

Confusion in the Courts: The Failure to Tax Punitive Damages Uniformly in Personal Injury Cases

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Introduction

In 1939, Congress enacted the modern form of the Internal Revenue Code,¹ which details the sources of income that are taxable² and those that are excluded from taxation.³ Section 104(a)(2) of the Internal Revenue Code states that damages received on account of personal injury or sickness are excludable from gross income, and thus not taxable.⁴ In 1989, Congress amended section 104(a)(2) to prevent punitive damages awarded in nonphysical injury and nonphysical sickness cases from qualifying for the exclusion provided under the statute.⁵ Since this congressional enactment, courts have interpreted the meaning of section 104(a)(2) differently, resulting in the disparate tax treatment by federal income taxpayers of punitive damage awards in physical injury cases.⁶

The Uniformity Clause of the Constitution requires that federal income taxes be uniformly imposed on taxpayers throughout the United States.⁷ The purpose of the Uniformity Clause is to prevent any preference of taxpayers in one state or region of the country over

1. After the ratification of the Sixteenth Amendment in February 1913, which explicitly gave Congress the power to "lay and collect taxes on incomes from whatever source derived," Congress passed the Revenue Act of 1913. See DOUGLAS A. KAHN, *FEDERAL INCOME TAX 1-2* (2d ed. 1992). In 1939, Congress codified the revenue acts that it had passed from 1913 to 1939 in the Internal Revenue Code of 1939. *Id.*

2. See, e.g., I.R.C. § 61 (1994).

3. See, e.g., *id.* §§ 102, 104 (1994).

4. In pertinent part, section 104(a) provides:

(a) [G]ross income does not include:

...
 (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness;

Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.

I.R.C. § 104(a) (1994).

Federal income taxation is based on the concept of gross income. If an item of income is "included" in gross income, then it is included (subject to any allowable deductions related to that item) when determining taxable income. If an item is "excluded" from gross income, then it is *not* subject to taxation. See KAHN, *supra* note 1, at 34-188.

5. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a)). Generally, the Act expressly affected the exclusion of punitive damage awards on account of nonphysical injury or nonphysical sickness cases recovered after July 10, 1989. See generally Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 *TAX LAW* 783 (1992).

6. Compare *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995) (holding section 104(a)(2) does not allow exclusion of any punitive damage recovery) with *Horton v. Commissioner*, 33 F.3d 625, 630 n.9 (6th Cir. 1994) (expressly disagreeing with the Ninth Circuit's opinion in *Hawkins*, and holding punitive damages received on account of a personal, tort-type claim are excluded from gross income).

7. U.S. CONST. art. I, § 8, cl. 1.

similarly situated taxpayers in another area of the country.⁸ To apply section 104(a)(2) uniformly among federal income taxpayers, as required under the Uniformity Clause, the judiciary must reach an agreement on the meaning of this statute.

Part I of this Note focuses on relevant Internal Revenue Service (IRS) interpretations⁹ of section 104(a)(2) and the latest congressional amendment to that section. Part II analyzes two recent decisions by the Sixth and Ninth Circuits that reached different conclusions on the ability to exclude punitive damage recoveries in physical injury or physical sickness cases under section 104(a)(2). Part III suggests that these disparate interpretations of section 104(a)(2) by different circuits violate the intent and purpose of the Constitution's Uniformity Clause. Part IV outlines a solution to remedy these violations by setting out a procedure to be followed by federal courts and the IRS when courts reach different conclusions on the meaning of a tax statute. Part V concludes that this issue, however resolved, deserves a swift resolution so that the burden of taxation is shared equally among similarly situated federal income taxpayers.

I. History of Internal Revenue Code Section 104(a)(2)

A. Revenue Act of 1918

Section 213(b)(6)¹⁰ of the Revenue Act of 1918 was the first time Congress excluded personal injury awards from taxable income.¹¹ At that time, Congress based this exclusion on the theory that a personal recovery is compensation for loss of human capital¹² and not income.¹³ That is, the damages recovered in a personal injury case were

8. See *infra* notes 151-155 and accompanying text.

9. See *infra* note 21.

10. Section 213(b)(6) was the precursor to section 104(a)(2). See James D. Egleston, *Taxation of Punitive Damage Awards from Personal Injury Actions: Should the Section 104(a)(2) Exclusion Apply?*, 20 OHIO N.U. L. REV. 117, 121 (1993); see also Henning, *supra* note 5, at 784. For a lengthy discussion of the history of section 104(a)(2) and one author's belief of the theoretically correct treatment of punitive damages, see James Serven, *The Taxation of Punitive Damages: Horton Lays an Egg?*, 72 DENV. U. L. REV. 215 (1995).

11. See Henning, *supra* note 5, at 784 n.6 (referencing Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1066 (1919)).

12. See Henning, *supra* note 5, at 784.

13. Cf. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (reversing a line of cases by holding that punitive damages received in an antitrust suit were not a return of capital, but rather income). "The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property." *Id.* at 432 n.8. But see Timothy R. Palmer, Note, *Internal Revenue Code Section 104(a)(2) and the Exclusion of Personal Injury Damages: A Model of Inconsistency*, 15 J. CORP. L. 83, 124-25

awarded in "an attempt to make the [injured party] whole,"¹⁴ and not to place the injured party in a better position than before the accident. After the enactment of section 213(b)(6) of the Revenue Act of 1918, subsequent interpretations of the statute¹⁵ expanded the exclusion of income to *nonphysical* personal injuries such as defamation,¹⁶ libel,¹⁷ and slander.¹⁸ In 1975¹⁹ and 1984,²⁰ the IRS issued Revenue Rulings²¹ describing the IRS interpretation of the taxation of punitive damages under section 104(a)(2) of the Internal Revenue Code, which is the present codification of section 213(b)(6) of the Revenue Act of 1918.²²

B. Prior to Revenue Ruling 75-45

Prior to the IRS publication of Revenue Ruling 75-45, the United States Supreme Court in 1955 decided *Commissioner v. Glenshaw Glass Co.*²³ Although *Glenshaw Glass* involved fraud and antitrust issues, and thus the decision did not directly interpret section 104(a)(2), the decision made a distinction between punitive and compensatory damages when deciding whether a damage award must be included in gross income for purposes of computing federal income tax.²⁴ Specifically, the Court in *Glenshaw Glass* held that punitive damages received for injuries resulting from fraud and antitrust violations must be included in gross income.²⁵ In its analysis, the Court stated that the IRS had previously allowed personal injury recoveries to be exempt from taxation only when the recovery "roughly corre-

(1989) (arguing that the statement made by the Court in footnote eight of *Glenshaw Glass* is pure dicta as it applies only in antitrust cases, not physical injury cases).

14. See Henning, *supra* note 5, at 796 & n.109 (citing *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1025 (1927), *acq.* VII-I C.B. 14 (1928)); see also Paul C. Feinberg, *Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions*, 42 CASE W. RES. L. REV. 339, 370-71 (1992).

15. See Henning, *supra* note 5, at 784-85 & n.12 (citing Sol. Op. 132, I-1 C.B. 92 (1922)).

16. See *Hawkins v. Commissioner*, 6 B.T.A. 1023 (1927), *acq.* VII-I C.B. 14 (1928).

17. See *Seay v. Commissioner*, 58 T.C. 32 (1972); see also Henning, *supra* note 5, at 785 & n.13.

18. See Henning, *supra* note 5, at 785 & n.13.

19. Rev. Rul. 75-45, 1975-1 C.B. 47, *revoked by* Rev. Rul. 84-108, 1984-2 C.B. 32.

20. Rev. Rul. 84-108, 1984-2 C.B. 32, *revk'g* Rev. Rul. 75-45, 1975-1 C.B. 47.

21. A "Revenue Ruling" is the IRS *interpretation* of a section of the Internal Revenue Code. See *Tax Analysts and Advocates v. Commissioner*, 362 F. Supp. 1298, 1302-03 (D.D.C. 1973) (stating an IRS interpretation of a statute is limited in future weight and authority). Usually, the IRS will base its interpretation on facts given in one or more hypotheticals. *Id.* at 1302 n.15. Revenue Rulings are *not* controlling and hold only persuasive value. *Id.* at 1306. Moreover, the persuasiveness of the Revenue Ruling is limited in applicability to the facts in the stated hypothetical. *Id.* at 1302 & n.15.

22. See Egleston, *supra* note 10, at 121.

23. 348 U.S. 426 (1955).

24. *Id.* at 427; see *Palmer*, *supra* note 13, at 124-25.

25. *Glenshaw Glass*, 348 U.S. at 432-33.

spond[ed] to a return of [the injured's] capital."²⁶ Under this reasoning, punitive damages were required to be included in gross income because punitive damages did not restore the plaintiff's loss of capital.²⁷ Rather, as the Court stated, punitive damages represent the "amount extracted as punishment" for the defendant's wrongdoing.²⁸ Thus, in the years following *Glenshaw Glass*, the question arose whether punitive damages awarded in personal injury cases were legally excludable from gross income under section 104(a)(2).

C. Revenue Ruling 75-45

By issuing Revenue Ruling 75-45, the IRS attempted to assert its position on whether the punitive-compensatory distinction elicited in *Glenshaw Glass* should also apply to section 104(a)(2).²⁹ In Revenue Ruling 75-45, which interpreted the language of section 104(a)(2),³⁰ the IRS stated that "the amount of *any* damages received (whether by suit or agreement) *on account* of personal injuries or sickness" is excludable from gross income.³¹ Specifically, the Ruling stated that "any damages" meant that both compensatory and punitive damages resulting from a personal injury or sickness case were excluded from gross income.³² By issuing this Ruling, the IRS made very clear that the punitive-compensatory distinction drawn in *Glenshaw Glass* did not apply to recoveries that qualified under section 104(a)(2).

