

1997

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17 Miss. C. L. Rev. 339 (1996-1997)

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# THE TAX TREATMENT OF PUNITIVE DAMAGES UNDER 26 U.S.C. § 104(a)(2)

*Treva Lowery McInnis*

## I. INTRODUCTION

The decision of the Sixth Circuit Court of Appeals in *Horton v. Commissioner*,<sup>1</sup> which affirmed the Tax Court's holding, was the first federal circuit opinion to interpret Internal Revenue Code [hereinafter the Code] § 104(a)(2) as excluding punitive damages recovered for personal, physical injury from the taxpayer's gross income. This decision conflicts with the decisions of five other circuits which have considered this issue.

This Comment will examine the tax treatment of punitive damages by looking at the significant case law of the Sixth Circuit, as well as the decisions of the other circuits and the Supreme Court. Also, this Comment will consider the position taken on this issue by the Internal Revenue Service [hereinafter the Service].

## II. HISTORICAL BACKGROUND OF THE TAX TREATMENT OF PUNITIVE DAMAGES

A taxpayer's gross income includes "all income from whatever source derived."<sup>2</sup> All realized accessions to wealth are presumed to be taxable income, unless the taxpayer can demonstrate that an acquisition is specifically exempted from taxation.<sup>3</sup> Therefore, it is clear that personal injury damage recovery is an accession to wealth and will be included in gross income unless specifically excluded under another section of the Internal Revenue Code.

Section 104 of the Code is the exclusionary provision for damage recoveries for personal injuries. This section entitled, "Compensation for Injuries or Sickness," excludes from gross income "any damages received . . . on account of personal injuries or sickness."<sup>4</sup> The ambiguous language of the statute has facilitated much discussion. The courts do not agree whether punitive damages should be included in gross income, and the Service has historically rendered inconsistent rulings on the issue.

### *A. The Internal Revenue Service's Rulings on Punitive Damages*

The Service has vacillated on the issue of whether punitive damages are or are not included in the taxpayer's gross income. This vacillation has contributed to the confusion surrounding the issue of taxation of punitive damages.

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1. 33 F.3d 625, 630 (6th Cir. 1994), *aff'g* Horton v. Commissioner, 100 T.C. 93, 101 (1993).

2. 26 U.S.C. § 61(a) (1994) states that "except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items." Section 61 then lists items that are included in gross income. *Id.*

3. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955).

4. 26 U.S.C. § 104 (1994).

The Service first issued Revenue Ruling 58-418<sup>5</sup> in which the taxpayer received both compensatory and punitive damages in settlement of a libel suit. The Service, relying on *Commissioner v. Glenshaw Glass Co.*,<sup>6</sup> held that the punitive damages were not excludable from gross income.

The Supreme Court in *Glenshaw Glass* addressed the taxation of punitive damages received as a result of fraud and antitrust actions.<sup>7</sup> The Court stated that it was Congress' intent to "tax all gains except those specifically exempted" and that punitive damages were "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."<sup>8</sup> The Court in *Glenshaw Glass* did not specifically address the taxation of punitive damages received as a result of personal injury, but courts have relied on the language in *Glenshaw Glass* to hold that punitive damages should be included in gross income. However, § 104(a)(2) is evidence of Congress' intent to exclude *any* damages as a result of personal injury.

Since the Court did not specifically address punitive damages received for personal injury, the Service must have relied on footnote eight in the Supreme Court's opinion.<sup>9</sup> This footnote stated that "[d]amages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes."<sup>10</sup> The Court used this footnote to illustrate the difference in "return of capital" and "accession to wealth" and not to say that punitive damages should be included in gross income.<sup>11</sup> Punitive damages are considered an accession to wealth because they are non-restorative in nature. However, this determination does not override the plain language of § 104(a)(2) which does not limit the exemption to compensatory damages.

Subsequently, the Service reversed its position in Revenue Ruling 75-45, holding that punitive damages in a wrongful death action were excluded from gross income.<sup>12</sup> The Service stated in its ruling that "under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income."<sup>13</sup>

The Service's current position is that § 104(a)(2) does not exclude punitive damages.<sup>14</sup> The Service stated in Revenue Ruling 84-108 that "[a]n award of punitive damages . . . does not compensate a taxpayer for a loss but adds to the taxpayer's wealth. Furthermore, punitive damages are awarded not 'on account

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5. Rev. Rul. 58-418, 1958-2 C.B. 18 (superseded by Rev. Rul. 85-2 C.B. 51).

6. 348 U.S. 426 (1955).

7. *Id.*

8. *Id.* at 430-31.

9. Brian R. Greenstein & Mark B. Persellin, *Recent Developments Provide Support for Excluding Punitive Damages from Income*, 79 J. TAX'N 108, 109 (1993).

10. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 (1955).

11. Greenstein & Persellin, *supra* note 9.

12. Rev. Rul. 75-45, 1975-1 C.B. 47.

13. *Id.*

14. Rev. Rul. 84-108, 1984-2 C.B. 32. The Service revoked Revenue Ruling 75-45 after litigating a position contrary to this Ruling in *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983). The Ninth Circuit, relying on Revenue Ruling 75-45, held that punitive damages received by the plaintiff on account of his personal injury were excludable under § 104(a)(2). 716 F.2d 693, 700 (9th Cir. 1983).

of personal injury,' as required by § 104(a)(2), but are determined with reference to the defendant's degree of fault."<sup>15</sup>

*B. Interpretations of Section 104(a)(2)  
by the Circuit Courts*

The following discussion illustrates the disparity of the circuit courts' opinions concerning the taxation of punitive damages received as a result of personal injury. The Ninth, Fourth, Federal, Fifth, and Tenth Circuits, have, for various reasons, held that punitive damages should be included in gross income. The Sixth Circuit, however, affirmed the Tax Court's decision that punitive damages should be excluded from gross income under § 104(a)(2).

