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Did the Sixth Circuit Get It Right in Stadnyk?: What to Do About the § 104(a)(2) Personal Injury Damages Exclusion

I. INTRODUCTION

Each year, millions of dollars are awarded to victims of physical and non-physical personal injury. These damages include amounts for lost wages, actual medical expenses, pain and suffering, emotional distress, and punitive damages, among others. Taxes are a lurking factor affecting the amount that ultimately ends up in the pocket of the injured party. The courts and Congress have changed the relevant income tax standards multiple times in the past ninety years, making planning difficult for the injured parties and their attorneys.

Courts provide remedies for wrongs; specifically, tort law attempts to restore the victim to his or her previous position. Although most scholars and empathizers agree that no amount of money can truly restore personal injury victims to who and what they were before the injury, federal income tax law still considers the amount of money received by tort victims as “accessions to wealth,” which are taxable sums except to the extent that Congress has provided a statutory exclusion.2

Legislators have grappled with the extent to which the injured party’s compensation should be taxed, and particularly with the implications of § 104(a)(2) of the Internal Revenue Code, which excludes compensation received for personal physical injuries but not for non-physical injuries.3 The relevant language is as follows: “gross income does not include . . . the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness.”4 From 1918 to 1996, however, if a judgment or settlement was granted “on account of personal injuries or sickness,” the statutory exclusion allowed the entire amount of damages to be exempt from federal income taxes, regardless of

3. Id. § 104(a)(2).
4. Id. (emphasis added).
whether the personal injury was physical or non-physical.\textsuperscript{5} Both Congress and the courts have made various changes since that time, first denying tax-free status for non-compensatory punitive damages\textsuperscript{6} and then, in 1996, reducing the exclusion to only “personal physical injuries or physical sickness.”\textsuperscript{7} Since 1996, as long as a recovery amount has its origin in personal physical injury or sickness, all resulting damages (except punitive damages) are excluded under \textsection{104(a)}\textsuperscript{8}. So, if a physical injury leads to emotional-distress damages, those damages would be excluded. However, Congress specifically decreed that “emotional distress” is not itself a physical injury or sickness and therefore cannot be the independent origin of an excluded recovery, although reimbursement for specific medical care costs may be excluded.\textsuperscript{9}

There has been significant uncertainty in determining whether a personal injury award qualifies for an exclusion. In order to promote predictability and consistency, the exclusion should be eliminated. Removing the exclusion would also result in increased clarity and uniformity in the law, sympathy for the victim, and revenue for the federal government. Moreover, it would comply with tax laws and constitutional principles.

This Note considers the current treatment and application of the \textsection{104(a)(2)} exclusion in the context of a recent case, \textit{Stadnyk v. Commissioner.}\textsuperscript{10} In \textit{Stadnyk}, the Sixth Circuit ruled that the exclusion did not apply to a settlement amount based on a claim of

\begin{itemize}
  \item \textsuperscript{5} \textit{Id.} \textsection{104(a)} (1994), amended by 26 U.S.C. \textsection{104(a)} (Supp. II 1995–1997).
  \item \textsuperscript{6} \textit{Comm’r v. Schleier}, 515 U.S. 323, 331–32 (1995); \textit{Bagley v. Comm’r}, 105 T.C. 396, 416–17 (1995). In 1996, Congress amended \textsection{104(a)(2)} to explicitly provide that the exclusion was inapplicable to punitive damages, but this amendment applied only prospectively. 26 U.S.C. \textsection{104(a)} (Supp. II 1995–1997). Later in 1996, the Supreme Court held that punitive damages are not excludable under the pre-amendment language of \textsection{104(a)}. \textit{O’Gilvie v. United States}, 519 U.S. 79, 89–90 (1996); see also H.R. REP. NO. 104-586, at 143 (1996) (explaining that punitive damages are not excludable because they “are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering”).
  \item \textsuperscript{7} 26 U.S.C. \textsection{104(a)(2)} (Supp. II 1995–1997) (emphasis added).
  \item \textsuperscript{8} \textit{Id.}
  \item \textsuperscript{9} \textit{Id.} \textsection{104(a)} (2006). Although emotional distress is not a physical injury, damages paid for the specific medical expenses from emotional distress can be excluded, but only if not previously allowed as a deduction under \textsection{213(d)(1)} and only to the extent of the actual amounts paid for the medical care. \textit{Id.} Damages from wrongful death claims—including punitive damages if no other damages may be awarded under state law—also may be excluded. \textit{Id.} \textsection{104(c)}.
  \item \textsuperscript{10} \textit{Stadnyk v. Comm’r (Stadnyk II), 367 F. App’x 586 (6th Cir. 2010).}
\end{itemize}
false imprisonment. In Part II, this Note will outline the history of the § 104(a)(2) exclusion and then describe the Stadnyk decisions by the Tax Court and the Sixth Circuit. Part III will provide analysis of these decisions as well as the actions of the legislature, the Internal Revenue Service (IRS), and other courts with respect to the § 104(a)(2) exclusion, and will then consider options for improvement. In Part IV, this Note will conclude.

II. TAX HISTORY AND STADNYK

In terms of what was considered "income," tax law used to be much more taxpayer-friendly than it is now. In the monumental 1955 *Glenshaw Glass* case, the Supreme Court ruled that any accession to wealth must be included in gross income unless a clearly defined exclusion applies. Based upon the precedent established in *Glenshaw Glass*, courts consistently construe income broadly and exclusions narrowly.

Thus, from the taxpayer’s view, the key to favorable tax treatment is finding an applicable exclusion, which is why the § 104(a)(2) exclusion for personal injuries has been so important. Beginning in 1918, the exclusion afforded wide opportunity for tax avoidance. Initially, judgments or settlements received on account of personal injuries or sickness were excluded from gross income in their entirety. Since 1918, however, the courts, the legislature, and the IRS have whittled away that exclusion to an exclusion allowance only for damages that are not punitive damages as long as they are based on personal physical injuries or physical sickness, with few exceptions.

A. The Stadnyk Story

On a fateful Wednesday in December 1996, the Stadnyks went to Nicholasville Road Auto Sales to buy a car for their son. Using

11. Id. at 593.
14. The two exceptions to the general § 104(a)(2) exclusion rules are that recovery amounts for punitive damages may be excluded for certain wrongful death claims, 26 U.S.C. § 104(a)(c), and that recovery amounts limited to the actual medical expenses for any emotional distress may be excluded, id. § 104(a).
15. Stadnyk II, 367 F. App’x at 587; Stadnyk I, 96 T.C.M. (CCH) at 475.
two checks written by Mrs. Stadnyk, the couple bought a Geo Storm for about $3500, but as they drove it away, the car broke down just seven miles from the store.\textsuperscript{16} The Stadnyks had the car repaired at a cost of about 14\% of the vehicle's purchase price.\textsuperscript{17} When the Stadnyks attempted to complain about the car, Nicholasville Auto ignored their calls, put them on hold, or did not return the calls.\textsuperscript{18} So Mrs. Stadnyk called Bank One to stop payment on one of the checks she tendered when making the purchase; the check was for $1100.\textsuperscript{19}

