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TAXES AND TORTS

Joseph M. Dodge†

INTRODUCTION

Section 104 of the Internal Revenue Code ("the Code") excludes from gross income recoveries for physical or nonphysical personal injuries, whether by way of damages, insurance, or settlement.¹ Section 104 was amended by the Omnibus Budget Reconciliation Act of 1989 ("OBRA '89") to expressly eliminate the punitive damages exclusion for nonphysical injuries.² Whether section 104 currently excludes punitive damages for physical injury, however, is somewhat unclear.³ The 1989 amendment seems to be based on the erroneous, or at least doubtful, assumption that punitive damages generally fall within the section 104 exclusion.⁴ Punitive damage...
ages aside, the exclusion encompasses recoveries representing lost earning capacity, lost past earnings, pain and suffering, and medical and legal expenses not deducted in a prior year. Moreover, the term "personal injury" has been defined broadly to encompass "tort-like" actions such as employment discrimination and civil rights violations.

This Article deals only tangentially with current doctrinal issues under section 104. Its main purpose is to examine whether tax policy, alone or in conjunction with policies of tort law, justifies the exclusion of any component of a personal injury recovery. Past ac-

Recoveries of expenses deducted in a prior year are includible under § 104(a) unless the deduction failed to produce a tax benefit. Recoveries for nondeductible legal expenses are excludible. Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983).


See generally Brooks, supra note 8, at 760-80 (arguing that damages should be tax-free only when they are a substitute for tax-free receipts, especially as they relate to human capital); Douglas K. Chapman, No Pain - No Gain? Should Personal Injury Damages Keep Their Tax-Exempt Status?, 9 U. ARK. LITTLE ROCK L.J. 407 (1986-87) (arguing that § 104 should be repealed as to recoveries for lost earnings); Mark W. Cochran, Should Personal Injury Damage Awards Be Taxed?, 38 CASE W. RES. L. REV. 43 (1987) (arguing for complete repeal of § 104); Lawrence A. Frolik, Personal Injury Taxation As a Tax Preference, 37 ME. L. REV. 1 (1985) (arguing that § 104 should be repealed insofar as it relates to lost earning capacity); Malcolm L. Morris, Taxing Economic Loss Recovered in Personal Injury Actions: Toward a Capital Idea?, 38 U. FLA. L. REV. 735 (1988) (advancing ad hoc compromise solutions); Edward Yorio, The Taxation of Damages: Tax and Non-tax Policy Considera-
tempts to justify the exclusion have been insufficient, leading some commentators to call for its repeal.\textsuperscript{10} This Article argues that the inclusion-exclusion dichotomy is a misleading way to frame the issue. Resolution of this issue should be sensitive to both federal tax policy and state tort policies. Thus, a better solution is to design a tax rule that achieves the twin goals of (1) substantive tax equity among recipients of recoveries, and (2) remedy neutrality with respect to various competing rules for computing recoveries. In this context, “substantive tax equity” means that plaintiffs should be placed in the same post-tax economic position after receiving the recovery as they would have been in if the injury had not occurred, regardless of the particular technique employed by state law to compute the recovery.\textsuperscript{11} “Remedy neutrality” means that states should be able to adapt their compensation rules to various notions regarding the efficient regulation of defendants’ conduct.

The concepts of substantive tax equity and remedy neutrality, while apparently incompatible, can converge on the plaintiff’s side under the rubric of “compensation.”\textsuperscript{12} In tort law the term “compensatory damages” encompasses recoveries for both economic harms, such as medical expenses, lost wages, and earning capacity, and noneconomic harms, such as pain and suffering, and humiliation.\textsuperscript{13} This Article, however, uses the term “compensation” more narrowly to refer to “pecuniary” damages designed to restore the status quo ante of the injured party in strictly economic (human capital) terms.\textsuperscript{14} “Compensatory” recoveries for noneconomic harms will be dealt with separately.\textsuperscript{15} On the defendant’s side, the principal policy of tort law is to create disincentives to socially harmful con-

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\textsuperscript{10} See authorities cited, supra note 9.

\textsuperscript{11} As used herein, “tax equity” is not to be confused with the well-known maxim of “horizontal equity.” Horizontal equity posits that persons in the “same position” should pay the same taxes, but it fails to prescribe any methodology for determining the “position” of taxpayers. In contrast, “tax equity,” as used herein, prescribes a “substantive” standard for comparing taxpayers who receive personal injury recoveries; that of “full restoration of human capital.”

\textsuperscript{12} See infra notes 71-77, 99-101, 111-13 and accompanying text.

\textsuperscript{13} See Restatement (Second) of Torts §§ 901(a), 903, 905 (1977). Obviously, tort law fails to achieve this aim insofar as the transaction costs of obtaining any recovery, even legal fees, are borne, under the “American rule,” by the plaintiff—even when the plaintiff is successful. \textit{Id.} § 914. This problem cannot plausibly be solved by federal tax law.

\textsuperscript{14} Restatement (Second) of Torts §§ 903 cmt. a, 906 cmts. a & c, 910, and 913A (1977).

\textsuperscript{15} See infra notes 183-214 and accompanying text (arguments that such damages should be included).
duct. However, opinions differ as to the appropriate degree of deterrence, and states can adapt their tort laws to embody these differences. At present, no federal policy exists which imposes a uniform national tort law, nor do existing federal tax deduction rules embody such a policy indirectly. This Article focuses on the tax side of the tax-tort boundary. It highlights the differing views on tort-side deterrence policy, without advocating any view as the correct one. The Article explicates the interplay between tax and tort remedy rules, demonstrating that a variety of tort remedy rules with differing impact on defendants, may reach the same plaintiff-side result—full compensation for human-capital loss.

Section 104 forces states to choose between overcompensating plaintiffs and potentially underburdening defendants. Yet, repeal of section 104 would create the inverse situation, forcing states to choose between undercompensating plaintiffs and over burdening defendants. In other words, retention or repeal of section 104 forces tort law to “adapt” to tax law in order to achieve economic compensation of plaintiffs, a result which may impose the “wrong” burden on defendants. It is not inevitable that federal tax law must operate in this manner. One solution is to make federal tax rules adaptive to state tort remedy rules; this achieves “correct” compensation for plaintiffs in all cases while simultaneously allowing states to pursue varying deterrence policies. Specifically, the adaptive approach suggested in this Article produces a set of federal tax rules that treat lost earning capacity damages and lost wages variably, according to the method used to compute damages under state law.

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16 RESTATEMENT (SECOND) OF TORTS § 901(c) (1977). A secondary tort law policy is punishment. Punishment and deterrence are not logically compatible, for one is a means to a behavioral end, while the other is a nonbehavioral end in itself. Punishment is briefly discussed infra at note 141.


18 Basically, the deductability of recoveries, as well as liability insurance premiums, hinges on whether the plaintiff’s claim arose from the payor’s business or investment, as opposed to “personal” activities. See I.R.C. §§ 162(a), 212, and 262 (1988 and Supp. 1990); see also id. § 162(g) (certain damages under antitrust laws not deductible). In appropriate cases, where the payment was made in a transaction in which the payor acquired property or a long-term benefit, a damages payment might be a nondeductible as a capital expenditure. Snively v. Tomlinson, 303 F.2d 325 (5th Cir. 1962). The capital expenditure would create a basis that will eventually be recovered through depreciation or loss deduction, or offset against amount realized in computing gain. See id. §§ 167(a), 165(a), (c), 1001(a), (b), and 1016(a)(1).

19 As used herein, the word “state” means any government, including the United States, the District of Columbia, and possessions, which has tort rules and remedies.

20 As will be pointed out, a compensation regime that ignores the effect of taxes has the effect of overcompensating plaintiffs, while taking taxes into account converts a potential plaintiff windfall into a reduction in the amount that the defendant must pay.

21 See infra notes 136-37, 144-56 and accompanying text.

22 See infra Table 2, notes 111-13 and accompanying text.
In some cases, a full exclusion of lump-sum and periodic-payment recoveries is actually warranted. Since neither pain and suffering nor punitive damages compensate for economic loss, and therefore cannot be burdened by any "implicit" tax, traditional tax policy considerations should control. These considerations would render such recoveries fully includible.

I

RECOVERIES PERTAINING TO HUMAN CAPITAL

At the core of section 104 is the issue of recoveries for injuries to "human capital," i.e., damages for lost wage-earning capacity, including recoveries for lost past wages. Both historic and present-day theories of exclusion (or inclusion) ultimately derive from a conception of human capital. Human capital is the key to distinguishing personal from commercial injuries in situations where they might be seen to overlap; thus, it holds the key to defining the proper scope of section 104. After a brief review of other theories, this section considers the proper role of section 104 from first the plaintiff's viewpoint, and then the defendant's.

A. Prior Theoretical Approaches to Section 104

One theory which might exclude damage recoveries views the purpose of the tax base, or taxable income, as an allocation of the national income "pie" among taxpayers. National income is limited to economic activity that generates gain or profit. Such income cannot result from a mere transfer, which would include damage recoveries of all kinds as well as gratuitous transfers. As a matter of positive law, this view has never had a substantial influence. Clearly receipts of transfers are includible unless specifically excluded; if such receipts were not considered "income," specific exclusions would not be necessary.

On the normative level, the "pie" theory is generally inferior to other theories such as the "ability to pay" and "standard of living".

23 See infra Table 2.
24 See infra notes 183-217 and accompanying text.
26 Gifts and bequests are excludible under I.R.C. § 102(a), and life insurance proceeds are excludible under I.R.C. § 101(a). Commercial cash subsidies are includible unless excluded under I.R.C. § 126. Alimony is includible, but child support is not under I.R.C. § 71(a), (c). Unemployment compensation benefits are includible under I.R.C. § 85, and Social Security retirement benefits are included, in part, under I.R.C. § 86. Other government welfare benefits are excluded under, or by analogy to, § 102(a). See Rev. Rul. 76-131, 1976-1 C.B. 16. Intra-family support is probably excludible on the theory that taxing the payor is a sufficient proxy for taxing the payee. See Gould v. Gould, 245 U.S. 151 (1917).
theories for constituting an income- or consumption-tax base. However, it is not necessary to develop justifications for these alternative approaches here, since the “pie” theory itself has no normative foundation. “National income” and even “income” are not self-justifying as tax-base norms. The argument for an approach that would limit the tax base to economic, as opposed to individual, gains and profits must proceed on a nonnormative basis as follows: An income tax, necessarily being less than the gain, would not prevent the gain-producing transaction from occurring. Of course, a tax system should not prohibit profitable activity, but it does not follow that only profitable activity can be taxed. No economic rationale exists for precluding taxation of transfers, including damage recoveries, that must occur for various reasons, such as death, moral constraint, or law.

Even under a pie theory, a transfer would be untaxed, net, if inclusion by the recipient were combined with a deduction for the payor. Therefore, the pie theory can never be a sufficient justification for an exclusion for damages received unless the payment of damages and liability insurance premiums were categorically nondeductible. Since no such nondeductibility rule or principle exists, the exclusion of section 104 cannot stand on this basis alone. In any event, no pervasive tax principle links inclusion or exclusion by the recipient to deductibility or nondeductibility by the payor.

A second possible explanation for section 104 is that Congress wants to provide a federal subsidy to personal-injury plaintiffs. However, this explanation is not supported by any legislative history. If Congress was so motivated, it acted arbitrarily by rewarding plaintiffs who receive recoveries, while precluding loss

28 See Lane, supra note 25, at 18-19.
29 See supra note 18.
30 See Duberstein v. Commissioner, 363 U.S. 278 (1960). Section 274(b), which disallows deductions for excludible gifts, would not be necessary if such a principle existed. Any link between includibility and deductibility would exist only in the area of intra-family gifts and support.
31 See Blackburn, supra note 8, at 668-69; Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490, 501 (Blackmun, J., dissenting), reh’g denied, 445 U.S. 972 (1980). However, no evidence bearing on legislative intent is cited, and the idea that the purpose of a statute, such as that of § 104, can be divined from one of its possible effects is a logical fallacy, especially where, as here, tort recovery rules can be designed that shift the tax savings from the plaintiff to the defendant.
32 As no serious attempt has been made to repeal § 104, no legislative history exists pertaining to its retention. It is hard to discern any political constituency for repeal, because both plaintiffs and defendants variously benefit from the exclusion. See infra note 97 and accompanying text.
33 Though punitive damages are excessive in terms of compensation, their current status under § 104 with respect to physical injuries remains unclear. See supra notes 3-4
deductions for nonrecovering injured parties. Conceivably, section 104 might have been premised on a perception that successful personal injury plaintiffs are systematically undercompensated. This, however, would have been an empirical question, and it is unlikely that current empirical evidence was available to the 1918 Congress. Moreover, even if such evidence were cited as a reason for not repealing section 104 today, it would be unpersuasive, unless the undercompensation bore a necessary relation to tax rates. The wide fluctuation of tax rates in the last seventy years, and the significant variation in marginal rates applicable to different plaintiffs in the same taxable year, makes such a hypothesis implausible. A blanket exclusion thus would be inequitable among persons who received, and were denied, adequate compensation. Further, a subsidy rationale for section 104 would expose it to the usual barrage of criticism aimed at tax expenditure provisions in general. Interestingly, the section 104 exclusion is not an item listed in the tax expenditure budget, suggesting that Congress does not view it as a tax subsidy. Finally, the subsidy rationale for section 104 has been rejected by the United States Supreme Court in *Norfolk & Western Ry. Co. v. Liepelt*.

and accompanying text. Thus, to hold that § 104 excludes such punitive damages is to impute an irrational motive to Congress. Arguably, pain and suffering damages are, or can be, excessive because no objective standard is available by which they can be measured.


36 *Frolik*, supra note 9, at 7-8. See generally *Stanley S. Surrey, Pathways To Tax Reform* (1973) (discussing “tax expenditure” concept). Systematic undercompensation would suggest tort reform before reliance on the tax system, thereby sparing the federal treasury from bearing the burden of defects in the compensation system.