D. Revenue Ruling 84-108

Nine years after issuing Revenue Ruling 75-45, the IRS expressly revoked that Ruling when the Service issued Revenue Ruling 84-108.³³ In Revenue Ruling 84-108, the IRS focused its analysis of the tax status of punitive damage awards—included or excluded from gross income—on whether the state statute under which the award was granted considered punitive damages to be compensation for the plaintiff's injury or punishment for the tortfeasor's wrongdoing.³⁴ Specifically, Revenue Ruling 84-108 analyzed damage awards received in wrongful death actions under two state statutes: first, a Virginia statute that limited the recovery to the actual loss sustained from

26. *Id.* at 432 & n.8.

27. *Id.*

28. *Id.* at 431.

29. See Henning, *supra* note 5, at 784; see also Palmer, *supra* note 13, at 124-25.

30. The language of section 104(a)(2) remains virtually the same today as when Revenue Ruling 75-45 was issued. In 1989, however, Congress made an amendment to the statute which limited the statute's scope. See *infra* notes 42-48 and accompanying text.

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

32. *Id.*

33. Rev. Rul. 84-108, 1984-2 C.B. 32.

34. *Id.*

the wrongful death, and did not allow for recovery of punitive damages;³⁵ and second, an Alabama statute that provided exclusively for the recovery of punitive damages.³⁶ In its final analysis of 84-108, the IRS stated that only the damages under the Virginia statute, which called the recovery in a wrongful death action compensatory damages, were excludable from taxable income under section 104(a)(2).³⁷ Additionally, the IRS concluded that the damages recovered under the Alabama statute were fully taxable because the State of Alabama considered these recoveries purely punitive and not compensatory.³⁸

Two years after the publication of 84-108, in *Burford v. United States*, a district court in Alabama severely criticized this ruling.³⁹ In contradiction to Revenue Ruling 84-108, the *Burford* court held that damages received under the Alabama wrongful death statute were excludable from gross income.⁴⁰ Five years after the IRS issued Revenue Ruling 84-108, Congress passed an amendment to section 104(a)(2).⁴¹

35. *Id.* (citing *Wilson v. Whittaker*, 154 S.E.2d 124 (Va. 1967)).

36. *Id.* (citing *Alabama Power Co. v. Irwin*, 72 So. 2d 300 (Ala. 1954)).

37. *Id.* Under this reasoning, it would appear that a recovery might be inflated to include "compensatory" damages that were in fact partially "punitive" to retain the necessary character to be excluded from taxes under section 104(a)(2). For the possible impact on the size of a damage award when the jury has knowledge that the award will be taxed, see Edward Yorio, *The Taxation of Damages: Tax and Nontax Policy Considerations*, 62 CORNELL L. REV. 701, 719-22 (1977) (arguing a jury's awareness of the taxability of a damage award will cause it to make the award higher to make the victim "whole" again). *Contra infra* notes 39-40 and accompanying text (noting a federal district court's conclusion that exclusion of an award under section 104(a)(2) should be based on the underlying action, and not based upon how a state legislature may label the recovery as "punitive" or "compensatory").

38. Rev. Rul. 84-108, 1984-2 C.B. 32. The IRS based its conclusion on *Starrels v. Commissioner*, 304 F.2d 574 (9th Cir. 1962), *aff'g* 35 T.C. 646 (1961), which held that punitive damages were not excluded from income under section 104(a)(2) because punitive damages were awarded based on a defendant's degree of fault, and not for recovery of a loss of human capital. See *supra* notes 11-14 and accompanying text.

39. Specifically, the court argued against the revenue ruling by holding that recovery of damages for a wrongful death is directly related to a personal injury—the fatal injury of the deceased—and the plain language of section 104(a)(2) allows for exclusion of any damages. 642 F. Supp. 635, 637-38 & n.5 (N.D. Ala. 1986); see also Craig Day, *Taxation of Punitive Damages: Interpreting Section 104(a)(2) After the Revenue Reconciliation Act of 1989*, 66 WASH. L. REV. 1019, 1023 (1991) (summarizing the *Burford* court's criticism of Revenue Ruling 84-108).

40. *Burford*, 642 F. Supp. at 638.

41. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989) (codified at I.R.C. § 104(a)).

E. The Omnibus Budget Reconciliation Act of 1989

In 1989, in an apparent attempt to clarify⁴² the scope of section 104(a)(2), Congress amended the statute.⁴³ The statute now states that paragraph (a)(2) "shall not apply to any punitive damages in connection with a case *not* involving physical injury or physical sickness."⁴⁴ Under this amendment, punitive damages awarded in *nonphysical* injury or sickness cases clearly fall outside the scope of section 104(a)(2) and therefore are not eligible for exclusion from gross income.⁴⁵ Thus, it would seem that punitive damages awarded in *physical* injury cases were not impacted by this amendment and therefore, should continue to maintain their "excluded from gross income" status held prior to the amendment.⁴⁶ However, several recent court decisions have reached different conclusions on whether punitive damages awarded in cases "involving physical injury or physical sickness"⁴⁷ are currently excludable from gross income under section 104(a)(2).⁴⁸

In light of the history of section 104(a)(2), including the ever-changing IRS position as reflected in its Revenue Rulings and the 1989 congressional amendment to the statute, the courts have diligently assumed the responsibility of determining the final meaning of section 104(a)(2) regarding the taxation of punitive damages in physical injury and sickness cases.

42. However, as this Note will show, apparent congressional attempt to clarify section 104 resulted in only more confusion, especially with respect to punitive damages. See *infra* notes 72-77, 128-130 and accompanying text.

43. See *supra* note 5.

44. I.R.C. § 104 (1994) (emphasis added). It is interesting to note that this is the first and only mention of "punitive damages" in section 104. Specifically, the amendment changed the statute to state now that punitive damages in nonphysical injury and nonphysical sickness cases are not excludable from gross income under section 104(a)(2). The amendment did not expressly mention the impact, if any, on punitive damages in physical injury and physical sickness cases.

Before the amendment, punitive damages in all personal injury, tort-type claims were excludable from gross income under the statute. See *Horton v. Commissioner*, 33 F.3d 625, 629 (6th Cir. 1994) (relying on *United States v. Burke*, 504 U.S. 229, 237 (1992)). Nonetheless, in light of this 1989 amendment, some courts have held that exclusion under section 104 should apply only to compensatory damages because that section is entitled "Compensation for injuries or sickness." See *Hawkins v. United States*, 30 F.3d 1077, 1083-84 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); *Reese v. United States*, 24 F.3d 228, 231 (Fed. Cir. 1994); see also *infra* notes 79-84. If Congress intended to allow only the exclusion of compensatory damages under section 104, then there was no reason to include the last clause of the amendment. That is, the amendment would have stated that "paragraph 104(a)(2) shall not apply to any punitive damages," and Congress would have eliminated the phrase "in connection with a case not involving physical injury or sickness."

45. See *Egleston*, *supra* note 10, at 127 & n.79.

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

47. I.R.C. § 104 (1994).

48. See, e.g., *Horton*, 33 F.3d at 630; *Hawkins*, 30 F.3d at 1078.

II. Two Methods of Interpreting Section 104(a)(2)

Within the last year, several circuits have attempted to interpret the scope of section 104(a)(2).⁴⁹ Generally, these courts have employed two methods in analyzing the meaning of section 104(a)(2) and have reached different conclusions on the excludability of punitive damages awarded in physical injury or physical sickness cases under section 104(a)(2).⁵⁰ One method of interpreting section 104(a)(2), as illustrated by the Ninth Circuit's decision in *Hawkins v. United States*, focuses on analyzing the sparse legislative history⁵¹ and purpose for awarding punitive damages, resulting in a determination that *no* punitive damage award (regardless of the type of underlying case) is excludable from gross income under section 104.⁵² The other approach, which is represented by the Sixth Circuit's decision in *Horton v. Commissioner*, relies on case law interpreting the pre-1989 section 104(a)(2) and on the plain language of the statute.⁵³ This second method finds that punitive damages in cases of physical injury or personal sickness cases are excludable from gross income under section 104(a)(2).⁵⁴

A. The Ninth Circuit Approach in *Hawkins v. United States*

A recent Ninth Circuit decision, *Hawkins v. United States*,⁵⁵ inter-

49. See, e.g., *Wesson v. United States*, 48 F.3d 894 (5th Cir. 1995); *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994); *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994); *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994).

50. See *supra* note 6.

51. A brief summary of the legislative history provides:

The House Ways and Means Committee Report and House bill made no mention of the tax treatment of punitive damages. The Senate version of the budget bill contained no provisions amending or limiting section 104(a)(2). The conference committee, however, agreed to end the tax-free treatment of punitive damage recoveries when physical injury or sickness is not involved, but declined to require physical injuries or sickness in order for nonpunitive damage recoveries to be excludable.

Henning, *supra* note 5, at 800; see *id.* at 800 & nn.138-41.

52. *Hawkins*, 30 F.3d at 1080-84; see, e.g., *Wesson v. United States*, 48 F.3d 894 (5th Cir. 1995).

53. *Horton*, 33 F.3d at 629-31. According to *Nalle v. Commissioner*, 997 F.2d 1134, 1139 (5th Cir. 1993), "it is a tenet of statutory construction that every word must be given meaning." Under the plain language approach, the statement in section 104(2)(a) that "any damages received" are excludable must mean *any* damages and not some damages. See *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting).

