (discussing the notion that the Tax Code was founded on principles of equity which entail uniform treatment of similarly situated individuals who are subject to the provisions of the Code).

<sup>132</sup> See *Germain, supra* note 24, at 204–05 n.82 (supporting the claim that no court has yet to apply the section 104(a)(2) exclusion to physical manifestations of emotional distress by citing several decisions including:

*Lindsey v. Commissioner*, 422 F.3d 684, 688 (8th Cir. 2005) (holding business tort claim recoveries not excludable because taxpayer's "hypertension and stress-related symptoms, including periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence . . . relate to emotional distress, and not to physical sickness"); *Goode v. Commissioner*, 91 T.C.M. (CCH) 901 (2006) (rejecting "physical injury" characterization in settlement agreement, and holding that employee's claimed "repeated, vehement verbal assaults" which caused him physical pain and suffering did not constitute physical injury); *Ndirika v. Commissioner*, T.C.M. (RIA) 2004-250 (2004) (holding there was no credible evidence employment settlement to compensate for previous miscarriage or pregnancy-related pain and suffering); *Lindsey v. Commissioner*, 87 T.C.M. (CCH) 1295 (2004) (holding that hypertension leading to "fatigability, occasional indigestion, and difficulty sleeping—are the types of injuries or sicknesses that Congress intended to be encompassed within the definition of emotional distress"); *Shaltz v. Commissioner*, 85 T.C.M. (CCH) 1489 (2003) (holding that sexual harassment settlement is not excludable because no evidence of physical injury, only "depression, anxiety, stress, and recurrent past stressors" caused by "depression and trauma at work"); *Henderson v. Commissioner*, 85 T.C.M. (CCH) 1469 (2003) (holding that \$5,000 settlement of credit reporting claim not excludable despite "life-threatening, pre-existing physical illness" exacerbated by the harm to his personal reputation); *Prasil v. Commissioner*, 85 T.C.M. (CCH) 1124 (2003) (holding that allegations of severe physical manifestations from sex discrimination and harassment not sufficient to establish physical injury or physical sickness); *Witcher v. Commissioner*, 84 T.C.M. (CCH) 582 (2002) (holding that physical manifestations caused by defamation and business torts are not physical injury or physical sickness)).

touching, however, does not cause any physical injuries to Elena. Richard has also consistently threatened Elena that he will make her work life miserable if she does not submit to his sexual advances. Elena endures this harassment for over two years and she starts seeing a psychiatrist because she experiences elevated stress levels, mild anxiety, and depression. She files complaints with the management, as well as human resources, but nothing is done. Eventually, the stress causes Elena to start missing work. Finally, Elena's job performance deteriorates to the point where she is placed on probation and eventually fired. Elena's life is turned upside down as she struggles to make ends meet. Her anxiety worsens and her depression becomes so severe that she sometimes spends the entire day in bed without a will or an inclination to do anything productive. In addition, Elena eats very little, begins to lose weight, and has acute insomnia.

Ultimately, all these emotional injuries begin to take a serious toll on Elena's physical health. She loses forty pounds of weight—to the point where her doctors classify her as anorexic, she develops several stomach ulcers that lead to moderate digestive system pain, and she has recurring migraine headaches of moderate to extreme severity that vary in duration from a few minutes to several hours at a time. Elena continues to see her psychiatrist throughout this ordeal. Her relatives convince her to find an attorney and she eventually files a sexual harassment lawsuit against her former employer. Her case is strengthened by the fact that the discovery process exposes two other sexual harassment complaints against her previous supervisor. In addition, Elena's attorney finds out that her previous supervisor was fired subsequent to an internal investigation that revealed highly damaging evidence. Elena's lawyer and her previous employer eventually reach a settlement agreement whereby Elena is paid \$200,000 in damages. The settlement agreement states that the payment is for Elena's pain, suffering, and lost wages.

Under the current interpretation and application of section 104(a)(2), Elena will have to pay taxes on the entire amount of the settlement. This is due to the fact that her initial injuries were purely emotional and that her physical injuries manifested themselves as a result of the emotional distress and not as a result of the sexual harassment itself. Elena's injuries started out as depression and anxiety but these conditions eventually manifested themselves into serious physical conditions such as the pain from the ulcers, the migraine headaches, and the dangerous drop in body weight. Nonetheless, Elena is taxed *on the entire amount of her recovery* because her recovery was not based "on account of a physical injury or sickness." After paying attorney's fees (33 percent) and federal taxes (35 percent), Elena is left with approximately \$87,000—less than half of what she recovered.