38 444 U.S. 490, 496 n.10 (1980). *Liepelt*, in construing the Federal Employers’ Liability Act (“FELA”), 45 U.S.C. §§ 51-60 (1988), held that the trial court erred in excluding evidence of the effect of federal income taxes on the decedent’s estimated future earnings, and in refusing to instruct the jury that the recovery would be excludible under § 104. The majority opinion stated:

The dissent takes the position that § 104(a)(2) . . . “appropriates for the tortfeasor a benefit intended to be conferred on the victim or his survivors.” . . . But we see nothing in the language and are aware of nothing in the legislative history of § 104(a)(2) to suggest that it has any impact whatsoever on the proper measure of damages in a wrongful-death action. Moreover, netting out the taxes that the decedent would have paid does not confer a benefit on the tortfeasor any more than netting out the decedent’s personal expenditures. Both subtractions are required in or-
A third possible explanation for section 104 assumes that if at least one significant component of a recovery, such as pain and suffering damages, is excludible on theoretical grounds, then the blanket exclusion obviates the need to differentiate among various components of the recovery—an extremely difficult task, especially in the case of settlements. However, this rationale equally supports the position that recoveries should be totally includible if the argument for excluding any particular component is weak or the excludible component is secondary to the dominant includible component(s). Alternatively, the difficulties of differentiation may be overstated.

Although not controlling as far as a policy discussion is concerned, it would be interesting to know Congress’s intent when enacting the predecessor of section 104 in 1918. Curiously, the exclusion did not appear in the first modern federal income tax law. One possibility is that the original concept of gross income excluded nonregular receipts, such as windfalls. Another is that income was viewed through the lens of either business or trust accounting, which emphasizes a clear-cut distinction between capital and income, often expressed in the “fruit and tree” metaphor. Under this view, a recovery for personal injury is not “fruit,” or income, but compensation for loss of part of the “tree,” or capital.

Id. Liepelt means that § 104 should not produce a windfall to plaintiffs under a tort regime that mandates recovery for pecuniary loss. Of course, a given tort regime may not have such a limited mandate; the overcompensation of plaintiffs that would occur by not only failing to reduce future wage streams by future taxes but also, more speculatively, by failing to inform juries that damages are excludible, is a choice made by tort law. Such overcompensation is not mandated by § 104 as an expression of federal tort policy. The Supreme Court subsequently held that Liepelt stated the general federal common-law rule. Gulf Offshore Co. v. Mobil Oil Corp., 453 U.S. 473, 486-87 (1981).

This Article argues that nonpecuniary damages should be includible, see infra notes 183-217 and accompanying text, and that pecuniary recoveries should be includible under certain scenarios, see infra notes 71-126 and accompanying text.


In 1918, the U.S. Attorney General, answering a Treasury Department inquiry, stated that life insurance proceeds were capital, not income. This ruling apparently induced the Commissioner to rule that personal injury recoveries were likewise not in-
These primitive conceptions of income began to lose influence around 1920. It is now understood that the gross income of a taxpayer includes any "accession to wealth clearly realized" unless there is an express exclusion, thereby abolishing any notion that income must be regular or recurring. Replacement of capital is now dealt with explicitly by the "basis" mechanism. The application of this mechanism to personal injury recoveries is discussed below.

Application of the accession-to-wealth idea initially seems to indicate that any recovery (net of medical costs) should be included in gross income. At this point, because no Code provision or other rule generically deals with damage recoveries, standard tax doctrinal analysis asks whether what is replaced by the damages would be includible or excludible.

Application of this "substitute for" approach also seems intuitively fair. The purpose of damages is economic restoration, and the taxpayer should be treated in the way that best approximates the treatment that would have occurred if the injury had not taken place. At first it seems plausible to include recoveries relating to lost earning capacity, because they represent an acceleration of includible wages. However, the recovery can equally be characterized as the loss of an asset, namely, wage-earning capacity, commonly referred to as "human capital," the present value of which is determined with reference to lost future wages.

See infra notes 53-60 and accompanying text. On the other hand, the analysis below is not ultimately contingent on the choice between the lost wages and the lost asset approaches, because the crucial facts are whether the future wages are computed on a before-tax or after-tax basis and whether a before-tax or after-tax discount rate is used.
In fact, shortly after enactment, the predecessor of section 104 was rationalized according to this lost asset approach, but in an inadequate way. In Solicitor's Opinion 132, the Internal Revenue Service stated that, because personal rights are not transferable and possess no market value, a recovery for a rights' violation does not result in gain to the recipient. This version of the replacement-of-asset theory is now regarded as obsolete. As discussed above, the tax concept of gain is relative to that of basis, not value. The taxpayer has the burden of proving the existence and loss of basis.

Some might argue that a person has a basis equal to the sum of human-capital expenditures, which might include such items as outlays for food, education, preventive health care, vitamins, and minerals. Unfortunately, no one keeps track of these outlays, nor would it be feasible to do so. Most (or all) of the foregoing are non-deductible personal expenses and not capital expenditures. At this point the sentimentalist would argue that the taxpayer, given the unfortunate circumstance of being injured, should be given the benefit of the doubt by a presumption that the basis lost as a result of the personal injury equals the amount realized. However, the "basis equals recovery" argument produces nonsensical results for very young taxpayers. In addition, it is inconsistent with other tax rules, including the tax system's normal treatment of human capi-

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50 I-1 C.B. 92 (1922).
51 This rationale is not an application of the pie theory, supra notes 25-30 and accompanying text, because the latter looks to social gain whereas Solicitor's Opinion 132 looks to whether the taxpayer alone incurred a gain.
52 Rev. Rul. 74-77, 1974-1 C.B. 33 (revoking Solicitor's Opinion 132, supra note 50). The I.R.S. has acknowledged that the basis of any exclusion is § 104, not a common-law theory of income. Id.
53 I.R.C. § 1001(a) (1988 and Supp. 1990). Basis is cost derived from nondeductible capital expenditures or income inclusions with respect to the asset itself (as opposed to distributions, etc., from the asset). Id. §§ 1011, 1012, 1016(a). See generally Dodge, supra note 27, at 21-46 (discussing the function of basis).
54 E.g., Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944) (taxpayer failed to prove existence of basis). Cf. Starrels v. Commissioner, 304 F.2d 574, 576-77 (9th Cir. 1962) (stating that the theory behind § 104 is that restoration of lost capital is not income, while elsewhere acknowledging necessity of basis). Burnet v. Logan, 283 U.S. 404 (1931), and Inaja Land Co. v. Commissioner, 9 T.C. 727 (1947), acq., 1948-1 C.B. 2, are two well-known cases which stand for the proposition that recoveries come first out of basis, even if the taxpayer cannot demonstrate any loss of earning capacity. These cases, however, are now obsolete on this point. Financial theory dictates that basis should be recovered only when there is a true loss of earning capacity. See, e.g., Dodge, supra note 27, at 238-73. In any event, the issue with personal injury recoveries is whether any basis exists in the first place.
56 Treas. Reg. § 1.262-1(b) (1958).
If a personal injury involves a loss of human capital, then it follows that there should be a deduction for uncompensated personal injury losses; however, no such deduction exists. Further, if one has basis in human capital, there should be depreciation deductions to offset wages, but again none exist.

On the merits, human capital should not be treated as a conventional asset with basis. Not only is it impossible to keep track of costs, but there are also conceptual problems. By what coherent principle would one distinguish between the capital expenditure and the expense portions of food, education, etc.? Is human capital used in business to earn wages, or is it held for personal consumption to enjoy life? Does a person’s human capital include only that which is self-purchased, or can it also be acquired by transfer from parents, government, and the like? If it is acquired by transfer, can it plausibly be added to basis if its value is not included in income when received?

Of course, the tax system could be restructured to require taxpayers to include in income the present discounted value (in excess of cost) of future wage-earning capacity as it is acquired. The basis resulting from the inclusions could then be amortized against actual wages, and any unamortized basis could be deducted as a loss at death or upon retirement. This scheme, however, would be extremely difficult, perhaps impossible, to implement in a reasonable manner. It would violently clash with the concept that the tax base should have some reference to a taxpayer’s ability to obtain funds to

58 See Blackburn, supra note 8, at 663-68.
59 Although here there would be no independent basis for ascertaining the amount of the loss, as distinguished from the recovery situation, such amount could be determined in the tax proceeding itself, as would be necessary in figuring a loss with respect to conventional property. Treas. Reg. § 1.165-7(b)(1)(i) (1960).
60 Normally, with depreciation it is necessary to know the amount of such basis, but in lieu of such knowledge some crude approximation method could be designed. Cf. I.R.C. § 613 (1988 and Supp. 1990) (percentage depletion for natural resources).
62 In general, the inclusion in income of an asset received in kind creates basis equal to the amount includible. An excludable receipt can yield a basis equal to value, but only if Congress so stipulates, or if the exclusion is clearly intended to be permanent. See, e.g., I.R.C. §§ 358(a), 362, 722, 723, 1031(d), 1033(b), 1034(c), 1041 (1988 and Supp. 1990) (basis in tax-free in-kind receipt or exchange not equal to value). If the exclusion derives from § 102 (gifts) or the support exclusion, see infra text accompanying note 205, the recipient should have a carryover basis, not a stepped-up basis. See §§ 1015 (gifts), 1041 (inter-spousal transfers). Contra, § 1014 (bequests).
63 Thus, in the case of education, the amount includible would be the excess of the present value of the education in terms of enhanced wage-earning power over the cost of the education to the taxpayer.
64 For example, would each job promotion be an accession of human capital? What about the accretion of seniority? Continuing education? If one were fired or laid off, how much of a “loss,” if any, would be sustained? What depreciation schedule would be
pay the tax. Thus, a heavy tax liability would become due at various stages, i.e., birth, completion of education, and new jobs and promotions. No bank would lend money to the taxpayer at these times to enable the taxpayer to pay the tax, because the bank could not obtain any security for this type of loan, and the taxpayer may not have the legal capacity to borrow commercially. A person cannot sell herself into slavery, nor can contracts for personal services be specifically enforced. Even if the tax could be deferred until the wage-earner achieves liquidity, with interest running in favor of the Treasury, such a deferral scheme would be extremely burdensome administratively and would subject the government to severe risks as an unsecured creditor over long periods of time. Also, with the amounts included in income as well as amortization deductions based on estimates, such calculations could be wildly inaccurate. However, compensating adjustments, feasible only when the "transaction is closed," might be too late to meaningfully benefit the taxpayer or the government for gross over- or under-taxation on a year-to-year basis. Finally, taxing human capital differently from investment capital cannot be considered a serious defect in the tax system unless: (1) one is more favorably taxed than the other overall, (2) investment in one is preferable to investment in the other in terms of social welfare, (3) the two are essentially the same, and (4) significant elasticity exists between the two. In sum, considering that wages generally rise with age? It would be mind-boggling to attempt to sort out these issues on an individual basis.

65 The tax-base norm of ability to pay, which encompasses wealth and consumption, is not, however, synonymous with liquidity to pay the tax in cash. See DODGE, supra note 27, at 133-35.

66 See Mary L. Fellows, A Comprehensive Attack on Tax Deferral, 88 MICH. L. REV. 722 (1990), for a discussion of an income tax regime that would treat deferral of income, mainly under the "realization" principle as involving the deferral of tax with interest.

67 Professor McNulty expresses doubt as to which regime is more favorable. Investments are subject to double taxation, but human capital expenditures are never accounted for. McNulty, supra note 61, at 22-26. However, because accretions to human capital are not taxed either, human capital is arguably treated more favorably than investment capital. On the other hand, persons who invest in their own human capital are in a less favorable position tax-wise than persons who acquire the same human capital from third parties. The former suffer from denial of deductions; the latter acquire tax-free benefits.

68 Human capital, whether in the form of knowledge and skills or the creation of new technology, is viewed in the economics literature as the primary engine of economic growth. See, e.g., PAUL A. SAMUELSON, ECONOMICS 685-95 (11th ed. 1980).

69 Clearly, they are not the same in liquidity terms, because human capital is difficult to "realize." Although some individuals might have access to unsecured credit, few lenders would lend up to 80% of such a borrower's earning capacity, reduced to present value, as is common even with illiquid property, such as real estate.

70 I do not intend to debate the merits of a "consumption" versus an "income" tax. Nevertheless, under a consumption tax no basis in either human capital or investments would exist.
human capital, or wage, income should be taxed only when received, and human capital basis should be disregarded.

B. Restoring the Plaintiff’s Economic Status Quo

1. Should Recoveries for Lost Earning Capacity Be Excluded?

Although the conventional replacement-of-capital theory cannot sustain an exclusion for personal injury recoveries, an exclusion with respect to lost earning capacity can be justified under certain circumstances by using financial concepts. Financial analysis determines, under various alternative assumptions regarding state law, what tax treatment for lost earning capacity recovery would best replicate what would have occurred had there been no personal injury.71 The legitimacy of this aim will be examined in due course. But first some numerical examples must be laid out.

Initially, without the personal injury, the taxpayer would have received wages over the shorter of: (a) the duration of the injury, (b) the period until expected retirement, or (c) the taxpayer’s life. The measure of the lost earning capacity, and therefore the “correct” amount of any lump-sum recovery, is the present discounted value of such wages.72 In computing such recovery, state law must address two points: (1) whether the wages being discounted are figured before or after putative federal income taxes,73 and (2) whether the discount rate is applied before or after taxes.74 If the recovery itself is in the form of an annuity designed to mimic the stream of lost wages, no discounting is required.75

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71 Under present law, a plaintiff receiving a personal injury recovery in the form of periodic payments receives such payments tax-free, notwithstanding the fact that some part of the payments may represent interest. I.R.C. § 104(a)(2) (1988 and Supp. 1990) ("whether as lump sums or as periodic payments"). Such a periodic-payment right is called a "structured settlement." This exclusion for interest can be lost if the settlement is "funded" by a lump-sum payment in a way that the "constructive receipt" or "economic benefit" doctrines apply. See Blackburn, supra note 8, at 684-85.

