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## Can the Taxman “Tax Your Tears”: Murphy v. I.R.S. and the Inclusion of Personal Injury Compensation in “Income”

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## CAN THE TAXMAN “TAX YOUR TEARS”: *MURPHY* v. *I.R.S.* AND THE INCLUSION OF PERSONAL INJURY COMPENSATION IN “INCOME”<sup>1</sup>

### I. INTRODUCTION

Perhaps Benjamin Franklin said it best, “In this world nothing can be said to be certain, except death and taxes.”<sup>2</sup> This old adage is grounded in reality, as conventional wisdom holds that Congress has plenary taxing power,<sup>3</sup> firmly

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1. The title is adapted from the opening line of Professor F. Patrick Hubbard’s article, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725 (1997).

2. THE WRITINGS OF BENJAMIN FRANKLIN VOL. X 69 (Albert Henry Smyth ed., Norwood Press 1907) (1789).

3. See, e.g., Douglas Kahn, *The Constitutionality of Taxing Compensatory Damages for Mental Distress When There Was No Accompanying Physical Injury*, 4 FLA. TAX REV. 128, 135 (1999); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 100 (1990):

A constitutional definition of income in terms of tax equity would recognize that as long as Congress is striving to impose a tax based on the relative annual financial positions of taxpayers, according to its concept of fairness, the Court should not overturn its determination. The sixteenth amendment [sic] should be read as authorizing just such a legislative exercise . . . . Under such an approach the concept of income would be an elastic one, since it could accommodate virtually any congressional definition of income.

Marjorie Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 24 (1992):

Given the broad underlying purpose of the taxing power generally, a proper reading of the Sixteenth Amendment must give Congress a fully vested power to tax *all* income, however Congress defines it, without worrying about fine distinctions. Such an interpretation yields a meaning of income that is broad and evolutionary. Income’s meaning is to be determined by Congress, not the Court, and that meaning changes over time as congressional conceptions of income change and become more sophisticated. A broad definition of income also harmonizes with the Court’s understanding of the balance of power among the three branches of government and its vision of the judiciary’s function in a regulatory state as one of deference to the legislative and executive branches.

*But cf.* Erik M. Jensen, *The Taxing Power, The Sixteenth Amendment, and the Meaning of “Incomes,”* 33 ARIZ. ST. L.J. 1057, 1059 (2001) (arguing that conventional wisdom, which says that Congress’s power to tax is plenary, is in fact erroneous, at least insofar as one contends that Congress may arbitrarily define income as it sees fit). See also *Taft v. Bowers*, 278 U.S. 470, 481 (1929) (“[T]he Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income.”).

entrenched in the Constitution as Congress's first enumerated power.<sup>4</sup> Further, the Sixteenth Amendment gives Congress the power "to lay and collect taxes on incomes, from whatever source derived, without apportionment."<sup>5</sup> Therefore, when a three-judge panel of the prestigious Federal D.C. Circuit declared unconstitutional 26 U.S.C. § 104(a)(2)<sup>6</sup> of the Internal Revenue Code (the Code), tax lawyers, constitutional law professors, and even President Bush were astounded.<sup>7</sup>

The case was *Murphy v. I.R.S.*, and the issue was whether Congress has the constitutional authority to tax non-physical personal injury compensation.<sup>8</sup> In a unanimous decision by a three-judge panel of the Federal D.C. Circuit, written by Chief Judge Douglas Ginsburg,<sup>9</sup> the Circuit Court Panel held that Congress cannot tax, under its Sixteenth Amendment taxing powers, monies given as compensation for nonphysical personal injuries.<sup>10</sup> In *Murphy*, the plaintiff, Ms. Marrita Murphy, challenged whether the I.R.S. could tax \$70,000 she received in 1994 from an administrative law judge (ALJ) for personal injuries. She sustained the injuries as a result of blowing the whistle on sexual harassment occurring by her former employer, the New York Air National Guard (NYANG).<sup>11</sup> The ALJ granted her \$45,000 as compensation for "emotional distress or mental anguish" and \$25,000 for "injury to professional reputation."<sup>12</sup>

After paying taxes on the full \$70,000, approximately \$20,665, Murphy sought a refund on the ground that her compensatory awards were either non-taxable under § 104(a)(2) of the Code, or that § 104(a)(2) was unconstitutional

4. U.S. CONST. art. I, § 8, cl. 1.

5. U.S. CONST. amend. XVI.

6. I.R.C. § 104(a)(2) (2000) ("[G]ross income does not include . . . the amount of any damages . . . received . . . on account of personal physical injuries or physical sickness . . .").

7. See Sheryl Stratton, *Experts Ponder Murphy Decision's Many Flaws*, 112 TAX NOTES 822, 822 (Sept. 4, 2006). See also Lee Sheppard, *Murphy's Law: Tax Provision Declared Unconstitutional*, 112 TAX NOTES 825, 825 (Sept. 4, 2006); Allen Kenney, *Murphy a Boon for Protesters, Critics Say*, 112 TAX NOTES 832, 832 (Sept. 4, 2006); Marcia Coyle, *Full Court May Weigh Taxation of Damages*, 29 NAT'L L.J. 1, 1 (October 30, 2006).

8. *Murphy v. I.R.S.*, 460 F.3d 79, 81 (D.C. Cir. 2006) *vacated*, 493 F.3d 170 (D.C. Cir. July 3, 2007).

9. No family relation exists between Chief Judge Douglas Ginsburg and current Supreme Court Justice Ruth Bader Ginsburg. Also, there exists no relation between Chief Judge Ginsburg and Justice Bader Ginsburg's husband, the eminent tax scholar Martin Ginsburg. Recall, however, that Chief Judge Ginsburg was nominated by President Ronald Reagan to fill the vacancy of retiring Justice Powell on the Supreme Court in 1987, but later withdrew his nomination. See MARK TUSHNET, *A COURT DIVIDED: THE REHNQUIST COURT AND THE FUTURE OF CONSTITUTIONAL LAW* 104, 121, 173–74 (2005).

10. *Murphy*, 460 F.3d at 92.

11. *Id.* at 81.

12. *Id.*

because compensatory awards for personal injuries are not income under either the statutory or constitutional meaning of the word.<sup>13</sup> In its initial decision, the panel agreed with Murphy on the latter point and struck down as much of § 104(a)(2) of the Code as it thought granted Congress the ability to tax personal injury compensation.<sup>14</sup> The panel struck down the statute after finding that Murphy's compensation was not paid in lieu of something ordinarily taxable and that such compensatory awards are not income within the reach of the Sixteenth Amendment.<sup>15</sup>

On December 22, 2006, the three-judge *Murphy* panel vacated its earlier decision and scheduled re-arguments for the government and Murphy.<sup>16</sup> On rehearing, Chief Judge Ginsburg and the other panel members made an about-face and upheld the tax against Murphy, bowing to the political and academic pressures of Bush administration lawyers, the I.R.S., and other tax groups.<sup>17</sup> Even though the initial *Murphy* decision was vacated and eventually overturned, the original decision should not be downplayed. The immediate reverberations that occurred after the initial decision, and the dusting off of tax principle books and the Sixteenth Amendment itself indicate that time is ripe to revisit exactly how and why Congress taxes personal injury compensation.

This Comment will use the *Murphy* decisions only tangentially, as a spring board into the question of whether compensatory personal injury awards are, or should be, taxable under the Sixteenth Amendment. In discussing the taxability of personal injury compensation, this Comment will not distinguish between physical and nonphysical personal injury compensation, unless explicitly mentioned otherwise. While specific holdings and reasoning from *Murphy* will be discussed at different points, this Comment primarily addresses two alternative theories under which personal injury compensation may not be taxable: human capital and fairness principles. As a final disclaimer, this Comment is concerned with compensatory damage status as income and will not, therefore, delve into questions of direct versus indirect taxation and transfer-transaction taxation of personal injury compensation.<sup>18</sup>

Section II begins by touching on reasons for the current controversy regarding personal injury compensation and its tax/non-tax status. Next, Section III discusses the history of the Sixteenth Amendment, the concept of

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13. *Id.* at 170.

14. *Id.* at 92.

15. *Id.*

16. *D.C. Circuit to Rehear Whistleblower's Tax Case*, BNA's Daily Labor Report No. 249, Taxes, December 29, 2006, at A9.

17. *Murphy*, 493 F.3d at 170.

18. The *Murphy* decision implicates other principles of taxation, besides the income tax, such as a debate concerning direct-indirect taxes and classifying personal injury income as something other than an income tax. The breadth of this comment is therefore limited solely to issues of income taxation under the Sixteenth Amendment and I.R.C. § 61 (2007).

income, and the personal injury compensation exclusion. Finally, Section IV analyzes, partially through the history just discussed, whether the Sixteenth Amendment's concept of income includes compensation given to personal injury victims. Section IV applies the various theories of income discussed in Section III to personal injury compensation. This Comment concludes that personal injury compensation is not, and should not, be included in the concept of income, and therefore Section IV will include a look at the human capital and fairness rationales for excluding such compensation from the statutory and constitutional meanings of income.

## II. REASONS FOR THE CURRENT CONTROVERSY

While many tax attorneys and commentators harshly criticized the *Murphy* panel for its initial decision,<sup>19</sup> the debate in *Murphy* over personal injury compensation is timely and appropriate. The legality of taxing personal injury compensation has been insulated for nearly eighty years even though it touches the very heart of America's modern tax system, including the vital concepts of income, capital, and basis. Whether or not one agrees with the way the *Murphy* court resolved the issues in its earlier or later decisions is one's own opinion, but the fact remains that after eighty years in insulation, it is time to revisit the continuing rationale for the personal injury tax exclusion.<sup>20</sup>

One of the biggest reasons for the dispute regarding the taxability of nonphysical personal injuries is the long-standing tradition of not taxing these types of compensatory awards. Almost since the beginning of the modern tax code, passed after ratification of the Sixteenth Amendment in 1913, the Code has included a provision that exclude from gross income amounts received as compensation for personal injuries.<sup>21</sup> In statutory form, the exclusion was codified as § 213(b)(6) of the Revenue Act of 1918, which is substantially the same as the current § 104(a)(2) exclusion.<sup>22</sup> Until 1996, § 104(a)(2) excluded

19. See sources cited *supra* note 7.

20. See Jensen, *supra* note 3, at 1060–61.

21. Revenue Act of 1918, ch. 18, § 213(b)(6).

22. *Id.* Specifically, the act stated that gross income did not include, and therefore exempted from taxation “[a]mounts received, through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.” *Id.* In the Internal Revenue Code of 1939, the exception became § 22(b)(5) which excluded from gross income “[a]mounts received, through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.” I.R.C. § 22(b)(5) (1940). In 1954, § 22(b)(5) was replaced by § 104(a)(2) of the Revenue Act of 1954 to its more or less current form (which was amended slightly in 1989 and 1996) and excluded from gross income “the amount of any damages received . . . on account of personal injuries or sickness.” I.R.C. § 104(a)(2) (1954). Finally, in 1996, I.R.C. § 104(a)(2) was amended to its

from gross income any awards given to compensate a victim of personal injuries or sickness, regardless of whether the injuries or sickness were physical, nonphysical, lost wages, loss of consortium, or emotional and included defamation, liable, assault and battery, worker's compensation, and employment discrimination.<sup>23</sup>

The impetus for the current debate came in 1996 when Congress, as part of the Small Business Protection Act of 1996, departed from its seventy-eight year history of excluding nonphysical injury compensation by amending I.R.C. § 104(a)(2) to only exclude compensation for personal *physical* injuries from gross income.<sup>24</sup> In so doing, Congress made nonphysical personal injury compensation taxable, in particular those damages for emotional distress not derived from physical injury. The amendment made taxable a new class of compensation that was untaxed for decades, particular discrimination-type cases dealing with emotional distress.<sup>25</sup>

Another reason for the current debate (discussed in more detail in Section IV) is Congress's original justification for creating the exclusion. In 1918, Congress was wary about the constitutionality of taxing compensatory damages as income under the Sixteenth Amendment, which was still in its infancy.<sup>26</sup>

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present-day controversial form with the addition of the word "physical" in front of the words "injuries or "sickness." I.R.C § 104(a)(2) (1954).

23. See, e.g., *Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991) (holding age discrimination damages awarded to terminated employees are tort-type recoveries for personal injuries that are excludable from gross income); *Threlkeld v. C.I.R.*, 848 F.2d 81 (6th Cir. 1988) (holding that compensation for malicious prosecution and harm to professional reputation constituted damages received on account of personal injuries and were exempt from gross income); *Bent v. C.I.R.*, 835 F.2d 67 (3d Cir. 1987) (holding damages received from an assault claim were excludable from taxable income as damages received for personal injuries); *Roemer v. C.I.R.*, 716 F.2d 693 (9th Cir. 1983) (holding defamation is a personal injury and compensatory damages received by taxpayer exempt from income).

