COPENHAGEN RESEARCH GROUP ON INTERNATIONAL TAXATION - CORIT
DISCUSSION PAPER NO. 6. 2010

THE PERSONAL INJURY EXCLUSION: ARGUABLY ARBITRARY

By
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Introduction

"Bruised and battered by your words, dazed and shattered now it hurts . . . ."[1] Although Delta Goodrem's song is about relationship issues, it reminds us that words can hurt as much as actions. This fact was something the United States Congress ("Congress") failed to consider when it in 1996 amended Internal Revenue Code ("Code") Section 104(a)(2), to exclude from taxable income only damage awards received on account of physical injuries.[2] Prior to 1996, Section 104(a)(2) applied equally to exclude both physical and nonphysical injury damage awards, but in one fell swoop, Congress forgot just how much pain words can sometimes inflict. An old adage teaches us that "sticks and stones may break my bones but words will never hurt me", but life experiences have taught us all that words and nonphysical injuries can be as damaging, and at times more damaging, than physical injuries. It is peculiar then that the 535 individuals who made up the Congress in 1996, with all their combined life experiences, chose to exclude from taxable income only damage awards received for physical injuries.

Across the pond, however, Congress' Danish brethren did not fair much better. Albert Einstein once said that the "[t]he hardest thing in the world to understand is the income tax."[3] Perhaps this explains why Danish tax law treats the human body differently, depending on who it benefits. In relation to periodic payments for damage awards, the tax law treats the human body like any other capital asset, making those payments taxable income. When it comes to deductions, however, the body is considered something private, thus disallowing deductions that are permissible for other capital assets.

The purpose of this Paper is to determine the proper tax treatment of money received on account of a personal injury. The interest in the subject first arose while the author was studying U.S. tax law, and learned that in 2006, the District of Columbia Circuit Court of Appeals overturned, on constitutional grounds, Code Section 104(a)(2). This was significant because not since 1920 has the Supreme Court of the United States

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[1] DELTA GOODREM, ALMOST HERE (Sony/Epic 2005).
[2] *See* I.R.C. § 104(a)(2) (2000).
[3] Murphy v. I.R.S., 460 F.3d 79, 96 (D.C. Cir. 2006) *vacated*, 2006 U.S. App. LEXIS 32293 (D.C. Cir. 2006) (citation omitted).

struck down a federal tax provision for being unconstitutional,[4] and not since 1972 has any federal court invalidated a substantive federal income tax provision on constitutional grounds.[5] Even more remarkable, after the decision created an uproar in the national tax community, the Circuit Court reversed itself. This newfound knowledge of U.S. tax law led to an interest in studying Danish tax law, and specifically the tax treatment of damage awards.

In designing its general tax scheme for damage awards, the Danish legislature relied on human capital principles. Similarly, when Congress originally enacted the predecessor to Section 104(a)(2), it based its rationale in part on human capital theory, although the evidence suggests that it did not fully understand the theory.[6] As will be further developed below, human capital is the present value of an individual's future earning capacity. Under the modern interpretation of human capital theory, taxpayers should be taxed on their human capital, and they consequently receive a tax basis in their well-being.[7] There are two common approaches to determining this basis. One approach is to assign a zero basis at birth, allowing taxpayers to use after-tax dollars to increase basis through various means such as education, training, and health care. Another approach is to assign basis at birth by taxing individuals at birth based on their prospective future earnings, and adjusting basis over time to take into account changes that impact future earnings. Accordingly, neither Congress nor the Danish legislature should tax money received as compensation for any human capital loss, because such compensation is a return of capital, provided that the amount received does not exceed human capital basis.[8] Regardless of whether one agrees with either of these two approaches, it is evident from the current tax regimes that the theory of human capital did not similarly motivate other sections of the Code or the Danish tax laws. Moreover, even

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[4] *See* Eisner v. Macomber, 252 U.S. 189 (1920) (holding that the receipt of certificates for additional shares issued by a corporation as stock dividends, was not income within the meaning of the Sixteenth Amendment, so the tax in question was unconstitutional).
[5] *See* Moritz v. Comm'r, 469 F.2d 466 (10th Cir. 1972) (where both the Internal Revenue Service and the tax court denied the taxpayer, an unmarried man, a deduction for expenses incurred in the care of his invalid mother, while the Tenth Circuit Court of Appeals held that the now repealed Section 214(a) of the Code invidiously discriminated non-married men, and therefore was invalid under due process principles).
[6] *See infra* Part IV.B.
[7] Tax basis in common law tax terminology is generally similar in all respects to the Danish tax system's acquisition price (anskaffelsessum).
[8] *See infra* Part VI.B.