72 The present value of a future amount is figured under the formula: \[ PV = \frac{A}{(1 + r)^n} \], where "A" is the future amount, "r" is the annual, monthly, or daily discount rate expressed as a decimal, and "n" is the number of periods (years, months, days) between the present and the future receipt. The present value of a wage stream is the sum of the present value of all future wages.

73 If the wages are reduced by future taxes, the "A" in the present-value formula is reduced. For example, if wages are $50,000 and the tax rate is 30%, each "A" is $35,000 [($50,000 - (.30 x $50,000)].

74 The before-tax discount rate is the rate of return (before taxes) on readily available nonrisky assets. The after-tax discount rate is such rate reduced by the applicable marginal tax rate. Thus, if the before-tax discount rate is 10% and the marginal tax rate is 30%, the after-tax discount rate is 7% [10% - (.3 x 10%)]. See Dodge, supra note 27, at 218-19 and 327-28.

75 Another possible state law issue is whether the decision-maker should consider the tax treatment of the recovery. As demonstrated below, this is a false issue. See infra note 140 and accompanying text.
Two issues also arise regarding taxes: (1) whether the recovery should be tax free and (2) whether any resulting stream of annuity payments should be (a) fully taxed, (b) exempt from tax, or (c) taxed like an investment taking the form of a debt obligation.\textsuperscript{76} The current rules for taxing annuities under section 72 will not be applied here, as they represent an inaccurate approach to taxing debt obligations.\textsuperscript{77}

An analysis of the various permutations of assumptions and tax results reveals at least four scenarios, i.e., combinations of state remedy regimes and federal tax treatments, which are compatible with the section 104 exclusion and which will leave the taxpayer in the same economic position as if the personal injury had never occurred:

(1) Scenario (1): the recovery (or settlement) is in the form of periodic payments rather than a lump sum, and each payment equals the amount that the taxpayer would have received net of federal income taxes.

(2) Scenario (2): the lump-sum recovery is computed, under applicable tort law, on a before-tax basis using a before-tax discount rate, and the annuity payments are taxed in full, with no basis offset.

(3) Scenario (3): the lump-sum recovery is instead computed on an after-tax basis, again using a before-tax discount rate, and the annuity payments are fully exempt from tax.

(4) Scenario (4): the lump-sum recovery is again computed on an after-tax basis, this time using an after-tax discount rate, and the annuity payments are taxed subject to a basis offset.

Table 1, below, presents the results of this analysis under columns (1) through (4) respectively.

\textsuperscript{76} The tax norm for a debt obligation is that any receipt is deemed to come first out of earned but unpaid income, calculated by applying the interest rate against the then principal balance, which, when used to discount all future payments to the date the debt was incurred, yields the amount of such debt. Only the excess of such receipt over income is a recovery of basis. See Prabel v. Commissioner, 882 F.2d 820 (3d Cir. 1989); Rev. Rul. 83-84, 1983-1 C.B. 97.

\textsuperscript{77} Under I.R.C. § 72 the basis, and any resulting taxes, would be prorated over time in the ratio of annual annuity payments to total expected annuity payments. I.R.C. § 72(b) (1988 and Supp. 1990). Where the annuity payments are level, this method produces the same results as straight-line depreciation. The financially correct approach is to treat annuities the same as level-payment mortgages. That is, under the "declining balance method," any payment first comes out of accrued, but unpaid, interest and the remainder comes out of the remaining principal. See supra note 76. Thus, the income portion and the tax are greater in the first year, and decline thereafter because a greater portion of each successive payment is allocated to principal. Therefore, the after-tax amounts increase over the same period.
### Table 1
Tax-Free Damage Recoveries

<table>
<thead>
<tr>
<th>Computational Steps</th>
<th>SCENARIOS (see above)</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Lump-sum recovery</td>
<td>-</td>
<td>$248,685</td>
<td>$174,080&lt;sup&gt;78&lt;/sup&gt;</td>
<td>$183,702</td>
<td></td>
</tr>
<tr>
<td>(2) Taxes on (1)</td>
<td>-</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>(3) Amount invested</td>
<td>-</td>
<td>248,685</td>
<td>174,080</td>
<td>183,702</td>
<td></td>
</tr>
<tr>
<td>(4) Total annuity payments&lt;sup&gt;79&lt;/sup&gt;</td>
<td>210,000</td>
<td>300,000</td>
<td>210,000</td>
<td>$221,607</td>
<td></td>
</tr>
<tr>
<td>(5) Annuity payments subject to tax</td>
<td>0</td>
<td>300,000</td>
<td>0</td>
<td>37,905&lt;sup&gt;80&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>(6) Total taxes [30% of (5)]</td>
<td>0</td>
<td>90,000</td>
<td>0</td>
<td>11,371</td>
<td></td>
</tr>
<tr>
<td>(7) Amount left [(5) - (6)]</td>
<td>210,000</td>
<td>210,000</td>
<td>210,000</td>
<td>210,236</td>
<td></td>
</tr>
<tr>
<td>(8) Allocation of (7)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>yr 1</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
<td>68,358&lt;sup&gt;81&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>yr 2</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
<td>70,023</td>
<td></td>
</tr>
<tr>
<td>yr 3</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
<td>71,855</td>
<td></td>
</tr>
<tr>
<td>(9) Present value of (8) at 7%&lt;sup&gt;82&lt;/sup&gt;</td>
<td>$183,702</td>
<td>$183,702</td>
<td>$183,702</td>
<td>$183,702</td>
<td></td>
</tr>
</tbody>
</table>

The following factual assumptions are made for clarity of illustration:

(i) the taxpayer has lost exactly three years of earning capacity;
(ii) the taxpayer would have earned wages of $100,000 a year, payable in full at the end of each year;
(iii) the applicable income tax rate is 30%;
(iv) the before-tax discount rate is 10%; and
(v) given that the tax rate is 30%, the after-tax discount rate is 7%.

<sup>78</sup> $174,080 is the present value, at 10%, of an annuity consisting of three annual payments of $70,000.
<sup>79</sup> In columns (2), (3), and (4), this number is derived by dividing the amount invested (line 3) by the 10% annuity factor for three years (2.4869) and multiplying the result by 3.
<sup>80</sup> The aggregate basis offset is $183,702, the amount invested.
<sup>81</sup> The before-tax annuity payment for each year is $73,869 (1/3 of $221,607). The “income” portion of each payment is computed in the manner described in note 76, supra. Thus, at the end of year 1, the accrued but unpaid interest on $183,702 (at 10%) is $18,370, producing a tax of $5,511 and an after-tax sum of $68,358. If $18,370 of the $73,869 is income, the remaining $55,499 is reduction of principal (basis), so that the income portion in year 2 (and the tax) is reduced, yielding a greater after-tax amount.
<sup>82</sup> The discounting at line (9) can be at any discount rate, so long as it is the same discount rate across the board, since the purpose here is simply to compare the present values of future amounts under alternative scenarios. Under any discount rate, the numbers in line (9) would be equal.
Therefore, without the personal injury, the taxpayer would have received $210,000 after taxes over the three-year period (70% of $300,000), the present value of which at a 10% discount rate is $248,685 and at a 7% discount rate is $183,702. The computational assumptions are: a 10% before-tax discount rate in columns (2) and (3), a 7% after-tax discount rate in column (4), and an annuity computation in line (4) which assumes a 10% before-tax rate of return and equal annuity payments at the end of each year, all such rates to be compounded on an annual basis.

One variation of Scenario (2), referred to as Scenario (2A), more closely adheres to familiar tax concepts; that is, the lump-sum recovery is fully taxed but the annuity payments are exempt from tax. Furthermore, two additional methods reach the same end result. The first, designated as Scenario (5), involves a lump-sum recovery computed on the basis of before-tax wages discounted using an after-tax discount rate. The lump-sum recovery is includible in gross income and the annuity stream is taxed as a debt obligation. The second method, designated as Scenario (6), involves a periodic-payment recovery figured on a before-tax basis. The annuity payments are taxed in full. Scenarios (5) and (6) are compatible with a full repeal of section 104. Table 2 presents the full array of six scenarios producing a wage-mimicking outcome.

Table 2
Wage-Replacing Damage Recoveries

<table>
<thead>
<tr>
<th>Steps</th>
<th>(1)</th>
<th>(2A)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>-</td>
<td>248,685</td>
<td>174,080</td>
<td>183,702</td>
<td>262,431</td>
<td>-</td>
</tr>
<tr>
<td>(2)</td>
<td>-</td>
<td>74,605</td>
<td>0</td>
<td>0</td>
<td>78,729</td>
<td>-</td>
</tr>
<tr>
<td>(3)</td>
<td>-</td>
<td>174,080</td>
<td>174,080</td>
<td>183,702</td>
<td>183,702</td>
<td>-</td>
</tr>
<tr>
<td>(4)</td>
<td>210,000</td>
<td>210,000</td>
<td>210,000</td>
<td>221,607</td>
<td>221,607</td>
<td>300,000</td>
</tr>
<tr>
<td>(5)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>37,905</td>
<td>37,905</td>
<td>300,000</td>
</tr>
<tr>
<td>(6)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>11,371</td>
<td>11,371</td>
<td>90,000</td>
</tr>
<tr>
<td>(7)</td>
<td>210,000</td>
<td>210,000</td>
<td>210,000</td>
<td>210,236</td>
<td>210,236</td>
<td>210,000</td>
</tr>
<tr>
<td>(8)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>yr 1</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
<td>68,358</td>
<td>68,358</td>
<td>70,000</td>
</tr>
<tr>
<td>yr 2</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
<td>70,023</td>
<td>70,023</td>
<td>70,000</td>
</tr>
<tr>
<td>yr 3</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
<td>71,855</td>
<td>71,855</td>
<td>70,000</td>
</tr>
<tr>
<td>(9)</td>
<td>$183,702</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
</tr>
</tbody>
</table>

Scenario (2) would be idiosyncratic tax-wise in disallowing any basis recovery (amortization) against a wasting investment asset (the annuity). Income exemptions, on the other hand, are not uncommon. See, e.g., I.R.C. §§ 103, 104(a)(2) ("structured, settlement").

For a discussion of the taxation of debt obligations, see supra note 76.
These results can be summarized as follows:

(1) For periodic-payment recoveries (Scenarios (1) and (6)), the payments should be fully excluded if the recovery is computed after taxes; otherwise it should be fully included.

(2) For lump-sum recoveries invested in annuities, Scenarios 2A, 3, 4, and 5:
   (a) the lump-sum recovery should be excluded if the recovery is figured on an after-tax basis; otherwise it should be fully included; and
   (b) the annuity payments should be fully excluded if the recovery is calculated using a before-tax discount rate; otherwise they should be treated as payments upon a debt obligation.

To a modest extent, these results rationalize the present section 104 exclusion. Essentially, the exclusion is justified where the recovery is calculated by reducing the future wages by the putative income taxes thereon. The taxpayer already bears an implicit tax on the wage-stream substitute, and it is axiomatic that wages are only to be taxed once. The foregoing also justifies the tax-free “structured settlement” involving an annuity provided directly by or through the defendant. Virtually all commentators have argued that the annuity income under a structured settlement should not be exempt because, in order to compensate for the delay in payment, the total payout will be greater than what the lump sum would have been. According to these commentators, this implicit interest income should be included, similar to other forms of implicit interest. The present analysis, however, contradicts this assertion. The exemption for the implicit interest does not give the taxpayer any undue overall economic advantage provided that a before-tax discount rate is used to compute the putative lump-sum recovery. By reducing the recovery, the before-tax discount rate effectively imposes an implicit tax on the income portion of the annuity.

The foregoing analysis, however, falls short of justifying section 104 in its present form. First, the present section 104 exclusion is not conditioned on the taxpayer actually securing an annuity to re-

85 See supra note 71.
87 An “implicit tax” is an amount that reduces a taxpayer’s net return but which is not actually transferred to the government. To illustrate, suppose $100,000 is invested at 10% before taxes for one year. The income of $10,000 is taxed at 30%, yielding $107,000 after taxes, the same result as if the $100,000 had been invested at 7% tax free for the same period.
place the wage stream. Although any implicit taxes will have been "paid" by the plaintiff even if an annuity is not purchased or received, given the aim of restoring the plaintiff's status quo ante, it seems reasonable to require that the recovery approximately replicate the wage stream in form.\textsuperscript{88} Second, section 104 does not allow an exemption for the income portion of an annuity purchased with a lump-sum recovery, even in cases where an implicit tax has already been imposed on such income by calculating the recovery using a before-tax discount rate as exemplified in Scenarios (2A) and (3). Tort law typically, if not universally, provides that recoveries are to be calculated with reference to the before-tax wage stream,\textsuperscript{89} but only a few jurisdictions have displayed any awareness of the discount-rate issue.\textsuperscript{90} In this respect, then, section 104 achieves the correct result haphazardly.\textsuperscript{91} Third, insofar as plaintiff equity is considered the dominant remedy policy, section 104 puts pressure on states to adopt an after-tax damages rule using, in the case of lump-sum recoveries to be invested in an annuity, an after-tax discount rate as illustrated in Scenario (4).\textsuperscript{92}

So far, exclusions with respect to damage recoveries make sense from a policy perspective only if one assumes that the appropriate equity norm is restoration of the taxpayer to her wage-earning status.
This result occurs because of implicit taxes arising from the way recoveries are sometimes computed. These implicit taxes detrimentally affect the taxpayer, but at the same time yield no benefit to the government. The implicit-tax rationale for exclusion would not persuade someone who believes that “implicit tax” never justifies the conferral of a tax benefit. I agree with the proposition that implicit tax is generally a bad reason for conferring a tax exemption. If the implicit tax idea were given free reign, tax exemptions would become the norm and the income tax revenue base would disappear. A system that exempts certain forms of economic return but not others would spawn allocative inefficiencies. An implicit-tax approach to personal injury recoveries, however, would not hemorrhage the tax system, or necessarily produce economic inefficiencies. The existence of tax benefits for personal injury recoveries would not induce potential plaintiffs to “demand” a significantly greater frequency of personal injuries.