The bank stopped the payment, but it incorrectly stamped the check as “NSF,” indicating insufficient funds, instead of the description Mrs. Stadnyk requested: “dissatisfied purchase.”\textsuperscript{20} In response to the seemingly worthless check, Nicholasville Auto filed a criminal complaint against Mrs. Stadnyk on February 4, 1997.\textsuperscript{21} On Sunday, February 23, 1997, at around 6:00 p.m., officers from the County Sheriff’s Office in Fayette, Kentucky arrested Mrs. Stadnyk in her home and in front of her husband, her daughter, and a family friend.\textsuperscript{22} The officers took Mrs. Stadnyk to the County Detention Center.\textsuperscript{23} They photographed her, handcuffed her, and put her in a holding cell.\textsuperscript{24} At 11:00 p.m.\textsuperscript{25} the officers transferred Mrs. Stadnyk to the Jessamine County Jail.\textsuperscript{26} After administering a pat-down and electric-wand search on Mrs. Stadnyk, the officers ordered her to undress to her undergarments, remove her bra while the officers stood nearby, and then put on an orange jumpsuit.\textsuperscript{27} She was released on bail at around 2:00 a.m. on February 24, 1997.\textsuperscript{28} In April of the same year, Mrs. Stadnyk was indicted for “theft by deception over $300.00” because of the misstamped check, but Nicholasville ultimately dropped all charges.\textsuperscript{29}
Mrs. Stadnyk admits she did not suffer any physical injuries—she was not jerked around or grabbed; she experienced no bruising or pain from handling or handcuffing during her imprisonment—but she was “physically restrained against her will and subjected to police arrest procedures.” She also visited with a psychologist eight times over a two-month period in the aftermath of the arrest. Her insurance and employer covered her treatment costs; she did not pay out-of-pocket costs for any repercussions of the incident.

In August of 1999, Mrs. Stadnyk filed a complaint against Bank One, the owner of Nicholasville Auto, and Nicholasville Auto itself. The charges and damages included the following:

nominal damages, compensatory damages and special damages, including, but not limited to, attorney’s fees to defend, lost time and earnings, mortification and humiliation, inconvenience, damage to reputation, emotional distress, mental anguish, . . . loss of consortium[,] . . . fraudulent misrepresentations relating to the condition of the Geo Storm[,] . . . [m]alicious prosecution, abuse of process, false imprisonment, defamation, and outrageous conduct.

In a mediation agreement in 2002, Bank One settled with Mrs. Stadnyk. In exchange for Mrs. Stadnyk’s dismissal of the complaint, Bank One wrote a letter of apology and agreed to pay her $49,000. The settlement agreement simply provided for a lump-sum payment and included no explicit allocation of the amount of the settlement. The claims against Bank One and Nicholasville Auto were each dismissed with prejudice, although the public record does not contain the terms for dismissal of the claims against the Nicholasville Auto entities.

During the mediation with Bank One, the mediator and attorneys all advised the Stadnyks that the settlement amount could

29. Id. at 476.
30. Id.
31. Id.
32. Id.
33. Id.
34. Id.
35. Id.
36. Stadnyk II, 367 F. App’x at 593–94.
37. Stadnyk I, 96 T.C.M. (CCH) at 476.
not be taxed.38 Without getting any additional tax advice, Mr. Stadnyk prepared a 2002 federal income tax return for himself and for Mrs. Stadnyk and excluded the settlement amount.39 In March of 2005, the IRS Commissioner issued a notice of deficiency to the Stadnyks (for not including the $49,000) in the amount of $13,119 with an accuracy-related penalty under § 6662(a) of $2624.40

B. Law, Major Arguments, and Court Analysis

The Tax Court followed the current and time-proven trend of interpretation to construe income broadly and exclusions narrowly.41 The Tax Court held that the Stadnyks were liable for the tax deficiency but not liable for the penalty.42 The Sixth Circuit Court of Appeals affirmed the Tax Court’s interpretation and ensuing order.43

In the Tax Court, the Stadnyks had two major arguments for relief from tax liability: (1) the settlement was excluded from gross income by the § 104(a)(2) personal physical injury exclusion,44 or, in the alternative, (2) the settlement was excluded because compensatory damages for personal injuries are not income in the first place.45

The success of the Stadnyks’ first argument depended on the court’s interpretation of § 104. Section 104(a) states: “gross income does not include . . . (2) the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness. . . . For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.”46 To determine whether the Stadnyks’ situation qualified for exclusion under § 104(a)(2), the Tax Court and Sixth Circuit

38. Id.
39. Id.
40. Id.
41. Id. at 477; see supra text accompanying notes 1–2, 12–13.
42. Stadnyk I, 96 T.C.M. (CCH) at 478–79.
43. Stadnyk II, 367 F. App’x at 587.
44. Id. at 591.
45. Id.
46. 26 U.S.C. § 104(a) (2006). The cases failed to mention, however, that the last sentence of § 104(a) provides for the exclusion of medical expenses not deducted under § 213, which can include expenses for the treatment of emotional distress. Id. The Stadnyks likely did not argue this point because Mrs. Stadnyk’s medical expenses were paid in full by her employer and her insurance. Stadnyk II, 367 F. App’x at 588.
Court applied the two-pronged test from *Commissioner v. Schleier.*\(^{47}\) Under this test, “(1) The underlying cause of action giving rise to the settlement award must be based upon tort or tort-type rights, and (2) the damages must be received on account of personal physical injuries or physical sickness.”\(^{48}\) In analyzing the underlying cause of action, courts must look to the intent of the payor in making the settlement.\(^{49}\) Considering the nature of Mrs. Stadnyk’s claims against the payor (Bank One) and the payor’s intent in making the settlement, the Tax Court recognized the possibility of the claims being either contract or tort claims, but decided that the ultimate injury resonated in tort law.\(^{50}\) Thus, the Tax Court found that the claims satisfied the first prong of the *Schleier* test,\(^{51}\) and the Sixth Circuit Court agreed.\(^{52}\)

According to both courts’ analyses, however, Mrs. Stadnyk’s case failed to satisfy the second prong of the *Schleier* test, which requires that the settlement proceeds be paid “on account of personal physical injuries or physical sickness.”\(^{53}\) Mrs. Stadnyk argued that although she did not suffer physical harm, physical restraint and detention qualify as physical injuries under § 104(a)(2).\(^{54}\) The Tax Court relied on Kentucky judicial opinions holding that “[i]njury from false imprisonment is ‘in large part a mental one’ where the plaintiff can recover for mental suffering and humiliation.”\(^{55}\) The court also referred back to the explicitly non-physical injury claims: “mortification and humiliation, inconvenience, damage to reputation, emotional distress, [and] mental anguish.”\(^{56}\) These non-physical injury claims are not excludable under the text of § 104(a)(2) or as applied in relevant cases.\(^{57}\) Even if Mrs. Stadnyk had

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47. *Stadnyk II,* 367 F. App’x at 591; *Stadnyk I,* 96 T.C.M. (CCH) at 476.
49. *Stadnyk I,* 96 T.C.M. (CCH) at 477 (citing Stocks v. Comm’r, 98 T.C. 1, 10 (1992)).
50. *Id.* at 477–78.
51. *Id.*
52. *Stadnyk II,* 367 F. App’x at 592.
53. *Id.* at 592–94; *Stadnyk I,* 96 T.C.M. (CCH) at 478.
54. *Stadnyk I,* 96 T.C.M. (CCH) at 478.
55. *Id.* (quoting Banks v. Fritsch, 39 S.W.3d 474, 479 (Ky. Ct. App. 2001)).
56. *Id.* at 476, 478. *See supra* text accompanying note 33.
57. *Id.* at 478 (citing Sanford v. Comm’r, 95 T.C.M. (CCH) 1618 (2008); Polone v. Comm’r, 86 T.C.M. (CCH) 698 (2003), *aff’d,* 505 F.3d 966 (9th Cir. 2007); Venable v. Comm’r, 86 T.C.M. (CCH) 254 (2003), *aff’d,* 110 F. App’x 421 (5th Cir. 2004)).
originally pleaded physical restraint as a physical injury, she would not have prevailed because the exclusion requires not just an incident that involves a physical act, but also that the physical act be the reason for the damages. The Sixth Circuit also recognized that following Mrs. Stadnyk’s position would be sanctioning a per se rule that all false imprisonment cases involved physical injuries. If physical restraint were enough to qualify an incident as a “physical injury” under § 104, every false imprisonment case—cases, which by definition require physical restraint—would fall under the § 104 exclusion.