if the theory may have motivated Section 104(a)(2)'s predecessor, as well as Danish taxation of damage awards principles, the theory suffers from a number of shortcomings and can therefore not be used as a justification for retaining the exclusion. Notwithstanding this Paper's rejection of human capital theory, there are a number of other policy arguments that supports retaining or enacting an exclusion for personal injury awards. As this Paper will show, however, there is no sound basis on which we can distinguish between physical and nonphysical injuries or between lump sums and periodic payments. As such, it is advisable both to expand the scope of Section 104(a)(2) to once again apply to nonphysical injury awards, and to enact a similar provision in Denmark in order to make periodic payments tax free as well.

I. Methodology and Overview of Arguments

It would be a stretch to argue that no two societies are more different than the U.S. and Denmark. For even an uninitiated observer, however, the many variances between the cultures are visible to the naked eye. Why then a comparative analysis between the two countries' tax regimes, the observant reader might ask. In so asking, however, the reader would be mischaracterizing the scope and methodology of this Paper. The analysis, discussion and proposed amendments to existing law that follows, is based on a policy methodology or analysis, that is, a discussion of current legislation, and analysis as to whether this legislation should be amended in accordance with one or more herein stated policy goals. As such, this Paper does not embark on an in-depth analysis of, nor will it contrast, as that word is usually understood in legal analysis, the tax systems of the U.S. and Denmark. Rather, the purpose is to show how personal injury awards should be taxed. The Paper will therefore not conduct a comparative analysis, but rather conduct a study of the proper tax treatment of damage awards by incorporating U.S. and Danish tax law into an empirical analysis. Any comparison that is nevertheless conducted is done purely as an academic exercise in emphasizing the similarities, or dissimilarities as the case may be, between the two. This is sound, given the Paper's argument that the approaches to this issue taken by the U.S. and Denmark, respectively, are only almost correct. Both approaches suffer from fundamental flaws, but a combination of the two reveals the most fair and efficient scheme through which to tax damage awards. This is significant, because fairness and efficiency are two of the most important measuring rods in tax policy. One cannot prove a negative, thereby excluding the possibility that an empirical analysis incorporating other countries' tax systems could lead to the same conclusion. Using U.S. and Danish tax law for this purpose is nevertheless relevant and interesting, because both regimes made the same mistake of policy, namely relying on human capital theory. Interestingly, however, they obviously nevertheless settled on two different approaches to taxing tort recoveries.

The methodology is, however, not without its shortcomings. The research has revealed that preciously little has been written about taxation of damage awards under Danish law.[9] Save for brief explanations in various casebooks, as well as a more detailed overview of the taxation of different types of tort recoveries in a legal journal, the issue has not garnered much attention. The main reason for this is that Danish tax law does not contain a separate provision governing the taxation of damage awards. Instead, taxation of tort recoveries is governed by what is included in taxable income, as that term is defined in the Danish State Tax Act ("DSTA") Section 4. While scholars and practitioners often debate about what taxable income under that section encompasses, the debate has apparently never centered on damage awards or any analogous type of income. In sharp relief to the lack of literature on the subject in Denmark, much has already been written about Section 104(a)(2), its relation to human capital theory, and its distinction between physical and nonphysical injuries.[10] Commentators have argued for the repeal, expansion, or retention of the current version of Section 104(a)(2), and in doing so have either supported or criticized human capital theory. Unlike those who have similarly criticized human capital theory and its relation to Section 104(a)(2), however, this Paper conducts a detailed analysis of the different components a damage award consists of, thereby offering a number of justifications unrelated to human capital theory for retaining the exclusion. In doing so, this Paper also throws into sharp relief the

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[9] This has subsequently been confirmed by, among others, Professor Jan Pedersen of Aarhus University.

[10] *See, e.g.*, Gregory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis of Murphy v. Internal Revenue Service*, 60 ARK. L. REV. 185 (2008); Mark J. Wolff, *Sex, Race, and Age: Double Discrimination in Torts and Taxes*, 78 WASH. U. L.Q. 1341 (2000); Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical but Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51 (1997); Frank J. Doti, *Personal Injury Income Tax Exclusion: An Analysis and Update*, 75 DENV. U.L. REV. 61 (1997); Nicholas M. Whittington, *Against the Grain: An Interdisciplinary Examination of the 1996 Federal Statutory Changes to the Taxability of Personal Injury Awards*, 37 WASHBURN L.J. 153 (1997).

exclusion's distinction between physical and nonphysical injuries, thereby providing a new framework to understand why it is desirable to have Section 104(a)(2) apply equally to both physical and nonphysical injuries. Lastly, contrary to what Danish tax law seems to believe, this Paper also shows why receiving a lump sum payment for an injury is not inherently different from receiving periodic payments for the exact same injury. As such, taxing these two types of payments differently is arbitrary and anomalous.