Although the section 104 exclusion is compatible with damage computation rules that consider the effect of hypothetical future taxes, such rules also have the effect of reducing the amounts that defendants, and their insurers, must pay. Thus, retention of section 104 in its present form appears to provide a stronger federal tax incentive for tortious conduct than either outright repeal or the proposed modification of section 104 would. Of course, states can ignore the incentive effect of current section 104, but doing so would be at the cost of providing windfall recoveries to plaintiffs who are compensated for lost human capital on a before-tax, and after-tax discount rate, basis. If the goal of plaintiff equity is deemed paramount, two courses of action are possible: (1) retaining current section 104 combined with the states’ bringing their tort regimes in line, thereby reducing the burden on defendants across the board—an unlikely prospect—or (2) amending section 104 to accommo-

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93 For example, if all investment returns were exempt, business could provide the same net rate of return to investors by lowering the dividend, interest, rental, and royalty rates (this reduction would be the implicit tax). The implicit tax would be captured by the payors, not the government. In addition, if implicit taxes were treated as real taxes, there would be pressure to repeal I.R.C. § 265, which disallows deductions for expenses of producing tax-free income. Businesses offering tax-free returns would have a competitive advantage in raising capital, because their cost of raising capital would be lowered relative to that of other businesses. Excessive economic resources would congregate in tax-favored businesses.

94 See infra notes 129-31 and accompanying text.


96 Id.

97 See infra notes 129-31 and accompanying text.

98 Many states have declined to follow Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490 (1980), discussed supra at note 38. See Theuman, supra note 89.
date those state policies that would impose greater burdens on defendants, as illustrated by Scenarios (2A), (5), and (6). The defendant-burden aspect of the equation, which, in economic terms, is essentially that of affecting the "supply" of tortious conduct is discussed below.\textsuperscript{99}

The "plaintiff equity" approach is based on the notion that taxpayers should be treated the same regardless of whether they receive wages or an equivalent substitute in the form of damage recoveries. One might ask why taxpayers should be treated the same in fact when they are arguably different. One is actually receiving wages, while the other, directly or indirectly, is investing. Indeed, Scenarios (2A), (3), (4), and (5) involve the actual reinvestment of the lump-sum recovery into an annuity. The distinction between human and investment capital is helpful in analyzing the equity issue, because it is axiomatic that human capital is treated differently, under an income tax, from investment capital, which is "taxed twice."\textsuperscript{100}

Initially, one might argue that, in the case of invested lump-sum recoveries, the results described in Scenarios (2A), (3), (4), and (5) above do involve double taxation although in the Scenarios (2A), (3), and (4) one or both of the taxes involved is merely implicit; that is, the tax(es) result from the calculation of the recovery. In taxpayer equity terms, an implicit tax is just as good as an explicit tax.\textsuperscript{101}

Established tax doctrine is compatible with applying the human-capital model here to achieve plaintiff equity. For instance, one can analogize the taxpayer's situation to that of an "involuntary conversion of property." Congress, in section 1033, has expressly provided that an involuntary conversion is not a "realization" event if the proceeds of the conversion are reinvested in "similar or related in service or use" property within a certain period of time.\textsuperscript{102}

Of course, section 1033 is technically distinguishable in that it involves conversions of property rather than human capital. However, section 1033, like the exclusions with respect to personal

\textsuperscript{99} See infra notes 142-65 and accompanying text.

\textsuperscript{100} Investments are normally made with after-tax dollars because capital expenditures creating or purchasing investments are not deductible. I.R.C. § 263(a) (1988 and Supp. 1990). This nondeductible cost of the investment is, in financial terms, the present discounted value of all future receipts, the net income portion of which will be taxed again when accrued or received. Human capital is not systematically taxed twice in the same manner: Accretions to human capital may or may not be taxed, but wage income is taxed on a gross basis, not on a "net" basis after amortizing human capital, which is nonexistent.


injury recoveries, would be justified by a concern that similarly situated investors be taxed the same, even though one investor underwent an involuntary disposition-reinvestment transaction. Of course, the section 1033 analogy strongly reinforces the suggestion that any exclusions with respect to lump-sum recoveries be contingent on reinvestment in a wage-replacing annuity. Involuntariness also negates the possibility of tax-avoiding behavior. For example, a concert pianist would not suffer a mutilated hand to convert from a wage-earner to an investor, nor could she reconvert into a wage-earner at will.\textsuperscript{103}

Even if the conversion were voluntary, tax doctrine supports recovery exclusions linked to reinvestments. True, the usual rationales for declining to tax unrealized gains, i.e., the possible difficulty of valuation and the absence of liquidity to pay taxes, do not apply to the recipient of a damage recovery. However, the rationale behind numerous "voluntary" nonrecognition-of-gain provisions in the Code is that the original realized investment continues in a new "form," and applies to a damages recovery linked with mandatory reinvestment in a wage-replacing annuity.\textsuperscript{104} Although any nonrecognition rule with respect to property is properly subject to criticism by those already hostile to the realization principle,\textsuperscript{105} the justification for a nonrecognition rule for conversions of human capital is much stronger. Tax law does not otherwise acknowledge the possibility of gain or loss with respect to acquisitions or dispositions of human capital.\textsuperscript{106}

\textsuperscript{103} The argument is not that an involuntary receipt should be excluded per se. In general, involuntariness does not necessarily result in the most favorable tax treatment imaginable. See, e.g., Helvering v. Hammel, 311 U.S. 504 (1941) (loss is capital loss even though involuntary). On the other hand, involuntariness is a common rationale for statutory tax benefits. See I.R.C. § 1231 (1988 and Supp. 1990) (recognizing involuntary-conversion gains and losses produce, crudely-speaking, capital gains and ordinary losses). Also, involuntariness underlies, to some extent, the personal deductions for medical expenses, casualty losses, taxes, and, possibly, the dependency exemptions. \textit{Id.} §§ 151(c), 164, 165(c)(3), 212(3) and 213. See DODGE, supra note 27, at 117-29. Cf. Joel S. Newman, \textit{The Deductibility of Nondiscretionary Personal Expenses}, 6 \textit{Am. J. Tax Pol'y} 211 (1987) (arguing that, although the involuntary nature of an expense should not create personal deductions, the discretionary nature of expenses otherwise deductible should bar the deduction).

\textsuperscript{104} \textit{E.g.}, I.R.C. §§ 108, 354, 721, 1031, and 1034 (1988 and Supp. 1990). Some of these are limited to exchanges; no rule exists that generally allows tax-free rollovers of property. The "exchange" requirement ties in weakly with anti-tax-avoidance and non-liquidity concerns, and is fairly easy to enforce.


\textsuperscript{106} See supra text accompanying notes 58-60. See generally Mark Gergen, \textit{Pooling or Exchange: The Taxation of Joint Ventures between Labor and Capital}, 44 \textit{Tax L. Rev.} 519, 544-50 (1989) (arguing that receipt of rights to future cash in exchange for agreement to perform future services should not be treated as a realization event; cash should be taxed as wages only as received).
An even closer analogy than the property nonrecognition rules is supplied by section 83, which provides that a wage-earner can voluntarily convert to being an investor without imposition of tax. For example, currently an employee is not taxed upon the receipt of in-kind compensation, usually stock of the employer, as long as the employer is subject to a substantial risk of forfeiture. Insofar as forfeitability is tied to continuing employment, and thereby subject to employee control, arguably no true conversion from employee to investment status has occurred. The same can be said for a lump-sum recovery subject to mandatory reinvestment in a wage-replacing annuity. The annuity differs only in that it maintains, by proxy, the wage-earner's "stock" of human capital as an employee in general, as opposed to a particular employment relationship.

Another possible analogy exists under the section 83 rule, whereby a services-provider can even defer vested compensation income until receipt, as long as the deferred-compensation right is unfunded and unsecured. Thus, in the implausible event that the taxpayer forgoes a lump-sum recovery in favor of an unfunded and unsecured promise to receive periodic payments, as might occur in Scenarios (1) and (6), the annuity payments should be taxed only when received, not when the right to the annuity accrues. Nevertheless, for the reasons described immediately above, deferral of tax in Scenario (6) should not depend on whether the annuity is in fact unfunded; that would simply be an additional reason in this situation for not treating the receipt of the annuity right as a taxable event. Whether to tax the annuity payments should hinge on whether the payments are set on a before- or after-tax basis.

These analogies may be subverted if one disagrees with the policy decisions embodied in section 83. The analogies, however, are not central to the argument, especially because they point to a non-

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109 This proposition is not inconsistent with current law, under which compensation for past and present services is taxed to the employee if such compensation takes the form of a "nonqualified" funded promise to pay cash in the future. I.R.C. §§ 83(a), 402(b) (1988 and Supp. 1990).
This Article argues only that personal injury recoveries and earnings thereon should be excluded in some cases. In sum, equity considerations appropriately view the tax treatment of the recovery in terms of "maintaining" the taxpayer's converted human capital. When the plaintiff is "overcompensated" because the recovery is figured on a before-tax basis or on the basis of an after-tax discount rate, or both, the federal government may appropriately "skim off" the windfall. By taxing the recovery according to the various Scenarios set forth in Table 2, the government will skim off exactly the right amount and still leave the plaintiff whole. Unlike any other possible approach to personal injury recoveries, a set of tax rules modeled on Table 2 will harmonize with state compensation regimes to produce a uniform national result, net of taxes, for similarly situated injured parties, whether the recoveries are received in a lump sum or otherwise.

The proper tax treatment of recoveries for lost past wages is easily discerned. Because no future amounts are discounted to present values, the only relevant consideration is whether the recovery for lost wages is computed, under state law, on a before- or after-tax basis. In the before-tax case, the recovery should be taxable, and in the after-tax case, it should not.

If a recovery is awarded under a schedule disregarding calculations involving future or past wages, as might occur under workers compensation and disability insurance plans, federal law should still follow the wage-replacement paradigm. Even when applicable state law does not replace lost human capital, federal tax law should presume equivalent treatment under the law; that is, the tax law should "first" view the recovery for a personal injury compensable under

110 See Brooks, supra note 8, at 769-80 (arguing for across-the-board nonrecognition rule).

111 See supra text accompanying note 71.

112 Although the injured party will not obtain full "net" restitution because of the conventional American rule that costs, including attorneys' fees, are borne by each litigant, the tax law cannot feasibly overcome this deficiency. In tax terms, costs borne by the plaintiff can be viewed separately as an expense rather than a reduction in the recovery. See infra notes 121-33 and accompanying text.

113 Varying comparative negligence or fault regimes will tend to reduce plaintiff recoveries below the present value of future lost wage streams and create state-by-state disparities among recoveries for the "same" personal injuries. Federal tax law can do nothing about such disparities, nor can it compensate for lost damage recoveries. All that I claim is that federal tax law is capable of treating a recovery for lost earning capacity the same after taxes as if the plaintiff had received the "recoverable" lost future wages that would have been received but for the injury.

114 The case for computing the recovery on a before-tax basis, however, is not strong. See Restatement (Second) of Torts § 914A cmt. c (1977) (noting stronger case for computing lost past wages on an after-tax basis, because factual uncertainties are absent). Cf. Rev. Rul. 85-97, 1985-2 C.B. 50 (§ 104 applied even when recovery is for lost past wages).
the otherwise applicable tort law. This rule would require an independent determination of lost earning capacity, under applicable assumptions, on the tax return. In theory, making the determination should not be especially difficult, although in practice it might be complex.\textsuperscript{115} Of course, any interest accrued on judgments or damage recoveries for past due amounts should be treated as includible interest.\textsuperscript{116}

At this point, it is appropriate to offer statutory language with respect to lost earning capacity and earnings, to replace what is currently in section 104(a):

(a) In General- Except in the case of amounts attributable to (and not in excess of) deductions allowed under Section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income shall not include, under regulations prescribed by the Secretary, such amounts received as damages (whether by suit or agreement and whether as lump sums or periodic payments), under worker compensation acts, or through accident, health, or disability insurance (other than amounts received by an employee, to the extent such amounts are (A) attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer) on account of personal injuries or sickness as are necessary to restore the injured or sick person, with respect to lost earning capacity and lost earnings, to the same economic position as would have occurred had the personal injury not occurred, but in the case of any lump-sum recovery only to the extent that it be invested in an annuity that provides level (or increasing) payments for a period which is to end no earlier than the earlier to occur of (i) 20 years, (ii) the attainment by the injured party of age 70, or (iii) the death of the injured party.

The regulations would incorporate the results of Table 2, which are keyed to state law. Determining state law may not always be easy, but this is a pervasive problem of federal law under the \textit{Erie} doctrine. The determination here, however, would be made by an administrative body in the first instance and not by a federal court. In marginal or doubtful cases,\textsuperscript{117} the regulations should operate on

\textsuperscript{115} Rarely would a plaintiff recover more than the present value of the lost earning capacity and lost wages. Therefore, perhaps there should be a presumption that the entire recovery is for lost wages or wage-earning capacity.

\textsuperscript{116} For example, if any interest rate is fixed by statute and is below a rate which is one percentage point above the current after-tax rate, computed with reference to the applicable federal rate, such interest should arguably be tax-free also: it has been subject to an implicit tax, even though the low interest rate results from statutory obsolescence rather than any notion of an after-tax return. Imposing a complex rule with respect to such a relatively insignificant feature of the recovery is probably not worth the benefit gained.