Instead, the court distinguished between an inherently physical act and a physical act that causes physical injury; only if the inherently physical act had caused a separate physical injury and was the reason for the damages would Mrs. Stadnyk have qualified for the personal physical injuries exclusion by having received her settlement “on account of personal physical injuries.” Because the agreement shed no light on the reasoning for the settlement, and because the Stadnyks provided no other evidence that the settlement was “on account of personal physical injuries,” the courts held that the settlement could not be excluded from the Stadnyks’ gross income under § 104(a)(2).

Both the Tax Court and the Sixth Circuit held that the Stadnyks’ constitutional argument—that taxing personal injury settlements violates the Sixteenth Amendment and is a direct tax that is not apportioned—were without merit. The Sixth Circuit relied upon

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58. See infra Part III.A.3.a.
59. Stadnyk II, 367 F. App’x at 593.
60. See infra text accompanying notes 102–19.
61. Stadnyk II, 367 F. App’x at 593.
62. Id.
63. Id. The Sixth Circuit explained that the wording “on account of” requires more than a “but for” link of causation. The physical injury must be the “direct causal link” for the settlement; the settlement must “be awarded by reason of, or because of, a personal physical injury.” Id. (citing O’Gilvie v. United States, 519 U.S. 79, 83 (1996)); see also Greer v. United States, 207 F.3d 322, 327 (6th Cir. 2000).
64. Stadnyk II, 367 F. App’x at 593–94.
65. Id. at 594–95. Although the constitutional argument is interesting, much literature and many court opinions confirm that § 104(a)(2) is constitutional. The constitutionality issue will not be explored in this Note. For information about the constitutionality question, see Murphy v. IRS, 460 F.3d 79 (D.C. Cir. 2006), overruled by Murphy v. IRS, 493 F.3d 170 (D.C. Cir. 2007); Margarita R. Karpov, Note, To Tax or Not to Tax – That Is the Question in the Midst of Murphy v. I.R.S., 23 AKRON TAX J. 143 (2008); Ellen Overmyer Lloyd, Comment, The Taxman Cometh: The Constitutionality of Taxing Compensatory Damages for
the Supreme Court in ruling that compensatory settlement awards are constitutionally taxable and are excludable from gross income only if specifically excluded by a provision of the Internal Revenue Code. Therefore, for the Stadnyks to succeed, their only recourse would be to prove that there was some physical injury to qualify for the exemption. Beyond the constitutionality of the tax, if personal awards were not income, §104(a) would be unnecessary. The Stadnyk cases and related literature discuss the constitutional issues in more depth, but this Note will focus on the statutory and policy questions surrounding “personal physical injury.”

Despite its ruling that the exclusion did not apply, the Tax Court found that the Stadnyks acted in good faith and had reasonable cause to understate their income, so the accuracy penalty did not apply.

III. ANALYSIS

The Tax Court and the Sixth Circuit may have done their best to follow the precedent as it has developed from 1918 to the present, but the Stadnyk case is a perfect example of how the law has become unnecessarily complicated. Although Stadnyk was correctly decided as to precedent and existing law, Stadnyk can serve to warn decision makers and urge them to reevaluate the path that the §104(a)(2) exclusion has taken to become the creature it is today. This Note will analyze what purpose the exclusion has come to serve and how removing the exclusion entirely will provide a better solution than the current law.

Part A will analyze the history of the exclusion and highlight some issues with the current state of the law, and Part B will consider the options for interpretation or alteration of the exclusion going forward and suggest a course of action.


66. Stadnyk II, 367 F. App’x at 590. The court emphasized the “sweeping” reach of income under § 61. Id. It quoted precedent exactly on point: “subject to certain exemptions, which are to be construed narrowly, § 61(a) applies to all income, including settlement payments.” Id. (quoting Polone v. Comm’r, 505 F.3d 966, 969 (9th Cir. 2007)) (internal quotation marks omitted).

67. Id. at 590.

68. For references to the constitutional discussion, see supra note 65.

69. Stadnyk I, 96 T.C.M. (CCH) at 481. Also, since the Internal Revenue Service did not appeal the Tax Court’s determination that the accuracy penalty should be dropped, the Sixth Circuit did not discuss the penalty.
A. The Law As It Stands and As Applied in Stadnyk

The fate of the Stadnyks’ pocketbook, to the tune of a federal income tax liability exceeding $13,000, was determined by the court’s definition of “physical injury.” The Sixth Circuit almost robotically checked off the Schleier checklist, filling in the blanks by analogizing precedent to fit the Stadnyks’ situation. The court did not explain the rationale behind its decision or behind the decisions upon which the court relied. What brought the courts and the code to their current positions? What should be the definition of “physical injury?”

Part 1 of this section will discuss the legislative history and issues that led the Stadnyk court to its position. Parts 2 and 3 will discuss the way the exclusion currently works as demonstrated in the Stadnyk cases, including an analysis of the two-part Schleier test, and the interpretation and exceptions to the common interpretation of “personal physical injury.”

1. Rationales for the § 104(a) exclusion

In order to understand the state of the law leading into Stadnyk, the policy considerations courts might promote in the future, and the direction the legislature may pursue in the future, a discussion of the potential rationales, or lack of rationales, for the § 104(a)(2) exclusion is helpful. From a tax standpoint, exclusions from gross income often contradict tax principles. Social policy and implications often drive the decision to implement a federal income tax exclusion.

The legislative history of § 104(a)(2) does not explain the rationale behind Congress establishing the exclusion, and the rationales suggested in court opinions for initially establishing an exclusion for personal injuries and then reducing the exclusion to only personal physical injuries or sicknesses are not particularly enlightening or intellectually satisfying. Two rationales have been offered as justifications for establishing the exclusion. First, recovery
for personal injuries simply restores the “human capital”\(^75\) that the victim lost—restoring him or her to the rightful, pre-injury position; and, therefore, the recovery of human capital that simply replaced nontaxable human capital adds nothing to the individual and cannot be taxed.\(^76\) A second suggested justification for the exclusion is sympathy for the victim of a personal injury.\(^77\) These rationales illustrate that the exclusion for personal injury victims focuses on the victim.

The human-capital theory can be explained through the example of a typical car accident. The human ability to move, think, and work can constitute capital. The car accident, however, may strip the human of all those abilities, resulting in a loss of human capital. A settlement puts a dollar amount on those forfeited abilities and restores the lost human capital. Early cases asserted that “restoration of capital [is] not income.”\(^78\) According to the human-capital theory, since restoration of capital is not income, restoration of human ability that was diminished or destroyed in an accident is also not income and therefore not taxable. The theory characterizes this human capital as “well-being,” or “personal assets that the Government does not tax and would not have taxed had the victim not lost them.”\(^79\) Based on this theory, the Supreme Court in 1996 emphasized “there is no strong reason for trying to interpret the statute’s language to reach beyond those damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, ‘return the victim’s personal or financial capital.’”\(^80\) In the false imprisonment context, the human-capital theory might encompass the view that “the ability to take a breath of fresh air, to sleep in one’s own bed, to attend a family gathering, is not taxable.”\(^81\)

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75. “Human capital” is the term for any characteristics or abilities that allow a human to earn compensation; these characteristics and abilities can be emotional, mental, or physical. JOSEPH M. DODGE, J. CLIFTON FLEMING JR. & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 269 (3d ed. 2004).