Now, a look at the other end of the spectrum. Ron is a healthy young man who works as a delivery truck driver. He exercises on a regular basis at his local fitness center. During one of his exercise sessions Ron is

injured when a weightlifting machine malfunctions. His injuries are not severe but he is unable to drive as a result of pain in his arms and shoulders. Ron files a negligence tort claim against the owner of the fitness center. Ron seeks damages for pain, suffering and lost wages. The two sides eventually reach a settlement agreement through non-binding arbitration. The settlement is for \$200,000.

The tax treatment for Ron's recovery is straightforward. Under section 104(a)(2) Ron *does not have to pay any tax* on the amounts recovered by virtue of the fact that his recovery was on account of a physical injury. After attorney's fees (33 percent), Ron is left with \$134,000. Consequently, Ron's injuries healed fairly quickly and he returned to work three months after the accident. Elena, on the other hand, is faced with several years of medical and psychiatric treatment before she can return to the job market. In addition, the long term damage to Elena's physical and psychological well being will impact her quality of life into the foreseeable future.

The unfair tax treatment afforded to these two hypothetical people shows the lack of uniformity and the inequity that lies at the heart of section 104(a)(2). It is a given that both Ron and Elena suffered injuries for which they were entitled to tort damages recovery. However, the seriousness of the injuries suffered and the long term impact on the lives of these two people are clearly different. Elena keeps just over one-third of what she received while Ron keeps two-thirds. However, Elena is faced with a long and arduous uphill battle before she returns to any semblance of her life as she used to know it, while Ron returns to work and leads a normal life after a short period. There is no logical tax policy or humanitarian reason why Elena has to pay income taxes on her recovery while Ron pays no income taxes on his. In contrast to the way section 104(a)(2) treats physical manifestations of emotional distress, medical science has established a link between emotional and physical well-being.<sup>133</sup>

#### B. Medical Science: There is a Nexus Between Emotional Injuries and Physical Manifestations

Through the one-sided application of section 104(a)(2), the Code treats equally situated individuals differently by failing to recognize that legitimate physical injuries can result from emotional distress.<sup>134</sup>

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<sup>133</sup> See *infra* Part III.B.

<sup>134</sup> See Leeper, *supra* note 16, at 1067–68 (“Not only is the statute [section 104(a)(2)] itself arbitrary by drawing without logical support a distinction between sufferers of physical and nonphysical injury, but by doing so it also creates ambiguity and opens the door to interpretation and thus potentially arbitrary application by the judicial system.”); Timothy R. Palmer, *Internal Revenue Code Section 104(a)(2) and the Exclusion of Personal Injury Damages: A Model of Inconsistency*, 15 J. CORP. L. 83, 127 (1989) (arguing that section 104(a)(2) was applied—both by the courts and by the I.R.S.—in an arbitrary manner and that “[t]he time has come for the adoption of consistent principles in determining

Historically, the link between mental and physical health was the subject of much research and hypothesizing.<sup>135</sup> Philosophers, including Aristotle, Descartes, and Kant, theorized about the relationship between mind and body with the debate centering on whether the mind and the body are inseparably linked, or whether each exists notwithstanding the other.<sup>136</sup> However, in modern times, the world of physical and psychological medicine has reached a consensus that an affirmative relationship exists between emotional distress and physical manifestations of that distress.<sup>137</sup> Many members of the psychological care community continue to emphasize the importance of studying, understanding, and addressing the impact of emotional distress on the physical condition of a patient.<sup>138</sup>

There are many examples of physical ailments that can be brought on by emotional distress.<sup>139</sup> One author, Shelley Taylor, states that “[a]nxiety, depression, and other psychological disorders are accompanied by a number of physical symptoms.”<sup>140</sup> Taylor goes on to provide some examples: “Anxiety can produce diarrhea, upset stomach, sweaty hands, shortness of breath, difficulty in sleeping, poor concentration, and general agitation. Depression can lead to fatigue, difficulty in performing everyday activities, listlessness, loss of appetite, and sleep disturbances.”<sup>141</sup> In addition, many of these symptoms, such as loss of appetite, anxiety, and stress, can lead to other, more serious physical injuries, such as stomach ulcers, high blood pressure, diabetes, and extreme pain.<sup>142</sup> Accordingly, the Code should not treat these serious physical injuries differently, regardless

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the tax consequences of a damage award received for personal injuries”).