\textsuperscript{117} See supra notes 89-90.
the basis of presumptions that recoveries are figured before taxes and that discount rates are before-tax. The taxpayer should be barred from showing that a particular recovery was calculated on a basis different from that prescribed by the regulations because the parties could sweeten the pie at the government’s expense, given that the parties would not be adverse to each other in this context. However, the taxpayer would still be allowed to show that the regulations’ characterization of state law was incorrect.

2. Deductibility of Legal Fees

The proposed revision of section 104 would fall short of producing the optimal result in terms of injured-party equity, because part of the recovery is likely to be eaten by legal fees and other expenses. The tax law could not guarantee that the injured party will be made economically whole except by way of a 100% tax credit for attorneys’ fees—a possibility that can be confidently ruled out. Tort law must decide whether the injured party should primarily bear the transaction costs, as is the case under the so-called “American rule,” or whether the unsuccessful defendant should bear them.

The best that tax law can reasonably be called upon to accomplish here would be to allow the deduction of unrecovered attorneys’ fees, which do not represent “consumption,” as an expense of producing income or, alternatively, as an expense pertaining to the maintenance or repair of human capital.

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118 See Restatement (Second) of Torts § 914A (1977) (general rule is that taxes are ignored).
119 If recoveries are excludible when damages are computed on an after-tax basis, the parties would likely settle on such a basis, thereby making more money available to the defendant, who might be induced to share it with the plaintiff.
120 The plaintiff would favor an after-tax computation of wages and a before-tax discount rate in order to avoid income taxes on both the recovery and the investment return. Similarly, the defendant would favor the same approach to minimize the amount payable. See Scenario 3 in Table 2.
121 A facile response would say that attorney fees are “made up” by the award for pain and suffering and, perhaps, punitive damages. Such a result, however, would occur only by coincidence.
122 In Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490, 495-96 (1980), the Court opined that the plaintiff’s recovery under the FELA should not be inflated (by computing wages on a before-tax basis and by failing to note that recoveries are tax-free) in order to make up for attorneys’ fees; the latter is a separate issue under tort law.
123 In economics jargon, the social harm resulting from personal injuries is not adequately “internalized” by potential tortfeasors unless tort law requires them to bear the “appropriate” burden of such costs. See also infra text accompanying notes 152-63.
125 Compare I.R.C. § 213(a) (medical expenses) with Treas. Reg. § 1.162-5 (expenses of maintaining or improving existing job skills are deductible as expense of carrying on existing business of being an employee).
However, the case for deductibility is not strong. Capital expenditures for acquiring human capital are never deductible, and the aim of the revised section 104 would attempt to treat the recovery as if it were a tax-free replacement of human capital. It is true that the fees do not become an annuity acquisition cost just because the exclusion is conditioned upon a reinvestment in an annuity.\textsuperscript{126} Even if the legal fees were treated as a cost of acquiring the annuity, they would not be added to the taxpayer’s basis in the annuity (the lump-sum excluded amount); they would be absorbed into it.\textsuperscript{127} The most accurate description is that the legal fees reduce the recovery. As under present law, the legal fees should be deductible only to the extent that the recovery is includible.\textsuperscript{128}

The best argument for deductibility is that the proposed revision of section 104 excludes recoveries only to the extent that they have implicitly been subject to tax. Admittedly, the implicit tax point also supports repeal of section 265(a)(2), which expressly disallows interest expense on debt incurred to purchase or carry obligations yielding exempt interest under section 103.\textsuperscript{129} Perhaps the section 265(a)(2) situation is distinguishable.\textsuperscript{130} On the other hand, the implicit tax rationale has never succeeded in avoiding section 265.\textsuperscript{131}

A feature of the proposal, however, precludes deductibility of the legal fees. That feature is the rule that sets the maximum excludible amount for a lump sum recovery (to the extent of the rein-

\textsuperscript{126} By analogy, prepaid interest on a mortgage is allocated to the loan period; it is not added to the basis of property acquired with the mortgage. See I.R.C. § 461(g) (1988 and Supp. 1990).

\textsuperscript{127} See, e.g., Treas. Reg. § 1.1015-4(a)(1) (as amended in 1972) (basis of property acquired in a part-gift, part-sale transaction is the greater of the cost or the § 1015 carryover basis, not the sum of the two).


\textsuperscript{129} The implicit tax arises because the rate of return on municipal obligations is less than that of taxable debt obligations.

\textsuperscript{130} There the implicit tax is typically less than what would be derived from the highest marginal rate of the particular investor. The yield on § 103 bonds is often greater than the before-tax rate of return on equivalent investments multiplied by one less the taxpayer’s marginal rate, because such yield must be set high enough to attract investors in lower tax brackets. See, e.g., DODGE, supra note 27, at 295-97. In the § 104 situation, on the other hand, the implicit tax would be keyed to the plaintiff’s actual marginal rate. Moreover, waiver of § 265(a)(2) in the § 103 context would have serious consequences for the integrity of the tax base, since without § 265(a)(2) the tax base would be readily eroded as people borrowed on a massive scale to purchase tax-free investments. In contrast, the § 104 transaction is involuntary and discrete; there would be no massive erosion of the tax base if attorneys’ fees to obtain personal injury recoveries were deductible.

\textsuperscript{131} Thus, § 265 has been held to apply to various types of nonabusive transactions. E.g., National Engraving Co. v. Commissioner, 3 T.C. 178 (1944) (expenses of obtaining excludible life insurance proceeds); Davis v. Commissioner, 79 T.C. 503 (1982) (legal fees to obtain tax-free inheritance). Any deduction for legal fees in the § 104 situation would have to be obtained through legislation.
vestment in the qualified annuity) as the "gross recovery" attributable to loss of earning capacity. Thus, the taxpayer would be able to obtain an exclusion for the full gross damages recovery if she can fund the requisite annuity from other sources (including punitive and pain and suffering damages). For example, if X receives a lump-sum recovery of $1 million gross (all for lost earning capacity) and pays $400,000 of attorneys' fees, investing $600,000 in the requisite annuity and Scenario (3) applies, the exclusion would be increased for each dollar invested in the annuity, provided that the total exclusion would not exceed $1 million. In short, the taxpayer would be able to invest tax-free in her own human-capital replacement to the extent of attorneys' fees. The effect of this rule is to deem certain amounts to be tax-free recoveries of legal fees. So viewed, the fees themselves clearly cannot be deducted.

C. Other Policies Bearing on Section 104

1. Federalism Issues Pertaining to Section 104

The government might decide to repeal section 104 simply to uncover a new source of revenue. Repeal of all section 104 exclusions would mean that tort law could achieve plaintiff equity only by adopting damage-computation Scenarios (5) and (6):

(5) Lump-sum recovery computed before taxes, reduced to present value using an after-tax discount rate; and

(6) Annuity recovery computed before taxes.

Only under Scenarios (5) and (6) will the federal government obtain the same revenue, $90,000, from the plaintiff as it would have obtained had the personal injury not occurred. Under Scenarios (5) and (6) the federal government becomes, in effect, a coplaintiff.

The government, however, is not generally considered to have a claim against private parties on account of action, even unlawful action, that deprives the government of future revenues. On the doctrinal level, parties who were not personally injured cannot recover in tort for their economic losses. A fortiori, the government cannot claim lost revenues against a defendant who inflicted

132 A more difficult question arises when the gross recovery is diminished by the application (or threat thereof) of a comparative fault rule. Here outside funds could be invested to "make up the difference" with respect to lost human capital only if the lost human capital can be objectively ascertained. Making such a determination may be required in the tax proceeding itself. To prevent abuse, this proceeding would have to be more adversarial than simply filling out a schedule on a tax return.

133 Otherwise exactly the same dollars will be both excluded and deducted. For another illustration, see infra note 182.

personal injuries on private parties. At the jurisprudential level, private parties owe no duty to the government to prevent erosion of the revenue base. Such a duty, contrary to American political culture, would have to be based on the subservience of private economic activity to government ends. Moreover, in policy terms, if the "deadweight" losses associated with destruction of earning capacity are shouldered entirely by the private sector, and not at all by government in the form of reduced taxes, improvement of aggregate social welfare would be unlikely.

Ultimately, tort law might not, and perhaps should not, be modified to conform to Scenarios (5) and (6) in response to a repeal of section 104. Because these Scenarios impose a higher burden on defendants than the others, lawmakers may be persuaded that their adoption, although achieving equity for plaintiffs, is bad policy or politics on account of overburdening defendants. At the same time, existing section 104 pressures states to compute damages on an after-tax basis if they desire to avoid overcompensating plaintiffs, with the incidental effect of possibly underpenalizing defendants, as illustrated in Table 1. Either retention or repeal of existing section 104, therefore, constitutes federal involvement in state remedy policy. Of course, the involvement is only indirect because the states can proceed to systematically over- or undercompensate plaintiffs and over- or underpenalize defendants at will. No persuasive reason exists, however, for states to view section 104 as being intended to produce overcompensation of plaintiffs.

An intermediate possibility is retention of the basic section 104 exclusion but repeal of the "structured settlement" exclusion. If

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135 See supra notes 72-84 and accompanying text discussing alternate scenarios.
136 See infra Part II.B; see also Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490, 493-98 (1980) (FELA case); Floyd v. Fruit Indus., Inc., 136 A.2d 918 (Conn. 1957); Adams v. Deur, 173 N.W.2d 100 (Iowa 1969); see generally Bradford, supra note 97, at 220-24 (discussing Liepelt).
137 See supra notes 32, 38. Whether states should overcompensate plaintiffs in other contexts or for reasons independent of § 104 is an issue that need not be addressed here. Overcompensation of plaintiffs results, for example, from the "collateral source rule," under which courts refuse to reduce a tortfeasor's obligation simply because the plaintiff receives compensation from third parties, typically by way of insurance. Restatement (Second) of Torts § 920A(2) (1977). However, the collateral source rule is distinguishable from the situation arising under § 104. Any § 104 tax benefit is not "compensatory" nor, if considered a "collateral source," would it come close to defeating a tortfeasor's obligation to pay damages. Deterrence policy mandates that tortfeasors not be allowed to shirk responsibility arising from tortious conduct on account of the fortuitous circumstance of third-party compensation. At the same time, the right to insurance proceeds, unlike the benefits obtainable under § 104, is a matter of contract which the insurer should not be able to avoid simply because the tortfeasor is fully liable. See also Bradford, supra note 97, at 216-19 (arguing that § 104 does not require states to compute damages on a before-tax basis thereby producing excess recoveries for plaintiffs; therefore, § 104 is not a true collateral source).
plaintiff equity were the goal, this move would rule out Scenarios (2A), (3), and possibly (1), leaving only Scenario (4), which arguably underdeters defendants, especially if the payments are deductible.

Only a federal tax regime modelled on Table 2 can guarantee equitable and truly "compensatory" results for plaintiffs while allowing lawmakers to pursue varying deterrence policies. States have generally failed, whether by oversight or by design, to strive for plaintiff equity in the context of the existing version of section 104. Consequently, one cannot assume that states will do a better job if section 104 is repealed or modified. Indeed, states that currently compute damages on a before-tax basis might err by telling juries that the damages are taxable, thereby inducing the juries to increase the recovery by the amount of the taxes that will be due. As indicated by Scenarios (5) and (6), however, computing damages on a before-tax basis is already compatible with fully taxing the recovery. If before-tax recoveries are increased by the taxes themselves, both plaintiffs and the government are overcompensated and defendants would probably be required to pay more than would be necessary to deter them.

In short, retention or repeal of section 104, or even repeal of the structured-settlement aspect of section 104, would invite states to "buy into" plaintiff equity at the "cost" of committing itself to a particular deterrence regime—a regime that may not coincide with its informed policy judgment. The state may decline the invitation, and subordinate plaintiff equity concerns to its view either of a proper deterrence policy or its inclination to overcompensate plaintiffs for other reasons. If the federal government has itself "solved" the deterrence issue, perhaps federal tort legislation should be enacted. Otherwise, the states should be free to experiment with deterrence policies. This can be achieved, without sacrificing plaintiff

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138 See infra Table 2.
139 The prevailing rule is that juries should not take taxes into account. RESTATEMENT (SECOND) OF TORTS § 914A(1) (1977). See Estate of Spinosa, 621 F.2d 1154, 1158-59 (1st Cir. 1980) (majority rule is that taxes cannot be considered in calculating damages). See generally Theuman, supra note 89. This rule, however, only produces the right result when damages are "correctly" computed with reference to existing tax rules. In that case, juries can be told, "Don't worry about taxes, they have already been taken into account in the formula for computing damages." See Norfolk & Western Ry. Co. v. Liepelt, 444 U.S. 490 (1980) (jury can be informed that damages were tax-free, so long as damages were computed on after-tax basis). See generally Robert J. Nordstrom, Income Taxes and Personal Injury Awards, 19 OHIO SR. L.J. 212 (1958); Robert H. Feldman, Personal Injury Awards: Should Tax-Exempt Status Be Ignored?, 7 ARIZ. L. REV. 272 (1966) (both articles arguing that juries should be told that damages are tax-exempt in order to prevent them from overcompensating plaintiffs).
140 For example, referring to Table 2, if the plaintiff's tax rate is 30%, the jury might award $374,901 ($262,431 under Scenario (5) divided by 0.7).
equity, by adopting an “adaptive” version of section 104 along the lines set forth in Table 2. The present system implicitly embodies a vaguely formulated federal tort policy, but it lacks any explicit rationale or force.

2. Deterrence Policy

The principal object of tort law on the defendant side is to adequately deter undesirable behavior without excessively discouraging desirable or neutral behavior. Because personal injuries entail the destruction of human capital, rather than its appropriation by the defendant, it is logically unnecessary to penalize the defendant to the same degree that the plaintiff is compensated, as would be proper in a rescission or unjust enrichment situation.