24. I.R.C. § 104(a) (2007). The 1996 amended/added portions are italicized as follows: "the amount of any damages (other than punitive damages) received . . . on account of personal *physical* injuries or *physical* sickness" (emphasis added). *Id.* at §104(a)(2). Further, the Act included an amendment stating that, "[f]or purposes of paragraph (2), *emotional distress shall not be treated as a physical injury or physical sickness*. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care." (emphasis added). *Id.* Clearly, Congress's explicit goal in the amendment was to make emotional distress type compensation taxable, probably out of some primitive pre-20th century belief that psychological trauma is not as devastating as physical trauma. See generally Patrick Hobbs, *The Personal Injury Exclusion: Congress Gets Physical but Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51 (1997).

25. Hobbs, *supra* note 24, at 83.

26. H.R. REP. NO. 65-767, at 9-10 (1918) ("Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such

A third impetus, related to but distinct from the above reasons (also discussed in greater detail later in this comment), is the divergence of the concept of income from its 1918 conception to its present day meaning. While the concept of income under the Sixteenth Amendment has gradually (and not so gradually) changed over time,<sup>27</sup> the physical injury compensation exclusion remained unchanged for nearly 80 years. Therefore, the constitutionality of taxing personal injury compensation in 1918 must be distinguished from the constitutionality of taxing personal injury compensation today.<sup>28</sup>

Given the reasons for the current controversy mentioned above, one may wonder why ten years passed before this issue reached prominence instead of asking how the D.C. Circuit missed the mark so badly.<sup>29</sup> With the reasons for the current controversy set forth above, a full and accurate analysis of these issues requires a look at the history of the Sixteenth Amendment, of the concept of income (as set forth by the Sixteenth Amendment and in § 61 of the Code), and finally of the personal injury exclusion.

### III. HISTORY

#### A. *History of the Sixteenth Amendment*

Some of the controversy over the meaning of income and the constitutionality of taxing personal injury compensation comes from the tenuous history of the Sixteenth Amendment itself. The Sixteenth Amendment reads:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.<sup>30</sup>

Ratified in 1913, the Sixteenth Amendment was actually Congress's rebuff to the Supreme Court's decision in two cases which held the 1894 Income Tax Act unconstitutional.<sup>31</sup> The two cases, collectively called the *Tax Cases*,<sup>32</sup>

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injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income."'). *See also infra* Part III.C.

27. *See infra* Part III.B.

28. *See infra* Parts IV.A–B.

29. Around the time of the Small Businesses Recovery Act of 1996, there was a small proliferation of law review articles on this very general topic, but the *Murphy* case and the presence of this debate in courts is partly what makes this discussion again necessary. *See, e.g.*, Kahn, *supra* note 3; Jensen, *supra* note 3; Hobbs, *supra* note 24; Hubbard, *infra* note 141.

30. U.S. CONST. amend. XVI.

31. Jensen, *supra* note 3, at 1058.

32. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895) (holding that tax on income from real property was direct tax under Article I and therefore required apportionment among the states); *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895) (extending direct tax principle to income derived from personal property).

invalidated sections of the 1894 Income Tax Act as unconstitutional under Article I of the Constitution because the Act imposed a direct tax on property that was not apportioned according to census.<sup>33</sup> Prior to the Court's rulings in the *Tax Cases*, Congress's income taxing power had not been seriously challenged.<sup>34</sup>

Despite the Court's invalidation of the 1894 income tax, strong language inside the *Tax Cases*, as well as cases decided shortly thereafter, hinted at a potential future reversal by the Court.<sup>35</sup> Subsequent cases validated certain types of income taxes on other premises, including: the privilege of doing business, employments, and profits from businesses and corporations.<sup>36</sup> Many in Congress at the time of the *Tax Cases* felt that, given an opportunity, the Supreme Court might overrule its prior decisions in the *Tax Cases*.<sup>37</sup>

However, rather than risk the institutional integrity of the Supreme Court or an inter-branch fight between Congress and the Judiciary, President Taft and moderate as well as radical members of Congress decided instead to propose an amendment to the Constitution to allow an unimpeded income tax.<sup>38</sup> That proposal carried the day, and the Amendment was approved in Congress and

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33. U.S. CONST. art. I, § 9, cl. 4. "No Capitation, or other direct Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." *Id.*

34. In fact, an income tax was used to finance the Civil War, and that income tax was explicitly upheld as an indirect tax and not in need of apportionment. *Springer v. United States*, 102 U.S. 586 (1880) (holding that an income tax is not a direct tax in the constitutional sense and therefore need not be apportioned; direct taxes are limited to real property and capitation taxes).

35. There was strong language in the *Tax Cases*, and also in the years following the *Tax Cases*, that certain income taxes were considered by the Court as indirect and therefore within Congress's Article I taxing powers. *Pollock*, 158 U.S. at 635. In dictum, the Court essentially distinguished the *Tax Cases* from *Springer* by noting, "[w]e have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and not so much of it as bears on gains or profits from business, privileges, or employments, in view . . . [where such taxes have] assumed the guise of an excise tax and been sustained as such." *Id.* See also *Flint v. Stone Tracy Co.*, 220 U.S. 107, 150 (1911) (holding that a tax on net corporate income was not a direct or income tax, but instead an excise tax, and therefore within Congress's Article I taxing powers).

36. See *Pollock*, 158 U.S. at 601 (1895); see also *Flint*, 220 U.S. at 107 (1911).

37. Jensen, *supra* note 3, at 1107–08.

38. See *id.* at 1108–14. Reading the historical view of Professor Jensen is time-well-spent and gives an insight into American politics at the turn of the 19<sup>th</sup> century. In his article he puts forward the view that many conservatives "embraced" a constitutional amendment proposal, as opposed to challenging the *Pollack* decisions by passing an income tax act identical to that of 1894, precisely because they opposed a Federal income tax and were certain such an amendment process would in fact fail once sent to the states. As Jensen purports, those politicians underestimated the support for progressive taxation, and instead helped to permanently enshrine the income tax into the Constitution itself (regardless of whether such a tax was already allowable as an indirect tax; now not even the Supreme Court could rule such "income tax" as requiring apportionment).



sent to the states in 1909; by 1913 forty-two states had ratified the Sixteenth Amendment.<sup>39</sup>

Thus, it is apparent that both before and after the passage of the Sixteenth Amendment, debate existed as to whether the Amendment was actually necessary to give Congress the constitutional ability to tax incomes.<sup>40</sup> Because the Sixteenth Amendment was passed without first challenging the *Tax Cases* in the Supreme Court, those cases are still technically the foremost and controlling interpretation of Congress's income taxing powers, the Sixteenth Amendment aside. Therefore, this comment will assume (maybe controversially) that any tax purporting to be one on income must pass the rigors of the Sixteenth Amendment to be held constitutional as an income tax (as opposed to an excise tax, for example).

### B. *History of the Meaning of "Incomes"*

#### 1. Early Income: the "res" and *Eisner v. Macomber*

The constitutional meaning of "income," as used by Article I of the Constitution, the Sixteenth Amendment and statute,<sup>41</sup> has undergone drastic changes throughout the years.<sup>42</sup> After the Sixteenth Amendment extinguished the *Tax Cases* debate, the arguments then turned to what the term income would encompass. Not-surprisingly, there was a proliferation of Supreme Court income cases in the few decades after passage of the Sixteenth Amendment.<sup>43</sup> The Amendment's text, "taxes on *incomes, from whatever*

39. *Id.* at 1123.

40. *Id.* at 1107–08.

41. It has long been held that Congress's use of income in present-day I.R.C. § 61 and its predecessors goes to the full extent allowed by the Sixteenth Amendment, and income in the statutory sense is therefore equivalent to the constitutional use of income. *Helvering v. Clifford*, 309 U.S. 331, 334 (1940) ("The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories.").

42. The original statute that empowered Congress to tax income was in the Revenue Act of 1916, § 2(a), which stated, "[t]he net income of a taxable person shall include . . . gains or profits and income derived from any source whatever." In form, this was changed into § 22(a) of the Internal Revenue Code of 1939, which read, "[g]ross [i]ncome includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid . . . or gains or profits and income derived from any source whatever." Finally, in the Internal Revenue Act of 1954, present-day § 61(a) succeeded § 22(a) to iterate the exact words of the Sixteenth Amendment, "all income from whatever source derived." Throughout this whole process of revising the income statutes, it was acknowledged that each "definition [was] based upon the 16th Amendment and the word 'income' is used in its constitutional sense." *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.11 (1955).

43. *See, e.g.*, *Gould v. Gould*, 245 U.S. 151 (1917); *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179 (1918); *S. Pac. Co. v. Lowe*, 247 U.S. 330 (1918); *Evans v. Gore*, 253 U.S. 245 (1920); *Eisner v. Macomber*, 252 U.S. 189 (1920); *Merchants' Loan and Trust Co. v. Smietanka*, 255

*source derived*" proved difficult, if not impossible, to clearly define and demarcate as the Court (especially in the time immediately preceding ratification of the amendment) scrambled to put parameters on the term.<sup>44</sup>

American *income* tax theory was still young and not fully developed at the time of the Sixteenth Amendment, borrowing various aspects of its body from other academic and legal fields, especially trust law which today still makes strong (but probably artificial) distinctions between the body of a trust (the corpus) and the income of a trust.<sup>45</sup> Subsequently, the Court's view of income at the time of the ratification of the Sixteenth Amendment in 1913 is largely considered to correspond, albeit imperfectly, with the *res* distinction that existed (and still exists) in trust law.<sup>46</sup> This understanding of income made the sharp distinction between capital and income, just as trust law makes the sharp distinction between corpus and income.<sup>47</sup> The corpus, or original endowment and capital, was not taxable.<sup>48</sup> Windfall receipts of cash, such as gifts, were viewed as additions to capital or endowments, and therefore distinct from income.<sup>49</sup> As in trust accounting, sale of capital would remain capital under this theory, as would any appreciation of the property.<sup>50</sup> The income stemming from the corpus (either figuratively as in trust terms, or as labor, as in the human corpus) was income; this included such receipts as investment interest, wages, and production income.

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U.S. 509 (1921); *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925); *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110 (1925); *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926); *Taft v. Bowers*, 278 U.S. 470 (1928); *Helvering v. Indep. Life Ins. Co.*, 292 U.S. 371 (1934); *Helvering v. Clifford*, 309 U.S. 221 (1940); *Helvering v. Bruun*, 309 U.S. 461 (1940); *Helvering v. Griffiths*, 318 U.S. 371 (1943).

44. "The Congress shall have power to lay and collect taxes on *incomes*, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI (emphasis added).

45. Joseph Dodge, *The Story of Glenshaw Glass*, in *TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES*, 15, 32 (Paul Caron ed., 2003).

46. *Id.*

47. See Marjorie Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization*, in *TAX STORIES*, 53, 65 (Paul Caron ed., 2003).

48. See, e.g., *Eisner v. Macomber*, 252 U.S. 189, 206 ("The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time.").

49. Kornhauser, *supra* note 47, at 65. Cf. Dodge, *supra* note 45, at 32–33 ("the *express* exclusion of gifts and bequests received, impl[ies] that gifts, at least plausibly, would be classed as income in the absence of such an exclusion."). Of course, this conclusion by Professor Dodge is tenuous and merely one way of looking at the existence of a statutory exclusion. Another way to look at the exclusion is that, to avoid confusion and ensure certainty, Congress added I.R.C. § 22(b)(3) (1939) (which corresponds to present-day I.R.C. § 102 (2000) (excluding gifts from income)).

50. Kornhauser, *supra* note 47, at 65.

Because the concept of income, at least in the Sixteenth Amendment's use of the word, was brand new, different theories competed for what might be considered income, and courts partly created rules and exceptions ad hoc alongside Congress's own exclusion-making ability.<sup>51</sup> The *res* theory of income, was codified, albeit imperfectly, for many years to come in the renowned case of *Eisner v. Macomber*.<sup>52</sup>

The landmark aspect of *Macomber* is the requirement that income be "realized," or else it is not income under the Sixteenth Amendment.<sup>53</sup> However, another equally important holding was the Court's characterization or defining of the term income as, "the gain derived from capital, from labor, or from both combined."<sup>54</sup> In *Macomber*, the Court discussed whether Congress, under the Sixteenth Amendment's conception of income could tax a stock dividend by a corporation to one of its shareholders, *Macomber*.<sup>55</sup> The Court held that Congress had no such power.