1. The Ninth Circuit's Rulings

In *Roemer v. Commissioner*,<sup>16</sup> the taxpayer, a successful insurance salesman, alleged that a credit report prepared by Retail Credit Company was published "with the intent to damage his reputation, and to injure him in his business profession and occupation"<sup>17</sup> The jury awarded \$40,000 in compensatory damages and \$250,000 in punitive damages for his injuries resulting from Retail Credit's libelous behavior.<sup>18</sup> The jury did not specify whether the award was for injury to Roemer's personal reputation or his professional reputation, nor did the jury specify whether the award was for his personal injury or his economic loss.<sup>19</sup> Roemer reported only \$16,020 of the damages as income on his federal tax return.<sup>20</sup> The Commissioner of Internal Revenue found that all of the damages awarded should be included in gross income.<sup>21</sup> The Tax Court upheld the Commissioner's decision, stating that the compensatory damages were not exempt under § 104(a)(2) because Roemer had failed to show that these damages were awarded as a result of an injury to his personal reputation.<sup>22</sup> Also, the court found that the punitive damages were included in gross income, since the compensatory damages were awarded for damage to the taxpayer's professional reputation.<sup>23</sup>

The Ninth Circuit reversed the Tax Court's decision.<sup>24</sup> The court recognized that all accessions should be included in gross income under Internal Revenue Code § 61(a) unless specifically excluded by another section of the Code.<sup>25</sup> The court stated that Congress, since 1918, has intended that damages awarded for personal injuries should be excluded from gross income per § 104(a)(2).<sup>26</sup>

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15. Rev. Rul. 84-108, 1984-2 C.B. at 34.

16. 716 F.2d 693 (9th Cir. 1983).

17. *Id.* at 694-95.

18. *Id.* at 695.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.* at 695-96.

24. *Id.* at 700-01.

25. *Id.* at 696.

26. *Id.* (citing Revenue Act of 1918, § 213(b)(6), 40 Stat. 1066).

Therefore, the issue expressed by the court in *Roemer* was whether damages received by Roemer in his defamation action were damages received "on account of personal injury."<sup>27</sup> The court stated that the Tax Court in its analysis "confuse[d] a personal injury with its consequences and illogically distinguish[ed] physical from nonphysical personal injuries."<sup>28</sup> The court emphasized that the issue was whether the injury was personal or nonpersonal, as that was the criterion set out in § 104(a)(2).<sup>29</sup> The court noted the fact that the Service had for a long time viewed nonphysical injuries as personal.<sup>30</sup>

In determining whether defamation results in a personal injury, the court looked to California law and found that defamation was an injury to the person.<sup>31</sup> The court stated that the "injury to the person should not be confused with the derivative consequences of the defamatory attack, i.e., the loss of reputation in the community and any resulting loss of income."<sup>32</sup> The court further stated that regardless of whether the defamatory statements impair personal or professional relationships, "all of the harm that is done flows from the same personal attack on the defamed individual."<sup>33</sup>

Upon determining that Roemer's injuries were personal, the court relied on the Commissioner's interpretation of § 104(a)(2) that all damages received on account of personal injury are excluded from gross income<sup>34</sup> and held that the compensatory as well as punitive damages awarded to Roemer should not have been included in gross income.<sup>35</sup>

After the Ninth Circuit issued its opinion in *Roemer*, the Service issued a new ruling reversing its position on the taxation of punitive damages.<sup>36</sup> In 1994, in *Hawkins v. United States*,<sup>37</sup> the Ninth Circuit changed its position on the excludability of punitive damages holding that punitive damages should not be excluded from gross income.<sup>38</sup> The court stated that because the 1975 Revenue Ruling had been overruled by the 1984 Ruling, the *Roemer* decision should not be followed.<sup>39</sup>

In *Hawkins*, the taxpayers sued Allstate Insurance Company for breach of good faith and fair dealing, recovering \$15,000 in compensatory damages and \$3.5 million in punitive damages.<sup>40</sup> The taxpayers included the punitive damages award on their 1988 federal income tax return and then filed an amended return

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27. *Id.*

28. *Id.* at 697.

29. *Id.*

30. *Id.* (citing Sol. Op. 132, 1-1 C.B. 92 (1922) (superceded by Rev. Rul. 74-1 C.B. 33) (stating that damages for alienation of affections, defamation of personal character, and surrender of child custody rights are damages for invasion of personal rights and not income).

31. *Id.* at 697-99.

32. *Id.* at 699.

33. *Id.* at 700.

34. *Id.* (citing Rev. Rul. 75-45, 1975-1 C.B. 47).

35. *Id.* at 700.

36. Rev. Rul. 84-108, *supra* note 14 and accompanying text.

37. 30 F.3d 1077 (9th Cir. 1994).

38. *Id.* at 1079.

39. *Id.* at 1081.

40. *Id.* at 1079.

claiming that the punitive damages should have been excluded from gross income and requested a refund.<sup>41</sup> The district court found for the taxpayers on cross-motions for summary judgment.<sup>42</sup>

The Ninth Circuit began its opinion by stating that any accession to wealth is presumed to be taxable income under § 61(a), and the taxpayer must prove that it fits into an exception of the Code.<sup>43</sup> The taxpayers contended that their punitive damages award fit into § 104(a)(2) and that their award should be excluded because the provision provided that “the amount of any damages received (whether by suit or agreement and whether as lump sum or as periodic payments) on account of personal injuries or sickness.”<sup>44</sup> The taxpayers also pointed out that the Service, in its regulations, defined “‘damages’ as amounts received ‘through prosecution of a legal suit or action based upon tort or tort-like rights.’”<sup>45</sup> The taxpayers and the government agreed that the taxpayers’ bad faith lawsuit was a tort-type action and that the taxpayers had suffered personal injuries.<sup>46</sup> Therefore, the issue in this case was “whether § 104(a) excludes all damages received in a tort-like lawsuit, or only those damages which have some compensatory purpose.”<sup>47</sup>

The court began its analysis by looking at the plain meaning of the statute.<sup>48</sup> The court determined that the phrase, “damages received on account of personal injuries,” might not mean *all* damages received in the personal injury lawsuit, but rather only the damages that compensated the taxpayer for her personal injury.<sup>49</sup> The court reasoned that the punitive damages received by the taxpayers were not “on account of” their personal injuries, because the amount of the damages did not “bear [any] relation to the severity of [their] injuries, but rather was awarded ‘on account of’ the tortfeasor’s egregious conduct.”<sup>50</sup> The court held that the punitive damages received by the taxpayers did not compensate them for their injuries; therefore, the punitive damages award should not be excluded from gross income.<sup>51</sup>

Next, the court examined the taxpayers’ contention that “the inquiry under § 104(a)(2) is limited to an examination of the nature of the taxpayer’s claim or injury.”<sup>52</sup> The court rejected this contention by stating that although the

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41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.* (citing 26 U.S.C. § 104(a)(2) (1988)).