76. Id. at 268–69 (quoting Hawkins v. Comm’r, 6 B.T.A. 1023 (1927)).

77. Roemer v. Comm’r, 716 F.2d 693, 696 (9th Cir. 1983) (citing Notes, Taxation of Damages Recoveries from Litigation, 40 CORNELL L. Q. 345, 346 (1955)).


79. Francisco, 267 F.3d at 307 (quoting O’Gilvie, 519 U.S. at 86).

80. O’Gilvie, 519 U.S. at 86.

In tax law, the flaw with this line of reasoning is that “human capital” has no basis and therefore cannot offset an accession to wealth or “return of capital.”82 If taxpayers receive a return from exercising human capital (as taxpayers do regularly to earn wages), they cannot claim a basis in human capital to offset that return. If recoveries of human capital were excluded pursuant to capital-recovery theory, taxpayers could argue that a basis in human capital offsets wages too, and ordinary income from wages would not be included in gross income.83 They might say that wages, after all, are only compensation for human capital in the form of time spent doing work, brainwork, or physical exertion. In personal injuries, taxpayers may argue that the amount of cash received was not even from the exercise of human capital, but rather given as a replacement of lost human capital. Even when capital is returned or replaced, if the capital had no tax basis to begin with, any amount received would be included in gross income; such is the case with “recovery” or “replacement” of human capital.84 The human-capital theory does not justify excluding personal injury recoveries.

The second rationale for the § 104(a)(2) exclusion is Congress’ sympathy for the injured party. The Ninth Circuit in Roemer v. Commissioner explains “[t]he rationale behind the exclusion of the entire award is apparently a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award.”85 Various courts recognize that settlement amounts, including lost wages, normally would be taxable but believe that Congress concluded that victims of personal injury should not have to deal with the headache of calculating and paying taxes on part of the money given to them in an effort to make them whole.86

The two rationales, as weak or as strong as they may be, were disregarded by Congress when it whittled away the § 104(a)(2) exclusion. Congress ignored prior attempts to sympathize with victims through simplified tax calculations by failing to allow

82. DODGE, FLEMING & GEIER, supra note 75, at 269–70.
83. Id. at 270.
84. Id.
85. Roemer v. Comm’r, 716 F.2d 693, 696 (9th Cir. 1983) (citing Notes, Taxation of Damages Recoveries from Litigation, 40 CORNELL L. Q. 345, 346 (1955)).
86. See, e.g., id.
exclusions of recoveries based on non-physical injuries and did not follow the human-capital theory for exclusion. The human-capital rationale may explain why punitive damages were the first part of personal injury settlements to become taxable and not excluded from gross income. 87 However, this theory provides that emotional capacities and ensuing injuries exemplify human capital and should be excluded from gross income, even though they are expressly excepted from the §104(a)(2) exclusion. Also, regarding the sympathy rationale, victims today are not any less deserving of sympathy than they were from 1918 to 1996. Based on today’s law that distinguishes personal physical injuries from personal non-physical injuries, victims certainly must sort through taxable and non-taxable portions of their awards and wonder if the IRS will hound them for what they think is excludable. 88 If Congress introduced the exclusion based on human-capital and sympathy theories, Congress apparently abandoned the rationales when it amended the § 104(a)(2) exclusion.

Despite any rationales for and benefits from the exclusion, the big picture of suffering puts that reasoning into perspective. One tax commentator and law professor astutely shared the following opinion:

The real reason that § 104[(a)(2)] is part of the law—whatever the tax theorists may say about it—is the idea that tort victims should be pitied rather than taxed. But if society is being solicitous of folks who are injured, why pick the most fortunate subset—injured folks who, unlike most victims of personal injury, receive monetary compensation? And, given the vagaries of the tort system . . . why give the biggest tax benefit to the most fortunate sub-subset, those who are fortunate enough both to be injured by a deep pocket and to be able to convince a jury to award massive damages? . . . Repeal of 104[(a)(2)] would merely recognize that compensated victims are better off than uncompensated victims. They are also better off
than the still larger contingency of people who suffer as a result of
natural causes, but are unable to sue God.90

Although Congress cannot realistically solve all the inequities in life,
Congress can improve this area of law by reconsidering the confusing
state of the § 104(a)(2) exclusion, reviewing the pros and cons to
the taxpayers and to the government of its application, and assessing
other solutions that might simplify and improve the law.

2. Schleier and the two-pronged test

One of the largest influences on the Stadnyk decision was the
two-pronged test made famous in Commissioner v. Schleier.91
Although “personal physical injury” is not specifically defined in the
Internal Revenue Code or in the test, the test attempts to sketch the
appropriate context for application of the exclusion. 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 on tort or tort type rights,
or through a settlement agreement entered into in lieu of such
prosecution.”92 Based on the text of the regulation, in Commissioner v. Schleier the Supreme Court stamped its approval on the two-
pronged test for exclusion under § 104(a)(2).93 Decisions since
Schleier have consistently relied on this test. The court in Stadnyk

90. DODGE, FLEMING & GEIER, supra note 75, at 272 (quoting email from Phillip D.
Oliver, Ben J. Altheimer Distinguished Professor, Univ. of Ark., Little Rock, Law School
(email on file with authors)).

Supreme Court before the 1996 amendments, but the test applies to the updated language in
the same way that it applied to the pre-1996 language; the amendment simply adds the
“physical” requirement to the Schleier test. Hennessey v. Comm’r, 97 T.C.M. (CCH) 1786
(2009). The courts have consistently applied the test to the present day. See infra note 94.

92. 26 C.F.R. § 1.104-1(c) (1964) (emphasis added).

93. The Court emphasized, however, that the two-pronged test did not subsume the
statutory requirement but was an additional aid to identify applicable cases. Schleier, 515 U.S.
at 333.

94. Courts in every circuit except the First Circuit (which has not addressed the issue)
have followed the Schleier test. Green v. Comm’r, 507 F.3d 857 (5th Cir. 2007); Murphy v.
IRS, 493 F.3d 170 (D.C. Cir. 2007); Rivera v. Baker W., Inc., 430 F.3d 1253 (9th Cir.
2005); Tamberella v. Comm’r, 139 F. App’x 319 (2d Cir. 2005); Peaco v. Comm’r, 48 F.
App’x 423 (3d Cir. 2002); Abrahamsen v. United States, 228 F.3d 1360 (Fed. Cir. 2000);
Fabry v. Comm’r, 223 F.3d 1261 (11th Cir. 2000); Greer v. United States, 207 F.3d 322 (6th
Cir. 2000); Pipitone v. United States, 180 F.3d 859 (7th Cir. 1999); Mayberry v. United
States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997);
Brabson v. United States, 73 F.3d 1040 (10th Cir. 1996).
delineated the two prongs as follows: “(1) The underlying cause of action giving rise to the settlement award must be based upon tort or tort type rights, and (2) the damages must be received on account of personal physical injuries or physical sickness.” This Part will discuss the first prong and Subpart 3 will discuss the second prong.

The first prong of the test states that the exclusion applies only in tort-type cases. The test causes courts, including the Stadnyk court, to step back and look at the claim to see if it as a satisfactory tort claim or not. A simple contract case, for example, would not satisfy the first prong of the test, and a related damage award would therefore fail to qualify for exclusion under § 104(a)(2).