In so holding, *Macomber* codified the trust law distinction between capital and income into the term income. As set out by the *Macomber* Court:

The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time.<sup>56</sup>

This definition closely resembled the trust law distinction between the corpus and income; in trust law, as with *Macomber*, if there is no "[growth], a gain, a profit . . . proceeding from the property, severed from the capital," then there is no income.<sup>57</sup> Under the *Macomber* definition, the broadest range of what is today considered income did indeed fall into the category of income; other things did not, such as windfall gains, including but not limited to, punitive damages,<sup>58</sup> gifts,<sup>59</sup> alimony,<sup>60</sup> and probably compensatory awards for personal

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51. A classic example of this ad hoc approach is the Court's 1917 holding in *Gould v. Gould*, 245 U.S. 151 (1917), that alimony transfer payments are "not income" under the constitutional meaning of the word. *Gould* has subsequently been ignored by Congress in I.R.C. § 71, now codified as I.R.C. § 61(a)(8), which explicitly includes alimony payments in gross income. Technically, *Gould* has never been expressly overruled.

52. *Macomber*, 252 U.S. 189 (1920); see also Kornhauser, *supra* note 47, at 65–66.

53. Kahn, *supra* note 3, at 131 ("*Macomber* stands for the view that realization [i.e. severance of income from capital] is a constitutional requisite to having 'income' for purposes of the Sixteenth Amendment.>").

54. *Macomber*, 252 U.S. at 207.

55. *Id.* at 199.

56. *Id.* at 206.

57. *Id.* at 207 (emphasis added).

58. *Highland Farms Corp., v. Comm'r*, 42 B.T.A. 1314, 1322 (1940).

59. *But see* Kornhauser, *supra* note 47.

60. *Gould v. Gould*, 245 U.S. 151 (1917).

injuries.<sup>61</sup> Unlike the *res* theory, however, the *Macomber* definition of income included gains accruing from appreciation of capital assets.<sup>62</sup>

This somewhat restrictive understanding of income (though more liberal than the *res* theory) survived in strong part until 1955, with the ushering in of what is often called the current state of the concept of income as explicated in *Commissioner v. Glenshaw Glass*.<sup>63</sup>

## 2. Modern Income Defined in *Commissioner v. Glenshaw Glass* with Haig-Simons

The modern concept of income comes not from the earliest part of the century, but instead from the 1955 Supreme Court decision in *Glenshaw Glass v. Commissioner*.<sup>64</sup> The issue in *Glenshaw* was whether then section 22(a) of the 1939 Internal Revenue Code<sup>65</sup> authorized Congress to tax punitive damages awarded to the Glenshaw Glass Company in a prior anti-trust settlement.<sup>66</sup> Although the case dealt solely with statutory construction, the Court noted that the statute's language "was used by Congress to exert in the [income tax] field 'the full measure of its taxing power.'"<sup>67</sup> In essence, the Court acknowledged, in sharp contrast to *Macomber's* more limited definition, that the residual catch-all phrase of the statute, "or gains or profits and income derived from any source whatever,"<sup>68</sup> evidenced the "intention of Congress to tax *all* gains except those specifically exempted."<sup>69</sup> In applying the catch-all phrase of the statute, the *Glenshaw* Court distinguished and essentially swept aside *Macomber's* definition of income as merely "the gain derived from capital, from labor, or from both combined,"<sup>70</sup> and declared that the *Macomber*

61. See *infra* Part IV.A.

62. *Macomber*, 252 U.S. at 207 ("[T]he gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets.").

63. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

64. *Id.*; see also Dodge, *supra* note 45, at 15 ("[*Glenshaw*] is considered a watershed case ushering in the modern era in thinking about 'income' issues."). *Glenshaw* is actually a collection of two cases regarding the taxability of punitive damages: *Commissioner v. Glenshaw Glass Co.* and *Commissioner v. William Goldman Theatres, Inc.*

65. I.R.C. § 22(a) (1939) ("'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid . . . or profits and income derived from any source whatever."). I.R.C. § 22(a) (1939)'s successor, I.R.C. § 61(a) (2000), states that "gross income means all income, from whatever source derived."

66. *Glenshaw Glass Co.*, 348 U.S. at 427.

67. *Id.* at 429 (citing *Helvering v. Clifford*, 309 U.S. 331, 334 (1940)).

68. I.R.C. § 22(a) (1939).

69. *Glenshaw Glass Co.*, 348 U.S. at 430 (emphasis added).

70. *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).

definition was “not meant to provide a touchstone to all future gross income questions.”<sup>71</sup>

In a narrow view, the Court simply held that punitive damages awarded to a taxpayer were taxable as income under the meaning of section § 22(a) of the Revenue Act of 1939.<sup>72</sup> In the broader view, however, the Court may have held two things. First, it expanded the definition of income to include windfalls, which are often not derived from labor, capital, or either combined.<sup>73</sup> This type of economic gain, under the narrower *Macomber* standard, had not been held as income under the Sixteenth Amendment, because it was not created by the taxpayer either as investment income or wages.<sup>74</sup>

The second broader holding in *Glenshaw* could be a new theory of income, a modern and all encompassing view which would remove all niceties regarding what actually constitutes “income.” It is this second broad holding that is commonly assigned to *Glenshaw*.<sup>75</sup> The second approach gives very real power to the catch-all phrases of both the income statute and the Sixteenth Amendment’s “from whatever source derived” and “gains and income derived from any source whatever.”<sup>76</sup> The *Macomber* Court was concerned with the source of the income in defining income itself (i.e., was the source of the proceeds from property or labor or both? If not, no taxable income existed). *Glenshaw* swept aside this origin distinction.<sup>77</sup> So long as a receipt is an “undeniable accession to wealth, clearly realized and over which the taxpayer has complete dominion,” then it falls within the statutory, and therefore constitutional, meaning of income.<sup>78</sup>

While *Glenshaw* went a long way in ridding the income definition of certain niceties, the exact parameters of the term under the Sixteenth Amendment are still not totally clear.<sup>79</sup> After all, while *Glenshaw* stands for

71. *Glenshaw Glass Co.*, 348 U.S. at 431 (citing *Helvering v. Bruun*, 309 U.S. 461, 468–69 (1940)).

72. *Id.* (“Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion . . . . And we find no such evidence of [congressional] intent to exempt [punitive damages from nonpersonal injuries].”).

73. *Highland Farms Corp. v. Comm’r*, 42 B.T.A. 1314 (1940) (holding punitive damages nontaxable).

74. *Id.* at 1322 (“A penalty imposed by law does not meet the test of taxable income set forth in *Eisner v. Macomber*, 252 U.S. 189, as ‘the gain derived from capital, from labor, or from both combined,’ provided it be understood to include profit gained through a sale or conversion of capital assets. The respondent erred in adding the \$10,000 punitive damages to petitioner’s taxable income.”).

75. *Id.* at 30–31.

76. U.S. CONST. amend. XVI; *see also* I.R.C. § 22(a) (1939).

77. Dodge, *supra* note 44, at 30–31.

78. *Glenshaw Glass Co.*, 348 U.S. at 431.

79. *See, e.g.*, Thuronyi, *supra* note 3; Jensen, *supra* note 3.

the proposition that income in the statutory and constitutional sense is very broad, there is language even in that opinion that left the waters slightly muddled.<sup>80</sup> The *Murphy* opinion picked up on the remaining muddiness, and despite the apparently clear language of *Glenshaw*, concluded that compensation for personal injury was not an "accession to wealth" or "gain."<sup>81</sup>

Since *Glenshaw*, however, the consensus appears to have become that income is equated, in a general sense, with the Haig-Simons model of income.<sup>82</sup> The Haig-Simons model defines income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."<sup>83</sup> Stated another way, it is consumption plus the change in accumulated wealth over the tax year.<sup>84</sup>

Consistent with most generalities, the Haig-Simons formulation of income and the one that Congress uses are not identical.<sup>85</sup> The Haig-Simons formulation of income would ideally include in taxable income many things that Congress chooses not to tax.<sup>86</sup> Despite this apparent inconsistency, it has become at least the benchmark by which tax proposals are measured. The Haig-Simons income formulation of taxation has in practice aligned with the apparent holding in *Glenshaw* more than any other theory of income.<sup>87</sup>

80. *Glenshaw Glass Co.*, 348 U.S. at 432 n.8 ("The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property. . . . Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.").

81. *Murphy v. I.R.S.*, 460 F.3d 79, 88 (D.C. Cir. 2006) *vacated*, 493 F.3d 170 (D.C. Cir. 2007).

82. See Dodge, *supra* note 45, at 34 (professor Dodge does not really accept the notion that the Court adopted the Haig-Simons definition, per se, or even knew of its existence as a theory of economic income. However, he concedes that in practice *Glenshaw Glass* has aligned the income tax more closely with the Haig-Simons conception of income than with any other concept); Jensen, *supra* note 3, at 1083; Thuronyi, *supra* note 3, at 46.

83. Thuronyi, *supra* note 3, at 48.

84. *Id.* at 46.

85. Dodge, *supra* note 45, at 34–35.

86. Imputed income, for instance, is not taxed by Congress, nor is it Constitutionally taxable, though many economists would include such income into any accurate measure of gross national productivity. Furthermore, in the sense that imputed income changes the value of stored property rights in a year, or amounts created for personal consumption, it most certainly fits within the Haig-Simons conception of income. The conclusion that imputed income is not income under *Glenshaw* is perhaps controversial, and some feel that the landmark case establishing this doctrine, *Helvering v. Indep. Life Ins. Co.* would be decided differently today. This Comment assumes, according to basic legal principles, that since *Helvering* has not been overturned or seriously challenged, that it is the law of the land, and imputed income is therefore not income in the constitutional sense.

87. Dodge, *supra* note 45, at 37.

Consistent with the broad language of IRC § 61(a), the Sixteenth Amendment, and *Glenshaw*, the Haig-Simons income formulation is very broad and appears to abolish many of the niceties adopted in *Macomber*.<sup>88</sup> According to a strict Haig-Simons formulation of income, Congress would have unfettered taxing authority over gifts, imputed income and consumption of durable goods, etc.; these are things Congress chooses not to tax.

Unfortunately, even the acclaimed Haig-Simons definition of income is not without its ambiguities.<sup>89</sup> For instance, what exactly is the extent of “consumption” and “accumulation?”<sup>90</sup> Does this imply that Congress may tax citizens who consume their leisure? Does *Glenshaw* really purport to allow Congress to tax its citizens on the time they spend in front of the television? After all, our leisure time is measurable as the opportunity cost of not working. Of course it is ludicrous to think that the Sixteenth Amendment goes so far as to allow a tax on leisure time as “income,” but such a tax is not outside the Haig-Simons formulation.

The Haig-Simons theory is actually an economic theory and not a legal one, and sometimes it breaks down when applied in the real world.<sup>91</sup> For instance, what is wealth in tax terms? In economic terms, wealth and income are inherently attached to vague and immeasurable notions of utility, which “recognize[] that fundamentally income is a flow of satisfactions, of intangible psychological experiences.”<sup>92</sup> While one could, if one so wanted, ignore the economic theory aspect of Haig-Simons and define income as any receipts of cash or tangible goods or services, this rips the true theory from its economic underpinnings and is no truer a concept of income than the *Macomber* ad hoc approach. In any event, these subtleties aside, the Haig-Simons analogy to *Glenshaw* is fairly uncontroversial. However, as demonstrated above, it is not true that just because something is income in the Haig-Simons definition that Congress could tax it as such.

### C. *The History of the Personal Injuries Exclusion*

Congress’s reasoning in passing the personal injury exclusion is a potential key in understanding how personal injury compensation awards should be treated for tax purposes, absent IRC § 104(a)(2). Unfortunately, as this Comment soon makes clear, the reasoning behind the initial exclusion is unclear at best and faulty at worst. Some courts, despite this muddled history, have relied on numerous departmental decisions and writings that were

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88. Thuronyi, *supra* note 3, at 46.

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 52.

interconnected with the legislative history of the personal injuries exclusion.<sup>93</sup> Those courts, based on their understanding of the history and correspondence, have sometimes made definitive holdings based on "Originalist" analyses of the Sixteenth Amendment in finding various personal injury compensation awards taxable or nontaxable under either IRC § 104(a)(2) or IRC § 61(a) or under the Sixteenth Amendment.<sup>94</sup> Therefore, the history of the exclusion deserves exploration in order to *understand* not only the *Murphy* case, but as well as to *fully understand* the arguments for each side of the question of whether or not personal injury compensation is income under the statute and Constitution.