<sup>135</sup> See generally JOHN G. BENJAFIELD, *A HISTORY OF PSYCHOLOGY* (2d ed. 2005).

<sup>136</sup> See JACK H. ORNSTEIN, *THE MIND AND THE BRAIN* 3–19 (1972) (discussing Descartes’ view of the mind-body relationship). See also BENJAFIELD, *supra* note 135, at 15–42 (detailing the development and evolution of the modern understanding of the mind-body relationship and the origins of the study of psychology, including an examination of the views of Aristotle, René Descartes and Immanuel Kant).

<sup>137</sup> See SHELLEY E. TAYLOR, *HEALTH PSYCHOLOGY* 3–7 (2d ed. 1991) (describing the scientific belief, spanning many centuries, that there is an integral mind-body connection, one through which harm to the mind can lead to physical injury and declaring that “[i]t is now known that physical health is inextricably interwoven with the psychological and social environment: All conditions of health and illness . . . are influenced by psychological and social factors”). See also Burke & Friel, *supra* note 15, at 179 (stating that “scientific research has brought an awareness of the potentially devastating physical impacts of psychological injuries”); Hubbard, *supra* note 75, at 751–52 (discussing the valid and serious implications of emotional distress on the physical well-being and stating that “mental trauma is a real experience; those who suffer mental distress suffer an actual loss”).

<sup>138</sup> Infanti, *supra* note 23, at 1237–38 (discussing a recent trend by psychologists to study the mental health effects of discrimination and concluding that “[a]mong the negative mental health effects reported by these studies were emotional distress, depression, obsessive-compulsive symptoms, anxiety, stress, and somatization (i.e., the conversion of anxiety into physical symptoms)”).

<sup>139</sup> See, e.g., Germain, *supra* note 24, at 193 (describing the physical ailments that afflicted the petitioner in *Murphy v. I.R.S.* including “anxiety attacks, shortness of breath, and dizziness” that resulted from Murphy’s initial emotional distress injury).

<sup>140</sup> See TAYLOR, *supra* note 137, at 275–76.

<sup>141</sup> *Id.* at 276.

<sup>142</sup> *Id.* at 192, 347 (stating that stress can lead to an increase in heart rate, blood pressure and blood sugar and adding that “anxiety-producing conditions . . . can lead to the formation of ulcers” while “anxiety can increase pain”).

of whether they are caused by an initial physical injury or subsequent to an emotional distress injury.<sup>143</sup> The expansive field of tort law has also recognized the integral relationship between emotional distress and physical manifestations of that emotional distress.<sup>144</sup>

### C. Tort Law: Physical Manifestations of Emotional Distress are Valid Forms of Tort Recovery

As opposed to the relative ease of recovery in physical injury claims, the field of tort law has grappled with the notion of plaintiff recovery for *purely* emotional distress—and physical manifestations of emotional distress—injuries.<sup>145</sup> The historical progression of emotional distress recoveries in tort law has evolved from one with an absolute physical injury requirement to the modern iteration of stand-alone emotional distress claims.<sup>146</sup> This transformation took place despite the reluctance of some courts to acknowledge purely emotional distress claims primarily due to the misperception that the number of fraudulent claims would increase.<sup>147</sup> Today, the notion that non-frivolous tort claims can be brought for purely emotional distress claims—in addition to claims based on physical manifestations of emotional distress—has become a well-established rule.<sup>148</sup>

Analysis of the “on account of” language in section 104(a)(2)—in the context of tort law—has frequently pointed to causation as an issue in

<sup>143</sup> See Doti, *supra* note 5, at 79–80; Burke & Friel, *supra* note 15, at 195–96; Stedman, *supra* note 89, at 405; Whittington, *supra* note 13, at 185.