The courts must determine whether tort principles are in question, which is not necessarily a simple task. For example, United States v. Burke,96 which was decided before the 1996 amendments, concerned the taxability of damages for Title VII sexual discrimination claims. The district court held that the damages were not excludable; the Sixth Circuit Court then reversed, holding that the amount was excludable; however, the Supreme Court reversed again holding that the amount was not excludable.97 The issue at all levels was whether or not discrimination is a tort or tort-like cause of action. The district court and the Supreme Court focused on the fact that the available remedies for Title VII discrimination were limited to back wages; tort damages, in contrast, typically include many other considerations and forms. Because of the stark difference in available remedies, the Court held the circumstances in Burke distinguished it from a tort or tort-type case, and, therefore, the ensuing damages were not excludable under § 104(a)(2). As Congress had established the available remedies, the Court claimed that Congress itself deemed the situation non-tort-like. Congress later expanded the available remedies, suggesting that the technical issues that swayed the Court were not truly dispositive to the determination of a personal injury.

Tying the analysis to tort principles seems to result in time—both in and out of court—spent away from the real crux of the issue: whether the case fits within the statutory exclusion itself. Attorney Robert W. Wood agreed, claiming that the test is “more tautological

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95. Stadnyk I, 96 T.C.M. (CCH) at 476; see also Stadnyk II, 367 F. App'x at 591.
97. Id. at 242.
than helpful.” For example, the taxpayer in the Schleier case tried to circumvent the statutory language by relying alone on the “tort or tort type rights” part of the language of the regulation and test. However, Schleier asserts that a given case cannot fall within the exclusion unless the situation meets both requirements: the requirement of the statutory language and both prongs of the two-prong test, which are implied from the statutory language. The “tort or tort type rights” prong of the Schleier test is a prime example of how complicated and time-consuming the § 104(a)(2) exclusion analysis has become.

3. Personal physical injuries

The second prong of the Schleier test, however, refers to the meat of the § 104(a)(2) exclusion’s statutory language: the damages must be received “on account of personal physical injuries or physical sickness.” Mrs. Stadnyk lost on this second prong because the Sixth Circuit Court found that her imprisonment was not a § 102(a)(2) “physical injury.” The court effectively set a precedent that false imprisonment, on its own, will never constitute a physical injury. Although this precedent is set, the court left the boundaries of “physical injury” undefined and vulnerable to costly, litigious debate in the future.

a. False imprisonment is not a physical injury per se. The Stadnyk court conceded that false imprisonment “involves a physical act—restraining the victim’s freedom.” The court, however, required an additional act of injury for the exclusion to apply and emphasized the importance of that injury actually being the reason for the damages.

Considering the specific circumstances of the case, the Stadnyk court first looked to the definition of false imprisonment to see if the tort itself could be considered a physical injury. Kentucky courts

100. Id. at 336–37.
102. Stadnyk II, 367 F. App’x at 593.
103. Id. at 593–94.
104. Id. at 592.
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define the tort of false imprisonment as “any deprivation of . . . liberty . . . or detention for however short a time without such person’s consent and against his will” and as a tort that “protects personal interest in freedom from physical restraint.” The Sixth Circuit joins with the Kentucky precedent to conclude that “[i]njury from false imprisonment is ‘in large part a mental one.’” Other jurisdictions and the Restatement of Torts share similar definitions of false imprisonment. Based on the non-physical definition of false imprisonment, the court concluded that making false imprisonment a per se physical injury would be inaccurate.

Commentators and sympathizers, however, urge that the physical and injurious nature of imprisonment qualifies it for the § 104(a)(2) exclusion. Wood asserts that “there is nothing mental about being subjected to the physical confinement of imprisonment/incarceration. . . . [T]he primary thrust of a false imprisonment claim . . . is not mental.” Mrs. Stadnyk was not imprisoned mentally, although the imprisonment had emotional repercussions; she was physically handcuffed and physically confined. If the court found that the physical nature of imprisonment qualified it as a personal physical injury, all damages flowing from the imprisonment itself, even emotional damages, would then be excludable under § 104(a)(2).

105. Id. (quoting Grayson Variety Store, Inc. v. Shaffer, 402 S.W.2d 424, 425 (Ky. 1966)) (internal quotation marks omitted).
106. Id.
107. Stadnyk I, 96 T.C.M. (CCH) at 478 (quoting Banks v. Fritsch, 39 S.W.3d 474, 479 (Ky. Ct. App. 2001)).
109. RESTATEMENT (SECOND) OF TORTS §§ 35–36 (1965) (noting that the tort of false imprisonment requires the victim to be conscious of his or her confinement and unaware of an escape).
111. See Wood, Are False Imprisonment Recoveries Taxable?, supra note 81, at 287.
The court, however, apparently was not persuaded by that argument. Although “false imprisonment . . . may cause a physical injury, . . . the mere fact that false imprisonment involves a physical act—restraining the victim’s freedom—does not mean that the victim is necessarily physically injured as a result of that physical act.”112 The court simply refused to accept the interpretation that false imprisonment alone is a physical injury. The court refused to “create a per se rule that every false imprisonment claim necessarily involves a physical injury.”113

Although not mentioned in the Stadnyk case, the strict requirement by the IRS that the injuries be visible likely underlies and informs the court’s determination that false imprisonment falls outside the definition of “personal physical injury.” In one specific ruling, the IRS established a bright-line rule that physical injuries must be observable. 114 The ruling, known as the “bruise ruling,”115 focuses on physical manifestation of injury: “physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a)(2).”116 The decision also quoted Black’s Law Dictionary, “which defines the term ‘physical injury’ as ‘bodily harm or hurt, excluding mental distress, fright, or emotional disturbance.’”117 Black’s definition alone does not rule out the possibility of false imprisonment being a physical injury, as the imprisonment itself could be considered “bodily harm or hurt,” but the lack of an outward, observable bodily harm sets false imprisonment per se—and the Stadnyk case—outside the bounds of the strict requirement.

Even if the imprisonment did result in a separate, observable physical injury, such as bruising from the handcuffs, the exclusion applies only when the physical injury directly resulted in the award. Stadnyk explains that the phrase “on account of” requires “a direct causal link between the physical injury and the damages recovery in order to qualify for the income exclusion,”118 establishing that

112. Stadnyk II, 367 F. App’x at 593.
113. Id.
117. Id.
118. Stadnyk II, 367 F. App’x at 593; see, e.g., Shelton v. Comm’r, 94 T.C.M. (CCH) 1592 (2009); Sanford v. Comm’r, 95 T.C.M. (CCH) 1618 (2008); Mumy v. Comm’r, T.C.
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evidence and causation must be provided by the plaintiff.\textsuperscript{119} Thus, if Mrs. Stadnyk were bruised from the handcuffs, the only damages that would qualify for the § 104(a) exclusion would be those she could prove were awarded specifically because of that bruising; the bruising would not bring all of the damages from the false imprisonment claim into the exclusionary ambit. The Sixth Circuit, by denying the interpretation that false imprisonment itself is a physical injury, effectively blocked false imprisonment cases like the Stadnyks’ from applying the exclusion.

\textit{b. A presumption of a physical injury could lead to exclusion.} A recent concession made in an IRS letter ruling provides that in rare cases, the court may deem physical injuries to exist although the plaintiff fails to provide sufficient evidence of the injuries and of the causal link between the injuries and the recovered damages.\textsuperscript{120} This presumption could arguably apply to false imprisonment cases but would not likely apply in the \textit{Stadnyk} case.