Before embarking on an analysis of this Paper's subject, Part II first clarifies the exact scope of that analysis. Part III then proceeds by providing a brief introduction to human capital theory and explains how the theory should be understood in relation to tax policy and theory. Then, a discussion of the term income, and its relation to section 104(a)(2), begins in Part IV with a definition of that term, and traces the history of the current version of Section 104(a)(2). Part IV will also briefly discuss the issue of whether damage awards under the current taxation regime of the U.S. are taxable in the first place. Next, Part V proceeds by examining the definition of income under Danish law, and describes how damage awards are taxed under the applicable statute.

Part VI proceeds by examining human capital theory as it relates to the taxation of tort recoveries, and concludes that because of a number of shortcomings, the theory should not be used as support for retaining a personal injury award exclusion. Next, Part VII discusses whether damage awards in general, be they on account of physical or nonphysical injuries, should be excluded from taxable income, concluding that tax policy favors exclusion. Notwithstanding this conclusion, Part VII then proceeds by identifying four components of a damage award, and examining each individually to determine whether excluding all four components is justified. It concludes that only two of them should properly be excluded, and provides a methodology by which we can separate and accurately value the additional taxable components. Using the four damage award components identified under Part VII, Part VIII continues by criticizing Section 104(a)(2)'s distinction between physical and nonphysical injuries. Part VIII also criticizes Danish law, under which periodic payments of damage awards are treated differently than lump sum payments of those awards. This critique leads Part VIII to argue that there is no sound basis that can support either distinction. Lastly, Part IX concludes.

II. Scope

In attempting to create a proper tax scheme for damage awards, a number of interesting related issues arise. Apart from money from the tortfeasor, one could consider the impact of other potential mechanisms through which an individual can receive compensation for injuries, for example, through services provided by the government. In relation hereto, the analysis could include a determination as to who ultimately bears the tax burden, if any, imposed on money received on account of an injury. Lastly, the how and why of tort law and policy could similarly be analyzed. Although not without their merits, these issues would steal focus away from the attempt at creating an ideal method of tax damaging awards. Moreover, due to the nature of the task at hand, including any or all of these issues would compromise and substantially dilute the analysis and conclusions herein reached. Thus, this Paper is limited to analyzing tax policy and tax theory as it relates specifically to damage awards for personal injuries. While this analysis necessitates a presentation and discussion of the definition of income and taxable income, an analysis of what these two concepts should properly consist of on a larger scale, is a subject for an entirely different paper, and thus beyond the scope of this one.

III. Human Capital and Tax Theory

As alluded to earlier and as the subsequent parts of this Paper will show, human capital theory played a decisive role in shaping the U.S. and Danish tax treatment of damage awards. Consequently, an analysis of the interplay between human capital theory and tax policy is inevitable. In order to properly conduct an analysis of the concept of human capital and its relation to tax theory, however, a brief overview of the former is in order. A founding father of modern economics, Adam Smith, argued in his seminal work *Wealth of Nations*, that investments in education and training should translate into a value in the human body, i.e. human capital.[11] In so doing, Smith likened the human body to a machine, reasoning that the value of leisure forfeited by an individual engaged in education or training, is similar to monetary investments into capital investment

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[11] See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, I.10.9 (5th ed. 1904).

machines.[12] As such, the more one invests in one's body, mentally or physically, the more value one can derive from the body.

In economic terms, human capital is thus properly understood as the present value of the flow of future satisfactions that one can command during the course of ones lifetime. Implicit in this definition lies proof that life is not fair. This is so, because part of the value of ones future services is determined by ones endowment. All things being equal, the present value of a child born to a Fortune 100 CEO is higher than the present value of a child born to a small-town gas station attendant. Similarly, the value of the offspring of rocket scientists is likely to be higher than the value of the offspring of janitors. Obviously, there are a number of factors that could, and actually do, disprove this hypothesis. This is the other part of the value of future services. Individuals can invest in bettering themselves through, for example, education, thereby increasing their worth. This results in fluctuations in the value of human capital, which in turn is the focus of tax theory and policy as it relates to human capital. In other words, when discussing human capital as a basis for taxable income, the focus is on the net changes in value of that capital over an accounting period, rather than the value of the human capital at any given time.[13] This is the interpretation of human capital theory that this Paper will use. Although a more thorough analysis of the taxation of human capital follows below, it is prudent at this point to make the following remarks. Taxing human capital presents a number of issues, mainly because human capital is not like other investment capital, because the human body, contrary to what Adam Smith believed, is not like other capital assets such as machines. More importantly, in order to properly tax value fluctuations, the tax system must be able to accurately value the baseline. As will be argued, however, and as numerous tax scholars have pointed out, a tax system cannot objectively assign a value to human capital, nor objectively measure changes in that capital.[14] As such, while human capital theory provides interesting insights into tax policy, in relation to taxing personal income it must remain just that – a theory.