<sup>144</sup> See *infra* Part III.C. See also Whittington, *supra* note 13, at 185 (“As the areas of . . . tort law . . . and medicine have taken steps towards the recognition that emotional distress is a very real injury, Congress[, by adding the physical requirement to section 104(a)(2),] has caused the tax code to take a tremendous leap backwards.”).

<sup>145</sup> KENNETH S. ABRAHAM, *THE FORMS AND FUNCTIONS OF TORT LAW* 29–30 (3d ed., Foundation Press 2007) (1997). See also Calvert Magruder, *Mental and Emotional Disturbance in the Law of Torts*, 49 HARV. L. REV. 1033, 1035 (1936) (describing the state of emotional distress claims during the early history of tort law and stating that “it is nevertheless true that the common law has been reluctant to recognize the interest in one’s peace of mind as deserving of general and independent legal protection, even as against intentional invasions”).

<sup>146</sup> See generally JON R. ABELE, *EMOTIONAL DISTRESS: PROVING DAMAGES* (2003). See also JOHN D. WINER ET AL., *PROVING MENTAL & EMOTIONAL INJURIES* §§ 2:31–2:33 (James Publishing 2005).

<sup>147</sup> See ABELE, *supra* note 146, at 70. See also Hobbs, *supra* note 11, at 88 (“Courts also discovered that their earlier concerns with proof and valuation were overstated; such claims more often than not presented the same difficulties as other components of personal injury.”); Leeper, *supra* note 16, at 1070 (arguing that the fear of frivolous lawsuits, evident in Congress’ addition of the “physical” requirement to section 104(a)(2), is “unfounded” because tort litigants are more likely to be motivated by the tort recovery itself rather than the tax consequences of such recovery).

<sup>148</sup> ABELE, *supra* note 146, at 70 (explaining that most “[j]urisdictions that impose the physical manifestation rule require that the plaintiff exhibit a physical injury from the emotional distress suffered”). See also Hobbs, *supra* note 11, at 88 (discussing the evolution of tort law and the transition of most courts from resistance to acceptance of purely emotional distress causes of action and concluding that “[t]oday, a clear majority of states recognize emotional distress as an independent cause of action”); Whittington, *supra* note 13, at 174–76 (discussing the fact that many courts have moved away from the physical manifestation rule to more liberal rules allowing purely emotional injury claims and that the “claimant must still prove he has suffered an emotional distress type injury”).

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proving that a physical injury was caused by emotional distress.<sup>149</sup> However, the vast majority of courts have recognized that a legitimate causal link can and often does exist between an initial emotional distress incident and subsequent physical manifestations.<sup>150</sup> Clearly, the field of tort law has accepted and even embraced the notion that legitimate, provable cases of physical manifestations of emotional distress are deserving of the very same monetary damages recoveries afforded to those who suffer purely physical injuries.<sup>151</sup>

Unfortunately, under the current interpretation and application of section 104(a)(2), the tax code runs contrary to tort law—and, by extension, to the world of medical science—because the tax code denies the personal injury tax exclusion for individuals who suffer real, verifiable physical injuries that manifest themselves as a consequence of emotional distress.<sup>152</sup> In addition to medical science and tort law, there are two conceptions of justice—horizontal equity and return of human capital—that illustrate the unfairness of section 104(a)(2).

#### D. Horizontal Equity and Human Capital: How I.R.C. § 104(a)(2) is

<sup>149</sup> See Lee, *supra* note 53, at 552, 555 (stating that “a causal connection must exist between the personal injury and the damages received” and that the “on account of language ostensibly employs a causal analysis”); Whittington, *supra* note 13, at 161 (“When pleading, proving or settling emotional distress damages in a tort suit, the tort practitioner is well advised to make certain the emotional distress damages are causally linked to a demonstrable and recoverable physical injury. Otherwise, the client’s emotional distress recovery will be taxable.”).