The letter ruling in question uses general language, describing a situation where a victim was injured in tort long before the recovery.\textsuperscript{121} Because the initial injuries occurred so long ago, establishing the origin and extent of physical injuries may be difficult. Based on that difficulty, the IRS states that it will presume not only the existence of physical injuries but also that the settlement amount was made on account of the presumed physical injuries.\textsuperscript{122}

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\textsuperscript{119} \textit{Stadnyk II}, 367 F. App’x at 593 (citing Greer v. United States, 207 F.3d 322, 334 (6th Cir. 2000)).

\textsuperscript{120} \textit{See Payments to Settle Tort Claims Are Excludable from Gross Income, Not Subject to Information Reporting}, TAX NOTES TODAY, March 3, 2008.

\textsuperscript{121} \textit{Id.} The exact language of the ruling is as follows:

You have inquired about the tax treatment of payments made by Entity to settle claims of Tort asserted by C. C has alleged that Entity’s agent(s) X caused physical injury through Tort while he was a minor under the care of X. A substantial amount of time has elapsed since the alleged Tort occurred. C alleges that he continues to struggle with the trauma resulting from the alleged Tort. Because of the passage of time and because C was a minor when the Tort allegedly occurred, C may have difficulty establishing the extent of his physical injuries. Under these circumstances, it is reasonable . . . to presume that the settlement compensated [the individual] for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.

\textit{Id.}

\textsuperscript{122} \textit{Id.}
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Because the letter ruling used such general terms and did not provide a clear line of analysis to apply to other cases, determining the ruling’s rationale and breadth of application seems a speculative task. On the other hand, the broad language allows, at the very least, general analogizing and application; the ruling itself also suggests that the IRS might be rethinking the rigidity of the observable-bodily-injury requirement. One commentator interprets the ruling to suggest that cases that are “inherently and incontrovertibly physical, whether or not they leave lasting outward scars,” such as sexual abuse cases or even false imprisonment cases, may fit into the narrow exception. Although not stated explicitly in the letter ruling, perhaps the bar for presumption of exclusion relates to the amount of sympathy a certain case elicits. It remains unclear, however, what other sorts of cases, if any, the IRS will deem to be based on a personal physical injury.

The court in Stadnyk did not consider a presumption of physical injury, probably because Mrs. Stadnyk herself testified that she did not suffer any physical harm apart from the imprisonment itself. In addition, the Stadnyk case did not involve a long-past incident that made proof of physical injury difficult, as in the letter ruling that presumed physical injury. However, leaving the Stadnyk precedent unaffected, the Sixth Circuit Court could theoretically find that a U.S. citizen falsely imprisoned for eight hours under fire in Iraq during the war and suffering from extensive mental trauma presumptively suffered physical injuries, and that those injuries led to an excludable settlement amount. A line needs to be drawn to

123. Additionally, revenue rulings and letter rulings, such as the ruling under consideration, while internally binding on the IRS, are not binding on the court system. DODGE, FLEMING & GEIER, supra note 75, at 99–101.
125. Wood, Are False Imprisonment Recoveries Taxable?, supra note 81, at 286.
126. The ruling suggests that a potential presumption of injury does not do away with the physical, observable injury requirement from the “bruise ruling,” but only says that the victim does not have to prove that physical injury. Id.
127. The presumption would likely have to be made based on the same difficulties of obtaining proof mentioned in the IRS letter ruling; although the injury victim does not prove physical injuries like cutting and bruising, the physical injuries are presumed to have occurred because of the specific circumstances of the case. Courts could also potentially follow the general direction of the letter ruling and broaden the application of the presumption to cases not based simply on a lack of proof, but based on the seriousness of an injury that is “inherently and incontrovertibly physical.” Id.
128. Even if the origin of the recovery was not held to be a “physical injury,” the last line
delineate cases presumptively deserving the tax-free status from cases that do not make the cut. Even though eight hours may not be enough to elicit a presumption of physical injuries, what about eight days or eight years? The length of time of the injury itself suggests an increased likelihood of physical injuries, and if the injury lasts for a long time, the difficulty of proving the physical origin of the injury claims increases and makes the situation analogous to the case in the letter ruling. If the breadth of the IRS ruling expands, some false imprisonment cases could be deemed to involve physical injuries if the conditions of the imprisonment are bad enough.

Confronted with the example used above, the court might presume personal physical injuries for the U.S. citizen imprisoned in Iraq and still suffering from the repercussions of the incident if that citizen legitimately could not prove the physical damages (based on the passage of time or difficulty of accessing evidence). Perhaps Congress’s intention in establishing the physical injuries requirement was that ancillary claims of physical injuries would differentiate cases like the Stadnyk’s, which are worthy of an award of damages but do not elicit enough sympathy to avoid taxes, from serious imprisonment cases.\(^\text{129}\) But with the state of the current law, even if Mrs. Stadnyk had been grabbed and bruised, the court still would not likely find that the entire settlement was “on account of” that bruising.\(^\text{130}\) The hypothetical U.S. citizen imprisoned in Iraq for eight hours would also likely not get his or her entire settlement excluded on the ground that physical injuries were deemed to occur. Courts considering a “serious” imprisonment case (a case that may qualify for the presumption, such as the U.S. citizen in Iraq) might also find that abuse and pain constitute “physical injury,” but only a small percentage of the ultimate settlement amount was actually “on account of” those physical injuries. The bulk of the recovery would be for the false imprisonment itself, a claim that is “in large part a mental one.”\(^\text{131}\) The IRS ruling may have some potential to change the personal-physical-injury exclusion analysis, but no case law of § 104(a) still allows that any recovery awarded specifically for this victim’s medical expenses, and not deducted under § 213, may be excluded.

\(^\text{129}\) Wood, supra note 98, at 1220.

\(^\text{130}\) See supra text accompanying notes 112–19.

\(^\text{131}\) Stadnyk I, 96 T.C.M (CCH) at 478 (quoting Banks v. Fritsch, 39 S.W.3d 474, 479 (Ky. Ct. App. 2001)) (internal quotation marks omitted).
currently supports the trend, and, even if the analysis changed, the exclusion still leads to complicated calculations and uncertainty.

In sum, the current law for applying and interpreting § 104(a)(2) requires a claim based on tort or tort-type rights. For the best chance of being excludable under § 104(a)(2), that claim must meet the “bruise ruling” requirement—with potential narrow exceptions—by involving an observable bodily physical injury that is the precise reason for a distinct amount of damages. If the initial threshold is met, to the extent that those damages are not punitive damages, they will be completely tax-free. The Stadnyk court applied this current law and appropriately found that Mrs. Stadnyk’s experience does not fit the exclusionary mold.

B. Removing the § 104(a)(2) Exclusion

Although Stadnyk was technically correct according to current law, it highlights some issues Congress should consider: the unnecessarily complicated state of the exclusion, the lack of predictability for the taxpayers, and the lack of clear reasoning for the exclusion, among others. Taking Stadnyk as a warning sign to reevaluate the law concerning the § 104(a)(2) exclusion, Congress should consider the various potential changes it could make to the exclusion in the future. This Comment argues that the best option is to remove the exclusion entirely. The exclusion could continue as established in Schleier and Stadnyk, requiring courts to determine case by case what matches the applicable precedent and jurisdictional definitions of tort and physical injury well enough to qualify for the exclusion. Alternatively, Congress could amend § 104(a)(2) so that it reverts to its original form, which allowed recoveries for non-physical injuries to qualify for exclusion. The exclusion could also be repealed so that all personal injury recoveries are fully taxable.

The exclusion will probably not revert to its former state or be repealed; it will likely continue to taunt taxpayers and appear as the subject of litigation into the indefinite future. However, this is not the best path. The exclusion should be repealed because doing so provides an alternative solution to fulfill the policy concerns motivating an exclusion; provides clarity, simplicity, and sympathy to the taxpayers; and, as an added bonus, will provide additional revenue to the deficit-stricken federal government.