### 1. Clear Origins but Muddled Rationale

As established above, the exclusion from gross income of personal injury compensatory awards has a very long history in the tax code. The predecessor of I.R.C. § 104(a)(2), I.R.C. § 213(b)(6), entered the Code in the Revenue Act of 1918, only five years after the ratification of the Sixteenth Amendment.<sup>95</sup> In the five years after ratification of the Sixteenth Amendment, but prior to the enactment of § 213(b)(6), the Treasury Department actually taxed compensatory personal injury awards.<sup>96</sup> In fact, Treasury Regulation 33 of the Revenue Act of 1916 specifically provided for such taxation, stating that any "amount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be accounted for as income."<sup>97</sup>

Historical evidence shows, as Professor Hobbs argues, that the decision by the federal government to treat personal injury compensation as distinct from income arose in a 1918 opinion by the Attorney General to the Secretary of the Treasury.<sup>98</sup> The Attorney General likened compensation for personal injuries to proceeds from accident insurance, which he then equated to a "return to

93. See generally *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006), *vacated*, 493 F.3d 170, (D.C. Cir. 2007) (relying on departmental rulings to invalidate I.R.C. § 104(a)(2)); *O'Gilvie v. U.S.*, 519 U.S. 79 (majority and dissenting opinions discussing the 1918 House Report, Treasury Decision, and Attorney General Opinion regarding personal injury compensation); *Glenshaw Glass Co.*, 348 U.S. 426 (mentioning the history of departmental ruling that deal with a return to capital policy underlying the personal injury exclusion).

94. *Id.*

95. Revenue Act of 1918, ch. 18, § 213(b)(6) (1918).

96. See Hobbs, *supra* note 24, at 56–57 (citing to 17 Treas. Dec. Int. Rev. 39, 42 (1915), which stated, "An amount received as a result of suit or compromise for 'pain and suffering' is held to be such income as would be taxable under the provision of law that includes 'gains or profits and income derived from any source whatsoever.'").

97. *Id.* at 57 (citing Treas. Reg. 33, art. 4 (1918)).

98. 31 Op. Att'y Gen. 304, 308 (1918). Subsequently, the *Murphy* panel relied heavily upon this opinion in concluding that personal injury compensation is not income in any constitutional sense. *Murphy v. I.R.S.*, 460 F.3d 79, 85–86, *vacated*, 493 F.3d 170 (D.C. Cir. 2007).



capital.”<sup>99</sup> The Attorney General then equated personal injury compensation to a restoration of human capital in the body.<sup>100</sup> The Treasury Department soon revoked Treasury Regulation 33, which effectively repealed Treasury’s decision to tax personal injury compensation.<sup>101</sup>

Thereafter, Congress passed the Revenue Act of 1918, which codified the exclusion for personal injury awards into section § 213(b)(6) of the Code. Section 213(b)(6) excluded from gross income any “amount received . . . as compensation for personal injuries or sickness, plus the amount of any damages received . . . on account of such injuries or sickness.”<sup>102</sup>

The legislative history regarding the exclusion is fairly sparse, save for one House Report. The House Report concerning the Act contained the following statement, “[u]nder the present law it is doubtful whether amounts received through accident or health insurance, or under workmen’s compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income.”<sup>103</sup> From there, the courts would determine the breadth of the exclusion.

## 2. Courts Interpret the Statute to Include Physical and Nonphysical Injuries

Until 1996, Congress never explicitly distinguished between physical and nonphysical injuries in reference to the personal injury exclusion.<sup>104</sup> The Court’s interpretation of § 213(b)(6) of the Revenue Act of 1918 (and its successor IRC § 104(a)(2)) and Congress’s subsequent silence were the driving forces behind nonphysical injuries being equated with physical injuries for purposes of interpreting the personal injury exclusion, such as emotional distress or alienation of affections.<sup>105</sup> With regard to the personal injury exclusion, the debate has been instead whether the compensatory damages were awarded “on account of” personal injury, which was restricted to tort or tort-type injuries, or whether punitive damages were included in § 104(a)(2).<sup>106</sup>

99. 31 Op. Att’y Gen. 304, 307–08 (1918).

100. *Id.*

101. Hobbs, *supra* note 24, at 64 (citing 20 Treas. Dec. Int. Rev. 457 (1918)).

102. Revenue Act of 1918, ch. 18, § 213(b)(6) (1918).

103. H.R. REP. NO. 65-767 (1918).

104. I.R.C. § 104(a)(2) (1954).

105. Hobbs, *supra* note 24, at 70.

106. *See, e.g.,* O’Gilvie v. United States, 519 U.S. 79 (1996) (holding that punitive damages that accompanied a personal injury case did not compensate for personal injury); U.S. v. Burke, 504 U.S. 229 (1992) (holding that back pay settlement originating in Title VII cases are not injuries “on account” of “personal injury”); Comm’r v. Schleier, 515 U.S. 323 (1995) (settlements under the Age Discrimination in Employment Act do not constitute awards based on account of personal injury); Threlkeld v. C.I.R., 87 T.C. 1294 (1987).

Prior to 1989, some members of Congress attempted to have § 104(a)(2) restricted to physical injuries only, but their efforts failed.<sup>107</sup> Ironically, Congress instead sanctioned a statutory merger of physical and nonphysical injuries to IRC § 104(a)(2).<sup>108</sup> In 1996, Congress amended § 104(a)(2) to its current form, essentially adding the word "physical" in front of the words "injury" and "sickness," and explicitly denying "mental distress" injuries from being included in the definition of "injury" and "sickness."<sup>109</sup>

#### IV. ANALYSIS

With a brief history of the Sixteenth Amendment, the concept of income and the personal injury exclusion complete, it is now possible to analyze whether Congress, in accordance with its Sixteenth Amendment income tax allowance, can tax personal injury awards as income. In the first subsection, this Comment briefly looks at whether, under the *res* and *Macomber* conceptions of income, personal injury damage awards would have been income. This section then discusses the current state of the term "income" in light of *Glenshaw* and *Haig-Simons* and analyzes whether Congress's income taxing powers encompass personal injury compensation according to those theories of income. Next, this Comment looks at the human capital argument espoused as the earliest justification for the personal injury exclusion and evaluates its continuing role as a limitation on the income concept. Finally, this section evaluates the personal injury exclusion according to a fairness standard and argues against taxing personal injury compensation.

##### A. *The Taxability of Personal Injury Damages Under Eisner v. Macomber and the Res Theory of Income*

It is at least worth a few pages to discuss whether compensatory damages would have been considered income at the time of *Macomber*. For instance, the *Murphy* panel relied, at least in part, on the *Macomber* definition of income which consisted of proceeds generated from "capital, from labor, or from both combined," when it invalidated IRC § 104(a)(2).<sup>110</sup>

107. See Hobbs, *supra* note 24, at 74 (citing H.R. Rep. No. 101-247, at 1355 (1989)).

108. See *id.* at 74–75.

109. I.R.C. § 104(a)(2) (2000).

110. *Murphy v. I.R.S.*, 460 F.3d 79, 85, 88–89, *vacated*, 493 F.3d 107, (D.C. Cir. 2007) ("[W]hen the Sixteenth Amendment was drafted, the word 'incomes' had well understood limits. . . . [I]n defining 'incomes,' we should rely upon 'the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment.'"); see also *Eisner v. Macomber*, 252 U.S. 189, 206–07 ("For the present purpose we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the [Sixteenth] Amendment. 'Income may be defined as the gain derived from capital, from labor, or from both combined.'").

Applying the basic framework of *Macomber*, as well as some of the reasoning in *Murphy*, it is certainly possible, though not positive, that had *Murphy* been decided eighty years ago, Chief Judge Ginsburg would not be on the chopping block as he is today. Applying the *Macomber* rationale to the compensatory damages in *Murphy* would likely result in a holding of no income.

Compensatory awards are by their nature given to compensate victims for certain losses.<sup>111</sup> In *Murphy*'s case, the compensatory awards were given partly in lieu of emotional distress. In other instances, however, the loss is an arm, an eye, or other body part. Human emotions, body parts and reputation are analogous to the *res* theory's concept of capital, distinguishable from income in that they produce income but are not actually themselves income.<sup>112</sup> According to this analogy, because the compensation is merely a replacement of bodily or emotional capital, and not product of the capital, it would not be income under the early *res* articulation.<sup>113</sup>

However, personal injury awards might be considered income under *Macomber*'s income analysis. *Macomber*'s conception of income includes appreciation of capital assets once they are realized,<sup>114</sup> unlike both the *res* theory<sup>115</sup> and trust law. In *Murphy*, as in all personal injury instances, the involuntary conversion of a person's body parts or emotions are considered realization events,<sup>116</sup> which according to *Macomber* would be a taxable event.<sup>117</sup>

111. See *Murphy*, 460 F.3d at 89 n.\* (citing nearly two pages of cases dealing with personal injury compensation and "in lieu of what" it is awarded).

112. See, e.g., Kornhauser, *supra* note 47, at 65 (explaining the *res* concept succinctly through the example: "[a] fruit tree might grow from a tiny seed, increasing in size and value, but at all times the entire tree—whether large or small—was capital. Only the regular, periodic fruit of that tree was income.").

113. *Id.*

114. *Macomber*, 252 U.S. at 207 ("[A] gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property.").

115. See, e.g., Kornhauser, *supra* note 47, at 65 (explaining the *res* theory: "if a person [under the *res* theory of income] bought Greenacre for \$100,000 and sold it some time later for \$150,000, he had no income.").

116. See, e.g., I.R.C. § 1033(b)(2) (2000) ("If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized.").

117. *Macomber*, 252 U.S. at 207 ("Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets . . . .") (quoting *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1919)).

However, this latter analysis under *Macomber* is flawed for two reasons. First, *Macomber* confined itself to a definition of income as the product from "capital, from labor, or from both combined."<sup>118</sup> Compensation for converted emotions or a severed arm is not really a "profit . . . proceeding from the property, severed from"<sup>119</sup> the property, but is loosely speaking replacing the property. Second, tax courts do not consider emotions or physical body parts to be either depreciable or appreciable property.<sup>120</sup> Therefore, personal injury compensation cannot constitute an appreciation of capital assets under *Macomber*, either.<sup>121</sup>

Interestingly, using either the strict *res* concept of income, or *Macomber*'s definition of income as "profit . . . proceeding from the property"<sup>122</sup> circumvents a discussion of the important tax concept of "basis."<sup>123</sup> Any modern discussion of income almost certainly must touch on the vastly influential basis idea. This brings the Comment to an analysis of whether personal injury compensation is modern income under *Glenshaw* and Haig-Simons.

B. *The Taxability of Personal Injury Compensation Under the Commissioner v. Glenshaw Glass Regime*

1. Background

In 1955, *Macomber*'s definition of income, to large extent, was replaced when the Supreme Court released its landmark decision in *Glenshaw*.<sup>124</sup> As mentioned above, *Glenshaw* held that *Macomber* "was not meant [to be the] touchstone to all future gross income questions."<sup>125</sup> *Glenshaw* then went on to prescribe the new test for defining income in the Sixteenth Amendment and statutory senses.<sup>126</sup>

An effect of *Glenshaw* was the broadening of the concept of income to eliminate an analysis of the origin of the income.<sup>127</sup> While the *Macomber* standard looked at whether a gain was created "from capital, from labor, or from both combined," *Glenshaw* changed the question of whether the proceeds were an "undeniable accession to wealth, clearly realized and over which the taxpayer has complete dominion," or "gains or profits and income derived

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. See e.g., Kornhauser, *supra* note 47, at 46.

124. See *supra* Part III.B.2. and sources cited therein.

125. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

126. *Id.* at 431–33.

127. Dodge, *supra* note 45, at 30.

from any source whatever.”<sup>128</sup> Therefore, when analyzing whether compensatory damage awards for emotional distress are income according to *Glenshaw*, the issue becomes whether an “undeniable accession to wealth” has occurred or not. Because gain is the issue involved in a *Glenshaw* income analysis, the important concept of basis is essential for an intelligent and full discussion of personal injury compensation taxation.

As *Glenshaw* stated, the income tax system works to ensure that individuals pay taxes on their “gains or profits . . . from any source whatever.”<sup>129</sup> Courts have “given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted.”<sup>130</sup> Most recently, the Court described IRC § 61 as encompassing “all *economic* gains not otherwise exempted.”<sup>131</sup> In tax terms, a gain is defined as, “the excess of the amount realized there from over the adjusted basis.”<sup>132</sup> Basis is defined as “the cost of such property.”<sup>133</sup> The point is that people are only taxed on the amount over which they spend on an item, and basis tracks the amount of post-tax dollars a taxpayer has spent on a particular item. This system ensures, generally, that taxpayers are not taxed twice on their dollars. With this brief introduction it is now possible to look at whether, under the modern theories, personal injury compensation is income.