Some asymmetry between plaintiff recoveries and defendant payments inevitably arises because of the existing tax system, since the tax treatment of plaintiffs is not tied to that of defendants, nor vice versa. Nonetheless, if the marginal rates of plaintiffs and defendants are the same, the amount paid by defendants, net of taxes, will equal the amount received by plaintiffs, net of taxes, only under Scenarios (5) and (6) (complete repeal of section 104), but only if payments are deductible by defendants. When the payments are not deductible, because the tort claim did not arise out of the defendant’s business or investment activities, the defendant will suffer more than the plaintiff gains under Scenarios (5) and (6). Under Scenario (1) (exclusion for annuity payments) and Scenario (4) (exclusion for lump-sum recovery only) the net recovery and the net payment are equal when the payments are nondeductible. Under

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141 Cf. Restatement (Second) of Torts § 901(c) (1977) (citing both deterrence and punishment). However, the punishment idea is carried out through the concept of punitive damages. Id. § 908 (citing deterrence as secondary goal). Neither “punishment” nor “deterrence” implies a corresponding reward to the plaintiff, except perhaps to induce potential plaintiffs to bring suits to vindicate society’s interests. The tax treatment of punitive damages is discussed infra at notes 175-82.

142 See Restatement (Second) of Torts § 901, cmts. a, c (1977). For example, the collateral source rule is accepted in order to impose a proper level of deterrence on defendants, even though the effect of the rule is to overcompensate plaintiffs.

143 See supra note 30. In addition, plaintiffs and defendants may be in different marginal rate brackets.

144 If a payment of $262,431 is deductible and the payor is in the 30% rate bracket, the net payment is $183,702. The net payment with respect to a series of three $100,000 payments is $210,000, the present value of which is $183,702. Under § 461(h)(2)(C), an accrual-method taxpayer can only deduct tort and workers-compensation liabilities when paid; otherwise, the net payment would only be $158,685 ($248,685, the present value of $300,000 future payments, less $90,000, the tax savings derived from an immediate deduction of 300,000).

145 The deduction can be for direct payments to plaintiffs or, for indirect payments, such as liability insurance premiums.

146 See supra note 18.
Scenario (3) (exclusion for both lump-sum recovery and annuity payments), the defendant always pays less, net, than the plaintiff receives. Under Scenario (2A) (inclusion of lump-sum recovery and exclusion of annuity payments), the defendant is in a better position than the plaintiff, net, if the payment is deductible; otherwise, the defendant is worse off—but the twain shall never meet. These results are summarized in Table 3, which assumes a 30% tax rate on plaintiffs and defendants:

**Table 3: After-Tax Burdens on Defendants**
(reduced, in Scenarios (1) and (6), to present value at a 7% discount rate)

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>(1)</th>
<th>(2A)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plaintiff nets</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
<td>183,702</td>
</tr>
<tr>
<td>Defendant's net payment:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>deductible</td>
<td>121,856</td>
<td>174,080</td>
<td>121,856</td>
<td>128,591</td>
<td>183,702</td>
<td>183,702</td>
</tr>
<tr>
<td>nondeductible</td>
<td>183,702</td>
<td>248,685</td>
<td>174,080</td>
<td>183,702</td>
<td>262,431</td>
<td>262,431</td>
</tr>
</tbody>
</table>

Deterrence policy is instrumental, and not driven by ethical considerations. The idea of general deterrence is inherently unfair: certain wrongdoers, even if equally “guilty” as others, may be singled out as examples for sanctions in order to induce modified conduct. Even if fairness among tort defendants were a desirable policy goal, it probably could not be implemented by damage awards, because particular wrongdoers can shift their burdens, in whole or in part, through insurance, and because awards of punitive and pain and suffering damages are largely rendered without regard to objective standards. There is no a priori reason for tax policy to attempt to mold tort policy in the direction of insuring that the net loss imposed upon a particular defendant will equal exactly the amount received by the plaintiff. If, from the torts perspective, it is deemed desirable that defendants who cause equal harm end up in the same position after taxes, then it is up to tort law to adapt to tax law, not vice versa.

However, an economic argument supports tying the net burden on defendants to the compensation received by plaintiffs. In economic theory, the social cost of torts will exceed the marginal busi-

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147 This is true unless the defendant is subject to a 26.13% rate, and the payment is deductible, while the plaintiff is subject to a 30% rate.

148 In this discussion, I am referring to the idea of general deterrence, making an example out of one member of a class, and not to the idea of specific deterrence, influencing one party’s behavior by acting directly against that party.

149 The standards that do exist in a few states typically involve a loose nexus between punitive and compensatory damages. However, a “cap” on punitive damages is not really a “standard.” See statutes collected in Johnston, supra note 17, at 1388 n.10; see also Restatement (Second) of Torts § 908(2) (1977) (jury “can properly consider the character of the defendant’s act, the nature and extent of the harm to the plaintiff that the defendant caused or intended to cause and the wealth of the defendant.”).
ness revenue from tort-risking activities unless these costs are "internalized" and made a marginal cost of business. The social costs can be internalized only if defendants, and indirectly, their customers, are made to bear the full social costs after taxes. This aim can be most closely achieved under Scenarios (5) and (6). Adopting this approach would suggest that Scenarios (1) through (4) under-penalize business defendants. The fact that Scenarios (1) and (4) appear to achieve the right result when the payment is non-deductible, is relevant only to business which is untaxed. Therefore, retention of section 104 in its present form brings about the right degree of internalization of social costs only by accident.

Arguably, retention of section 104 could be accommodated to "internalization" by disallowing any deduction for compensatory personal-injury damages. Even then, however, the deterrence level would be theoretically "wrong" under Scenarios (2A) and (3). More importantly, no economic or tax justification exists for singling out this one particular category of business-related cost for disallowance. Federal tax law disallows deductions on a public policy basis only in aggravating circumstances, which are not present here. Further, any federal policy of penalizing defendants by disallowing deductions could be subverted by a state rule calculating damages on an after-tax basis using a before-tax discount rate, as exemplified in Scenario (3).

Although economic theory suggests repeal of section 104 and a move to Scenarios (5) and (6), with or without deductibility, ultimately the proper level of deterrence is an empirical, or even political, question. For example, a certain level of deterrence might well exist independently of tort law by reason of criminal law, government regulation (or the fear thereof), the possibility of injuring oneself, moral standards, business judgment, and so on. On the other hand, purely economic injuries may be undercompensated due to plaintiffs' failure to file claims, the threat of delay, comparative neg-

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150 By internalizing such costs, the defendant must raise its prices for its goods or services. If customers continue to purchase the goods or services at the higher prices, then the aggregate welfare gain will at least equal the aggregate welfare loss attributable to the tortious conduct. Otherwise, the defendant will go out of business, which is the right economic result when social loss exceeds social gains. See, e.g., Steven Shavell, Economic Analysis of Accident Law 127-28 (1987); Guido Calabresi, The Cost of Accidents 68-73 (1970).

151 Shavell, supra note 150, at 143 (damages should be computed on a before-tax basis in order that defendants will bear total welfare loss).

152 The following deductions are disallowed: illegal payments under § 162(c), fines and penalties under § 162(f), certain treble damage payments under antitrust laws in § 162(g), and expenses of illegal drug businesses under § 280E.

153 In addition, the government has no economic interest in denying the deduction to defendants because, if the injuries had not occurred, an employer would have received deductions for the wages paid.
ligence regimes, defenses, countersuits, capriciousness of juries, other legal obstacles, and insolvency of defendants. In addition to these uncertainties, the notion that the proper level of deterrence can be determined by the operation of the market makes the improbable assumption that private parties can, and are willing to, accurately weigh costs and benefits while factoring "risk" into account. For these very reasons, some have argued that the link between compensation policy and deterrence policy should be severed by moving to a no-fault compensation system, especially in the context of nonbusiness torts.

Above all, the results set forth in Table 3 only describe the impact on defendants of damages for the destruction of human capital. Punitive, pain and suffering, and other damages for noneconomic harms are disregarded, rendering implausible the notion that tort and tax law should converge to match the defendant's net obligation, exactly to the plaintiff's net recovery with respect to lost earning capacity. More broadly, it would be error to assume that tax deductibility rules pertaining to damages for lost human capital, or any other component of damages, are the crucial ingredient in deterrence policy. Further, it would be dogmatic to insist that only Scenarios (5) and (6) pertaining to recoveries for lost earning capacity provide just the right level of deterrence in practice.

It is best, then, to conclude that deterrence policy is beyond the reach of section 104, meaning that tax rules affecting defendants should be evaluated strictly from the vantage of tax policy and plaintiff-side compensation policy. Since compensation policy has already been discussed, it only remains to consider tax policy from the

154 See Johnston, supra note 17, at 1385-88 and authorities cited, supra notes 3-6.

155 See CALABRESI, supra note 150, at 73-96. Whether economics can be readily applied to nonbusiness torts is problematic. Possibly "plaintiff utility" could replace "marginal business revenue" in the analysis. On the other hand, because utility is subjective and not converted into any market equivalent, like prices and output, it would seem that the concept of economic efficiency could not be readily imposed. Also, for an individual, a rational utility calculation is virtually impossible to make, because the "negative rate of return," especially in the case of negligence, is a function of risk for which the "odds" are not likely to be available, much less considered. See id. at 56-57.

156 See, e.g., Jeffrey O'Connell, A "Neo No-Fault" Contract in Lieu of Tort: Preaccident Guarantees of Postaccident Settlement Offers, 73 CAL. L. REV. 898 (1985); Guido Calabresi & Jon T. Hirschoff, Toward a Test of Strict Liability for Torts, 81 YALE L.J. 1055 (1972). Economic deterrence presupposes that the potential tortfeasor has the capacity and material incentive to control its harmful acts. Under no-fault regimes, potential tortfeasors have only the most diffuse economic incentive to avoid harm. For this reason, no-fault systems make the most sense in a nonbusiness context where noneconomic incentives would weigh more heavily. Section 104, of course, comes into play under no-fault compensation systems as well as fault systems.

157 See Johnston, supra note 17, at 1390, 1395-98 (arguing that, in a legal system fraught with uncertainty, the best deterrence system is one that imposes a relatively low risk of liability but a disproportionately high payment obligation if liability is found).
defendant-side, where it appears that any of the Scenarios create horizontal inequity between business and nonbusiness defendants. As noted above, however, one can rule out disallowing deductions to business defendants, because payment obligations and liability insurance premiums are appropriate business expenses; in other words, the "inequity" derives from an inaccurate perception of how to make the relevant comparison.\textsuperscript{158}

The alternative way of obtaining defendant "horizontal equity" would be to repeal section 104, thereby triggering Scenarios (5) and (6), but to allow nonbusiness tort payments and liability insurance premiums to be deductible. However, because nonbusiness costs are generally nondeductible, it is necessary to devise a substantive theory of why these particular nonbusiness costs should be deductible. Such a theory would hold that involuntary, or nondiscretionary, expenses should be deductible on ability-to-pay "fairness" grounds, even if not business- or investment-related.\textsuperscript{159} If this premise is accepted, then even payments by individual defendants in a personal capacity should be deductible. Nondiscretionary payments would be deductible under this approach only if they are extraordinary in amount and kind. Liability insurance premium payments, though, are normal and relatively small; hence, the case for deducting them is weak. Still, one may argue by analogy to the casualty loss situation that self-insured damage payments should be deductible, even though insurance premiums are not.\textsuperscript{160} And yet, the casualty loss deduction itself, as well as the proposed deduction for damage payments, can be viewed as being inappropriate. Neither personal casualty losses nor damage payments are nondiscretionary, or involuntary, to the extent that they could have been insured against. Moreover, a rule allowing deductions for damage payments and casualty losses, while disallowing deductions for insurance premiums, provides the wrong incentive structure.\textsuperscript{161} Universal insurance is by far preferable to self-insurance as a means of

\textsuperscript{158} The business defendant should be compared to other business taxpayers incurring the same costs, not to nonbusiness defendants.

\textsuperscript{159} The premise would be that the correct "fairness" norm for the tax base is "ability to pay," rather than the Haig-Simons definition of "income" that refers to "consumption" plus net increases in wealth; the "income" concept itself being a compromise between fairness and minimal neutrality norms. See Dodge, supra note 27, at 117-29.

\textsuperscript{160} I.R.C. § 165(c)(3) & (h) (1988 and Supp. 1990). Nonbusiness and noninvestment casualty insurance premiums are nondeductible personal expenses. Id. § 262.

\textsuperscript{161} The concept of what constitutes "nondiscretionary" losses necessarily has a strong normative flavor, and is not decided on an individual basis. For example, the tax system operates on the assumption that people spend certain amounts for subsistence and medical care, whether or not they actually do so. See Id. §§ 63(c), 63(f), 151(d)(1), and 213(a) (flat amount standard, self-support, and dependent-support deductions; medical expenses deductible only in excess of 7.5% of adjusted gross income).
TAXES AND TORTS

compensating plaintiffs. Large payment obligations are likely to extend beyond an individual defendant’s financial means and, when they are not, they are dischargeable in bankruptcy.\textsuperscript{162} Insurance may be the best available means of obtaining the right “price” from consumers for their personal risk-taking activities. All things considered, the case for a deduction for nonbusiness damages is plausible but unconvincing. Since the disparate tax treatment of business and nonbusiness defendants is justified under tax theory, and because economic theory is inconclusive, such disparate tax treatment cannot, in itself, lead one to demand its elimination or to prefer any of the possible alternative solutions to the section 104 problem.