Although removing the “personal physical injuries or physical sickness” exclusion would be a bold and unexpected move by
Congress, the overall result would benefit victims and the government. As the law stands, the uncertainty over the difference between physical and non-physical personal injuries causes advisors and taxpayers to be unsure of what qualifies for the § 104(a)(2) exclusion and what does not, and the lines drawn by the code seem arbitrary. Although the initial public reaction to removing the exclusion may be that the taxpayers would be hugely disadvantaged, the publicity would hopefully attract enough attention to the subject that opinion leaders would examine the situation and realize the benefits.

The benefits of removing the exclusion include satisfying practical and policy considerations and adhering to appropriate tax law principles. Removing the exclusion will allow practitioners and courts to apply the law predictably and consistently, place the burden on the appropriate party (the person responsible for the personal injury), increase sympathy to the victims,\(^{132}\) and provide revenue for the federal government. Additionally, the proposed tax scheme would adhere to tax and constitutional principles; courts have ruled that a tax on personal-injury recoveries is constitutional,\(^ {133}\) and an analysis based on tax principles reveals that taxing personal-injury recoveries is consistent with time-proven tax theories and practices.\(^ {134}\)

1. Policy and practical rationales for removing the exclusion

Since courts and scholars say that the exclusion for personal physical injuries and sicknesses is not constitutionally required,\(^ {135}\) the decision whether to keep or remove the exclusion depends on policy, practical, and political considerations. Since the 1996 amendments eliminated much of the exclusion, completely abolishing the exclusion seems possible if supported by appropriate policy and practical reasons. By removing the exclusion, the law will provide predictability and sympathy for the taxpayer, appropriately shift the

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132. The proposed tax scheme will show sympathy to personal injury victims in that they will not be subject to surprise costs and protracted litigation if they reasonably, but incorrectly, apply the law and exclude an amount that should be included (like the Stadnyks did). See infra Part III.B.1.b.

133. See supra text accompanying notes 65–68.

134. See DODGE, FLEMING & GEIER, supra note 75, at 268–72 (“The only combination of tort and tax rules that produces a correct result on ‘both sides’ (claimant and defendant) is one where tort damages are computed on a before-tax basis and are included in the claimant’s gross income.”); infra Part III.B.1.c.

135. See supra text accompanying notes 65–68.
burden of the tax liability to the personal-injury perpetrator, and provide much-needed revenue to the federal government.

a. Predictability for the taxpayer. As the law currently stands, predicting which part of a personal injury recovery will be excludable can be extremely complicated, and, based on the excludability of the recovery, the taxpayer also has to consider what part of his or her attorney’s fees will be deductible. Personal injury recovery amounts may include various parts: recovery for future lost earning capacity, recovery for past lost earnings, recovery for medical expenses, recovery for future medical expenses, recovery for pain and suffering, punitive damages, and prejudgment interest, among others.\textsuperscript{136} After allocating portions of the settlement or award to each of those parts, the injured parties and their advisors then have to parse out the parts of the recovery that represent excludable amounts.

If a victim received each of the above listed categories of awards, if he or she can prove the allocation of the total award to each part, and if the injury was “physical” according to § 104(a)(2), then all the categories listed except punitive damages,\textsuperscript{137} prejudgment interest, and recoveries for medical expenses already deducted under § 213 will be excludable under § 104(a)(2).

If another victim received each of the above listed categories of awards and he or she can prove the allocation of the total award to each part, but if the injury was not “physical” according to § 104(a)(2), then all of the categories listed above will be includable under § 104(a)(2) except recoveries for medical costs not deducted under § 213 and perhaps the recovery amount for future medical expenses. The key provision for non-physical injury recoveries is the last sentence of § 104(a). The phrase that bars emotional distress from being considered as a personal physical injury or physical sickness “shall not apply to an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress.”\textsuperscript{138} Therefore, personal injury recovery amounts for “paid” medical care may be excludable, regardless of whether the recovery amount was for a physical injury or for non-physical emotional distress. The law is unclear, however, as to whether recovery

\textsuperscript{136} Examples taken generally from \textsc{dodge, fleming & geier, supra note 75, at 275.}
\textsuperscript{137} If the situation falls within the narrow exception in § 104(c) for some wrongful death claims, however, the punitive damages will be excludable. 26 U.S.C. § 104(c) (2000).
settlements for future medical care can fall under the provision in the last line of § 104(a). The word “paid” may or may not include future medical expenses.

After determining the parts of the actual recovery that are excludable or not excludable, that determination will then affect the portion of the victim’s legal fees that may be deductible. Only legal fees allocable to the taxable portions of the recovery are deductible, so the victim will determine the proportion of the recovery that is taxable and then deduct that same proportion of the legal fees.139 For example, assume that a personal-injury victim received a settlement of $9 million and paid $3 million in legal fees. If the $9 million was a recovery for physical injuries under § 104(a)(2) and included no punitive damages, none of the $9 million would be includable, so none of the $3 million would be deductible. If the $9 million included $3 million of punitive damages not excluded by the exception in § 104(c), then only one-third of the recovery was includable, so only one-third of the $3 million in legal fees will be deductible. If the recovery is not clearly excluded under § 104(a)(2), then planning and tax reporting become even more complicated.

The simplified examples in the above paragraphs directly contradict the Ninth Circuit’s sentiment in *Roemer* that “the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award.”140 Since the 1996 amendments, the injured party has had a more difficult time determining the tax implications of his award. By eliminating the § 104(a)(2) exclusion entirely, Congress would remedy this difficulty, follow *Roemer*, and provide predictability and workability.

Making all personal injury recoveries includable in income taxes would give the personal injury sufferers the predictability necessary to make informed decisions about what settlement amount to accept and how much of the amount to report to the IRS. With all other circumstances held the same, if all personal injuries were includible in gross income, all the different categories from the settlement would

139. Although those legal fees will be deducted under § 212, the fees will be deducted as miscellaneous itemized deductions and subject to the disadvantages characteristic of miscellaneous itemized deductions. For explanations of miscellaneous itemized deductions and the alternative minimum tax, see DODGE, FLEMING & GEIER, *supra* note 75, at 516–18, 569–70, 772–74.

be taxable, the legal fees would be entirely deductible, and the courts would waste no time or expense making the “physical” or “non-physical” determination.

The benefit of a predictable application of the law can only be realized, however, if the parties involved are informed and apply these principles. Currently, state courts, which typically determine litigated personal-injury recovery amounts because personal-injury claims fall under state-determined tort law, vary as to whether juries are instructed to consider taxes or not when they make their judgments.\textsuperscript{141} Although the states’ actual practices will not be conclusively determined by a change in federal law, as long as the change in the taxability of personal injury recoveries is well advertised, the state courts may and hopefully will\textsuperscript{142} begin to consistently deliver before-tax recovery amounts (i.e., increased damage awards to include the amount of tax due thereon). Also, if settling out of court, parties to a dispute and their advisors need to be aware of the change in the law and the necessity to consider taxes in their settlement amounts.

Congress would easily produce the awareness necessary by making the bold move to abolish the § 104(a)(2) exclusion. The general public would likely be aware of the change, but even if citizens do not understand, advisors (such as the mediator and attorneys who misadvised the Stadnyks) and the judiciary should be informed of such a drastic modification to the current law.

In sum, removing the complicated, litigiously expensive, and unpredictable § 104(a)(2) exclusion would simplify litigation, reduce its costs, and provide predictable results for taxpayers.