45. *Id.* (citing 26 C.F.R. § 1.104-1(c) (1993)).

46. *Id.*

47. *Id.* at 1080.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* at 1083-84.

52. *Id.* at 1081 (quoting *United States v. Burke*, 504 U.S. 229 (1992)).

Supreme Court in *United States v. Burke*<sup>53</sup> "did examine the nature of the taxpayer's claim or injury to determine whether or not the damages . . . were recovered for personal injury," the Court in *Burke* "did not hold that whenever the underlying claim [wa]s tort-like, all damages [were] excludable."<sup>54</sup> The court noted that the Federal Circuit had recently, in *Reese v. United States*,<sup>55</sup> rejected this argument, finding that the taxpayer in *Burke* did not receive punitive damages and, therefore, the Supreme Court did not address the excludability of punitive damages.<sup>56</sup> The court stated that the Supreme Court mentioned punitive damages only for illustrative purposes.<sup>57</sup> The Court in *Burke* stated that the availability of punitive damages indicates that the underlying claim is tort-like.<sup>58</sup> The court concluded that not only was the court to look at the nature of the claim but also whether the damages were awarded on account of a personal injury.<sup>59</sup> The court reasoned that just because the Court in *Burke* did not include this additional requirement does not mean that it was not an important factor in the equation.<sup>60</sup> The court stated that "[t]he Court's alleged failure to 'mention any additional requirements for exclusion under § 104(a)(2)' means little, given that the Court concluded that the taxpayers' underlying cause of action was not 'tort-like.'"<sup>61</sup>

The court addressed the fact that Congress had amended § 104(a)(2) in 1989.<sup>62</sup> The provision now states that the exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."<sup>63</sup> This amendment did not apply to the taxpayers in this case because it only applies to amounts received after July 10, 1989.<sup>64</sup> Although the amendment did not apply to the taxpayers, they wanted the court to read § 104(a) in light of this amendment.<sup>65</sup> The taxpayers contended that Congress would not have amended the statute to omit punitive damages received for non-physical injuries as excludable unless these damages were previously excludable under §

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53. 504 U.S. 229 (1992). The Supreme Court in *Burke* expressly approved of the approach to section 104(a)(2) used by the Sixth Circuit in *Burke v. United States*, 929 F.2d 1119 (6th Cir. 1991), *rev'd on other grounds*, 504 U.S. 229 (1992). The Court of Appeals for the Sixth Circuit set forth the analysis as follows:

In sum, *Threlkeld* [v. Commissioner, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)] and its progeny require that for the purposes of § 104(a)(2), this court determine whether the injury is personal and the claim resulting in damages is tort-like in nature. If the answer is in the affirmative, then that is "the beginning and [the] end of the inquiry." *Threlkeld*, 87 T.C. at 1299. The damages resulting from such a claim are fully excludable under § 104(a)(2). At no point do we inquire into the nature of the damages involved. Rather the narrow scope of our gaze is properly limited to the "origin and character of the claim, . . . and not to the consequences that result from the injury." *Threlkeld*, 87 T.C. at 1299.

*Burke*, 929 F.2d 1119, 1123, *rev'd on other grounds*, 504 U.S. 229 (1992).

54. *Hawkins v. United States*, 30 F.3d 1077, 1081 (9th Cir. 1994).

55. 24 F.3d 228, 234 (Fed. Cir. 1994).

56. *Hawkins*, 30 F.3d at 1081.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* (quoting *Burke v. United States*, 504 U.S. 229 (1992)).

62. *Id.* at 1082.

63. *Id.* (citing Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 § 7641, 103 Stat. 2106, 2379 (1989)).

64. *Id.*

65. *Id.*

104(a)(2).<sup>66</sup> The court rejected this argument, stating that “an amendment to a statute does not necessarily indicate that the unamended statute meant the opposite.”<sup>67</sup> The court reasoned that the probable purpose of the amendment was to clarify the law or to overrule recent cases which had held that punitive damages were excluded and that damages recovered for employment discrimination were excluded.<sup>68</sup>

Since the plain language of the statute, the interpretive case law, and the 1989 amendment did not answer the question of whether non-compensatory damages should be excluded from gross income under § 104(a)(2), the court decided to analyze the design of the statute as a whole.<sup>69</sup> The court began with § 104 entitled — “Compensation for injuries or sickness” — and noted that the statute was enacted to exclude damages that compensate the taxpayer for injuries.<sup>70</sup> The court then discussed the return of capital theory — that “damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights . . . .”<sup>71</sup> The court concluded that the punitive damages received by the taxpayers did not compensate them for their injuries, but were awarded to the taxpayers in order to punish Allstate for its wrongdoing.<sup>72</sup> The court stated that the award of the punitive damages “ha[d] nothing to do with restoration of lost capital.”<sup>73</sup> Therefore, the court held that the taxpayers’ pure accession to wealth should not be exempt from gross income.<sup>74</sup>

Judge Trott dissented from the decision of the majority in *Hawkins*.<sup>75</sup> He opined that the majority’s restoration of capital theory could not be aligned with the text of § 104(a)(2), its legislative history, or the case law.<sup>76</sup> Judge Trott reasoned that the plain language of the statute — “the amount of *any damages* received . . . on account of personal injuries or sickness” — does not allow a distinction between compensatory and punitive damages.<sup>77</sup> His position is supported by the Tax Court in *Miller v. Commissioner*<sup>78</sup> and *Horton v. Commissioner*,<sup>79</sup> which held that “any damages” implicates “all damages” and that the language of the statute is unambiguous and does not permit a distinction between compensatory and punitive damages.