<sup>150</sup> See Haralson v. State Farm Mut. Auto. Ins. Co., 564 F. Supp. 2d 616, 622 (N.D. Tex. 2008) (stating that “[t]he clear weight of authority holds that physical symptoms of emotional distress constitute a “bodily injury” in the insurance context” and citing numerous cases in support of that statement including:

Twin City Fire Ins. Co. v. Colonial Life & Accident Ins. Co., 124 F. Supp. 2d 1243, 1247 (M.D. Ala. 2000) (emotional trauma can constitute “bodily injury” if accompanied by physical symptoms); General Star Indemnity Co. v. Schools Excess Liability Fund, 888 F. Supp. 1022, 1027 (N.D. Cal. 1995) (physical injury resulting from emotional distress constitutes “bodily injury”); Garvis v. Employers Mutual Casualty Co., 497 N.W.2d 254, 257 (Minn. 1993) (emotional distress with appreciable physical manifestations can qualify as a “bodily injury” within the meaning of an insurance policy); Voorhees v. Preferred Mutual Ins. Co., 607 A.2d 1255, 1262 (N.J. 1992) (emotional distress resulting in headaches, stomach pains, nausea, and body pains constituted “bodily injury” under homeowner’s policy); Western Casualty & Surety Co. v. Waisanen, 653 F.Supp. 825, 832 (D.S.D. 1987) (emotional distress accompanied by high blood pressure was sufficient to establish physical harm); Kufalk v. Hart, 636 F. Supp. 309, 311–12 (N.D. Ill. 1986) (emotional distress resulting in high blood pressure, headaches, stomach pains, and diarrhea constituted “bodily injury” under general liability policy); McGuire v. American States Ins. Co., 491 So.2d 606, 608 (Fla. Dist. Ct. App. 1986) (mental distress accompanied by headaches and muscle spasms, requiring treatment and medication, could be construed as “bodily injury” under insurance policy); Holcomb v. Kincaid, 406 So.2d 646, 649 (La. Ct. App. 1981) (emotional distress resulting in rash, hair loss, weight loss, and symptoms of stroke fell within definition of “bodily injury” in homeowner’s policy).

<sup>151</sup> See ABELE, *supra* note 146, at 70–71; Germain, *supra* note 24, at 196; Hubbard, *supra* note 75, at 748.

<sup>152</sup> See, e.g., Murphy v. I.R.S., 493 F.3d 170 (D.C. Cir. 2007) (“*Murphy II*”). See also Burke & Friel, *supra* note 15, at 168 (“[N]o substantial policy-based justification was advanced for distinguishing between physical and nonphysical injuries.”).



### Inherently Unfair

Horizontal equity and return of human capital are two inter-related notions of basic equity and justice that permeate the foundation of our various systems of laws, including the tax code.<sup>153</sup> Horizontal equity describes the “notion of justice that similarly situated people should be treated equally and that people with equal incomes should pay equal taxes.”<sup>154</sup> Looking back at Elena and Ron in the hypothetical situations above, it is obvious that section 104(a)(2) violates the concept of horizontal equity because it treats similarly situated individuals in an inequitable manner. The concept of return of human capital involves the notion that money received to help restore a person’s body and mind to its state before the tortious act took place should not be taxed because there is no gain—and therefore no taxable income—for that individual.<sup>155</sup> Again, in the two hypothetical situations, Elena and Ron both received tort damages awards to restore them to their previous state of well-being. Yet, the fact that one pays taxes and the other does not further illustrates the inequity of section 104(a)(2).

This analysis has focused on the inequitable treatment of similarly situated individuals under section 104(a)(2). Those individuals are ones who suffered real, verifiable physical injuries and recovered money damages awards under established notions of tort law. Yet, this analysis has shown that these individuals are treated differently by section 104(a)(2) simply because of the timing of the physical injury suffered. If the tort directly caused the physical injury, then the money damages received are not taxed. However, if the tort caused purely emotional distress that later leads to physical manifestations of that distress, the money damages received are fully taxed. This analysis has presented two hypothetical situations to illustrate the nature and severity of this inequity. In addition, the evidence presented shows that both medical science and the field of tort law have recognized that a positive link does exist between emotional distress and physical manifestations of that distress. Subsequently, basic notions of fairness and justice—horizontal equity and return of human capital—indicate that section 104(a)(2) treats similarly situated taxpayers in a disparate manner. Finally, numerous courts have faced this very issue and, out of deference to the perceived congressional intent discussed throughout this comment, have refused to extend the application of section 104(a)(2) to physical manifestations of emotional distress.<sup>156</sup> The next section introduces a proposal that can resolve this inequity and continue to

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<sup>153</sup> See Lederman, *supra* note 32, at 701–04 (discussing the nature of horizontal equity and its influence on tax policy). See also Doti, *supra* note 5, at 63–65 (explaining the significance of human capital as a basis for fair, equitable treatment under the tax code).