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128. *Glenshaw Glass Co.*, 348 U.S. at 430–31.

129. *Id.* at 429 (quoting I.R.C. § 22(a) (1939) (emphasis added)).

130. *Id.* at 430 (citing *Comm’r v. Jacobson*, 336 U.S. 28, 49 (1949)).

131. *Comm’r v. Banks*, 543 U.S. 426, 433 (2005) (holding that under anticipatory assignment doctrine, the taxpayer cannot exclude economic gain from gross income by assigning gain in advance to another party).

132. I.R.C. § 1001(a) (2000) (“The gain from the sale or other disposition of property shall be the excess of the amount realized there from over the adjusted basis [which equals cost plus additional post-tax expenditures on the property].”).

133. I.R.C. § 1012 (2000).

2. The Dominant View Regarding Taxability of Personal Injury Compensation; *Glenshaw Glass* and the I.R.S.'s Income Analysis in *Murphy v. I.R.S.*

The dominant view of the taxability of personal injury compensation has been the I.R.S.'s view, which was espoused in *Murphy*.<sup>134</sup> Not surprisingly, the I.R.S. view favors the inclusion of personal injury compensation in income.<sup>135</sup> Using the Code, and the system espoused in the paragraph above, the normal process is to look at the value that has been realized from the transaction and offset that amount by any basis, or post-tax dollars, the taxpayer has invested in the item.<sup>136</sup>

The first step is to calculate the amount realized. In *Murphy*, the plaintiff received \$70,000 in total compensation for her emotional distress and loss to professional reputation; \$70,000 would then be her amount realized.<sup>137</sup> After determining the amount realized, the next step in determining gain in the tax sense is to offset any amount realized by the taxpayer's post-tax dollar expenditures in the property.<sup>138</sup> The I.R.S. argued that Murphy's basis was zero on the premise that Murphy did not "pay cash or its equivalent to acquire [her] well-being, [therefore she had] no basis in it for purposes of measuring a gain."<sup>139</sup> Accepting the I.R.S.'s argument that Murphy's expenditures in her own emotional well-being and professional reputation are zero, she would have no tax basis with which to offset her \$70,000 amount realized. Therefore, her taxable gain or income is the full \$70,000; this is exactly what the I.R.S. argued in *Murphy* as the "income from whatever source derived."<sup>140</sup>

Under an ad hoc Haig-Simons application to the personal injuries compensation, a similar, though less mechanical, result would occur. In the non-economic, ad hoc fashion in which tax scholars analogize it, the *Glenshaw* and Sixteenth Amendment's "incomes from whatever source derived," Murphy's \$70,000 appears to be an accumulation in wealth of that exact amount. Plus, because tax scholars give no fair market value for one's leisure

134. Even though the I.R.S. did not carry the day, the analysis employed by the I.R.S. in *Murphy* is the dominant view held by scholars and tax experts. See, e.g., sources cited *supra* note 7.

135. Brief for the Appellee, at 15–18, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139).

136. See I.R.C. §§ 1001, 1011, 1012 (2000) (sections explaining the legal definition of gain, basis, etc.).

137. See, e.g., *Roemer v. Comm'r*, 716 F.2d 693, 700 (9th Cir. 1983) (money received as compensation for an injury to a person's health and other personal interests is considered a realized accession to wealth).

138. *Id.*

139. Brief for the Appellee *supra* note 135, at 35–36.

140. *Murphy*, 460 F.3d 79, 87 (D.C. Cir. 2006), *vacated*, 493 F.3d 170 (D.C. Cir. 2007).

time or emotional well-being, per se, the fair market value of her consumption rights have not been diminished.

A different result occurs, however, under the Haig-Simons argument, phrased in economic terms. In that event, the economic value (in utility functions) of Murphy's consumption rights decrease to the exact amount offsetting the increase in her accumulated wealth. This equal offset is plausible because Murphy was personally injured and harmed emotionally, amounting to a decrease in her happiness and utility. The idea of compensatory damages is to return the victim to the status quo, and this occurs in an economic Haig-Simons formulation. Tax experts do not use the economic theory of Haig-Simons as much as the artificial tax one. This analysis is not meant as a criticism of the Haig-Simons formula, but merely as a demonstration, again, that putting technical precise definitions to income might not be as easy as saying, "cash minus basis equals gain."

Of course, in order for the I.R.S.'s tax argument to work, there is an express assumption that Murphy could not offset any of her \$70,000 amount realized with basis. This very assumption is what came under fire in *Murphy* and in the following sections of this comment. Some scholars have taken a similar stance as Murphy, advocating that compensatory damages should have a basis offset in the form of human capital or fairness-equity principles.<sup>141</sup>

### C. *Countering the Taxability of Personal Injury Compensation with the Human Capital Rationale and Equity-Fairness Concepts*

#### 1. Human Capital Theory

##### a. Generally

Aside from the statutory exclusion, a popular argument against taxing compensatory personal injury awards is that such awards are merely a return of human capital to the tort victims.<sup>142</sup> The Code taxes income which is defined as "gains . . . from whatever source derived."<sup>143</sup> Gains are defined by the Code as the amount realized in a transaction over the amount of basis, or capital.<sup>144</sup> Proponents of the human capital argument equate personal injury

141. See e.g., F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725 (1997) (arguing that a tax on mental distress compensation is a capitation tax and/or it is not income because people have basis in their body, or in the alternative, basis is a totally inappropriate measure of human capital).

142. See, e.g., Brief for the Appellant at 16–18, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139).

143. I.R.C. § 61(a) (2000).

144. I.R.C. § 1001(a) (2000).

compensation to an amount necessary to "restore" an amount of personal human capital destroyed or taken by a particular liable party.<sup>145</sup> In this context, proponents treat human capital synonymously with capital and basis for purposes of IRC § 1001.

*Murphy* is a suitable illustration of the proponents' argument. In *Murphy*, Murphy presented the human capital argument<sup>146</sup> and argued that she accrued no economic gain or "accession to wealth" from her compensatory awards.<sup>147</sup> The entire \$70,000, she argued, was only supposed to restore whatever emotional and "reputational" capital she possessed prior to the NYANG's wrongdoing.<sup>148</sup> If accepted, Murphy's argument would mean that whatever she realized as compensation for her emotional stress and diminished reputation would be completely offset as restoring capital, resulting in a zero-sum (zero-gain) situation; this means no taxable income would accrue. Ultimately, the *Murphy* panel never explicitly ruled on the human capital reasoning, but chose instead to rely upon the *Macomber* theory that income equals *proceeds* from labor or capital.<sup>149</sup> The panel opinion, however, appeared to largely agree with Murphy's analogy.<sup>150</sup>

b. Historical Underpinnings of the Human Capital Theory, As It Relates to the Exclusion for Personal Injury Compensation

The human capital line of reasoning is nothing new, especially in relation to the personal injuries exclusion. The history of and discussion of the personal injuries exclusion is infused and inseparable from the human capital rationale. Human capital, with strong historical linchpins, may be the strongest argument against Congress's ability to tax personal injury compensation. The personal injury exclusion is largely based on the theory that such

145. Hubbard, *supra* note 141, at 764.

146. *Murphy v. I.R.S.*, 460 F.3d 79, 85 (D.C. Cir. 2006), *vacated*, 493 F.3d 170 (D.C. Cir. 2007).

147. *Id.*

148. *Id.*

149. *Id.* at 88.

150. *Id.* The Court also stated that:

In any event, the Government's quarrel with Murphy's analogy, based upon *Glenshaw Glass*, of "human capital" to financial or physical capital is not persuasive. To be sure, the analogy is incomplete; personal injuries do not entail an adjustment to any basis, nor are human resources, such as reputation, depreciable for tax purposes. But nothing in Murphy's argument implies a need to account for the basis in or to depreciate anything. Her point, rather, is that as with compensation for a harm to one's financial or physical capital, the payment of compensation for the diminution of a personal attribute, such as reputation, is but a restoration of the status quo ante, analogous to a "restoration of capital," in neither context does the payment result in a "gain" or "accession[] to wealth."

*Id.* at n.\* (alteration in original) (citations omitted).



compensation, like accident insurance, is meant to restore a victim to his or her prior status quo.<sup>151</sup>

The 1918 opinion of the Attorney General to the Treasury (discussed in Section III, above) is apparently the first official statement by any governmental department discussing the taxability of personal injury accident insurance at length. By arguing that personal injury insurance proceeds were not gains, and therefore not income, the Attorney General endorsed a human capital analogy, albeit while saying he was not doing so:

Without affirming that the human body is in a technical sense the “capital” invested in an accident policy, in a broad, natural sense the proceeds of the [personal injury accident insurance] do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore ‘capital’ as distinguished from “income” receipts.<sup>152</sup>

As discussed in Section III, the Treasury Department then issued Treasury Decision 2747, which stated that that personal injury accident insurance was not income, and thus would not be taxed as such.<sup>153</sup> Shortly thereafter, Congress enacted the Revenue Act of 1918 which essentially codified the Treasury Decision 2747, stating that “it is doubtful whether amounts received . . . as compensation for personal injury . . . [are] included in gross income.”<sup>154</sup> With that history, it can hardly be doubted that the personal injury exclusion was based, at least partly, on a rough conception of personal injury compensation as a restoration of human capital, and outside of Congress’s ability to tax such proceeds as income.<sup>155</sup>

Proponents of the human capital rationale also point to dictum contained in *Glenshaw*.<sup>156</sup> In what has since become a controversial footnote, which appears to acknowledge the human capital rationale,<sup>157</sup> Chief Justice Warren wrote:

The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property.

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151. Hubbard, *supra* note 141, at 727 (arguing that compensatory damages work to make victims whole and do not substitute for normally taxable income, such as wages, and therefore are not income).

152. 31 U.S. Op. Atty. Gen. 304, 308 (June 26, 1918).

153. See Hobbs, *supra* note 24.

154. See *id.*

155. Cf. *O’Gilvie v. United States*, 519 U.S. 79, 96–99 (1996) (Scalia, J., dissenting).

156. See, e.g., Brief for the Appellant, *supra* note 142, at 16–18.

157. Others have claimed that the *Glenshaw* footnote actually endorses the human capital rationale. E.g. Brief for the Appellant, *supra* note 142.

Damages for personal injury are by definition compensatory only . . . considered a restoration of capital for taxation purposes.<sup>158</sup>

In the Court's 1996 opinion in *O'Gilvie v. U.S.*, Justice Breyer named the human capital rationale as the "original focus" of the personal injury statute, "an important part of . . . if not the entirety of, the statute's rationale."<sup>159</sup> Distinguishing the punitive damages that oftentimes accompany personal injury compensation, Justice Breyer reasoned that punitive damages "are not 'designed to compensate ADEA victims.'"<sup>160</sup> In fact, Justice Breyer's *O'Gilvie* opinion goes on to recite the history of the personal injury exclusion and its human capital roots. Justice Breyer cites, verbatim, the above excerpts from the Attorney General's 1918 opinion, Treasury Decision 2747, and the House Report on the Revenue Act of 1918.<sup>161</sup> This acceptance of human capital as the original and continual reason for the exclusion is apparent in numerous lower federal court decisions as well.<sup>162</sup>

Despite the human capital rationale's frequent mention in lower court decisions, the Supreme Court has never critically assessed the theoretical underpinnings of the human capital rationale or faced the issue of whether personal injury compensation is income under the constitutional meaning of the word.<sup>163</sup> The only critical analysis of the theory done by an official source was the 1918 Attorney General's opinion to the Treasury.<sup>164</sup> As explained, a main reason for the lack of critical analysis between 1918 and 1996 was that, until 1996, Congress excluded all personal injury compensation by statute (first in § 213(b)(6) of the Revenue Act of 1918 and then in IRC § 104(a)(2)), and

158. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955) (citation omitted).

159. *O'Gilvie*, 519 U.S. at 86.

160. *Id.* at 84.

161. *Id.* at 84–86.

162. *Dotson v. United States*, 87 F.3d 682 (5th Cir. 1996) ("[The] human capital [rationale] continues to support the [I.R.C. § 104(a)(2)] exclusion"); *see also* *Brooks v. United States*, 276 F.Supp.2d 653 (E.D. Ky. 2003) ("The rationale underlying such exclusion is the human capital principle."); *Starrels v. Comm'r*, 304 F.2d 574, 576 (9th Cir. 1962) ("Damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights--because, in effect, they restore a loss to capital.").