Judge Trott did not agree with the majority’s view that the taxpayer must prove that “(1) the damages were recovered in a tort-like suit and (2) the damages were received on account of personal injury.”<sup>80</sup> He noted that the majority’s rationale

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66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 1083.

70. *Id.*

71. *Id.* (quoting *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)).

72. *Hawkins v. United States*, 30 F.3d 1077, 1083 (9th Cir. 1994).

73. *Id.*

74. *Id.* at 1084.

75. *Id.* (Trott, J., dissenting).

76. *Id.*

77. *Id.*

78. 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

79. 100 T.C. 93 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994).

80. *Hawkins v. United States*, 30 F.3d 1077, 1085 (1994) (Trott, J., dissenting).



was that because punitive damages were not awarded to the taxpayers to compensate for their injury, but rather to punish the wrongdoer's conduct, and that because the damages did not bear any relation to the injury, then the punitive damages were not received on account of personal injury.<sup>81</sup> Judge Trott stated that in most jurisdictions the plaintiff must show some amount of actual damage before punitive damages are available.<sup>82</sup> Therefore, he concluded "that punitive damages are received on account of personal injury because punitive damages are not available unless a personal injury has occurred."<sup>83</sup>

Judge Trott stated that he would adopt the Tax Court's approach:

The beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.' This inquiry is answered by determining the nature of the underlying claim. Once the nature of the underlying claim is established as one for personal injury, any damages received on account of that claim, including punitive damages, are excluded.<sup>84</sup>

This approach was used by the Sixth Circuit in *Burke v. United States*, and Judge Trott believed that the Supreme Court, in reviewing the Sixth Circuit's opinion, adopted this approach.<sup>85</sup> He stated that if the Supreme Court intended for there to be any additional requirements (the majority's second prong) for the exclusion, the Court would have mentioned them.<sup>86</sup>

In considering the 1989 amendment, Judge Trott expressed that the taxpayers' argument to the court was reasonable — that all punitive damages received before the 1989 amendment were excluded from gross income.<sup>87</sup> He reasoned that Congress was narrowing the statute by expressly excluding from the exemption of § 104(a)(2) punitive damages received in connection with a case not involving physical injury or physical sickness; therefore, after the amendment, only punitive damages received in personal injury cases involving physical injury or sickness were excludable from gross income.<sup>88</sup> He expounded that "if Congress wanted to clarify that all punitive damages were taxable, why did the amendment create a distinction between physical and nonphysical injury cases?"<sup>89</sup>

Judge Trott dispensed with the majority's return of capital theory by illustrating that the damages the majority called compensatory are many times a windfall to the taxpayer.<sup>90</sup> He gave this example to illustrate his point:

Suppose [the taxpayers] are injured in an automobile accident and, as a result, can't work for two weeks. If they receive compensatory damages equal to two

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81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* (quoting *Horton v. Commissioner*, 100 T.C. 93, 96 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994).

85. *Id.*

86. *Id.*

87. *Id.* at 1086.

88. *Id.*

89. *Id.* at 1086-87.

90. *Id.* at 1087.

weeks' lost earnings, the damages would clearly be excludable under § 104(a)(2). But haven't they been made more than whole? After all, if they had worked during those two weeks, they would have been required to pay taxes on their wages. But because of the injury, they received more money than if they had worked.<sup>91</sup>

Judge Trott concluded his opinion by saying that Congress should straighten out the confusion this statute has caused, but until they do, the courts should apply the plain language of the statute.

## 2. The Fourth Circuit's Ruling

In *Commissioner v. Miller*,<sup>92</sup> Bonnie A. Miller obtained net proceeds of \$525,000 in settlement of a defamation action and an action for intentional infliction of emotional distress.<sup>93</sup> She did not include any of the proceeds on her federal income tax return.<sup>94</sup> The Service determined that all of the proceeds were taxable income.<sup>95</sup>

The Tax Court looked to the plain meaning of § 104(a)(2) and found that "any damages" included compensatory as well as punitive.<sup>96</sup> Also, the Tax Court held that "on account of" indicates causation, and therefore, Miller was awarded the damages because of a personal injury.<sup>97</sup> Thus, the Tax Court held for Miller, finding that none of the proceeds had to be included in gross income.<sup>98</sup>

The Court of Appeals for the Fourth Circuit reversed the Tax Court's holding.<sup>99</sup> The court disagreed with the Tax Court's plain meaning approach in interpreting § 104(a)(2).<sup>100</sup> Instead the court stated that "to determine whether Miller's settlement award may be excluded pursuant to § 104(a)(2), 'the nature of the cause of action and the injury to be remedied must be identified.'"<sup>101</sup> To make the determination, the court looked to Maryland law.<sup>102</sup> The court found that under Maryland law, a defamation action was considered an action for personal injury.<sup>103</sup> However, in Maryland, punitive damages were considered a windfall because they were not awarded to compensate the plaintiff for her injury, but were "exemplary in nature" and were used to punish the wrongdoer.<sup>104</sup>

The court agreed that "on account of" connoted causation, but rejected the Tax Court's finding that "on account of" suggested but-for causation.<sup>105</sup> The court

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91. *Id.*

92. 914 F.2d 586 (4th Cir. 1990).

93. *Id.* at 587.

94. *Id.* at 587.

95. *Id.*

96. *Miller v. Commissioner*, 93 T.C. 330, 334-37 (1989).

97. *Id.* at 339.

98. *Id.*

99. *Commissioner v. Miller*, 914 F.2d 586, 592 (4th Cir. 1990).

100. *Id.* at 589.

101. *Id.* (quoting *Thompson v. Commissioner*, 866 F.2d 709, 711 (4th Cir. 1989)).

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* at 589-90.

noted that the phrase just as easily could suggest sufficient causation.<sup>106</sup> The court stated that:

[U]nder a sufficient causation approach, the fact that personal injury is a prerequisite to punitive damages does *not* lead to the conclusion that the punitive damages were “on account of” the plaintiff’s injuries because, even if the other elements of the tort are present, personal injury alone does not sustain a punitive damage award.