\textsuperscript{141} DODGE, FLEMING & GEIER, \textit{supra} note 75, at 271–72 (“[T]ort law (mostly state law) is not consistent in its approach to calculating damages, and in some cases the jury isn’t even told about the taxability or exclusion of damages.”); Laura Dietz et al., \textit{Effect of Income Tax Exemption, Generally}, 22 AM. JUR. 2D Damages § 794 (2010); John E. Theuman, \textit{Propriety of Taking Income Tax into Consideration in Fixing Damages in Personal Injury or Death Action}, 16 A.L.R. 4TH 589 (2010) (describing trends and listing cases where the state courts allow or disallow instructions to the jury regarding federal-income-tax implications of a tort award).

\textsuperscript{142} In ideal circumstances, the courts would begin to consistently deliver before-tax recovery amounts. In reality, this consistency may or may not occur due to rules regarding includability of evidence regarding tax, but removing the exclusion would give the courts a reason to conform. Also, many courts concede that even without tax instructions, juries already will often inflate awards to account for tax liabilities. Theuman, \textit{supra} note 141.
b. Sympathy to the taxpayer. If the § 104(a)(2) exclusion were removed, Congress would show sympathy to the taxpayer by giving the victim of a personal injury predictable tax results while placing the burden of the tax on the appropriate party—the party responsible for the personal injury (assuming that all states adopted a rule of awarding damages that included the amount of tax due).

With the clarity and consistency that would result from removing the exclusion, injured parties could get the appropriate amount, and the appropriate party would pay the tax liability. As the law stands, when the excludable or includible status of the remedy is unclear, parties sometimes walk away with a windfall and sometimes walk away with tax liabilities that reduce their recovery to an amount below what they deserve or need. For example, if a party loses $10,000 in wages from a personal injury, to restore that party to her pre-injury state, she needs $10,000 before taxes. So, if the jury awards her $10,000, and the award ends up being excludable under § 104(a)(2), she walks away with a windfall of the amount she would have been taxed if she had actually received her wages and paid taxes. If the jury takes taxes into account and awards less than $10,000 based on her tax bracket, but then the amount ends up being includible in her gross income because the personal injury was non-physical, she walks away with less than she would have ended up with if she had actually received her wages and paid taxes.

When certain personal injury recoveries are excludable from gross income and other recoveries are includible in gross income, if the courts fail to take taxes into account when calculating damages (i.e., the damages are not increased to include taxes thereon), the party with the benefit will always be the personal-injury perpetrator. If taxes are not considered, the perpetrator of a non-physical personal injury has a smaller amount to pay, but the personal-injury victim still has to pay taxes from that amount. Because the benefit goes to the perpetrator, the current law could be seen to sympathize with the party responsible for the personal injury and not the injured party. Opponents of removing § 104(a)(2) may argue that

143. Example based generally on the example in DODGE, FLEMING & GEIER, supra note 75, at 271.

144. Along that same sympathizing vein, when the perpetrating party is a company, the entire settlement or judgment against them is likely to be deductible as a business expense. In Stadnyk, Bank One’s settlement amount of $49,000 was likely deductible against Bank One’s ordinary income as a business expense.
abandoning the exclusion and attempting to include taxes in recovery amounts may discourage perpetrators from buying liability insurance because an increase in damage awards will increase insurance costs. Increased insurance costs may discourage some perpetrators from buying insurance, but the inclusion of tax liability in damage awards may alternatively encourage perpetrators to buy insurance, even at a higher rate, because the need for coverage increases with the change in law. Perpetrators would be responsible for greater damage awards, so they would have a greater incentive than before to have insurance coverage. Overall, removing the exclusion is a step in the direction of justice and sympathy for the appropriate party—the injured party—assuming that state law follows the federal charge and begins increasing damage awards by the tax due thereon.

The Stadnyks’ case may be analogized to the latter example above where the party ended up with an amount less than she deserved. In Stadnyk, thinking that the amount was excludable from gross income, the parties settled on $49,000. If the exclusion had been removed and all parties were aware that the amount would be includable in the Stadnyks’ gross income, then, to account for the tax liability, they would likely have required the settlement amount to be closer to $66,940 instead of $49,000.145 Because the law was unclear, the Stadnyks ended up with only $35,881 after taxes. The §104(a)(2) exclusion, however well intentioned, resulted in a significant loss to a couple that had already suffered. Removing the exclusion and shifting the tax burden to personal-injury perpetrators will allow sufferers like the Stadnyks to consistently get the amounts they deserve.

c. Revenue for the federal government. The United States government operates with a yearly deficit and has an increasing bill of public debt.146 As of December 18, 2010, the outstanding public debt was above $13.8 trillion—meaning each citizen’s “share” is approximately $44,840 as the national debt continues to increase at

145. If the tax on $49,000 was $13,119, the average rate was around 26.8%. To get an after-tax amount of $49,000, the before tax settlement would have to be around $66,940.

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about $4.15 billion a day. The government needs additional sources of revenue, and taxing personal-injury recoveries will provide some of that much-needed revenue from the pocket of the wrongdoer.

If courts and parties who settle can consistently calculate recovery amounts to include taxes, the victims will receive the appropriate amounts while the wrongdoers will pay the dues to the government.

2. Consistency with tax principles

Tax principles concerning human capital, basis, and income suggest that the correct treatment of personal injury recoveries is inclusion in gross income. Additionally, as discussed above, the only way to get a consistent and accurate result for both sides of a personal injury claim involving tort damages is to compute the amount of damages on a before-tax basis and include the amount in the gross income of the injured party.

Based on tax principles, recovery amounts in this context could be excludable if they are offset by basis as a tax-free return of capital. Personal injury recoveries, however, cannot be offset by a basis in human capital because human capital does not create a basis or have any tax attributes. Moreover, personal injury recoveries cannot be excluded from gross income under the theory that they are lost human capital because that approach does not create an exclusion for gross income. It merely allows the taxpayer to offset basis against the amount received if there is any basis. But as we have seen, there is no basis in human capital. The natural treatment of personal injury recoveries, then, is full inclusion, unless Congress interferes to create an exclusion. Tax theories do not justify

148. If the party responsible for the personal injury is a business, it will likely get a deduction for the recovery amount paid to the victim. In this case, if the exclusion were abolished, the government might not end up with revenue from the damages, but the taxpayers would not get the double tax benefit they would experience otherwise. If the exclusion were in place, both sides would theoretically get a tax break from the excludability.
149. See DODGE, FLEMING & GEIER, supra note 75, at 272; supra Part III.B.1.a.
150. DODGE, FLEMING & GEIER, supra note 75, at 269–70.
151. See id. at 269–71.
Congress’s decision embodied in §104(a)(2) to exclude personal injury recoveries from gross income.

IV. CONCLUSION

Congress’s intervention to create exclusions may sometimes be justified and function well, but based on the cost to the taxpaying public and the government of determining when the § 104(a)(2) exclusion applies, the cost and stress to personal injury victims of determining what parts will or will not be excluded (the benefit often being inappropriately bestowed on the perpetrator from the exclusion), and the revenue needs of the federal government, the § 104(a)(2) exclusion should be abolished. If the § 104(a)(2) exclusion is removed, Congress will be changing the rules one last time to put the excludability question to rest. The millions of dollars awarded each year based on claims of personal injury or infringement of personal rights will do the same as before to restore the victim to his or her previous position, while the perpetrator effectually pays the cost to the injured party and to the federal government. Tort and tax law cannot solve all the injustices of personal injury, but Stadnyk and similar cases can provide Congress with the stimulus necessary to take a step in the direction toward legal accuracy and fairness to personal-injury victims.

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