54. See *Horton*, 33 F.3d at 630.

55. 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995). In denying review in *Hawkins* on June 19, 1995, the Court may have believed this issue was decided by its June 14, 1995 opinion in *Commissioner v. Schleier*, 115 S. Ct. 2159 (1995) (6-3). The issue in *Schleier*, however, was whether liquidated damages awarded in an age discrimination suit were excludable under section 104(a)(2). In reversing the IRS position of the past 35 years that these damages were excludable from gross income, see *id.* at 2171 (O'Connor, J.,

preted section 104(a)(2) to mean that *any* punitive damage recovery is taxable and thus *not* excludable from gross income.⁵⁶ In *Hawkins*, the Ninth Circuit based its decision on the return of lost-human-capital theory.⁵⁷ That is, only the costs associated with making the taxpayer “whole” should be excluded under section 104(a)(2).⁵⁸ Because “purely punitive awards . . . ‘are not intended to compensate the injured party, but rather to punish the tortfeasor whose wrongful action was intentional or malicious, and to deter him and others from similar extreme conduct,’”⁵⁹ the Ninth Circuit concluded that any punitive

dissenting), the Court held in *Schleier* that liquidated damages were not received “on account of personal injuries or sickness.” *Id.* at 2164. The Court in dicta stated that pain and suffering recoveries are excludable under 104(a)(2), but punitive damages, which include liquidated damages, are not. *Id.* To determine whether a recovery may be excluded under section 104(a)(2), the Court “created” a two-part test that, in fact, relied on the test in its earlier decision in *United States v. Burke*, 504 U.S. 229 (1992): “First, the taxpayer must demonstrate that the underlying cause of action . . . is ‘based upon tort or tort type rights’; and second, the taxpayer must show that the damages were received ‘on account of personal injuries or sickness.’” *Schleier*, 115 S. Ct. at 2167 (quoting *Burke*, 504 U.S. at 234). This was similar to the test used by the court in *Horton*, in which the Sixth Circuit determined punitive damages awarded in a personal injury case satisfied this two-part test and thus were excludable from gross income. *Horton*, 33 F.3d at 630-31.

56. *Hawkins*, 30 F.3d at 1081, 1084. *But cf.* *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994) (same two judges who constituted the majority in *Hawkins* joined the dissenter in *Hawkins* in holding *punitive* damage payments made in settlement of a suit under the Age Discrimination in Employment Act (ADEA) are excludable under section 104(a)(2)).

Schmitz was decided six weeks after *Hawkins*. In *Schmitz*, the Ninth Circuit tried to square its decision with its opinion in *Hawkins* by allegedly applying the same two-part test it applied in *Hawkins*. *Schmitz*, 34 F.3d at 792. The taxpayer “must show both (1) that the underlying cause of action was tort-like . . . and (2) that the damages were received ‘on account of’ the taxpayer’s personal injury.” *Id.* (citations omitted). Judge Trott, the dissenter in *Hawkins*, pointed out in his concurrence, however, that the ADEA liquidated damages awarded to *Schmitz*, like punitive damages, “are intended to punish and deter” the tortfeasor. *Id.* at 798 (Trott, J., concurring). Therefore, “[b]ased on [the majority’s decision in] *Hawkins*, ADEA liquidated damages should be taxable.” *Id.* at 799.

Additionally, agreeing with the Ninth Circuit, Justice O’Connor in her dissent in *Schleier* stated that ADEA liquidated damages should be excluded from gross income under 104(a)(2) since liquidated damages “are tort like because they ‘compensate victims for damages which are too obscure and difficult to prove.’” *Schleier*, 115 S. Ct. at 2169 (O’Connor, J., dissenting).

57. *Hawkins*, 30 F.3d at 1083-84. In explaining its decision, the court stated, “we find that the exemption [under section 104(a)(2)] does not apply to punitive damages which bear no relationship to actual injuries, do not even purport to compensate the victim for actual losses, and cannot rationally be characterized as anything but a windfall.” *Id.* at 1084; *see also supra* notes 13-14 and accompanying text.

58. *Hawkins*, 30 F.3d at 1083. Specifically, the Ninth Circuit relied on its earlier decision, made before Revenue Ruling 75-45, in *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962). *Starrels*, however, did not involve punitive damages, and thus the comments by the Ninth Circuit in 1962 were dicta. *See Palmer, supra* note 13, at 125.

59. *Hawkins*, 30 F.3d at 1083 (quoting *City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 266 (1981)).

damage award is taxable⁶⁰ and not excludable under section 104(a)(2).⁶¹

In *Hawkins*, the taxpayers crashed their automobile⁶² and sought reimbursement from their insurance carrier, Allstate.⁶³ After Allstate pressured the Hawkinses into purchasing an inferior car as a replacement for their totalled car,⁶⁴ the Hawkinses sued Allstate for breach of good faith and fair dealing.⁶⁵ The Hawkinses received a compensatory award of \$15,000 and a punitive award of \$3.5 million.⁶⁶

In 1988,⁶⁷ when the Hawkinses filed their income taxes reflecting these awards, they reported the punitive award as gross income⁶⁸ because they did not believe punitive damages were excludable from gross income under section 104(a)(2).⁶⁹ Later, the Hawkinses filed an amended return based on their new belief that punitive damages based on personal injury were excludable under section 104(a)(2).⁷⁰ In their amended return, the Hawkinses requested a refund of \$793,277.⁷¹ The Hawkinses based their new understanding of section

60. In reaching its holding, the Ninth Circuit overruled the district court's opinion that the Hawkinses punitive damages were excludable under section 104(a)(2). *Id.* at 1080; see *Hawkins v. Allstate*, 733 P.2d 1073 (Ariz. 1987); cf. *Schmitz*, 34 F.3d at 795-96 (holding ADEA liquidated damages are excludable under section 104(a)(2) because those damage awards serve a compensatory purpose, and thus are not punitive); *supra* note 56.

61. *Hawkins*, 30 F.3d at 1084. *But cf. Schmitz*, 34 F.3d at 796 (stating that "[l]iquidated damages are traditionally compensatory; punitive damages are not").

62. *Hawkins*, 30 F.3d at 1078.

63. *Id.* at 1079.

64. The value of the Hawkinses' original car, prior to being totalled was \$8000. *Id.* at 1078. Allstate convinced the Hawkinses to settle for a car worth only \$6,741. Furthermore, Allstate did not outfit the new car with certain options as Allstate had agreed. *Id.* at 1079.

65. Without providing more facts, the Ninth Circuit stated that the Hawkinses "suffered 'personal injuries' as a result of Allstate's conduct." *Id.* at 1079. The court implied that the Hawkinses suffered mental distress due to Allstate's actions, and these injuries qualify as "personal injuries" for purposes of section 104. *Id.* (citing *Bates v. Superior Court*, 749 P.2d 1367, 1370 (Ariz. 1988)).

66. *Id.* at 1079.

67. It should be noted that the Ninth Circuit recognized the 1989 amendment to section 104(a)(2), but that change did not impact this case because the Hawkinses received their damage awards in 1988. See *supra* notes 5, 42-48 and accompanying text. However, because the Hawkinses relied on the 1989 change to the statute in arguing that the congressional intent was only to tax punitive damages in nonphysical injury and sickness cases, the court analyzed the current meaning of the statute. *Hawkins*, 30 F.3d at 1082. Ultimately, the Ninth Circuit rejected the Hawkinses' assertion. *Id.*

68. The actual amount reported as gross income was \$2,937,406, which equals the \$3.5 million punitive award less expenses, attorney fees, and costs. *Id.* at 1079.

69. *Id.*

70. *Id.*

71. *Id.* A limited survey of cases involving taxpayers who paid taxes and then asked in amended returns for refunds indicates that taxpayers are not likely to prevail on their claim. In 1992, the IRS kept \$276 million—approximately 63% of all previously paid

104(a)(2) on the 1989 change to the statute.⁷² Specifically, they argued that this amendment expressly stated that punitive damages recovered *after* July 10, 1989 from nonpersonal injury cases were not excludable under section 104(a)(2).⁷³ By implication, the Hawkinses argued that *before* July 10, 1989, punitive damages from nonpersonal injury cases and personal injury cases were excluded.⁷⁴ Thus, the 1989 amendment impacted only one class of punitive damages—those awarded in *nonphysical* injury or *nonphysical* sickness cases.

The Ninth Circuit did not agree.⁷⁵ The court stated that “Congress may amend a statute simply to clarify existing law, to correct a misinterpretation, or to overrule wrongly decided cases.”⁷⁶ Thus, the court found that the Hawkinses incorrectly interpreted the congressional purpose for enacting the 1989 amendment, and incorrectly concluded that punitive damages in personal injury cases are excludable from gross income.⁷⁷

taxes—in the lawsuits in claims court or district court. DEP’T OF TREASURY, IRS ANN. REP. 50 (1992). Interestingly, the taxpayer lost 85% of all Tax Court cases in 1992. *Id.*

However, these Tax Court results do not hold true on whether punitive damage awards in physical injury cases are excludable from gross income. Generally, the Tax Court has ruled in favor of the taxpayer in holding that punitive damages in physical injury cases are excludable under section 104. *E.g.*, *Horton v. Commissioner*, 100 T.C. 93 (1993) (16-3); *Commissioner v. Miller*, 93 T.C. 330 (1989), *rev’d*, 914 F.2d 586 (4th Cir. 1990); *see also* Robert A. Clifford, *Courts, IRS Disagree on Whether Punitive Damages Taxable*, CHICAGO LAW., March 1995, at 13 (referring to the disparate court opinions on the issue of taxation of punitive damages under section 104(a)(2)). Mr. Clifford suggests that the court (federal district court or Tax Court) that decides the case is the determinative factor of success:

This split has created an anomalous situation for personal injury claimants: Those who report the damages as income, pay the tax, and then seek a refund must do so through federal court, where the taxpayer generally loses. However, if instead the taxpayer decides not to report the punitive damages as income, he is likely to face a claim brought by the IRS and wind up in Tax Court. In *Horton*, the taxpayer fared better [in the Tax Court] because the IRS position was rejected and the income was held not taxable.