The court emphasized that the plaintiff must also prove egregious conduct on the part of the defendant in order to be awarded punitive damages.<sup>108</sup> The court determined that the plaintiff’s injury alone was insufficient cause for the award of punitive damages.<sup>109</sup> Therefore, the court concluded that § 104(a)(2) was not clear on the type of causation intended by the “on account of” language.

The court decided that it must resort to two extrinsic aids to interpret § 104(a)(2).<sup>111</sup> First, the court noted the “well-recognized, even venerable, principle that exclusions to income are to be construed narrowly.”<sup>112</sup> Since the statute’s language was ambiguous, the court adopted a more restrictive view of the types of damages that could be excluded.<sup>113</sup>

Second, the court addressed the underlying purpose of the statute.<sup>114</sup> Adopting the Ninth Circuit’s rationale, the court stated that “‘damages 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.’”<sup>115</sup> The court continued to say that “[p]unitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.”<sup>116</sup> The court concluded that punitive damages were a windfall and, thus, did not fall within the ambit of § 104(a)(2) because they were not compensatory in nature.<sup>117</sup>

### 3. Federal Circuit’s Ruling

The Federal Circuit affirmed the United States Court of Federal Claims decision that punitive damages should not be excluded from gross income. In *Reese v. United States*,<sup>118</sup> Elizabeth Reese won a jury verdict awarding her \$150,000 in compensatory damages and \$100,000 in punitive damages against her former employers for unlawful termination.<sup>119</sup> The parties entered into a settlement

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106. *Id.*

107. *Id.*

108. *Id.* at 590.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.* (citing *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949)).

113. *Id.*

114. *Id.*

115. *Id.* (quoting *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)).

116. *Id.* (quoting *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432 (1955)).

117. *Id.* at 591.

118. 24 F.3d 228 (Fed. Cir. 1994).

119. *Id.* at 229.

agreement after the jury verdict.<sup>120</sup> The defendant agreed to pay Reese \$250,000 for her withdrawal of claims against certain defendants.<sup>121</sup>

Reese included the \$100,000 in punitive damages on her 1987 federal income tax return, but then in 1989 filed an amended return for a refund, claiming the \$100,000 should have been excluded for federal income tax purposes.<sup>122</sup> The United States Court of Federal Claims granted the United States's motion for summary judgment.<sup>123</sup> The Claims Court stated that the exemptions to gross income should be construed narrowly, and thus, the exemption of § 104(a)(2) is "limited to payments received as 'compensation.'"<sup>124</sup> The court held that an award of punitive damages was not compensation.<sup>125</sup>

The Court of Appeals for the Federal Circuit framed the issue as "whether punitive damages are received 'on account of personal injuries' and therefore excludable from gross income."<sup>126</sup> The court noted that the phrase "on account of" was susceptible to two different interpretations.<sup>127</sup> The first, advocated by Reese, was that "on account of" connotes a causal relationship between the injury and the damages.<sup>128</sup> Therefore, "any damages ultimately received in a case involving personal injury are damages received 'on account of' that personal injury."<sup>129</sup> The other interpretation, and the one advocated by the Government, was that punitive damages are not received "on account of" personal injury, but rather to punish the defendant's egregious conduct.<sup>130</sup> The court determined that these two conflicting interpretations did not answer the question at issue; hence, the court had to consider the language of § 104 as a whole.<sup>131</sup>

The court began by looking at the title of § 104 which is entitled "Compensation for Injuries or Sickness."<sup>132</sup> The court stated that compensatory damages, as defined by Black's Law Dictionary, "means damages 'such as will compensate the injured party for the injury sustained, and nothing more; such as will simply make good or replace the loss caused by the wrong or injury.'"<sup>133</sup> Thus, the court concluded that § 104 only encompassed payments that "make good or replace the loss caused" by the personal injury.<sup>134</sup> The court reiterated the Claims Court finding that exemptions to federal income tax are to be construed narrowly.<sup>135</sup> Also, the court examined the jury instructions which explicitly differentiated the compensatory and punitive damages, stating that punitive

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120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 230.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.* at 231.

131. *Id.*

132. *Id.*

133. *Id.* (quoting BLACK'S LAW DICTIONARY 390 (6th ed. 1990)).

134. *Id.*

135. *Id.*

damages were to be awarded to deter the wrongdoing of the defendant.<sup>136</sup> Upon this examination of the instructions, the court declared that the punitive damages were a “pure accession to wealth” and, therefore, could not be excluded for income tax purposes because the damages did not fall within § 104(a)(2).<sup>137</sup>

Relying on *United States v. Burke*,<sup>138</sup> Reese argued to the court that when interpreting the phrase — “any damages received . . . on account of personal injuries” — one must look to the nature of the underlying claim rather than the nature of the specific damages at issue.<sup>139</sup> In *Burke*, the Supreme Court held that the damages received must redress a tort-like personal injury in order for the damages to qualify under § 104(a)(2).<sup>140</sup> Thus, the issue presented in *Burke* was simply whether damages were awarded for tort-like claims.<sup>141</sup> In defining a tort-like claim, the Court in *Burke* stated that the “‘hallmark[] of traditional tort liability is the availability of a broad range of damages[,]’ including ‘punitive or exemplary damages.’”<sup>142</sup> The court in *Reese* used the same rationale as the court in *Hawkins*, and found that *Burke* was not saying that if the claim was tort-like, then all damages awarded were within the § 104 exemption.<sup>143</sup>

Reese also asserted that the Treasury regulations supported the view that all damages received for a tort or tort-like claim were excluded under § 104(a)(2).<sup>144</sup> Treasury Regulation § 1.104-1(c) states that “[t]he term ‘damages received (whether by suit or agreement)’ means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.”<sup>145</sup> The court dispensed with this argument by stating that the regulation does not say that all damages received in a tort or tort type action are necessarily received “on account of personal injuries” within the meaning of § 104(a)(2).<sup>146</sup> Thus, the Court of Appeals held that the punitive damages awarded to Reese were considered gross income and not excluded under § 104(a)(2) because the damages were not paid “on account of personal injury.”<sup>147</sup>

#### 4. Fifth Circuit’s Ruling

The taxpayers in *Wesson v. United States*<sup>148</sup> recovered punitive damages in an insurance bad-faith action.<sup>149</sup> The taxpayers included this recovery as income on their federal income tax return and were later refused a refund of this amount.<sup>150</sup>

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136. *Id.* at 232.