One potential drawback to simple repeal of section 104 can be identified: state courts may explicitly or implicitly sanction a before-tax discount rate in figuring recoveries for lost-earning capacity.\textsuperscript{163} Scenario (5) produces the right result, using an after-tax discount rate. \textit{Use of a before-tax discount rate in the context of a repealed section 104 imposes a double tax on plaintiffs: one implicit, the before-tax discount rate, and one explicit, the tax on the annuity return. Therefore, Congress should approach simple repeal of section 104 with extreme caution. This action should not be undertaken without a clear signal to states that plaintiff equity can be achieved only by figning lump-sum damage recoveries on a before-tax basis using an after-tax discount rate.}

A virtue of the adaptive model of section 104 presented in Table 2 is that those states which misguidedly believe that defendant liabilities should match plaintiff lump-sum recoveries with respect to lost earning capacity could allow for a case-by-case election between Scenarios (4) and (5). For annuity recoveries, states could allow an election between Scenarios (1) and (6), depending on whether the damage payments are deductible, directly or indirectly, by the defendant. Some might object that the adaptive model is already complicated enough. It is doubtful that states could, or would, “adapt” to a tax provision that itself was designed to adapt to state damages rules. Historically, state courts have been reluctant to take federal tax law into account in fixing damages.\textsuperscript{164} Nevertheless, a move to the adaptive model would offer states the opportunity, in general, to choose among various possible deterrence levels, with or without taking deduction rules into account, without sacrificing the goal of correct compensation for plaintiffs for lost human capital.

\textsuperscript{163} If the discount-rate issue is not addressed, it is likely that a before-tax discount rate will be employed by default, because “investment talk” usually refers to before-tax rates. \textit{See supra} note 90.
\textsuperscript{164} \textit{See Theuman, supra} note 89.
If the adaptive model is not adopted, the federal legislators must choose between retaining or repealing section 104. Although a case can be made for repeal, it is unconvincing, especially if one gives any substantial weight to plaintiff equity concerns. If tort law should achieve the correct level of plaintiff compensation, it can be done in the context of section 104. The Liepelt case and this Article provide the requisite analytical tools.

D. What Is a Personal Injury Under Present Section 104?

Given the absence of meaningful legislative history regarding the scope of section 104, reference should be made to the concept of human capital in order to determine what constitutes a "personal," as opposed to "commercial," injury in case of possible overlap. The problem is best illustrated by the leading case of Roemer v. Commissioner, which involved libel. The government claimed that the recovery was not excludible under section 104 because the measure of damages was the economic loss to the taxpayer's insurance business proprietorship. The taxpayer successfully argued that libel was historically and inherently a "personal" action within the scope of section 104. Though computation of damages by referring to lost business income does not establish a "business" tort, neither should the history and categories of tort law dictate the result for federal income tax purposes, especially when relevant categories of tort and contract law often overlap. Of course, tort law is a "necessary" input as far as understanding the facts, but it does not follow that it is "sufficient."

The essential distinction, for example, between "business" and "personal" goodwill, or capital, is that the former is transferable

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166 See also Brooks, supra note 8, at 791-804 (although reaching somewhat different conclusions than those reached here).
169 Business income can result from the employment of both human and physical capital; hence, loss of business income can result from loss of either kind of capital.
170 Byrne, 883 F.2d 211 (holding that wrongful discharge claim is more tort-like than contract-like).
171 For example, the tort of libel can be based on the same facts as the tort of business disparagement. See W.P. Keeton et al., Prosser and Keeton on Torts 962-65 (5th ed. 1984 & 1988 Supp.).
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and the latter is not.\textsuperscript{172} Perhaps section 104 cases involving libel and slander could be decided on the basis of evidence, introduced in the tax proceeding, as to what an unrelated party would have paid for business goodwill before and after the injurious conduct. This portion of the recovery would be for commercial loss, while the remainder would cover personal injury.

An alternative approach, derived from cases limiting the deduction for business wages to payments of "reasonable compensation," would treat future return from a proprietorship or professional business as salary, to the extent that the taxpayer would have received wages in the market from an arms-length employer in a comparable situation.\textsuperscript{173} The injured party's wage-earning capacity could be compared on a before-and-after basis with reference to the tortious conduct, and that loss would be from a personal injury.

Employment discrimination and civil rights deprivation cases are apparently more complex, because it is often difficult to determine whether the plaintiff has really lost human capital: the plaintiff can recover for lost past and future wages even if she ends up with a higher-paying job. Insofar as damages in these cases are awarded to deter or punish defendants, no more reason exists to exclude them from income than exists to exclude punitive damages.\textsuperscript{174} On the other hand, these and other cases do not usually involve the distinction between personal and commercial injury, because a "business" apart from the person and her employment is not typically present. Furthermore, present section 104 mandates the exclusion not only of damages for lost earning capacity, but also for "noneconomic personal injury," such as humiliation, fear, and embarrassment. The fact that damages for noneconomic injuries may possess a deterrent or retributive function does not negate the fact that these same damages are supposed to "compensate" for noneconomic harm. Therefore, under current section 104, damages for personal torts should be fully excluded from gross income to the extent that they are not readily identifiable as punitive damages.

\textsuperscript{172} See Bateman v. United States, 490 F.2d 549 (9th Cir. 1973) (issue was whether the goodwill in question was a partnership asset or a personal attribute of one of the partners).


\textsuperscript{174} For a discussion of punitive damages under current law, see supra note 4. For a policy discussion of punitive damages, see infra text accompanying notes 175-82.
II
PERSONAL INJURY RECOVERIES OTHER THAN
FOR HUMAN CAPITAL

This Part discusses the policy issue of whether punitive damages and “noneconomic” damages, encompassing both pain-and-suffering damages in physical-injury cases and nonphysical, noneconomic torts, should be excludible from income.

A. Punitive Damages

As a matter of policy, there is little doubt that punitive damages should be included in gross income. Such damages represent an economic windfall, and do not compensate for any loss whatsoever. Punitive damages represent a pure accretion to wealth.175

One argument advanced in favor of excluding punitive damages is that the exclusion might compensate the plaintiff for legal fees and other expenses, and thereby truly make the plaintiff whole. However, punitive damages have no relation, under tort law, to legal fees.176 The argument for excludibility would be better directed toward reforming tort law to award legal fees to plaintiffs and to create standards for punitive damages. No justification exists for excluding punitive damages in excess of legal fees.

The only other plausible argument for excluding punitive damages is that their inclusion, while retaining exclusions for compensatory damages, would create an administrative problem of distinguishing includible from excludible damages, especially when the case was settled or went to judgment without specification of the punitive damages amount. However, one could also advance this argument in favor of the proposition that compensatory damages should be included in gross income. An allocation by the parties should not control, because their “tax” interests are not necessarily opposed.177 Nor should the plaintiff’s allocation of damages in the complaint control,178 because tax law should not unnecessarily dic-


176 RESTATEMENT (SECOND) OF TORTS § 908 cmt. e (1977) (barest hint that expenses of bringing suit may be considered in awarding punitive damages). See supra note 149.

177 The defendant’s payment of damages is deductible whether the damages are compensatory or punitive. Even if punitive damages were categorically nondeductible, one would not expect a settlement to accurately embody a proper allocation when the parties are subject to different tax rates.

178 If better evidence of a proper allocation cannot be found, the IRS looks to the complaint. Rev. Rul. 58-418, 1958-2 C.B. 18.
tate the behavior of personal-injury lawyers. With no external reference, such as a judicial decree or findings, the allocation must be made on the basis of an independent "tax" examination of the cause of action.

The proposed revision of section 104 along "adaptive" lines, as illustrated by Table 2, already accommodates these arguments, because any exclusion for a lump sum is limited to the lesser of (1) the gross loss, before legal fees, of human capital and (2) the amount reinvested in a qualified annuity. The person receiving the recovery can show the gross loss of human capital in the tax proceeding, without being bound by the tort proceeding, though the latter may be heavily weighed if it proceeds to judgment, on the basis of the usual kinds of evidence. All damages, including punitive damages, would be available for investment in the qualifying annuity. Thus, punitive damages would, in effect, be potentially excludible in an amount equal to the attorneys' fees allocable to the compensatory damages. Alternatively, no allocation problem would exist in those cases where lump-sum compensatory damages are includable in gross income. This approach also moots the possibility of allowing a full deduction for legal fees. Legal fees would be treated the same as under conventional tax doctrine.

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179 Actually, recoveries would be allocated first to medical expenses and other out-of-pocket costs. Rev. Rul. 75-230, 1975-1 C.B. 93. Evidence of lost earning capacity would relate to current wages, expected period of future employment, and possibly prospects for future merit raises and promotions. Of course, a discount rate also needs to be selected. See Restatement (Second) of Torts §§ 912 cmt. d, 913A (1977). It is doubtful that any account should be taken of future inflation because (1) future inflation is taken into account in prevailing discount rates and (2) no reason exists to assume that wages do not generally adjust to inflation. The recovering plaintiff would adversely suffer only if "locked into" an annuity investment with a fixed rate of return. Variable annuities, however, are available in the market. For this reason, the plaintiff might well prefer a lump-sum recovery rather than an annuity obligation of the defendant or insurer. Certainly tax law should not favor the latter over the former. Of course, some market risk is unavoidable.

180 For example, assume a judgment returns $600,000 in damages for lost earning capacity plus $400,000 in punitive damages, and that legal fees and other expenses are $300,000. Assuming that the lump sum would qualify for an exclusion in one of the Scenarios presented in Table 2, $600,000 would be excluded if $600,000 were reinvested in a qualified annuity.

181 See supra notes 124-33 and accompanying text.

182 An otherwise deductible expense is disallowed under § 265 if it triggers a tax-free reimbursement. To illustrate, assume the same facts as discussed supra in note 180. Under normal allocation principles, the $300,000 attorneys' fees would be allocated as follows: $180,000, or 60%, to the compensatory damages, and $120,000, or 40%, to the punitive damages. This allocation would hold if the exclusion were in fact $600,000, because that amount is invested in a qualified annuity. The $180,000 would be disallowed and the other $120,000 would be deductible. If only $500,000 were invested in a qualified annuity, the allocation of attorneys' fees would be on a 50-50 basis. See Rev. Rul. 58-418, 1958-2 C.B. 18. Cf. United States v. Gilmore, 372 U.S. 39 (1963) (certain legal fees in divorce action are not deductible).
B. Recoveries for Noneconomic Harms

Section 104 currently excludes damages for pain and suffering, as well as for purely personal injuries, such as loss of privacy, loss of consortium, intentional infliction of emotional distress, and deprivation of rights. Conceptually, the damages represent a conversion of some nonmaterial benefit, such as lost "normality," peace of mind, or dignity, into cash. This is not a situation in which an exclusion could be justified as maintaining the tax status quo with respect to income from human capital. Since no "basis" exists in any recovery of this type, such damages seemingly should be fully includible as pure accessions to material wealth. The burden of persuasion in the policy sense lies with the proponents of exclusion.

Some argue that these damages should not be taxed because they are a substitute for goods of a nontaxable nature, such as pleasure, pain, or normalcy. However, the "substitute for" analysis is not a policy tool. Rather, it is a doctrinal device employed to ascertain the substance of a receipt in order to determine which statutory category to apply. Moreover, in the doctrinal context, the "substitute for" analysis has limits, which have been imposed in the very area under scrutiny, section 104.

If one were to apply this doctrinal device to the policy arena, it would lead nowhere, because damages for noneconomic harm are not a "substitute for" any other kind of receipt that has tax significance. They are simply damages for noneconomic harm. Nonpecuniary damages are not computed with reference to foregone consumption which would have been purchased in the market. If they were so computed, computing foregone consumption on an

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184 See Brooks, supra note 8, at 763-73. See also United States v. Kaiser, 363 U.S. 299, 311 (1960) (Frankfurter, J., concurring) (noting difficulty of applying concept to recoveries for assets with no basis).
185 E.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260, reh'g denied, 356 U.S. 964 (1958) (purported "sale" of production payment is really acceleration of ordinary gross income; however, the better analysis would have been to treat the transaction as a "loan"); Hort v. Commissioner, 313 U.S. 28 (1941) (lease cancellation payment is really "rent," not "amount realized" in "sale"); Rev. Rul. 67-221, 1967-2 C.B. 63 (property received in-kind by ex-wife on divorce is excluded, with basis equal to value, presumably because property is acceleration of inheritance or, possibly, support, both of which are "permanently" tax-free).
186 See, e.g., Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944) (commercial damages measured by lost future profits are not "substitute for" such profits but are "amount realized" on involuntary conversion of business goodwill).
187 See Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983), reviewing 79 T.C. 398 (1982) (defamation damages measured by lost business profits are really for involuntary conversion of human capital).
after-tax basis would subject the taxpayer to an implicit tax that would be preserved by an exclusion.\textsuperscript{188} In fact, pain-and-suffering damages compensate that which cannot be purchased. Thus, it is fundamentally misleading to call these damages "compensation"; they "replace" the irreplaceable.

A variation of the "substitute for" argument is that recoveries for noneconomic harms are mere restorations of a status quo which, in itself, would have been nontaxable as imputed income.\textsuperscript{189} Appeals to imputed income, however, are fruitless, because imputed income, by definition, refers to economic benefits that have not been converted to cash or property. In contrast, noneconomic damages result from a conversion to cash. It is also misleading to consider imputed income as nontaxable in the sense of being "excluded"; rather, it is simply ignored. The difference lies in the fact that excluded items are capable of creating a basis.\textsuperscript{190} To argue that conversions of imputed income to cash should be excluded is essentially the same as arguing that wages, which involve a conversion of leisure to labor, should be excluded. This argument actually cuts in favor of includibility; noneconomic damages are like wages for a miserable job.