Id.

72. *Hawkins*, 30 F.3d at 1082.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* However, all three of the court’s stated purposes for amending a statute fall into the court’s first stated category: clarification. That is, both correcting a misinterpretation of a statute and overruling a court decision that incorrectly interpreted the statute involve *clarifying* the statute’s meaning so that a proper interpretation of the law can be made.

77. *Id.* If the congressional intent in the 1989 amendment was to make *all* punitive damages taxable, as is suggested by the Ninth Circuit, then it would have expressly stated so. This 1989 amendment was the first time that Congress used the word “punitive” in the statute. *See supra* note 44.

It appears that the Ninth Circuit is imploring Congress to clarify this issue. Because of the unpopularity of raising taxes among constituents, however, this congressional silence

After rejecting these arguments, the Ninth Circuit looked at the legislative history of the 1989 amendment to section 104(a)(2).⁷⁸ Prior to 1989, a majority, if not all, of courts held that section 104(a)(2) allowed for the exclusion of punitive damages in a variety of cases.⁷⁹ These cases included punitive damages awarded in employment discrimination and injury to reputation suits.⁸⁰ The court recognized that the legislative history indicated that "Congress was not concerned with punitive damages, but with nonphysical injury cases."⁸¹ Originally, the House wanted all recoveries received on account of nonphysical injuries to be completely taxable, and thus not covered under section 104(a)(2).⁸² The Senate, however, refused to pass this version.⁸³ In conference, the House and Senate agreed to a compromised amendment to section 104(a)(2) that withdrew only punitive damages recovered in nonphysical injury cases from the exclusion under section 104(a)(2).⁸⁴

After the Ninth Circuit reviewed the legislative history of the statute and determined that it lacked sufficient clarity to decide the issue of the taxability of punitive damages in physical injury cases, the court focused on the policy concerns for not including these punitive damage awards under section 104(a)(2).⁸⁵ In its analysis, the court relied on its earlier opinion in *Starrels v. Commissioner*.⁸⁶ Specifically, the Ninth Circuit reaffirmed its finding in *Starrels* and stated that damages recovered from personal injury actions may be excluded from gross income only to the extent that the damages "restore a loss to capital."⁸⁷ The court further held that the purpose of awarding puni-

may signal an actual desire for the courts to interpret the statute as did the Ninth Circuit in *Hawkins* to raise critically needed revenue.

78. *Hawkins*, 30 F.3d at 1082 n.6.

79. *Id.* at 1082 (citing *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983) and *Commissioner v. Miller*, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990)); *see Horton*, 33 F.3d at 631 n.12 (refuting the Ninth Circuit's majority decision in *Hawkins*).

80. *Hawkins*, 30 F.3d at 1082 (citing *Threlkeld v. Commissioner*, 848 F.2d 81, 83-84 (6th Cir. 1988), *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983), and *Commissioner v. Miller*, 93 T.C. 330 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990)).

81. *Hawkins*, 30 F.3d at 1082 n.6. With this admission, it is difficult to ascertain how the Ninth Circuit came to the conclusion that it ultimately reached. That is, if before the 1989 amendment, punitive damages in both physical and nonphysical injury cases were excluded from gross income under section 104, and the court admitted that the 1989 change focused on recoveries received in nonphysical injury cases, then the 1989 change should not impact punitive damage recoveries in physical injury cases.

82. *Id.* (citing H.R. REP. NO. 247, 101st Cong., 1st Sess. 1354-55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2824-25).

83. *Id.* (citing H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 623 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 3225-26).

84. *See id.*

85. *Id.* at 1083.

86. 304 F.2d 574 (9th Cir. 1962).

87. *Hawkins*, 30 F.3d at 1083 (citing *Starrels*, 304 F.2d at 576).

tive damages was not to restore a plaintiff's loss of human capital, but rather to serve as a means of punishment to the tortfeasor for wrongdoing.⁸⁸

When applying this rationale in the *Hawkins* case, the court held that the compensatory award was the only amount eligible for exclusion under 104(a)(2) because that amount was directly related to restoring the Hawkinses' loss of capital.⁸⁹ However, the \$3.5 million punitive award was not compensation for restoring any loss of capital sustained by the Hawkinses.⁹⁰ Rather, as the court described, receiving a punitive award is akin to winning the "litigation lottery."⁹¹ Specifically, the punitive award was granted solely to punish Allstate for its alleged bad faith.⁹² Because the punitive award was granted not to compensate the Hawkinses for their injuries, but to punish Allstate for its tortious conduct, the Hawkinses were not allowed to exclude the punitive damages from their gross income under section 104(a)(2).⁹³

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.* at 1084. An analysis of the taxation of a punitive award under the *Hawkins* approach, however, provides a different conclusion. Under the *Hawkins* holding, the real winner in the "litigation lottery" is the government. Two examples, one when the government is the losing party, and the other when a private individual or company is the losing party, will demonstrate the impact of the taxation of punitive damages. For simplicity purposes, assume a 40% tax rate, 30% attorney's fee, and 20% deductible litigation expenses. *First scenario: Government as the tortfeasor.*

When the federal government is found guilty of tortious conduct, the government effectively only has to pay 68% of the judgment. The federal government will pay 100% of the judgment, but will receive 32% of the judgment back when the taxpayer and her attorney pay taxes (see below), resulting in only 68% outlay of funds by the government.

The successful claimant will ultimately recover only 30% percent of the award. The claimant will receive 100% of the judgment and will be able to deduct 20% for expenses and 30% for attorney fees. Then, the taxpayer will be taxed on the remaining 50%, resulting in a tax bill of 20% of the actual judgment. Thus, the taxpayer will receive only 30% of the judgment.

The attorney will be taxed on his or her 30% as ordinary income, resulting in approximately 12% of the judgment, thus receiving 18% of the punitive damage award.

In the final analysis, the government will receive approximately 32% of the judgment in taxes: 20% from the claimant and 12% from the attorney. Thus, the approximate percentage distribution of the judgment after taxes would be: 32% to the government, 30% to the plaintiff, 18% to the plaintiff's attorney, and 20% for expenses.

Second scenario: Private individual as the tortfeasor.

Unlike the situation where the government is the tortfeasor and receives a set-off of the actual judgment from the taxes paid by the winning party and her attorney, the private company or individual as tortfeasor must pay 100% of the punitive damage judgment. Nevertheless, the government will still benefit by receiving 32% of the judgment through taxes from the successful claimant and her attorney (see above scenario). Therefore, by receiving 32% of the judgment, the government gains an unearned windfall.

92. *Id.* at 1083.

93. *Id.*

Thus, under the Ninth Circuit's reasoning, punitive damage awards are not excludable from gross income under section 104(a)(2) because these damages neither relate to restoring nor provide compensation for a party's loss of capital, but rather punish the tortfeasor for wrongdoing.

B. The Sixth Circuit Approach in *Horton v. Commissioner*

One month after the Ninth Circuit decided *Hawkins*, the Sixth Circuit decided the same issue in *Horton v. Commissioner*.⁹⁴ The Sixth Circuit, however, expressly disagreed with the Ninth Circuit's reasoning in *Hawkins*.⁹⁵ In *Horton*, the Sixth Circuit held that the plain language of section 104(a)(2) allows for the exclusion of punitive damages if those damages meet the test adopted by the United States Supreme Court in *United States v. Burke*.⁹⁶ Under the *Burke* test, the underlying injury must be personal and result from a tort-type claim.⁹⁷ *Burke*, however, did not consider the effect of the 1989 amendment to section 104(a)(2). Thus, in *Horton*, the Sixth Circuit held that only damages that meet the *Burke* test, and are received due to physical injuries or physical sickness, may be excluded from gross income.⁹⁸

In *Horton*, the plaintiffs were injured when their house exploded because of a gas leak that the defendant power company failed to detect.⁹⁹ The jury awarded the Hortons \$103,552 in compensatory damages¹⁰⁰ and \$500,000 in punitive damages.¹⁰¹ Relying on section 104(a)(2), the Hortons excluded the \$500,000 punitive damage recovery from gross income when reporting their 1985 federal income tax.¹⁰² In response, the IRS sent the Hortons a notice of deficiency,

94. 33 F.3d 625 (6th Cir. 1994).

95. *Id.* at 630 n.9. Interestingly, one day after *Horton* was decided, the Ninth Circuit decided *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994). *See supra* note 56. The Ninth Circuit's decision in *Schmitz*, unlike its decision in *Hawkins*, reached a result fairly similar to the court in *Horton* in finding that punitive damages received from personal injury claims are excluded from gross income under section 104(a)(2). *Schmitz*, 34 F.3d at 797 (Trott, J., concurring).

96. *Burke*, 504 U.S. 229 (1992), cited in *Horton*, 33 F.3d at 630-31.

97. *Horton*, 33 F.3d at 631 (citing *Burke*, 504 U.S. at 237).