137. *Id.* at 233.

138. 504 U.S. 229 (1992).

139. *Reese v. United States*, 24 F.3d 228, 234 (Fed. Cir. 1994).

140. *Id.* at 234 (citing *Burke v. United States*, 504 U.S. 229 (1992)).

141. *Id.*

142. *Id.* at 234 (quoting *Burke*, 504 U.S. 229).

143. *Id.*

144. *Id.*

145. *Id.* at 234-35 (quoting 26 C.F.R. § 1.104-1(c) (1987)).

146. *Id.* at 235.

147. *Id.*

148. 48 F.3d 894 (5th Cir. 1995).

149. *Id.* at 895.

150. *Id.* at 896.

The Court of Appeals for the Fifth Circuit initially addressed the issue of whether these punitive damages should be excluded from taxable gross income by looking at the language of the statute.<sup>151</sup> The court found two ambiguities in the language of § 104(a)(2) — the phrase “on the account of” and also what “personal injury” means.<sup>152</sup>

The court began by revisiting the Supreme Court opinion in *Burke v. United States*<sup>153</sup> which connected the identification of a personal injury to traditional tort principles.<sup>154</sup> The Court in *Burke* also examined the remedies available to a plaintiff under tort law, which included punitive damages.<sup>155</sup> The Fifth Circuit stated that the threshold question, according to *Burke*, was to determine whether the cause of action redressed a personal injury.<sup>156</sup> Upon review of Mississippi law, the court found “that a bad faith cause of action [wa]s one sounding in tort, and accordingly, one redressing a personal injury.”<sup>157</sup>

The court next addressed the ambiguity of the phrase “on account of,” stating that one must “look not only to the particular statutory language, but to the design of the statute as a whole and to its object and policy.”<sup>158</sup> The court found that the statute, as a whole, was designed to compensate a person for some loss.<sup>159</sup> The court then addressed whether this taxpayer had been awarded damages to compensate for a tort-like injury.<sup>160</sup> Looking to Mississippi law, the court stated that “punitive damages are not awarded to compensate a plaintiff for an injury [but rather], ‘to punish [the] tortfeasor.’”<sup>161</sup> The Court distinguished the Sixth Circuit’s decision in *Horton*, stating that punitive damages in Kentucky serve a compensatory function.<sup>162</sup> Therefore, the Sixth Circuit had to decide whether damages that served as both a deterrent and compensation should be excluded from gross income.<sup>163</sup> Whereas the Fifth Circuit’s determination, based on Mississippi law, was whether a damage award that served only as a deterrent should be excluded.<sup>164</sup> The court concluded by stating that two requirements must be met in order to exclude damages under § 104(a)(2): “first, that the underlying cause of action [must be] tort-like under *Burke*; and second, that the damages [are] received on account of the personal injury, that is, to compensate.”<sup>165</sup>

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151. *Id.*

152. *Id.* at 897.

153. 504 U.S. 229 (1992).

154. *Wesson v. United States*, 48 F.3d 894, 897 (5th Cir. 1995).

155. *Burke v. United States*, 504 U.S. 229 (1992).

156. *Wesson*, 48 F.3d at 897.

157. *Id.* at 898.

158. *Id.* (quoting *Reese v. United States*, 24 F.3d 228, 231 (Fed.Cir. 1994)).

159. *Id.* at 899.

160. *Id.*

161. *Id.* (quoting *State Farm Mut. Auto. Ins. Co. v. Daughdrill*, 474 So. 2d 1048, 1052 (Miss. 1985) (responding to certified question by the Fifth Circuit concerning uninsured motorist act)).

162. *Id.* at 901.

163. *Id.*

164. *Id.*

165. *Id.* at 901-02.

### 5. Tenth Circuit's Ruling

In *O'Gilvie v. United States*,<sup>166</sup> the jury awarded the taxpayers \$10,000,000 in punitive damages in a wrongful death suit.<sup>167</sup> The taxpayers reported their share of the punitive damages on their individual federal income tax return, and later filed for a refund.<sup>168</sup> The basis for filing a claim for a refund was that punitive damages were excluded from gross income under I.R.C. § 104(a)(2).<sup>169</sup>

The Internal Revenue Service took no action to refund the taxpayers' money; consequently, the taxpayers filed suit against the United States for the refund.<sup>170</sup> The district court held that the punitive damages were excludable from income and that the taxpayers should have received their refund.<sup>171</sup> The Government appealed to the Tenth Circuit Court of Appeals.<sup>172</sup>

The Court of Appeals for the Tenth Circuit did a survey of the decisions previously made by the Circuit Courts which had addressed this issue.<sup>173</sup> The court agreed with the four Circuit Courts which had found the language ambiguous in § 104(a)(2) which says "the amount of any damages received . . . on account of personal injuries or sickness."<sup>174</sup>

Because the court found the language in § 104(a)(2) ambiguous, it then sought to ascertain Congress' intent when enacting the section.<sup>175</sup> The court stated that "[all] of the [other] subsections of §104 address replacement [of income] for losses resulting from injury or sickness and thus are compensatory in nature."<sup>176</sup> This led the court to the logical conclusion that § 104(a)(2) must be compensatory in nature also.<sup>177</sup> The court noted that this conclusion was "bolstered by the 'default rule . . . that exclusions from income must be narrowly construed.'"<sup>178</sup>

Also, the court was troubled by the 1989 amendment to § 104(a)(2) which stated, "[p]aragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."<sup>179</sup> The court stated that it was apparent to them "that when Congress was debating the amendment it believed that § 104(a)(2) applied to punitive as well as compensatory damages."<sup>180</sup> Notwithstanding Congress' belief, the court stated that the amendment should not be used to interpret the intent of Congress in 1954 or 1918 because of the lapse of time.<sup>181</sup>

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166. 66 F.3d 1550 (10th Cir. 1995).

167. *Id.* at 1552.