One could argue that damages for noneconomic harms should not be taxed because the recovery merely replaces a loss of intangible benefits. This argument is equivalent to stating that wages are not income because they do not result in "gain," the laborer having "given up" leisure and other psychic goods to obtain wages.\textsuperscript{191} Of course, wages are the result of voluntary transactions, whereas pain-and-suffering damages are not. The question squarely raised, then, is whether the involuntariness of the transaction justifies not taxing the accession to wealth.\textsuperscript{192} One could argue for no taxation by analogy to the argument for taxing recovery of lost earning capacity like wages rather than like investments.\textsuperscript{193} Involuntariness may be a legitimate rationale for deferral of income or perhaps deductibility of

\textsuperscript{188} This analysis answers the practical argument that, if damages for lost earning capacity are received in a lump sum and are consumed, rather than being invested, the effect is exactly the same as that achieved by an exclusion for pain-and-suffering damages. Therefore, the two might as well be treated identically. However, recoveries for lost earning capacity, unlike pain-and-suffering damages, can be computed with reference to lost future wages on an after-tax basis.

\textsuperscript{189} Brooks, supra note 8, at 769-73.


\textsuperscript{191} Taking this position on one's tax return is likely to bring about a criminal fraud prosecution. See, e.g., Cheek v. United States, 111 S. Ct. 604 (1991).

\textsuperscript{192} As a matter of positive law, involuntariness is a prerequisite to application of § 104. Starrels v. Commissioner, 304 F.2d 574 (9th Cir. 1962).

\textsuperscript{193} See supra text accompanying notes 107-13.
outlay,\footnote{See supra notes 102-06, 159-62 and accompanying text.} but not for total and permanent exclusion of a clearly-realized accession to wealth.\footnote{Some employee fringe benefits are excluded (e.g., I.R.C. §§ 79, 105, 106, 127, and 132), and the rest are taxed (I.R.C. § 61(a)(1)). The ones excluded, however, include many benefits that a person would ordinarily purchase voluntarily, such as health care and life insurance up to $50,000.}

One could also argue that the difference between taxing something once instead of twice (as section 104 accomplishes for recoveries for lost human capital) parallels the exclusion of something entirely rather than the taxation of it once.\footnote{The nonpecuniary recovery could be subjected to tax "once" if it were required to be invested in an annuity, in which case the annuity income would be taxed. But nonpecuniary recoveries are not categorically intended to replace future streams of income, or utility. Thus, a reinvestment requirement here would be gratuitous.} Mathematically, this is nonsense; proportionality would be achieved by excluding only half of the pain-and-suffering damages. In addition, the statement that investment income is taxed twice is only true in present value terms\footnote{See supra note 100.} and only under a "correct" capital recovery system.\footnote{Accelerated writeoffs have the effect of exempting all or some of the income from tax. \textit{See, e.g.,} DODGE, supra note 27, at 238-52.}

Similarly, it is inaccurate to say that wage income is only taxed once, because both "human-capital" capital expenditures and accessions are ignored.\footnote{For example, educational expenses are nondeductible, except when they maintain or improve the taxpayer's existing business. Treas. Reg. § 1.162-5 (1967). Nondeductible "human-capital" capital expenditures produce no depreciation or loss deductions, even though human capital is a wasting asset.} Thus, the relationship of wage income to investment income cannot be reduced to a constant ratio. Though the differences are significant, the ultimate burden on wage and investment income is not so radically different as to justify, by inference, a total exclusion for pain-and-suffering damages.

A less metaphysical, but more plausible, argument for excluding noneconomic recoveries is simply that the transaction, as a whole, represents a net decrease in the taxpayer's "utility." That is, the plaintiff would be in a worse, not better, position if the recovery for nonpecuniary loss were taxed. Even working in an awful job presumably entails some increase in taxpayer utility; otherwise the employment would not have been undertaken. People do not risk life and limb in the hope of obtaining noneconomic damage recoveries, presumably because such transactions are acknowledged to be "losers" or, at least too risky.\footnote{For purposes of this analysis, it is irrelevant that laborers sometimes make bad bargains or that tort victims sometimes end up with good ones. Tax rules cannot be tailored to subjective differences among individuals.}
One reason for taxing transactions which generate a utility gain is that the tax, if designed properly, will not unduly inhibit socially desirable activity.\textsuperscript{201} It does not follow, however, that involuntary transactions should be exempt from tax. Taxing plaintiffs on noneconomic damages will, if anything, increase deterrence and net social utility, especially if courts and juries shift plaintiff taxes to defendants.

The no-utility-gain argument raises the fundamental issue of the role of "utility" in taxation. Utility in taxation must be distinguished from utility in social welfare. Progressive rates in taxation, for example, have been justified on the theory that sacrificing dollars is less burdensome, in utility terms, on the rich than it is on the poor.\textsuperscript{202} Similarly, the desirability of excluding employee fringe benefits can be questioned on economic efficiency grounds. Excluding nonpecuniary damage recoveries has the effect of enriching personal injury plaintiffs relative to taxpayers generally. This kind of subsidy is subject to classic "tax expenditure" analysis,\textsuperscript{203} but apparently no welfare economist has undertaken to justify a discrete subsidy to plaintiffs receiving noneconomic damages.\textsuperscript{204} Any "economic incentive" justification for the exclusion is totally implausible. A social welfare claim based, at most, on a "hunch" is not a persuasive justification for this aspect of the section 104 exclusion. Finally, the tax rule for nonpecuniary loss recoveries does not ultimately solve the social welfare equation. Even if such recoveries are taxed to plaintiffs, the legal (tort) system can compensate plaintiffs for the incremental tax burden by shifting it to defendants.

We are left with the question of whether the core concept of "income" is ultimately tied to that of "utility." In practice, and ignoring "tax expenditure" provisions, the concept of income is not systematically tied to subjective utility, as opposed to changes in objective net wealth. Imputed income from consumer durables, as well as the value of self-provided services and leisure, is ignored. Income is taxed to the person who earns and controls it, not the person who enjoys it.\textsuperscript{205} Amounts includible are measured by mar-

\textsuperscript{201} See Lane, supra note 25, at 31-32, 45-46.
\textsuperscript{202} See Henry Simons, Personal Income Taxation (1938); Walter Blum & Harry Kalven, The Uneasy Case for Progressive Taxation (1953).
\textsuperscript{203} See supra note 36 and accompanying text.
\textsuperscript{204} I am unaware of any such studies.
\textsuperscript{205} E.g., I.R.C. §§ 101(a), 102(a) and 262 (gifts, bequests, and life insurance proceeds); Helvering v. Horst, 311 U.S. 112 (1940) (income from property); Helvering v. Clifford, 309 U.S. 381 (1940) (same); Lucas v. Earl, 281 U.S. 111 (1930) (services income); Gould v. Gould, 245 U.S. 151 (1917) (support payments). But see Centex Homes v. Director, 10 N.J. Tax 473 (N.J. Tax Ct. 1989).
ket transactions, not subjective worth. Deductions, like medical expenses and casualty loss, can be rationalized on a non-utility basis. Other deductions, such as those for charitable contributions and taxes, are allowed despite substantial utility to the taxpayer.

It is not obvious that the income tax base, as opposed to government policy in general, should be tied to utility in any normative sense, though influential commentators operating out of the tradition of Utilitarian welfare economics have made the connection. Though government policy may rely on utility analysis, and although virtually all items considered to be gross income potentially yield utility to the taxpayer (or to the taxpayer’s family and friends), it does not logically follow that the tax base should be equated with utility. The tax base should be equated with material resources that can be appropriated by government for redistributive purposes, or, perhaps, with material resources that represent a claim against society’s store of scarce resources. These concepts of the tax base are objective in principle, not merely as an expedient. Government, which is supported mostly by taxes, has no interest in appropriating utility directly from taxpayers. Utility is subjective; that is, the utility “curves” of various individuals differ. Therefore,

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206 Turner v. Commissioner, 13 T.C.M. (CCH) 462 (1954) only holds that when property is received “involuntarily” and is not transferable, the amount includible is wholesale value, not retail value. It is doubtful that Turner states any general rule. See, e.g., I.R.C. § 83(a)(1); Treas. Reg. § 1.61-21(b) (1989) (retail market value controls).

207 Essentially, basic subsistence and maintenance expenses are deductible because minimal private welfare has priority over any obligation to contribute to government (and, therefore, to the welfare of others). See Dodge, supra note 27, at 117-29; 3 Report of the Royal Commission on Taxation 1-24 (1966) (Canada). The casualty loss deduction may be wrong under an “income” tax; alternatively, the deduction can be viewed as a deduction for duplicative (involuntary) consumption expenditures, as opposed to consumption foregone. See Dodge, supra note 27, at 124-25.

208 Utility plays a marginal role in distinguishing “personal” from “business” expenses. See Treas. Reg. § 1.183-2(b)(9) (1972) (personal pleasure is one factor in determining whether activity is “not for profit”); Moss v. Commissioner, 758 F.2d 211 (7th Cir.), cert. denied, 474 U.S. 979 (1985) (meal expenses). “Forced” consumption in-kind is sometimes said to raise the issue of whether the consumption fits the “dominion and control” aspect of the gross income definition. See Sibla v. Commissioner, 611 F.2d 1260 (9th Cir. 1980). This argument, which is tenuous already, certainly fails when the employer pays a cash allowance to the taxpayer. Commissioner v. Kowalski, 434 U.S. 77 (1977).

209 See Thomas Chancellor, Imputed Income and the Ideal Income Tax, 67 Or. L. Rev. 561 (1988). Elsewhere, I have expressed preference for an objective “ability to pay” concept of the tax base, as opposed to the Haig-Simons definition with its emphasis on “consumption.” Dodge, supra note 27, at 85-105.


211 See Dodge, supra note 27, at 91-94.
the government cannot transfer utility;\textsuperscript{212} it can only deal in money and property. Finally, as a normative concept, "income" is rendered much weaker by burdening it with goals that are unobtainable for practical or political reasons.\textsuperscript{213}

A huge practical advantage would result from eliminating the exclusion for noneconomic damages. In the absence of a "special verdict" that clearly allocates damages among the relevant categories, the line to be drawn would be between possibly excludible human-capital damages and all other includible damages, not between includible punitive damages and all other excludible damages.\textsuperscript{214} It is easier to draw the line around human-capital damages because these losses can be determined objectively and, if necessary, in the tax proceeding, thereby avoiding having to plumb the psyches of judges, juries, and the parties. Indeed, if human-capital recoveries are also includible, as under Scenarios (5) and (6), no need would exist to draw any bright lines. Moreover, under the proposed revision of section 104, recoveries would be deemed to pertain first to human-capital losses to the extent thereof; recoveries would not have to be prorated in any way.

C. Wrongful Death Recoveries

Recoveries that accelerate tax-free receipts of money or property are \textit{prima facie} candidates for exclusion.\textsuperscript{215} The best examples are wrongful death actions, where the recovery is for the lost tax-free support, gifts, and inheritance, which would have derived from the decedent's human capital.\textsuperscript{216} However, the amount of such support actually received would have been "after-tax" amounts; that is, such sums would have been reduced by the decedent's own income taxes before given to the recipients. Therefore, wrongful death recoveries should be treated like recoveries for other personal injuries.

\textsuperscript{212} These arguments are developed at greater length in Joseph M. Dodge, Zarin v. Commissioner: \textit{Musings About Debt Cancellations and 'Consumption' in an Income Tax Base}, 45 Tax L. Rev. 677, 692-96 (1991).
\textsuperscript{213} See Chancellor, supra note 209, at 561-66, 580.
\textsuperscript{214} Recoveries for medical expenses can be identified easily under the rule that damages are deemed to compensate first for such expenses. Rev. Rul. 75-230, 1975-1 C.B. 83.
\textsuperscript{215} Rev. Rul. 67-211, 1967-2 C.B. 63 (wife realizes no income or gain in property settlement incident to a divorce in which she gives up inheritance and support rights). Section 1041 dilutes this result by giving the wife only a carryover basis in the property.
\textsuperscript{216} See Restatement (Second) of Torts § 925 cmts. a & b (1977). The IRS was correct in its holding in Rev. Rul. 75-45, 1975-1 C.B. 47, that an Alabama wrongful death recovery was excludible under § 104, notwithstanding its characterization under Rev. Rul. 58-578, 1958-2 C.B. 38.
If the survivor of a deceased plaintiff succeeds to the plaintiff’s cause of action, any recovery by the survivor should not be treated as a tax-free bequest or inheritance. Instead, the recovery should be treated as “income in respect of a decedent,” meaning that the survivor would step into the decedent’s shoes for tax purposes.\textsuperscript{217}

**CONCLUSION**

The analysis of existing section 104 with respect to recoveries for lost earning capacity yields the interesting conclusion that section 104 is neither categorically right nor wrong with respect to plaintiffs. Rather, plaintiffs end up in the right position after taxes under current section 104 if the damages are calculated in certain ways. However, tort law has been slow to adapt to section 104. As a result, plaintiffs are often overcompensated for human-capital losses. Moreover, if court decisions adapt to section 104, many will view such action as providing a “windfall” to defendants, who would pay less than what plaintiffs receive. The optimal version of section 104 would “adapt” the tax treatment of the recovery for lost human capital to the manner in which damages are computed under state law, because states would not then be influenced by federal tax law. Specifically, recoveries would be deemed to be “first” for lost human capital. However, to be excludible any lump-sum recoveries would be required to be reinvested in a wage-mimicking annuity. If such an adaptive system is not adopted, then Congress must either repeal or retain section 104. Despite the problems with section 104 in its current form, repeal is not necessarily the answer. States can adapt to present section 104 without seriously undermining the deterrence and punishment functions of tort law, because these functions, especially deterrence, can be achieved by punitive damages and damages for noneconomic harms.

Punitive damages and damages for noneconomic harms, as opposed to recoveries for human capital, should not be excluded from income. Such an exclusion is an unwise tax expenditure with no sound basis in either tax theory or general policy. If lawmakers feel sympathetic towards plaintiffs who are taxed on such recoveries, they can enact tort rules to shift the burden to defendants. Finally, including all recoveries in gross income other than, perhaps, certain recoveries for human capital, would make section 104 much easier to administer.

\textsuperscript{217} I.R.C. §§ 691(a), 1014(b).