98. *Id.*

99. *Id.* at 626. The decision does not describe the extent of the Hortons' injuries. The court, however, did state that the Hortons recovered damages on an underlying claim of personal, physical injuries. *Id.* at 631.

100. The jury awarded \$62,265 in compensatory damages to Mr. Horton and \$41,287 in compensatory damages to Mrs. Horton. *Id.*

101. The jury awarded Mr. Horton \$100,000 in punitive damages and Mrs. Horton \$400,000 in punitive damages. *Id.*

102. *Id.* Although the taxpayers' reported income tax was for the year 1985, the taxpayers cited the 1989 amendment as support for their conclusion that section 104(a)(2) allows for exclusion from gross income of punitive damage awards in physical injury cases. *Id.* at 627.

claiming that the punitive damage recovery was not excludable from gross income under section 104(a)(2).¹⁰³

After the Tax Court decided in favor of the Hortons,¹⁰⁴ the Commissioner appealed to the Sixth Circuit.¹⁰⁵ Although the issue decided by the Sixth Circuit centered on whether punitive damages awarded on account of personal injuries are excludable from income under the pre-1989 section 104(a)(2),¹⁰⁶ the Sixth Circuit's analysis is significant because the court analyzed the impact of the 1989 amendment on the current ability to exclude punitive damage recoveries under section 104(a)(2).¹⁰⁷

Upon recognizing that there was no consensus within the federal judiciary on the issue of excluding a punitive damage recovery in personal injury cases from gross income,¹⁰⁸ the Sixth Circuit in *Horton* carefully evaluated each of the Commissioner's arguments.¹⁰⁹ The court also analyzed several recent decisions on the issue¹¹⁰ before ultimately rejecting each of the Commissioner's assertions.¹¹¹ First, the Sixth Circuit rejected the opinion of the Ninth Circuit in *Hawkins* that found that the underlying purpose of section 104(a)(2) was to exclude only those damages, such as compensatory damages,¹¹² which make a taxpayer "whole."¹¹³ The Sixth Circuit stated that "a plaintiff in a personal injury suit who is permanently maimed is really never 'made whole' by compensatory money damages."¹¹⁴ Second, the Commissioner argued that punitive damages, as opposed to compensatory damages, are not received "on account" of a personal injury, and thus should not be excludable under section 104(a)(2).¹¹⁵ The Sixth Circuit

103. *Id.* at 626.

104. *Horton v. Commissioner*, 100 T.C. 93 (1993). In the Tax Court decision, sixteen judges concurred and only three dissented in the conclusion that punitive damage awards received on account of personal injuries are excludable from gross income under section 104(a)(2). *Id.*

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

106. *Id.* at 626.

107. *Id.* at 631 ("[O]ur holding is consistent with [the 1989 revision to] section 104(a)(2) . . . which in effect allows punitive damages awarded in personal injury cases to be excluded from gross income.").

108. *Id.* at 627 (citing *Estate of Wesson v. United States*, 843 F. Supp. 1119, 1121 (S.D. Miss. 1994)).

109. *Horton*, 33 F.3d at 626-32.

110. *Id.* at 628-29 (analyzing *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994), *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990) and *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994)).

111. *Id.* at 630.

112. See *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995).

113. *Horton*, 33 F.3d at 627, 632.

114. *Id.* at 632.

115. *Id.* at 626.

rejected this argument and stated that section 104 did not distinguish between punitive damages and compensatory damages received “on account” of a personal injury.¹¹⁶ Furthermore, the court stated that punitive damages are “inextricably bound up” with the underlying tort-type claim,¹¹⁷ and it is therefore “logical to conclude that punitive damages are received ‘on account’ of [personal injury claims].”¹¹⁸ Third, the Commissioner urged the court to follow the Federal Circuit’s decision in *Reese v. United States*,¹¹⁹ the Fourth Circuit’s decision in *Commissioner v. Miller*,¹²⁰ and the Ninth Circuit’s decision in *Hawkins*¹²¹—all of which held that punitive damages should be included in gross income. The Sixth Circuit distinguished each of these cases by stating that either the statute at issue in the case provided or the plaintiff expressly agreed¹²² that the punitive damage recovery did not serve any compensatory purpose.¹²³

In reaching its decision the *Horton* court adopted the test from *United States v. Burke*.¹²⁴ Specifically, the injury must be personal and

116. *Id.* at 631; *see supra* note 44.

117. *Horton*, 33 F.3d at 630 (quoting *Horton v. Commissioner*, 100 T.C. 93, 99 (1993)).

118. *Id.* (quoting *Horton*, 100 T.C. at 99).

119. 24 F.3d 228 (Fed. Cir. 1994).

120. 914 F.2d 586 (4th Cir. 1990).

121. 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); *see supra* notes 55-93.

122. Reliance on a plaintiff’s statement such as the *Hawkinses*’ is tenuous at best. The *Hawkinses* stated that their compensatory recovery included all damages, including those for emotional distress. *Hawkins*, 30 F.3d at 1080. If they had stated that the award of punitive damages included compensation for emotional distress, then under the Sixth Circuit’s analysis, the *Hawkinses* would be able to exclude punitive damages from their gross income under section 104(a)(2). The Sixth Circuit’s decision in *Horton* will encourage a plaintiff to state that the punitive damage award is partially, if not fully, “compensatory.”

123. *Horton*, 33 F.3d at 632.

124. 504 U.S. 229 (1992). In *Burke*, the Supreme Court decided that backpay awards received in settlement of Title VII claims are not excludable from gross income under section 104(a)(2) because the recoveries are not from an underlying tort-type claim. *Id.* at 241.

Although the Supreme Court in *Burke* overruled the Sixth Circuit’s lower court decision in that case, the Supreme Court expressly approved of the Sixth Circuit’s framework for determining what damages are excludable under section 104(a)(2). *Id.* at 237 (citing *United States v. Burke*, 929 F.2d 1119, 1121 (6th Cir. 1991)). The Sixth Circuit’s framework stated:

that for the purposes of section 104(a)(2), . . . [the inquiry is] whether the injury is personal and the claim resulting in damages is tort-like in nature. If the answer is in the affirmative, then that is “the beginning and end of the inquiry.” The damages resulting from such a claim are fully excludable under section 104(a)(2). At no point do we inquire into the nature of the damages involved. Rather the narrow scope of our gaze is properly limited to the “origin and character of the claim, . . . and not to the consequences that result from the injury.”

Burke, 929 F.2d at 1123 (citations omitted), *rev’d on other grounds*, 504 U.S. 229 (1992).

result from a tort-like claim.¹²⁵ In *Burke*, the Supreme Court stated that the focus of the inquiry under section 104 should be on the type of underlying claim (tort-like or not) and not on the nature of the damages received.¹²⁶ To further support this argument, the Sixth Circuit in *Horton* expressly found that “the plain meaning of the broad statutory language [of section 104(a)(2)] simply does not permit a distinction between punitive and compensatory damages.”¹²⁷

Because the test in *Burke* did not take into full consideration the 1989 amendment to section 104(a)(2), the Sixth Circuit in *Horton* analyzed that amendment:¹²⁸

Since punitive damages in a case not involving physical injury or sickness are singled out as being includable in gross income, the clear implication of Congress’s phraseology is that punitive damages in a case involving physical injury or physical sickness are excludable and were excludable even before the amendment.¹²⁹

Thus, the Sixth Circuit relied on the plain meaning of the statute to conclude that punitive damages in physical injury cases remain excludable from gross income under section 104(a)(2).¹³⁰

In sum, the Sixth Circuit in *Horton* analyzed: first, whether the recovery was “on account of a personal injury”;¹³¹ second, whether the underlying claim was tort-like;¹³² and third, whether the plain language of the statute allowed for the exclusion of *any* recovery result-

125. *Burke*, 504 U.S. at 237.

126. *Id.* (citing *Burke*, 929 F.2d at 1121).

127. *Horton*, 33 F.3d at 631 (quoting *Commissioner v. Miller*, 93 T.C. 330, 338 (1989)). The Sixth Circuit expressly agreed with Judge Trott’s “cogent reasoning” in his dissent in *Hawkins*, which stated that “the Tax Court’s conclusion that the language of [section 104(a)(2)] was unambiguous, permitting no distinction between compensatory and punitive damages is a sound construction of the statute.” *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting), cited in *Horton*, 33 F.3d at 631 n.9.

128. The 1989 amendment stated that “[p]aragraph 2 shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.” Omnibus Budget Reconciliation Act § 7641(a); see *supra* notes 42-48 and accompanying text.

129. *Horton*, 33 F.3d at 631 n.12.

130. As the *Horton* court pointed out, this conclusion is supported by the Supreme Court’s comment in *Burke* that “[in 1989] Congress amended section 104(a) to allow the exclusion of punitive damages only in cases involving ‘physical injury or physical sickness.’” *Burke*, 112 S. Ct. at 1871 n.6, cited in *Horton*, 33 F.3d at 631. That is, the distinction that Congress intended to make with the 1989 amendment to section 104 was whether the underlying injury was physical or nonphysical. If the underlying personal injury was nonphysical, then punitive damages based on that injury would not be excludable from gross income under the amended section 104. The amendment, however, did not change the ability to exclude punitive damages for personal, physical injuries. Thus, punitive damages recovered from an underlying personal, physical injury would continue to be excluded under section 104 if the underlying injury passed the two-part *Burke* test.