163. *See, e.g., O'Gilvie*, 519 U.S. at 79 (1996) (dealing directly with punitive damages and an interpretation of I.R.C. § 104(a)); *Comm'r v. Schleier*, 515 U.S. 323 (1995) (dealing with a statutory interpretation of I.R.C. § 104, and whether § 104(a)'s language required a strong causation nexus in the words "on account of personal injury"); *United States v. Burke*, 504 U.S. 229 (1992) (also dealing with statutory interpretation of I.R.C. § 104(a), interpreting the meaning of "tort or tort-type" in relation to Title VII cases). *See also* Hubbard, *supra* note 141, at 741 ("The Supreme Court has not had to address the issue of whether compensatory damages constitute income under the Sixteenth Amendment. Instead, the Court has focused on matters of statutory interpretation.").

164. 31 Op. Att'y Gen. 304, 308 (1918).

therefore no issues arose requiring a critical analysis of the exclusion's constitutional necessity.<sup>165</sup>

c. Human Capital, Theoretically Incompatible with Basis?

Despite its facial appeal, the theoretical soundness of the human capital argument has come under strong criticism from tax professionals. Even the *Murphy* panel did not use such a rationale in making its final decision. In fact, opponents of the theory might consider the human capital theory a misnomer. As explained above, capital and basis are synonymous tax law terms, each used to keep a record of the amount of post-tax dollars expended on a particular item.<sup>166</sup> Critics argue that the capital in human capital, however, does not really represent post-tax dollars, but merely a physical state or attribute.<sup>167</sup> According to some, emotional well-being is an endowment which by itself has zero basis.<sup>168</sup> With zero basis in emotional well-being, any compensation given to replace such an endowment will create a taxable gain equal to the full amount of compensation.

This endowment concept is more apparent when describing physical human attributes. For example, people do not buy their limbs, ears, or toes any more than they buy their emotional or mental health; they are endowed with them at birth. Since no cost is exerted to acquire body parts, no initial basis, or capital, exists to offset a taxable gain should a victim be compensated for losing a limb or their mental happiness.<sup>169</sup> Critics liken the compensation to a windfall gain, such as a lottery win, treasure trove, or one who receives a free sample.<sup>170</sup> Furthermore, once these personal attributes are acquired, the cost of maintaining one's limbs, ears, toes, and mental well-being (i.e., cost of food, water, shelter, education, etc.) are primarily personal expenses, disallowed by the Code.<sup>171</sup> Therefore, any compensation for personal physical injuries, and

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165. See *supra* Part III.C.2.

166. For example, a taxpayer pays \$5,000 as an initial cost for an antique vase. In tax terms, he has a basis, or capital, of \$5,000. Every time he expends more money on the vase, his basis (capital in the vase) goes up by that amount. If his vase is destroyed when it is worth \$6,000, and he is reimbursed by his insurance the entire value of \$6,000, he will not be expected to pay taxes on all \$6,000, but instead only on the difference between his adjusted basis (total capital) and the amount reimbursed, or realized, which is his gain for tax purposes. In our example, he would then only be responsible for paying taxes on a \$1000 gain.

167. See Kahn, *supra* note 3, at 133.

168. *Id.*

169. *Id.*

170. Hubbard, *supra* note 141, at 753.

171. I.R.C. § 262(a) (2000).

by implication emotional injuries is a gain, taxable unless otherwise exempted by the Code.<sup>172</sup>

The critics of the human capital theory have mostly carried the day in court. For instance, where taxpayers have sold their blood and attempted to exclude the proceeds from gross income, federal circuit courts have found exclusively for the I.R.S..<sup>173</sup> Furthermore, where tax protestors have used a human capital rationale to oppose paying income taxes on their wages (on the theory that wages are merely a return of human capital to the taxpayer for his spent labor), their arguments have been summarily rejected.<sup>174</sup> Even *O'Gilvie*, which proponents of the human capital theory say implicitly supports the theory for exclusion of personal injury damages, contains criticism of the rationale. Justice Scalia's dissent in *O'Gilvie*, which was joined by Justices O'Connor and Thomas, attempted to debunk the "return to capital" rationale of the early administrative rulings in and around 1918.<sup>175</sup>

Even the Attorney General's 1918 letter to the Treasury (relied on by many different entities thereafter in promulgating personal injury compensation policies) appears to improperly grasp the difference between an endowment and capital/basis in their technical tax meanings.<sup>176</sup> Either that, or the Attorney General was looking at personal injury compensation through the *res* conception of income, equating personal injury to loss of trust corpus. A few scholars have picked up on the Attorney General's unsound or antiquated reasoning and argued that the whole rationale for the personal injury exclusion is unsound and should therefore be abandoned.<sup>177</sup> This Comment is not so bold, but it does agree that the Attorney General's reasoning was either fallacious or based upon a *res* conception of income that is no longer in use.

In the Attorney General's letter to the Treasury, the Attorney General analogized accident insurance for personal injury to fire and casualty

172. I.R.C. § 213(a) (2000) (allowing a deduction from gross income the cost of medical expenses actually acquired by a victim, a deduction which would likely have allowed Murphy to offset a portion of her \$70,000 award-income although it is likely that Murphy was awarded a separate payment for future and past medical expenses for her injuries).

173. *E.g.*, *Lary v. United States*, 787 F.2d 1538 (11th Cir. 1986); *United States v. Garber*, 589 F.2d 843, 848 (5th Cir. 1979) (holding blood includable as income under I.R.C. § 61); *Green v. Comm'r*, 74 T.C. 1229 (1980) (holding that sale of blood with rare blood type income under I.R.C. § 61, and that selling blood could constitute a trade or business).

174. *E.g.*, *United States v. Connor*, 898 F.2d 942, 943-44 (3d. Cir. 1990); *Coleman v. Comm'r*, 791 F.2d 68, 70 (7th Cir. 1986); *Perkins v. Comm'r*, 746 F.2d 1187, 1188 (6th Cir. 1984); *Lonsdale v. Comm'r*, 661 F.2d 71, 72 (5th Cir. 1981); *Cullinane v. Comm'r*, 77 T.C.M. 1192, 1193 (1999) (noting that "[c]ourts have consistently held that compensation for services rendered constitutes taxable income and that taxpayers have no tax basis in their labor.").

175. *See O'Gilvie v. United States*, 519 U.S. 79, 97 (1996) (Scalia, J., dissenting).

176. *See Hobbs, supra* note 24, at 57-59.

177. *Id.* at 93-94.

insurance.<sup>178</sup> From there, the Attorney General wrote that fire and casualty insurance proceeds were excluded from gross income because they simply restored the fire victim to his previous status quo.<sup>179</sup> Returning the victim to their status quo resulted in a zero-sum situation of no gain or “accession to wealth,” or a simple neutralization of income and outcome.<sup>180</sup> Therefore, because accident insurance for personal injury insurance also created a zero-sum situation and a restoration to the status quo, no gain or accession to wealth (i.e., no income) was created.<sup>181</sup>

Unfortunately, in this simple analogy, the Attorney General failed to correctly distinguish the two uses of the term capital. One definition of “capital” denotes property while the other denotes a system of recording post-tax expenses on a particular item for tax purposes.<sup>182</sup> Even in 1918, the latter use of capital was well-known as the correct tax definition.<sup>183</sup> It was also recognized that compensation proceeds for the value of destroyed property were only exempt from gross income to the extent the proceeds restored the insurance holder’s *basis* in his property.<sup>184</sup> It is the distinction between restoring value and restoring basis that the Attorney General failed to grasp. Therefore, when he mischaracterized the nature of fire and casualty insurance proceeds to be excluded from gross income, the Attorney General also mischaracterized the distinction between compensating a personal injury victim for the value of his lost limbs from restoring the victim’s basis in his lost limbs. This characterization is a subtle but vastly important distinction in the tax arena since a return of capital in the tax sense denotes a tax-free recovery of basis while any recovery of value exceeding basis is gain.<sup>185</sup> This same line of reasoning is why the Code taxes endowments to the extent that compensation for the endowment exceeds a taxpayer’s basis in it.<sup>186</sup>

178. 31 U.S. Op. Atty. Gen. 304, 307–08 (1918).

179. *Id.*

180. *Id.*

181. *Id.* at 308.

182. *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 184–85 (1918).

183. *Id.* at 185. The court also stated that:

[I]t cannot be said that a conversion of capital assets invariably produces income . . . . Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of “gross income” received “from all sources.” . . . . In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

*Id.*

184. *Id.*

185. See generally I.R.C. § 1001 (2000) and cross-referenced sections therein.

186. For example, if a taxpayer is gifted an antique vase, he takes the adjusted basis in the vase that the donor had (I.R.C. § 1015), but if it is later destroyed and he has insurance proceeds

It may be telling that the *Murphy* and *O'Gilvie* majority opinions both cite the Attorney General's letter as support for the exclusion, and that both failed to recognize the Attorney General's apparent fallacy.<sup>187</sup> In fact, the *Murphy* panel used the letter as almost dispositive of whether personal injury compensation was income within the Constitution's original meaning.<sup>188</sup>

Insofar as some commentators have connected the Attorney General's apparently fallacious letter to the impetus for the House Report for the Revenue Act of 1918, they advocate a total abandonment of the personal injury exclusion, even in its current "personal physical injury" form.<sup>189</sup> This connection between the Attorney General's 1918 letter, the Treasury's Decision 2747, and Congress's 1918 House Report was criticized by Justice Scalia's *O'Gilvie* dissent.<sup>190</sup> Coincidentally, or ironically, Justice Scalia's dissent appears to partially discredit the human capital line of reasoning in a way that discredits professor Hobbs's arguments against the human capital rationale. However, this incongruity demonstrates that even among *critics* of the human capital rationale there is no consensus as to whether the Attorney General's fallacious reasoning requires a total abandonment of the personal injury exclusion or the human capital argument.

#### d. Concluding Remarks on Human Capital

Regardless of the merits of the human capital theory, and whether one is a proponent or critic of it, two facts should be accepted unanimously. First is the fact that the tortured history of the personal injury exclusion does not substantially support one side of the debate or the other, and therefore history alone should not be relied upon as the basis for either supporting or

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compensating him for the full value, any recovery in excess of the donor's adjusted basis (plus any additional basis contributed by the taxpayer) will be includable in gross income.

187. In fact, while professor Hobbs's arguments are quite convincing, no court dealing with the issue of personal injury exceptions has yet had occasion to use them.

188. *Murphy v. I.R.S.*, 460 F.3d 79, 109 (D.C. Cir. 2006), *vacated*, 493 F.3d 170 (D.C. Cir. 2007).

189. *See generally* Hobbs, *supra* note 24.

190. *O'Gilvie v. United States* 519 U.S. 79, 98 (1996) (Scalia, J., dissenting):

So, to trace the Court's reasoning: The statute must exclude punitive damages because the Committee Report must have had in mind a 1918 Treasury Decision, whose text no more supports exclusion of punitive damages than does the text of the statute itself, but which must have *meant* to exclude punitive damages since it was based on the "return-of-capital" theory, though, inconsistently with that theory, it did *not* exclude the much more common category of compensation for lost income. Congress supposedly knew all of this, and a reasonably diligent lawyer could figure it out by mistrusting the inclusive language of the statute, consulting the Committee Report, surmising that the Treasury Decision of 1918 underlay that Report, mistrusting the inclusive language of the Treasury Decision, and discerning the Treasury *could* have overlooked lost-income compensatories, but could *not* have overlooked punitives. I think not.

abandoning the rationale behind the personal injury compensation exclusion. That the *Murphy* panel found the history of the personal injury exclusion so dispositive on this issue was probably an error. Second, opponents of taxing personal injury compensation should not rely exclusively upon a human capital rationale without preparing something else. The human capital rationale flies squarely in the face of current-modern tax basis analysis. Therefore, proponents of the rationale must be prepared to use outside rationale to either supplement or replace these human capital arguments when arguing against Congress's power to tax emotional distress compensation. The next section discusses a supplementary or alternative argument, in terms of fairness and equity.

## 2. Tax Fairness and Equity in the Tax System: Sidestepping the Basis Issue

While the human capital theory above attempts to squeeze itself into the modern technical tax system of gain, basis, capital, and accession to wealth, it fails to properly do so because its conception of capital is a misnomer that is more similar to endowment than tax basis. Perhaps the more effective, or at least honest, approach by those scholars who oppose taxing personal injury compensation is to use the human capital argument in conjunction with a fairness and equity argument. While the human capital argument attacks the classification of personal injury compensation as a "gain," a fairness argument takes up the issue of whether traditional basis is or should be applicable to personal injury compensation, and also whether such compensation should be "gross income" at all.