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.* at 1553.

172. *Id.*

173. *Id.* at 1555-60.

174. *Id.* at 1556 (citing *Wesson v. United States*, 48 F.3d 894 (5th Cir. 1995); *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994); *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990)).

175. *Id.* at 1558.

176. *Id.*

177. *Id.*

178. *Id.* (quoting *United States v. Burke*, 504 U.S. 229, 248 (1992)).

179. *Id.* at 1559.

180. *Id.*

181. *Id.*

The Tenth Circuit Court of Appeals concluded by stating that "it is not clear whether Congress intended to exclude punitive damages from income under § 104(a)(2)."<sup>182</sup> Nevertheless, the court decided to rule with the majority and what they called the "default rule" that exclusions from income should be narrowly construed.<sup>183</sup>

## 6. Sixth Circuit's Ruling

In 1994 in *Horton*, the Tax Court held that the Hortons had properly excluded punitive damages from their gross income.<sup>184</sup> This decision reaffirmed the Tax Court's position on the excludability of punitive damages under § 104(a)(2).<sup>185</sup> The Tax Court had previously held in *Miller* that "'the plain meaning of the broad statutory language simply does not permit a distinction between punitive and compensatory damages. . . . Thus, we read 'any damages' to mean 'all' damages, including punitive damages. Further, 'punitive damages are received 'on account of personal injury.'"<sup>186</sup>

In *Horton*, the Hortons' house had exploded as a result of the gas company's failure to detect a leak in their house.<sup>187</sup> The jury awarded Mr. Horton \$62,265 in compensatory damages and \$100,000 in punitive damages and awarded Mrs. Horton \$41,287 in compensatory damages and \$400,000 in punitive damages.<sup>188</sup> The Hortons did not include the punitive damages as income on their 1985 federal income tax return.<sup>189</sup> The Tax Court held that the Hortons were correct not to include the punitive damages.<sup>190</sup> The Tax Court stated that "the beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.'"<sup>191</sup> The Tax Court explained that this determination was to be made by looking at the nature of the underlying claim.<sup>192</sup> In this case, the Tax Court found that the nature of the Hortons' underlying claim was one for personal injury, and, therefore, the damages should be excluded under § 104(a)(2) from gross income.<sup>193</sup>

The Sixth Circuit affirmed the Tax Court's holding.<sup>194</sup> The only issue that the Sixth Circuit saw a need to address was whether the punitive damages received by the Hortons were "damages received . . . on account of personal injury."<sup>195</sup>

The court began its analysis by examining the Supreme Court's decision in *Burke*.<sup>196</sup> The court acknowledged that the specific holding in *Burke* was not

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182. *Id.* at 1560.

183. *Id.*

184. *Horton v. Commissioner*, 33 F.3d 625, 626 (6th Cir. 1994).

185. *Id.* at 629.

186. *Miller v. Commissioner*, 93 T.C. 330, 338-40 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990).

187. *Horton*, 33 F.3d at 626.

188. *Id.*

189. *Id.*

190. *Id.*

191. *Horton v. Commissioner*, 100 T.C. 93, 96 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994).

192. *Id.*

193. *Id.*

194. *Horton v. Commissioner*, 33 F.3d 625, 632 (6th Cir. 1994).

195. *Id.* at 626.

196. *Id.* at 629.



applicable to the case at hand, but stated that the opinion would enable the court to determine whether a claim was excludable under § 104(a)(2).<sup>197</sup> Although the Supreme Court in *Burke* reversed the Sixth Circuit's decision on other grounds, the Supreme Court expressly agreed with the analysis used by the Sixth Circuit "insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying [the taxpayers'] damages award."<sup>198</sup>

Applying the analysis approved by the Supreme Court in *Burke*, the court in *Horton* looked to the nature of the underlying claim brought by the Hortons.<sup>199</sup> The court reasoned that if the Hortons suffered personal injury and the underlying claim which resulted in damages was tort-like in nature, then all of the damages awarded to the Hortons were excluded from gross income under § 104(a)(2).<sup>200</sup> The court found that the Hortons' underlying claim "[wa]s one for a personal, physical injury, therefore, the [Hortons] entire recovery [wa]s excludable."<sup>201</sup> Further, the court stated that "[t]he Hortons' damages both — compensatory and punitive — were received 'on account of' their personal injuries from the explosion."<sup>202</sup>

Furthermore, the court declared that its holding was consistent with the 1989 amendment of § 104(a)(2) which stated that the exclusion would not apply "in cases not involving physical injury or physical sickness."<sup>203</sup> The court, in explaining its reasoning, stated in a footnote:

Since punitive damages in a case not involving physical injury or physical sickness are singled out as being includable in gross income, the clear implication of Congress' phraseology is that punitive damages in a case involving physical injury or physical sickness are excludable, and were excludable even before the amendment.<sup>204</sup>

The court stated that its holding was consistent with Treasury Regulation § 1.104-1(c) which defines "damages" as "'an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights.'"<sup>205</sup> The action brought by the Hortons was a tort action.<sup>206</sup>

The court emphasized that under Kentucky law punitive damages serve a compensatory purpose.<sup>207</sup> The court quoted the Kentucky Supreme Court stating that "[the] reason for paying punitive damages awarded to the injured party . . . is because 'the *injury* has been *increased* by the *manner* [in which] it was inflicted.'"<sup>208</sup> The Sixth Circuit rejected the return of capital argument made by the

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197. *Id.*

198. *Burke v. United States*, 504 U.S. 229, 237 (1992). See also *supra* note 53 and accompanying text for the analysis used in *Burke v. United States*.

199. *Horton v. Commissioner*, 33 F.3d 625, 631 (6th Cir. 1994).

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.* at 631 n.12.

205. *Id.* at 631.

206. *Id.*

207. *Id.*

208. *Id.* (quoting *Horton v. Union Light, Heat & Power Co.*, 690 S.W.2d 382, 390 (Ky. 1985)).