131. See *supra* notes 124-125 and accompanying text.

132. See *supra* notes 124, 126 and accompanying text.

ing from a personal injury in an underlying tort-type claim.¹³³ Under this analytical framework, the court held that the Hortons's punitive damages, received on account of a personal injury from the defendant's gross negligence, were excludable under section 104(a)(2).¹³⁴

III. Inconsistent Decisions Result in Unequal Treatment of United States Taxpayers

As both *Hawkins* and *Horton* illustrate, different circuit interpretations result in different taxation of United States taxpayers. For example, under the Ninth Circuit's decision in *Hawkins*, a taxpayer who receives punitive and compensatory damages resulting from a personal, physical injury claim will not be able to exclude the punitive damages under section 104(a)(2), and thus will be fully taxed on the punitive damage award, resulting in a tax of approximately 39.6% of the punitive recovery.¹³⁵ If this same taxpayer, however, was fortunate enough to live within the jurisdiction of the Sixth Circuit,¹³⁶ or within the jurisdiction of courts with similar decisions,¹³⁷ the taxpayer would be able to exclude this punitive damage recovery, essentially retaining 39.6% more of the damage recovery than a similarly situated taxpayer within the jurisdiction of the Ninth Circuit.

This Note argues that this unequal tax treatment violates the Uniformity Clause of the United States Constitution.¹³⁸ The following section proposes a solution and encourages either the Supreme Court or Congress to resolve these inconsistent results which have a materially disparate impact on taxpayers.

A. Background of the Uniformity Clause

After the colonialists won their fight for independence, the Articles of Confederation, the governing document of the new federal sys-

133. See *supra* note 130 and accompanying text.

134. *Horton*, 33 F.3d at 631.

135. This is the marginal rate of taxation for married couples filing jointly with income above \$250,000. I.R.C. § 1 (1994). In *Hawkins*, the taxpayers owed approximately \$800,000 in taxes on a punitive award of \$3.5 million. After expenses and attorney fees, the Hawkinses had approximately \$2.9 million of income. The \$800,000 tax payment due on \$2.9 million of income resulted in an effective tax rate of approximately 27%. See *Hawkins*, 30 F.3d at 1079-82. Without more information than what is provided in the case, it is difficult to speculate why the Hawkinses' effective tax rate is not higher.

136. See *Horton*, 33 F.3d at 630.

137. See, e.g., *Brabson v. United States*, 859 F. Supp. 1360, 1364 (D. Colo. 1994) (holding mandatory statutory prejudgment interest awarded in a personal injury action was compensatory and therefore to be excluded from gross income under section 104(a)(2), even though the "obligation to pay . . . is tied inextricably to the concept of fault").

138. U.S. CONST. art. I, § 8, cl. 1.

tem, did not grant Congress the power to tax.¹³⁹ That power was left to the states.¹⁴⁰ Although the new Congress had the power to govern, this severe limitation on the power to raise revenues caused the government to flounder.¹⁴¹ So, "to form 'a more perfect Union,'" delegates from the several states met in Philadelphia in 1787.¹⁴²

Under the Constitution of 1787, which replaced the Articles of Confederation, the first enumerated power granted to Congress was the power of taxation.¹⁴³ Specifically, the Constitution states that "[t]he Congress shall have Power to Lay and collect Taxes, Duties, Imposts and Excises, . . . but all Duties, Imposts, and Excises shall be *uniform* throughout the United States."¹⁴⁴ Income taxes and other indirect taxes must be uniform because they are classified as duties, excises, or impost.¹⁴⁵ This requirement of uniformity in taxation is more commonly referred to as the "Uniformity Clause."¹⁴⁶

On September 12, 1787, five days before the September 17, 1787 ratification of the Constitution, the rule of uniformity stated that taxes should be "uniform and equal" throughout the United States.¹⁴⁷ In the drafting process, however, the language requiring "uniform and

139. See ARTS. OF CONFEDERATION OF 1781 art. VIII; see also CHARLES ADAMS, FOR GOOD AND EVIL: THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION 307 (1993) (supporting the hypothesis that taxes are a "powerful mover of people" by using an historical overview).

140. ADAMS, *supra* note 139, at 307-08.

141. *Id.*

142. *Id.* at 309 (quoting U.S. CONST. pmb.).

143. *Id.* at 310.

144. U.S. CONST. art. I, § 8, cl. 1 (emphasis added).

145. See *Apache Bend Apartments v. United States*, 702 F. Supp. 1285, 1295 (N.D. Tex. 1988) (citing *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 15 (1916)). Congressional authority to collect *income* taxes is derived expressly from the Sixteenth Amendment to the Constitution. U.S. CONST. amend. XVI; see *supra* note 1. Section eight, however, imposes the requirement that Congress uniformly impose income taxes. U.S. CONST. art. I, § 8, cl. 1.

146. There are two uniformity clauses. See *infra* note 175. For a brief history of Uniformity Clauses, see William L. Matthews, Jr., *The Function of Constitutional Provisions Requiring Uniformity in Taxation*, 38 KY. L.J. 31, 35-50 (1949) ("Justice Kent mentions uniformity as an inseparable part of equality . . .") The Supreme Court has held void at least one law that unequally discriminated on the burden of taxation. See *Cumberland Coal Co. v. Board of Revision of Tax Assessments*, 284 U.S. 23, 29 (1931) ("The [Court's] conclusion is based on the principle that where it is impossible to secure both the standard of the true value [of property for assessment purposes], and the uniformity and equality required by law, the latter requirement is to be preferred as the just and ultimate purpose of the law." (quoting *Sioux City Bridge Co. v. Dakota County*, 260 U.S. 441, 446 (1923)); cf. *United States v. Ptasynski*, 462 U.S. 74, 82 (1983) ("The one issue that has been raised repeatedly is whether the requirement of uniformity encompasses some notion of equality. It was settled fairly early that the Clause does not require Congress to devise a tax that falls equally or proportionately on each State.").

147. See ADAMS, *supra* note 139, at 310.

equal” taxation was deleted.¹⁴⁸ Fortunately, before the states passed the Constitution, James Madison noticed and remedied this omission.¹⁴⁹ Thus, the final understanding of the states in passing the Constitution was that taxes must be imposed “uniformly” throughout the United States.¹⁵⁰

The Uniformity Clause was included in the Constitution to “cut off all undue preferences of one State over another.”¹⁵¹ The Framers did not want Congress to “impose an indirect tax on the inhabitants of one state which was different than the indirect tax imposed on the inhabitants of another state.”¹⁵² Specifically, they intended to prevent “oppressive inequalities” of the inhabitants and economy of a state or region of the country.¹⁵³ Without the Uniformity Clause, the Framers feared that the people and economy of one area of the country would thrive at the expense of another area of the country.¹⁵⁴ Thus, to limit the congressional taxing power and ensure uniform imposition of those powers, the Framers included the rule of uniformity in the Constitution.¹⁵⁵

B. Cases Interpreting the Uniformity Clause

In one of its early decisions on the meaning of the Uniformity Clause, the United States Supreme Court in the *Head Money Cases* held that a tax is uniform if it “operates with the same force and effect in every place where the subject of it is found.”¹⁵⁶ In the *Head Money Cases*, the Court upheld the constitutionality of a law that taxed immigrants coming into the United States through port cities, but did not tax immigrants entering the United States through inland cities.¹⁵⁷ The Supreme Court concluded that these tax policies were uniform because all immigrants coming through port cities were taxed at the same rate.¹⁵⁸

148. *Id.*

149. *Id.*

150. *Id.*

151. JOSEPH STOREY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 706 (5th ed. 1891).

152. *See Apache Bend Apartments v. United States*, 702 F. Supp. 1285, 1296 (N.D. Tex. 1988); *see also Ptasynski*, 462 U.S. at 81 (“There was concern that the National Government would use its power . . . to the disadvantage of particular States.”).

153. STOREY, *supra* note 151, at 706.

154. *Id.*

155. *See Nelson Lund*, Comment, *The Uniformity Clause*, 51 U. CHI. L. REV. 1193 (1984) (criticizing the Court’s uniformity rulings and arguing the Uniformity Clause should be read to prefer free markets and unrestrained economic competition as well as to prevent deliberate discrimination by majority factions).

156. 112 U.S. 580, 594 (1884); *see Lund*, *supra* note 155, at 1195.

157. 112 U.S. at 589-95.

158. *Id.* at 594.

The Court reaffirmed its holding in the *Head Money Cases* in *Knowlton v. Moore*.¹⁵⁹ In *Knowlton*, the issue was whether Congress could classify legacies into categories and tax each category at a progressive rate,¹⁶⁰ or whether uniformity required that all legacies be taxed at the same rate.¹⁶¹ The Court held that Congress can classify taxpayers, and as long as the tax imposed is uniform among that classification, the statute is constitutional under the Uniformity Clause.¹⁶²

In *Ptasynski v. United States*, the most recent decision interpreting the meaning of the Uniformity Clause, the Court held that the Uniformity Clause only requires Congress to impose tax statutes in a geographically uniform manner.¹⁶³ In *Ptasynski*, the federal statute in controversy specifically exempted the taxing of oil produced in or near Alaska.¹⁶⁴ The issue was whether a tax statute satisfied the requirements of the Uniformity Clause if the classifications in the statute were based on geography—that is, exempting oil produced in Alaska.¹⁶⁵ The Court upheld the statute in what has become a much criticized decision.¹⁶⁶ The Court reasoned that the tax was not actually based on geographic or state lines because the “Alaska oil” exemption also applied to oil produced offshore, which is “beyond the limits of any State.”¹⁶⁷ Relying on its decision in *Knowlton*, the Court

159. 178 U.S. 41, 106 (1900).