There are three fairness aspects of personal injury compensation that, taken together, should give tax analysts second thoughts as to the equity, prudence, and legality of taxing such compensation, especially when considered in conjunction with the human capital rationale.<sup>191</sup> These three factors are: (1) the intimate and personal nature of certain personal injury compensation; (2) the non-marketability of personal injury rights; and (3) the involuntary conversion of such personal rights that occurs and leads to compensation.<sup>192</sup> A combination of these factors creates a distinct *something* that is inadequately addressed in the Code, thereby creating an unfair result. There is no case law directly addressing this issue, as it has only regained notoriety since 1996, as discussed above in Part II.

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191. See Kahn, *supra* note 3, at 135.

192. *Id.*

a. The Code's Inadequate Treatment of Personal Injury Compensation

The problem with analyzing personal injury compensation under the Code's modern tax definition of basis is that such compensation deals with (1) inherently personal rights that are often-times (2) unmarketable and (3) involuntarily taken from a victim.<sup>193</sup> While the Code does in fact deal separately with both personal rights and involuntary conversions, it does not deal with them together (except to assume that they are taxable since not explicitly exempted in the Code).<sup>194</sup> Non-marketability is an aspect the Code ignores completely. This failure to consider these factors together (or at all) and to not later exempt them from income (via the post-1996 § 104(a)(2)) created the current problem in tax law. The combination of these three aspects of personal injury compensation suggests a need to approach personal injury compensation differently than other types of compensation for basis purposes.<sup>195</sup>

i. Inherently Personal Features

One aspect of personal injury compensation taxation that is odious to prudential and just senses is the inherently personal thing that is being replaced or compensated for.<sup>196</sup> One's eyes, limbs, tears, happiness, and labor are all very personal attributes to which the individual attaches more than other material objects, such as cars, money, or jewelry. Personal injury compensation is meant to replace such personal attributes when they are tortiously taken in order to return victims to their previous status quos.<sup>197</sup> Except for I.R.C. 104(a)(2), which distinguishes personal injury compensation based solely upon the physical or nonphysical origin of the injury, the Code treats inherently personal features no differently than it treats one's car or house.<sup>198</sup> Actually, the Code *does* distinguish between homes and cars on one hand and blood, emotions, reputation, and feelings on the other. Amazingly, the Code treats personal features *worse* for tax purposes, since the Code

193. *Id.*

194. *See* I.R.C. § 1033 (2000).

195. *Cf.* Khan, *supra* note 3, at 135–37 (arguing that such arguments are merely value judgments, and therefore properly reserved for consideration by the legislature on mere policy grounds, not statutory or constitutional grounds). *See also supra* Part IV.C.2.b.

196. *See* Kahn, *supra* note 3, at 135.

197. *See generally* Hubbard, *supra* note 141 (including a history of emotional distress compensation and its purposes); Laura Spitz, *I Think, Therefore I Am; I Feel, Therefore am Taxed: Descartes, Tort Reform, and The Civil Rights Tax Relief Act*, 35 N.M. L. REV. 429 (2005); Laura Quigley, *Reparation Rights Tax Relief Restores Human Rights as a Civil Right in Tax Tort Reform*, 40 VAL. U. L. REV. 41 (2005); Mark J. Wolff, *Sex, Race, and Age: Double Discrimination in Torts and Taxes*, 78 WASH. U. L.Q. 1341 (2000).

198. I.R.C. § 104(a)(2) (2000).



precludes deductions for personal expenditures<sup>199</sup> and does not attribute any basis to one's person.<sup>200</sup>

To be fair to the Code, just because an attribute is inherently personal does not mean that it cannot or should not be taxed. After all, employee wages are technically compensation, given in exchange for the employee's time, tears, leisure, sweat, and, to an extent, happiness and emotional well-being. Modern economics is based on the premise that humans interact the way they do solely to maximize happiness (or utility). No reasonable person, however, doubts that the Sixteenth Amendment's conception of income is so narrow as to exclude compensation for labor as income.<sup>201</sup> Furthermore, even the *Macomber* definition of income includes gains from "labor."<sup>202</sup>

Another line of cases that comes even closer to this "personal injury compensation" situation deals with the sale of human blood. Blood is extremely personal and has no use other than for personal human benefit. However, courts summarily reject taxpayer arguments that compensation for their blood is not income under I.R.C. § 61 and the Sixteenth Amendment.<sup>203</sup> Proceeds from the sale of blood are completely taxable as income (since there is no basis in blood), while donations of blood to charitable organizations are not deductible as charitable expenses (again, because the Code does not allow people basis in their blood).<sup>204</sup>

However, this Comment does not argue against the taxability of sales of one's labor or blood. In fact, sales of labor and blood are distinguishable from personal injury compensation on two grounds: labor and blood transactions are both freely marketable and done voluntarily. This leads to the next point that personal injury compensation is often awarded to compensate victims for assets that are not freely transferable or marketable.

199. I.R.C. § 262 (2000).

200. See *Lary v. United States*, 787 F.2d 1538 (11th Cir. 1986); *Green v. Comm'r*, 74 T.C. 1229 (1980); *United States v. Garber*, 589 F.2d 843, 848 (5th Cir. 1979).

201. Tax protestors often espouse a human capital argument in court to avoid paying taxes on their wages. Consequently, the human capital argument in relation to wages has been summarily, and with much irritation, rejected by all courts. See sources cited *supra* note 174.

202. *Eisner v. Macomber*, 252 U.S. 189, 207 (1919) ("Income may be defined as the gain derived from capital, from labor, or from both combined.").

203. See *Lary v. United States*, 787 F.2d 1538 (11th Cir. 1986); *Green v. Comm'r*, 74 T.C. 1229 (1980); *United States v. Garber*, 589 F.2d 843, 848 (5th Cir. 1979).

204. *Lary v. United States*, 787 F.2d 1538, 1540-41 (11th Cir. 1986) ("In the instant case, section 170(e)(1)(A)'s limitation on charitable contributions precludes any charitable deduction for the value of the donated blood. Taxpayers have proffered no evidence as to any basis in the donated blood . . .").

ii. Nonmarketability of Emotions and Other Personal Attributes

A person's eyes, arms, emotions, and psychological well-being are not marketable assets, which distinguishes personal injury compensation from the sale of blood and labor. The second factor, non-marketability, which describes much personal injury compensation, is not mentioned explicitly in the Code at all.<sup>205</sup> Yet, the I.R.S. claims to have power to tax all human eyes, ears and limbs upon some realization event.<sup>206</sup> As in Murphy's case, where she was compensated for emotional and psychological pain (and physical pain which was brought on as a result of her psychological trauma), she could not ordinarily have cashed in on her emotional well-being prior to having it stolen or destroyed (essentially what NYANG did here).

The Code does not address this "marketability" factor because, for tax purposes, the marketability of an asset is apparently irrelevant.<sup>207</sup> For the Code's concept of income (distinguished, perhaps, from the constitutional and statutory definition of income) the only important questions to ask are what is the amount of monetary benefit (cash) and whether that amount exceeds the amount of post-tax dollars directly expended on the unmarketable item. Again, the Code does not allow basis for personal attributes (not even the food and water that go into maintaining them) but instead treats body parts similar to endowments, with no post-tax dollars having been expended on them.<sup>208</sup> Remember, an analytical consequence of allowing a person to acknowledge post-tax dollar expenditures (basis) on their body and emotions could be to essentially make wages nontaxable as well as create a host of other deductions.<sup>209</sup> Therefore, justifying that compensation for emotions and psychological well-being is not income under the Sixteenth Amendment and I.R.C. § 61 based solely on their status as nonmarketable assets would be disastrous for the current income tax system and irreconcilable with judicial precedents and the likely intent of the Framers of the Sixteenth Amendment.<sup>210</sup>

205. As is fairly obvious, inherently personal attributes are mostly nonmarketable, with some exceptions, such as reputation/goodwill, blood, hair, and labor, all of which are clearly marketable inherently personal assets.

206. See *infra* Part IV.B.2.iii.

207. See Kahn, *supra* note 3, at 133; Hubbard, *supra* note 141, at 764–65.

208. See, e.g., Lary v. Unites States, 787 F.2d 1538 (11th Cir. 1986); Green v. Comm'r, 74 T.C. 1229 (1980); United States v. Garber, 589 F.2d 843, 848 (5th Cir. 1979).

209. For example, personal deductions for *anytime* a person is unhappy, depressed, or emotionally or physical unwell, whether or not it is the fault of someone else or whether or not a legal suit is initiated and won.

210. For instance, it would be ludicrous to allow taxpayers to take tax deductions on the water, food, and shelter expenses that are necessary for keeping themselves healthy and happy. If that were the case, the wealthiest and most extravagant spenders would be allowed the most tax deductions. This is just one consequence of such a broad exclusion from income.

However, despite the harm that a principle based on non-marketable status might do to the state of the income tax system, it seems intrinsically unfair and inequitable to tax Americans on inherently personal attributes that could not have been, and would not be, exchanged for cash equivalent, but for the intentional, reckless, or negligent conduct of some tortious actor. This moves the Comment along to the final factor that, together with the inherently personal attributes and non-marketability factors make the taxation of personal injury compensation unfair, imprudent, and probably unconstitutional: that these assets are involuntarily converted.

### iii. Involuntarily Converted Assets

The last factor that makes taxing certain personal injury compensation odious is the involuntary conversion that occasions such compensation. As in *Murphy's* case, where NYANG effectively stole her peace of mind and caused extensive emotional pain and anguish, personal injury compensation goes to victims who have had their personal rights violated and their assets harmed by no choice of their own. Many times, the only thing the victims can do is go to court and get compensated monetarily. This factor further distinguishes the case of sales of blood and labor, where the compensation is for voluntary acts.

Unlike the former two factors listed above, the Code explicitly deals with involuntary conversions.<sup>211</sup> For the Code, conversions of property are realization events and make previously unrealized gain taxable at that point.<sup>212</sup> This concept inherently makes sense, in the context for which it usually applies. For instance, if a person owned a house for twenty years, and it burns down, it is likely the homeowner will be compensated for the fair market value of her house at the time it burned down. However, since the time she purchased her house, twenty years prior, the property likely appreciated in value. When she receives her insurance compensation, any gain would normally become realized and taxable.<sup>213</sup> When this conversion principle is applied to the incidents of personal injury compensation, it means that the victim is about to get taxed. The I.R.S. has no qualms about applying this a conversion principle to cases involving mental and physical anguish of victims, as the *Murphy* case shows.

To counteract what at first appears to be slightly unfair for the victim of an involuntary conversion, who probably did not want to recognize a gain and cannot replace her home exactly without the pre-tax sum of insurance proceeds, the Code includes a deferment mechanism for gain in the form of

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211. I.R.C. § 1033 (2007).

212. *Id.*

213. If she were not taxed on amount of insurance money that exceeded her adjusted basis in her home, she would make an untaxed profit off of the destruction of her home, which is not fair when compared to those who sell their homes voluntarily (I.R.C. § 121 aside).

I.R.C. § 1033.<sup>214</sup> Section 1033 allows taxpayers to defer gains realized upon some involuntary conversions, under certain specific conditions.<sup>215</sup> Important to this article is the specific condition that the proceeds from the compensation be converted back to "property similar or related in service or use to the property so converted."<sup>216</sup> This requirement effectively excludes victims of personal injury from deducting any of their compensation from gross income. There is nothing "similar or related in service" to "emotional happiness" that Murphy can buy with her compensation that would allow her to qualify under IRC § 1033.<sup>217</sup> A car accident victim cannot buy himself another arm or another set of eyes if he loses them in a car accident.<sup>218</sup>

This Comment does not criticize the current section 1033, but only points out the obvious, that such a section is not appropriate to deal with inherently personal attributes. However, the existence of I.R.C. § 1033 is an acknowledgement that involuntary conversions should be dealt with in a manner different than voluntary conversions. The "similar or related in service" requirement merely strengthens the notion that our income tax system does not force citizens to pay taxes on circumstances that are by and large not their fault and not their own doing. The involuntary conversion of personal injury victims' physical, emotional, and psychological well-being is especially egregious, because such victims would NEVER have converted their emotions, body, or psyche to monetary form but for the actions of some liable person.