Commissioner.<sup>209</sup> The court explained that in many instances, money damages could not make a plaintiff whole; therefore, the "make whole" theory is just a legal fiction.<sup>210</sup> If money cannot make a person "whole," then the money damages received are an accession to "wealth."<sup>211</sup> The court determined that "there [wa]s no bright-line distinction . . . between damages which make plaintiffs whole and damages which are accessions to wealth."<sup>212</sup> Thus, the court concluded that the punitive damages received by the Hortons were excludable under § 104(a)(2).<sup>213</sup>

### *C. The 1989 Amendment of § 104(a)(2)*

The 1989 amendment was Congress' response to the confusion in the courts over the proper application of § 104(a)(2). The amended § 104(a)(2) states "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."<sup>214</sup> The use of the double negative has seemed only to confuse the judges that are trying to interpret the section and then apply it in a case.

As is evident in the discussion above, the courts are still divided on the implications of the amendment on the tax treatment of punitive damages. Some courts have taken the view that Congress was trying to narrow the application of the statute, and, therefore, before the amendment, all punitive damages were excludable, and now, after the amendment, punitive damages awarded in cases involving personal physical injuries are excludable.<sup>215</sup> Other courts, however, interpret the amendment as only clarifying the existing law and, thus, hold that punitive damages were not excluded before or after the amendment. Obviously, the response by Congress did nothing to clarify the application of the exclusion in § 104(a)(2). The application of the exclusion depends entirely upon the interpretation of the individual court.

### III. ANALYSIS AND CONCLUSION

As seen in the above discussion, the federal courts are divided on the interpretation and application of § 104(a)(2) of the Internal Revenue Code. The Tax Court<sup>216</sup> and the Sixth Circuit<sup>217</sup> have held that punitive damages are excludable from gross income, whereas the Ninth, Fourth, Federal, Fifth, and Tenth Circuits<sup>218</sup> have concluded that such damages are taxable. The various interpre-

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209. *Id.* at 632.

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. 26 U.S.C. § 104(a)(2) (1994).

215. *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994); *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994) (Trott, J., dissenting).

216. *Miller v. Commissioner*, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990); *Horton v. Commissioner*, 100 T.C. 93 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994).

217. *Horton*, 33 F.3d at 625.

218. *Hawkins*, 30 F.3d at 1077; *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990); *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994); *Wesson v. United States*, 48 F.3d 894 (5th Cir. 1995); *O'Gilvie v. United States*, 66 F.3d 1550 (10th Cir. 1995).

tations seem to hinge on the outcome of several considerations: (1) Whether the Supreme Court in *Burke* endorsed the *Threlkeld* one-step test of simply determining the underlying nature of the claim? (2) What was Congress' intent when it amended § 104(a)(2) in 1989? and (3) Does the return of capital theory resolve the issue?

It is difficult to determine which court's interpretation of § 104(a)(2) is the correct one. However, the most logical seems to be the interpretation of the Sixth Circuit in *Horton*. First, it is reasonable to conclude that the Supreme Court in *Burke* did not endorse the *Threlkeld* one-step test. The Court in *Burke* expressly stated that it agreed with the Sixth Circuit's analysis: "insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying [the taxpayer's] damages award. . . ." <sup>219</sup> The Court did not explicitly or implicitly indicate that the test of any other circuit court was more favorable. The Supreme Court continued to say that "[i]n order to come within the § 104(a)(2) income exclusion, [the taxpayers] therefore must show that [their claim] . . . redresses a tort-like personal injury. . . ." <sup>220</sup> The Supreme Court did not mention that a court had to determine whether the resulting recovery was "on account of" that personal injury, in addition to determining that the claim was tort-like. Therefore, it is evident that the Supreme Court intended the courts to use the one-step analysis set forth by the Sixth Circuit in *Burke*.

Second, the most plausible interpretation of Congress' intent in amending § 104(a)(2) is that of the Sixth Circuit in *Horton*. The court reasoned that since Congress explicitly stated that damages recovered in cases not involving physical injury or physical sickness are taxable, then the rational interpretation is that damages for physical injury or sickness are excluded. Judge Trott's opinion in *Hawkins* is also a very logical explanation of Congress' intent. He opined that "if Congress wanted to clarify that all punitive damages were taxable, why did the amendment create a distinction between physical and nonphysical injury cases?" <sup>221</sup> He believed that the reasonable interpretation of the amendment was that Congress was narrowing the statute by omitting from the income exclusion punitive damages received in cases resulting in nonphysical injury. He reasoned that if punitive damages received in physical injury cases prior to 1989 had been taxable and if Congress had intended to broaden the statute to include those damages, then the amendment could have simply been amended to read: "Punitive damages in cases involving physical injury or sickness are excludable." <sup>222</sup>

Finally, the Ninth, Fourth, and Federal Circuits have made the argument that § 104(a)(2) was enacted to exclude only damages which compensate a taxpayer for injuries. These courts rest their argument on the fact that the statute is titled "Compensation for Injuries or Sickness" and that punitive damages in most states are awarded to punish the wrongdoer for his egregious conduct. Because in some states, such as Kentucky, punitive damages serve a compensatory func-

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219. *Burke v. United States*, 504 U.S. 229, 237 (1992).

220. *Id.*

221. *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting).

222. *Id.*

tion, this analysis leads to inconsistent results depending upon the relevant state law, thus undercutting the uniformity needed in the application of federal income tax law. Also, the argument that § 104(a)(2) was intended only to exclude damages that restored lost capital to the plaintiff or made the plaintiff whole is not sound because, as brought out by the court in *Horton* and by Judge Trott's dissent in *Hawkins*, many times what is termed "compensatory damages" makes the plaintiff more than whole.<sup>223</sup>

Because § 104(a)(2) of the Internal Revenue Code is still subject to interpretation of the individual courts, there is no definitive answer to whether punitive damages are excluded from gross income. Therefore, we as taxpayers are still faced with the dilemma of whether to include punitive damages on our federal income tax return or whether to take the chance that the court in our jurisdiction will interpret § 104(a)(2) consistently with the Tax Court and the Sixth Circuit. With the current confusion over the taxation of punitive damages awarded in personal injury cases, Congress desperately needs to take this opportunity to amend and clarify this section of the Code.

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223. See *supra* notes 91 and 180 and accompanying text.