160. The particular statute in *Knowlton* imposed “a progressive tax on legacies and varied the rate of the tax among classes of legatees.” See *United States v. Ptasynski*, 462 U.S. 74, 82 & n.11 (1983).

161. *Knowlton*, 178 U.S. at 83-84.

162. *Id.* at 96-106. More recently, the Supreme Court briefly analyzed the Uniformity Clause. *United States v. Ptasynski*, 462 U.S. 74 (1983). *Ptasynski* reaffirmed *Knowlton*'s holding that Congress can enact statutes creating classifications resulting in geographic discrimination, as long as the statute is applied uniformly throughout the United States. *Id.* at 85-86. Because the issue in *Ptasynski* was “whether the Uniformity Clause prohibits Congress from defining the class of objects to be taxed in geographic terms,” *id.* at 83, and the statute at issue in this Note, section 104, does not define the taxpayer class by geography, *Ptasynski* is not particularly useful for the purposes of this Note.

163. 462 U.S. 74, 84 (1983).

164. *Id.* at 75-78.

165. *Id.* at 78-79.

166. *Id.* at 85-86. Several commentators have criticized the Supreme Court's ruling in *Ptasynski* as completely dismantling the purpose of the Uniformity Clause. See, e.g., Lund, *supra* note 155, at 1209 (“the *Ptasynski* analysis eviscerates the Uniformity Clause”); Philip J. Deutch, Note, *The Uniformity Clause and Puerto Rican Statehood*, 43 STAN. L. REV. 685, 706 (1991) (“[T]he *Ptasynski* decision makes it impossible to determine the scope of discretion the Court allows Congress in defining a geographically nonuniform tax.”); Lawrence Zelenak, *Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?*, 44 TAX L. REV. 563, 591 (1989) (“[T]he *Ptasynski* opinion sends mixed signals.”); Ellen Eggleston, Comment, *United States v. Ptasynski: A Windfall for Congress*, 61 DENV. U. L. REV. 395, 405 (1984) (“The Court's treatment [in *Ptasynski*] . . . subverts the purpose of the uniformity clause.”).

167. *Ptasynski*, 462 U.S. at 78.

stated that the tax on oil satisfied the Uniformity Clause because Congress taxed *each category* of oil uniformly throughout the United States.¹⁶⁸ Moreover, Congress did not "intend to grant Alaska an undue preference at the expense of other oil-producing States."¹⁶⁹ Thus, the Court concluded that as long as taxes are imposed uniformly on taxpayers within nongeographically discriminatory tax classifications, then the Uniformity Clause is satisfied.¹⁷⁰

C. Violation of the Uniformity Clause by Inconsistent Court Decisions Interpreting I.R.C. Section 104(a)(2)

As the discussion in the previous section demonstrates, a tax statute is constitutional under the Uniformity Clause if the statute uniformly taxes similarly classified taxpayers. The class of taxpayers at issue under section 104(a)(2) are successful claimants who have received punitive damage awards from personal, physical injury cases.¹⁷¹ In violation of the Uniformity Clause, circuit courts have reached differing conclusions on the application of section 104(a)(2) to this class of taxpayers.¹⁷² For example, the Sixth Circuit has decided that punitive damage awards for this class of taxpayers are excludable from gross income,¹⁷³ the Ninth Circuit, however, has contended that these punitive damage awards are fully taxable, and must be included in gross income.¹⁷⁴ These divergent interpretations of the exclusion of punitive damage awards in physical injury cases under section 104(a)(2) result in inconsistent, geographically-based taxation of United States taxpayers.¹⁷⁵

168. *Id.* at 82, 84.

169. *Id.* at 86.

170. *Id.* at 85.

171. *See supra* notes 4, 5.

172. Because the Uniformity Clause is in Article I of the Constitution, which grants legislative powers to Congress, it is arguable that only Congress, and not the judiciary, can violate the Uniformity Clause. However, it would appear that this Clause would be meaningless if the judiciary could circumvent the Framers' purpose for including the Uniformity Clause by deciding tax lawsuits inconsistently and thus failing to uniformly apply tax statutes. Because the judiciary has the final word on interpreting the Constitution, including the Uniformity Clause, only the judiciary can determine if its own practice violates the Clause. *See McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819).

Should the Supreme Court determine that only the Legislature, and not the courts, can violate the Uniformity Clause, then to preserve the Framers' intent, the judiciary should consider relinquishing its current responsibility of deciding tax cases. This action would force Congress to create an appellate form of the Tax Court. In 1969, Congress formed the Tax Court under its Article I powers. *See Gary L. Rodgers, The Commissioner "Does Not Acquiesce,"* 59 NEB. L. REV. 1001, 1009 (1980).

173. *See supra* text accompanying notes 94-134.

174. *See supra* text accompanying notes 55-93.

175. There is another Uniformity Clause that applies to cases involving bankruptcy. U.S. CONST. art. 1, § 8, cl. 4. In *Ptasynski v. United States*, the Court mentioned that

The inconsistent application of this tax statute violates the Framers' intent.¹⁷⁶ Specifically, the Uniformity Clause was included in the Constitution to prevent the preferential tax treatment of a state or region of the country at the expense of another state or region.¹⁷⁷ However, this inconsistent approach by different courts of appeals violates the Uniformity Clause by resulting in geographically disparate tax treatment of a specific class of taxpayers—those who receive punitive damages on account of personal, physical injuries. For example, a resident in Arizona will be fully taxed on punitive damages received on account of a physical injury claim.¹⁷⁸ However, the successful claimant in Kentucky will be entitled to pocket the full amount (less expenses and fees) of the punitive award.¹⁷⁹ The effect of this practice is that the Arizona resident's tax payment will supply the federal treasury with revenues to provide federal services benefitting residents of all other states, including Kentucky. Conversely, the Kentucky punitive damage award will benefit only the state resident who is successful on the physical injury claim and the economy where the award is spent. As illustrated by this example, such disparate tax treatment violates the Uniformity Clause by voiding the Framers' intent of preventing the inequality that results when some states benefit from not having to pay certain taxes for which other states are re-

"[a]lthough the purposes giving rise to the Bankruptcy Clause are not identical to those underlying the Uniformity Clause, we have looked to the interpretation of one Clause in determining the meaning of the other." 462 U.S. 74, 83 n.13 (1983). Recently, the Ninth Circuit held that a congressional statute regulating fees paid under a chapter 11 bankruptcy violated the Uniformity Clause because the statute did not apply uniformly to a defined class of debtors. *Saint Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525, 1531-32 (9th Cir. 1994). Under the legislation, Congress granted North Carolina and Alabama an extension in complying with the bankruptcy fee schedule. Because other states were required and had implemented the law, this disparate treatment resulted in a "more costly system" for resolving bankruptcy disputes in jurisdictions where the law had been implemented. *Id.* at 1532. The court concluded that the statute could not be enforced because, to remain constitutional under the Uniformity Clause, "a law must *at least* apply uniformly to a defined class of debtors." *Id.* at 1532 (quoting *Railway Labor Executives Ass'n v. Gibbons*, 455 U.S. 457, 473 (1982)).

The Ninth Circuit decision in *Saint Angelo* is similar to the argument proposed by this Note. That is, due to differing appellate court opinions, section 104(a)(2) is not uniformly applied to a defined class of successful personal injury claimants who receive punitive damage awards. This disparate tax treatment under the statute results in the failure to uniformly tax punitive damages as required by the Uniformity Clause.

176. *See Apache Bend Apartments v. United States* 702 F. Supp. 1285, 1295-96 (N.D. Tex. 1988).

177. *Ptasynski*, 462 U.S. at 80 n.10, 81; *see also supra* notes 151-155.

178. *See, e.g., Hawkins v. United States*, 30 F.3d 1077, 1079-80 (9th Cir. 1994) (stating that the *Hawkins* case was first decided in Arizona); *see also supra* notes 55-93 and accompanying text.

179. *See, e.g., Horton v. Commissioner*, 33 F.3d 625, 626 (6th Cir. 1994) (stating that the Hortons resided in Florence, Kentucky); *see also supra* notes 94-134.

quired to carry the burden.¹⁸⁰

IV. A Solution to Encourage Equal Application of the Law

To prevent violation of the Uniformity Clause, this Note proposes a mechanism that, first, allows for dialogue among the circuit courts on the issue of taxation under section 104 (and other similar tax statutes), second, encourages either Congress or the Supreme Court to take action to resolve the inconsistent interpretations among the circuits, and, third, results in a more uniform treatment of taxation among United States taxpayers in line with the Uniformity Clause.

In the past, several commentators have recognized the failure to uniformly apply other tax statutes when the Commissioner has appealed a decision to different circuit courts, resulting in disparate imposition of taxes.¹⁸¹ A few have argued for the creation of a Tax Court of Appeals to address the problem of lack of uniformity in circuit decisions.¹⁸² Under this solution, all cases involving disputed tax issues would be appealed to a court whose decisions would be uniformly applied to all taxpayers throughout the United States. This practice would, among other effects, result in the uniform application of federal tax laws. Although the Tax Court of Appeals idea has been advocated by several noteworthy and scholarly individuals, the recommendation has never been implemented. Because this idea has been repeatedly suggested and never implemented, this Note does not address the Tax Court of Appeals alternative.