Section 1033's deferment mechanism works to correct a situation where a taxpayer would have paid taxes on his gain anyway, so no tax revenue is lost, only postponed. This Comment advocates for a total nonrecognition of such personal injury compensation as income and in that respect this Comment

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214. I.R.C. § 1033 (2007) ("If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted [i]nto property similar or related in service or use to the property so converted, no gain shall be recognized.").

215. *Id.*

216. *Id.*

217. While Murphy could not use her compensation to buy emotional happiness, she could of course use it to buy a vacation to the Bahamas, where she would undoubtedly cope with her mental anguish better. However, a vacation is likely not closely "similar or related in service" enough to meet section 1033 standards. Nor is a "medical vacation" allowable as a deduction under I.R.C. § 213 (deduction from gross income for medical expenses), via 26 CFR 1.213-1(e)(1)(ii), which states, "an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care."

218. Of course, prosthetic limbs are available and are allowed as deductible medical expenses in I.R.C. § 213 of the Code. See Treasury Regulation § 1.213-1(e)(1)(ii) (stating that "[d]eductions for expenditures for medical care allowable under section 213 will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for the following are payments for medical care: . . . artificial teeth or limbs.").

diverges from I.R.C. § 1033's principle of "later, but not never."<sup>219</sup> However, the fairness and equity rationale that underlies I.R.C. § 1033's deferment nonetheless adds credibility to a policy of total nonrecognition of gain for personal injury compensation. In a sense, any other conclusion would advocate for a perverse situation in which tortious individuals build the government coffers by injuring people; this is because the Constitution does not allow Congress the right, without apportionment, to tax people for their arms, legs, and emotions in and of themselves.<sup>220</sup> Had victims not been FORCED to convert their personal attributes to compensatory damages because of civilly liable individuals, they never would have realized income in the first place!<sup>221</sup> It is these three factors, all present in personal injury compensation, which warrants their separate treatment as non-income in the constitutional, statutory, and common-sense meaning of the word.

#### iv. The Three Factors Together

Personal injury compensation that involves personal attributes that are non-marketable and converted involuntarily from the victim cannot be, under any standard of fairness and equity, taxable. As demonstrated above, it is the interplay between these three factors together that ensures a court ruling that held personal injury compensation nontaxable and not subject to the normal gain rules of realization over basis would not be readily exploitable in a much larger sense. Individually, these factors do not make a compelling argument against taxing personal injury compensation. Instead, it is the combination of all three factors together that compel a different result.

Removing personal injury compensation that meets these three requirements from the realm or definition of income would not impact tax revenue in any significant way. Presently, physical personal injury compensation and all compensation stemming from it (punitive damages aside), is already completely excluded from gross income via I.R.C. § 104(a)(2).<sup>222</sup> The discussion is really only concerned with damages for emotional distress, personal reputation, and other psychological damages that accompany various tort and tort-like suits. Furthermore, the non-marketability

219. I.R.C. § 1033 (2007).

220. U.S. CONST. art. I, § 9, cl. 4 ("No capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.").

221. One can imagine the editorial cartoon in the newspaper where a sneaky, bureaucratic, top-hatted I.R.S. tax collector is plotting with the mean, gruff, jail-suited villain to injury the poor, gentle, unsuspecting victim taxpayer so as to then reap the tax revenue from any ensuing civil settlement! It is a disturbing, yet theoretically sound, (even if practically ridiculous) picture of the taxman taxing one's tears. Although, it would not be the first negative depiction of the I.R.S.; if you would like to see a few other cartoons depicting tax issues comically, see [www.cartoonstock.com/directory/t/tax\\_collector](http://www.cartoonstock.com/directory/t/tax_collector).

222. I.R.C. § 104(a)(2) (2007).

factor accompanying most personal injury situations means that the federal coffers are not losing out on anything that would have become taxable outside of some faulty person's actions.

Admittedly, requiring a personal injury exclusion to meet these three factors would leave out some otherwise popular categories of "personal rights." For instance, while professional and personal reputations (i.e. goodwill) are personal attributes, they are nonetheless marketable in many situations. Therefore, under this Comment's fairness concept of income personal injury compensation meant to restore one's personal and professional reputation would be subject to taxation, for failing to meet the second factor, unmarketability. However, tort compensation for pain and anguish, mental or physical, would indeed not be income under this meaning; mental and physical pain and anguish are inherently personal attributes, not marketable, and were involuntarily forced upon a victim.

#### b. Likely Criticisms and Responses to a Fairness Limitation on Income

Advocating for a fairness limitation on Congress's power to define income (at least, in the case of personal injury compensation) is bound to run into more than a few criticisms.

First, a most obvious criticism is that income definitions are best left to Congress.<sup>223</sup> Again, this advocates for Congress to use its plenary power to define income; but this violates the notion of a limited government with checks and balances and a constitution.<sup>224</sup> Particularly on point is the Supreme

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223. See e.g., Kahn *supra* note 3, at 135; Thuronyi *supra* note 3, at 100.

A constitutional definition of income in terms of tax equity would recognize that as long as Congress is striving to impose a tax based on the relative annual financial positions of taxpayers, according to its concept of fairness, the Court should not overturn its determination. The sixteenth amendment [sic] should be read as authorizing just such a legislative exercise. . . . Under such an approach the concept of income would be an elastic one, since it could accommodate virtually any congressional definition of income.

*Id.* Marjorie Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 24 (1992).

Given the broad underlying purpose of the taxing power generally, a proper reading of the Sixteenth Amendment must give Congress a fully vested power to tax all income, however Congress defines it, without worrying about fine distinctions. Such an interpretation yields a meaning of income that is broad and evolutionary. Income's meaning is to be determined by Congress, not the Court, and that meaning changes over time as congressional conceptions of income change and become more sophisticated. A broad definition of income also harmonizes with the Court's understanding of the balance of power among the three branches of government and its vision of the judiciary's function in a regulatory state as one of deference to the legislative and executive branches.

*Id.*

224. See Jensen, *supra* note 3, at 1087–91 (arguing that simply deferring to Congress to the meaning of income without any supervisory role violates the notions of having the Sixteenth

Court's holding by Justice Brandeis in *Burk-Waggoner Oil Ass'n v. Hopkins* that, "Congress cannot make a thing income which is not so in fact."<sup>225</sup> "Congress cannot by any definition [of income] it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."<sup>226</sup> Because Congress cannot simply define as income that which is not income, some parameters inherent in the Sixteenth Amendment's conception of income surely must exist. A parameter based on fairness principles is not totally out of the question.<sup>227</sup>

A second criticism of this three factored fairness test for non-income is that fairness is itself so amorphous as to be impossible to set firmly into a standard. While a complete all-encompassing definition of fairness might be unattainable, there should be little doubt that fairness has played and continues to play a fundamental part of the income tax system in the United States. One fairness principle replete in United States income tax history and implementation is that the government does not tax heaviest the poorest and most downtrodden.<sup>228</sup> Taxing personal injury compensation does exactly that; it burdens victims who have been deprived of their personal rights and leaves them only partially restored to their previous status quo.

A third potential criticism is the implementation and administration of such fairness principles. In relation to personal injury compensation, critics charge that separating the compensation for injury is often difficult to distinguish from the lost wages, punitive, and other liquidated damages<sup>229</sup> and that juries are ill-equipped to judge the value of pain, anguish, and psychological suffering.<sup>230</sup> However, this objection has long been dismissed, as judging personal injury values for physical pain and mental anguish is accepted as a risk of providing a

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Amendment and the Constitution, as well as our branched system of governance, allowing lawyers and Congress to disregard legal texts and avoid courts of law).

225. *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925); *see also* *Taft v. Bowers*, 278 U.S. 470, 481 (1929) (stating that the "settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income.").

226. *Eisner v. Macomber*, 252 U.S. 199, 206 (1920).

227. *See generally* Thuronyi *supra* note 3.

228. *See, e.g.*, Jensen *supra* note 3, at 1091–1107 (discussing the history of the 1894 income tax, the Sixteenth Amendment, the populist party movement, and the general push for a progressive system of taxation that removed the heaviest burdens of tax from the ones least able to pay it).

229. *E.g.*, Kahn *supra* note 3, at 136 ("There is great difficulty at arriving at the correct amount of monetary award that approximates the personal loss that a victim has suffered.").

230. *Id.*

legal remedy to a legal wrong.<sup>231</sup> In any event, excessively large jury awards are reviewable by courts.<sup>232</sup>

A final argument that has been espoused is that fairness and equity actually *mandate* for taxation of personal injury compensation.<sup>233</sup> The argument is that many people suffer tortious personal injury suffering. However, only some are so "lucky" to be compensated for it.<sup>234</sup> Allowing a tax deduction for those compensated in effect makes the two groups of people (i.e., those compensated and those not compensated) unequal, which is unfair.<sup>235</sup> While this argument is at first insulting and ridiculous to the eyes and ears of anyone reading or listening, politeness and thoroughness mandates that it be addressed. All that need be said is that those who attain redress in court had such a right to redress. They were not "lucky"; they were entitled to such compensation, on the basis that they had been legally harmed. It is a fundamental principle that those who suffer legal harms are entitled legal remedy (or do tax professionals ignore the basic precepts of our legal system as related in *Marbury v. Madison*<sup>236</sup> just as they are so willing to ignore the Sixteenth Amendment?). For any law practitioner to accept such an argument is to concede defeat that our system strives to give legal redress to those legally injured. Just because our system of justice is not perfect does not mean that the tax system should encourage or exploit its imperfections.

## V. CONCLUSION

In December 2006, once the *Murphy* rehearing was scheduled and the initial decision vacated, it became fairly apparent to this author that, in all likelihood, Chief Judge Ginsburg and the other two panel members would rule against *Murphy*. After all, why would the panel have vacated their prior

231. W. PAGE KEETON ET. AL., PROSSER AND KEETON ON THE LAW OF TORTS § 12, at 55 (5th ed. 1984).

232. See, e.g., *Gasperini v. Center for Humanities*, 518 U.S. 415 (1996).

233. E.g., Deborah A. Geier, *Murphy and the Evolution of "Basis,"* 113 TAX NOTES 576, 582 n.25 (Nov. 6, 2006) ("Many others have noted the difficulties in articulating a satisfactory rational for . . . [personal injury] exclusion . . . . [I]t is hard to justify why the most fortunate subset of injured parties – those fortunate enough to receive a recovery of some sort—should be the ones blessed with a tax benefit."); Thuronyi *supra* note 3, at 90–91 (making the argument that those lucky enough to be compensated for their personal injury are in effect better off than those who are not compensated, since it would be ludicrous and unmanageable to allow a tax deduction to those who are personally injured but not compensated. In effect, this would make the two injured persons (one compensated legally, the other not compensated) *unequal* and therefore violate equity precepts).

234. Thuronyi *supra* note 3, at 90–91.

235. *Id.*

236. *Marbury v. Madison*, 5 U.S. 137, 163 (1803) ("[I]t is a general and indisputable rule, that where there is a legal right, there is also a legal remedy by suit or action at law, whenever that right is invaded.").



decision if not just to decide the matter differently and keep it out of taxpayer briefs and future court opinions (where it would undoubtedly fester as an open sore)? The second *Murphy* decision contains language more deferential and broader than any other court case on the subject of income.<sup>237</sup> Under all of the negative criticism and pressure from tax articles and tax scholars, Chief Judge Ginsburg's buckling is understandable. His buckling is also unfortunate. Some things are too solemn for Congress to tax so arbitrarily.

It was the hope of this Comment to instill in readers the notion that Congress cannot simply make up whatever it likes as a constitutional definition of income. It was a second goal that readers could see, through the brief histories set out in the paragraphs above, the changing conceptions of income and personal injury compensation that have existed throughout the country's history. After this reading, it should be apparent that personal rights to one's body and emotional-well being were not income as the Framers conceived the term, nor are they income now, in the twenty-first century. While society has moved past a stale definition of *res* income to a more dynamic and evolving definition under *Glenshaw* and Haig-Simons, there are still certain things, such as psychological health and human physical attributes, which Congress must leave solemn. This author's position is, of course, the minority view. However, as the concept of income has proven, even unfair notions of what is allowable eventually give way to more enlightened times.

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237. *Murphy v. I.R.S.*, 493 F.3d 170, 179 (D.C. Cir. 2007) (“[Income] extend[s] to all economic gains not otherwise exempted”; “Section 61 encompasses all accessions to wealth”; “Section 61(a) includes *Murphy*’s award in her gross income regardless whether it was an accession to wealth, as *Glenshaw Glass* requires. . . . In other words . . . [Congress] can *label* a thing income and tax it, so long as it acts within its constitutional authority . . .”).

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