<sup>154</sup> Chapman, *supra* note 6, at 407 n.3.

<sup>155</sup> See Doti, *supra* note 5, at 63–65.

<sup>156</sup> See Germain, *supra* note 24, at 204–05 n.82 (citing several examples of decisions where the courts have refused to apply section 104(a)(2) to physical manifestations of emotional distress).

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uphold the intentions of Congress when it created, modified, and retained section 104(a)(2).

IV. PROPOSAL: A SIMPLE ADDITION TO I.R.C. § 104(a)(2) WILL LEAD TO  
MORE EQUITABLE TAX LAW TREATMENT FOR SIMILARLY SITUATED  
TAXPAYERS

Based on the authorities presented in this comment it is clear that the unidirectional application of section 104(a)(2) is inequitable, inherently unfair to similarly situated individuals and should be revised. This comment has not argued, nor does it support the proposition that purely emotional injury tort recoveries should be excluded under section 104(a)(2). The intent of Congress was clear in that the drafters of the 1996 amendment to section 104(a)(2) were cognizant of the possibility that purely emotional injuries are very difficult to prove and may often be based on fraudulent claims. Instead, this comment focuses on one aspect of the application of section 104(a)(2): the fact that section 104(a)(2) does not apply to individuals who suffer legitimate, verifiable physical manifestations of emotional injuries and that section 104(a)(2) has led to a lack of uniformity and inequitable treatment under the tax code.

This comment proposes that a simple addition to section 104(a)(2) will resolve the inequitable treatment currently rendered upon similarly situated taxpayers. The semi-colon at the end of section 104(a)(2) should be deleted and the following phrase should be added: “or personal physical injuries proximately caused by emotional distress;” This simple addition would allow those who have legitimate claims and subsequent recoveries to exclude from their taxes those amounts received on account of the physical injuries proximately caused by the emotional distress. The proximate causation requirement mandates that the physical manifestation be proven according to the preponderance of evidence burden of proof currently used in civil law courts.<sup>157</sup> This eight-word addition to section 104(a)(2) would reinstate the balance of equity for those who have suffered verifiable physical injuries regardless of whether the physical injury came first or resulted from an emotional distress injury.

This addition would also preserve the underlying intentions of Congress when it enacted, modified, and retained section 104(a)(2). The evidence presented shows that Congress intended to help those who suffered physical injuries and that Congress expressly did not intend the exclusion to apply to those who suffered purely emotional distress injuries. This proposal maintains that intention because it allows those who suffer physical manifestations of emotional distress to enjoy the benefits of the section 104(a)(2) exclusion while still maintaining the prohibition of the exclusion for those who suffer purely emotional distress injuries.

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<sup>157</sup> See Leeper, *supra* note 16, at 1068.

## CONCLUSION

This comment has examined the lack of uniformity with which section 104(a)(2) is applied to similarly situated taxpayers. The argument centered around the fact that those who suffer real, verifiable physical manifestations of emotional distress do not receive the same tax treatment as those who suffer purely physical injuries. If section 104(a)(2) was intended to alleviate the tax burden for those who suffer physical injuries, then it should not matter whether the physical injury took place immediately after the tort or later in time. As long as an affirmative causal link is established between the initial emotional distress injury and the subsequent physical manifestations, then the section 104(a)(2) exclusion should apply.

The background and history of section 104(a)(2) show that it has experienced a rather tumultuous existence. This turbulent existence became more evident through an analysis of the case decisions that have shaped the modern understanding of section 104(a)(2). Evidence was presented to demonstrate that there are solid legal, medical, prudential, and ethical grounds to show that section 104(a)(2) does indeed treat similarly situated taxpayers differently. A simple proposal was offered—allowing application of section 104(a)(2) to those who have physical manifestations proximately caused by emotional distress—in order to make section 104(a)(2) more equitable and uniform in application. Allowing someone who suffers legitimate physical manifestations of emotional distress to receive the same tax treatment as someone who suffers purely physical injuries will *reinforce* the notion that the tax code is founded on basic notions of fairness and uniformity.