Rather, this Note proposes a solution to the current problem of the failure to impose taxes uniformly by providing a rule of procedure¹⁸³ to be followed by courts when deciding tax cases and the IRS when attempting to enforce those decisions. Specifically, in cases

180. See *supra* notes 151-155 and accompanying text.

181. See, e.g., Samuel Estreicher & Richard L. Revesz, *Nonacquiescence by Federal Administrative Agencies*, 98 YALE L.J. 679, 713-18 & nn.175-85 (1989) ("Although the IRS's practice has been strongly criticized by the [1975 Commission which reviewed and recommended changes for the Federal Court Appellate System] and [by] the secondary literature, we have not found extensive judicial censure."); Rodgers, *supra* note 172; Peter K. Nevitt, *Achieving Uniformity Among the 11 Courts of Last Resort*, 34 TAXES 311 (1956).

182. See H. Todd Miller, Comment, *A Court of Tax Appeals Revisited*, 85 YALE L.J. 228, 228 (1975) (discussing that "our system for the resolution of federal tax controversies still lacks a unified court to hear tax appeals"); Roger J. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes—A Criticism and A Proposal*, 38 COLUM. L. REV. 1393 (1938) (noting the ineffectiveness of the current administrative and judicial procedures for taxes); Erwin N. Griswold, *The Need for a Court of Tax Appeals*, 57 HARV. L. REV. 1153 (1944) (suggesting the solution to the inconsistencies in tax decisions is to create a new tribunal called the Court of Tax Appeals).

183. This rule could be created either by the Supreme Court or Congress. Because the issue addressed in this Note involves the judiciary's failure to uniformly apply tax laws due to inconsistent interpretations of tax statutes, the Supreme Court should take responsibility

where circuits reach conflicting opinions on the meaning of a federal tax statute, the rule would prevent the enforcement of tax judgments and allow for the refund of any taxes that have been paid in connection with the statute.¹⁸⁴ This rule of preventing the imposition of taxes under an unclear tax statute would remain in effect until either the Supreme Court or Congress provided a “uniform” meaning of the statute. Even though this rule would prevent the IRS from collecting taxes under the statute in conflict, the IRS would still be able to appeal cases that it believes to be incorrectly decided to the different courts of appeals. These appellate decisions would continue to be a resource to be used by the Supreme Court should it decide to rectify the conflict. Essentially, the effect of this rule would be an application of a tax statute that most favorably benefits the taxpayer until the Supreme Court or Congress decides differently.¹⁸⁵

To illustrate how this rule would work, assume three circuit courts are deciding three separate cases involving the same issue of the meaning of a particular federal tax statute—whether punitive damages in personal, physical injury cases are excludable under section 104(a)(2). In chronological order, the First Circuit decides *Able*, the Second Circuit decides *Bakker*, and the Third Circuit decides *Carr*.

for initiating this rule to prevent the problem created by cases such as the disparate tax treatment of section 104(a)(2).

A sample draft of this proposed rule is as follows:

- (a) Unless there is a conflict among the circuits on the interpretation of a tax statute, a tax judgment is fully enforceable.
- (b) If there is a conflict of decision among the circuits on the interpretation of a tax statute at the time the taxpayer’s case is decided, then the enforceability of the tax judgment is deferred until clarity is provided by the Supreme Court or Congress.
- (c) If a conflict among the circuits regarding the interpretation of a specific tax statute arises after the taxpayer’s case has been decided, and the taxpayer has submitted a tax payment, then the taxpayer’s payment shall be returned. The taxpayer shall be required to pay taxes subject to any future clarifications of the meaning of the statute provided by the Supreme Court or Congress.

184. Although conflicts may arise among the district courts, the taxpayer still may appeal that decision to the circuit court. Because the circuit court decision is the final stage of due process for most taxpayers—depending on whether the Supreme Court grants certiorari—this proposal focuses on the conflict that arises at this stage of the judiciary’s decision process.

185. Cf. *Hawkins v. United States*, 30 F.3d 1077, 1080 (9th Cir. 1994) (stating that exclusions under the I.R.C. are to be narrowly construed); *United States v. Centennial Sav. Bank FSB*, 499 U.S. 573, 583 (1991) (“Consistent with the rule that tax-exemption[s] . . . are to be construed narrowly . . .”). Although in light of the current federal fiscal crisis, the author does not anticipate a welcome reception of this proposal, she encourages honest consideration of a proposal to solve the failure to impose federal taxes uniformly.

First Scenario

Suppose the first two circuits both decide that the statute in issue does not require the taxpayers to pay taxes under the statute. However, the Third Circuit decides differently and its opinion requires Carr to pay taxes. Because the conflict among circuits on the meaning of the tax statute at issue arises with the *Carr* case, Carr would not be required to pay any taxes until the Supreme Court or Congress addresses this issue. In the event that Carr has already paid taxes, she would be entitled to a refund.

Second Scenario

In this situation, suppose the first two circuits decide that the tax statute requires the taxpayer to pay taxes. At this point there is not a conflict, so the first two taxpayers must pay the taxes required under the statute. However, suppose the conflict among courts arises when the Third Circuit decides that the meaning of the statute does not require the taxpayer to pay taxes. In this case, the first two taxpayers would be allowed a refund and future decisions by circuit courts would not be able to enforce tax judgments until either the Supreme Court or Congress provides an interpretation of the statute that allows for "uniform" taxation under the statute in issue.

Third Scenario

Suppose the First Circuit decides that punitive damages are not excludable under the tax statute, and in accordance with this decision, Able pays taxes on his punitive award. The conflict among court decisions arises, however, when the Second Circuit decides that punitive damages are "clearly" excludable under section 104(a)(2), and thus Bakker does not pay taxes on her punitive award. At this point, Able would be entitled to a refund of the taxes he paid on his punitive award. In addition, suppose that later the Third Circuit decision aligns with the First Circuit in deciding that punitive damages do not fall under section 104(a)(2), and are thus taxable. In this case, Carr would not be required to pay any taxes, although the Third Circuit decision held the statute required her to pay taxes. These three taxpayers would not have to pay taxes under the statute and any future decisions imposing taxes would not be enforceable until the Supreme Court or Congress decided the statute mandated the payment of taxes.

In addition to facilitating the uniform application of tax statutes, the rule proposed by this Note would continue to provide the Supreme Court a useful resource of varying interpretations of a tax statute by allowing the circuits to express their differing opinions and

interpretations of tax statutes. Moreover, if Congress disagrees with this procedure that effectively favors the taxpayer, it will be encouraged to amend the statute to reflect its true intent in enacting the law.¹⁸⁶ This process of delaying the imposition of taxation until resolving the debate on the meaning of a tax statute will facilitate the uniform application of tax laws throughout the United States. Furthermore, by uniformly taxing similarly situated taxpayers, the rule will remove any future violations of the Uniformity Clause.¹⁸⁷

V. Conclusion

Section 104(a)(2) of the Internal Revenue Code has a confusing and varied legislative and judicial history. Recently, in an attempt to interpret this statute, two courts of appeals reached strikingly different conclusions on the meaning of section 104(a)(2). In *Hawkins*, the Ninth Circuit relied on the return of lost capital theory, and held that punitive damages are not compensation for lost human capital under section 104(a)(2).¹⁸⁸ The court held that punitive damages received from physical injury claims are not excludable under section 104(a)(2), and thus such damages are fully taxable for residents within the Ninth Circuit's jurisdiction.¹⁸⁹

Just one month later, the Sixth Circuit countered with a completely different result. In *Horton*, the court held that punitive damages received from an underlying claim on account of a physical injury fall into the exclusion under section 104(a)(2) and thus, are exempt from taxation for residents within the Sixth Circuit's jurisdiction.¹⁹⁰

These conflicting circuit interpretations of section 104(a)(2) violate the Uniformity Clause of the United States Constitution.¹⁹¹ To remedy this violation, the Supreme Court should create a rule that prevents the enforcement of tax judgments and allows for the refund of tax payments when circuit courts differ in their interpretation of a

186. Both the dissent and majority in *Hawkins* asked Congress to "straighten out this mess." *Hawkins*, 30 F.3d at 1082 n.7, 1087 (Trott, J., dissenting).

187. See *supra* notes 171-180 and accompanying text. This solution is arguably a more palatable proposal than the Tax Court of Appeals recommendation, see *supra* note 182, for at least two reasons. First, in addition to the benefits mentioned in the text, this solution, unlike the Tax Court of Appeals solution, does not allow the fox to guard the hen house. Instead of one Tax Court of Appeals, which would have the sole mission of reviewing tax cases, and might be encouraged to find tax cases in favor of the IRS, 13 courts of appeals would have an opportunity of delivering an opinion on an interpretation of a particular tax statute. Second, this proposal could easily be implemented within the current structure of the federal court system, and would not require creation of a new court of appeals system to review tax cases.

188. *Hawkins*, 30 F.3d at 1080-81; see *supra* notes 55-93 and accompanying text.

189. See *supra* notes 55-56 and accompanying text.

190. *Horton v. Commissioner*, 33 F.3d 625, 630 (6th Cir. 1994).

191. See *supra* notes 171-180 and accompanying text.

tax statute.¹⁹² In addition to enabling circuit courts to continue to decide tax cases, this procedure would also provide the Supreme Court with different approaches and opinions when making a final determination of the appropriate meaning and application of a tax statute.¹⁹³ Moreover, this rule should encourage Congress to come to a uniform conclusion on the statute's meaning and to address the pain and suffering among the circuit courts of appeals in interpreting a statute that lacks legislative history and clear intent.¹⁹⁴ In any event, Congress and the Supreme Court have an obligation to taxpayers to address this problem and "straighten out this mess."¹⁹⁵

192. *See supra* notes 183-187 and accompanying text.

193. *See id.*

194. *Id.*

195. *Hawkins v. United States*, 30 F.3d 1077, 1087 (9th Cir. 1994) (Trott, J., dissenting).