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[12] *Id.*
[13] *See, e.g.*, Paul B. Stephan III, *Federal Income Taxation and Human Captial*, 70 VA. L. REV. 1357, 1359 (1984).
[14] *Id.* at 1360.

IV. Prior History – The Correlation Between Taxable Income and the Exclusionary Provision of Code Section 104(a)(2)

An analysis of Code Section 104(a)(2), which excludes certain damage awards from taxable income, logically begins by defining the scope of the term "income" as it is used in the Code. Although the Code defines taxable income,[15] the Supreme Court found it necessary early on to interpret this definition, and has subsequently expanded or elaborated on this interpretation, showing that taxable income is not a static term.[16]

A. <u>The Definition of Income</u>

An often-quoted definition of income explains that the term may be defined as the sum of an individual's consumption plus accumulation during the taxable period.[17] This definition, promulgated by Henry Simons in the 1930s, is known as the Haig-Simons definition of income, in acknowledgement of the prior contributions of Robert Haig.[18] This, however, is not the definition the current tax system applies.[19] Section 61(a) of the Code defines "gross income" as "all income from whatever source derived . . . ."[20] Although this language might seem clear, the United States Supreme Court found it necessary in *Eisner v. Macomber*[21] to explain the definition, only seven years after Congress had enacted the first version of the Code.[22] In holding that income does not encompass certificates for additional shares issued by a corporation as stock dividends to a shareholder, the Court explained that income may be defined as "'the gain derived from capital, from labor, or from both combined'."[23]

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[15] I.R.C. § 61(a) (2000).
[16] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955) (discussed in more detail below); Eisner v. Macomber, 252 U.S. 189 (1920) (discussed in more detail below).
[17] *See* Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes"*, 33 ARIZ. ST. L.J. 1057, 1083 (2001).
[18] *See* Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 46 (1990).
[19] *See* Jensen, *supra* note 17 (explaining that the present income tax only reaches part of the Haig-Simmons definition of income).
[20] I.R.C. § 61(a). The section also includes a non-exhaustive list of items that are taxable income. *Id.*
[21] 252 U.S. 189.
[22] *See id.* at 205, 219.
[23] *Id.* at 207 (citing Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918); Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913)).

Courts began applying this definition, but in 1955, the Supreme Court departed from *Macomber*, and in effect broadened the meaning of income under Section 61(a).[24] At issue in *Commissioner v. Glenshaw Glass Co.* was whether a recovery of punitive damages was taxable income under Section 22(a) of the Code (the predecessor of Section 61).[25] The Court held that punitive damages did fall within its redefined definition of income, and was therefore taxable under Section 22(a).[26] In so concluding, the Court explained that in context, the *Macomber* definition served a useful purpose, however, the definition "was not meant to provide a touchstone to all future gross income questions."[27] The Court explained that Congress was exerting "the full measure of its taxing power," when it chose to tax "income derived from any source whatever."[28] Congress therefore intended to tax all gains except those specifically exempted.[29] Consequently, taxable income may properly be understood as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[30] Courts today continue to apply this definition in order to determine what constitutes taxable income.[31]

B. Damages Excluded Under Section 104(a)(2)

In 1918, Congress enacted the predecessor to Section 104(a)(2), which excluded from income damage awards received for personal injuries or sickness.[32] Specifically the Section excluded "amounts received, [. . .], as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness." Three years prior, the Treasury Department held

[24] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).
[25] *See id.* at 427.
[26] *See id.* at 432-22.
[27] *Id.* at 431.
[28] *Id.* at 429.
[29] *Id.* at 430.
[30] *Id.* at 431.
[31] *See, e.g.*, Comm'r v. Banks, 543 U.S. 426, 433 (2004) (citing *Glenshaw Glass Co.* and explaining that gross income under the Code means "all income from whatever source derived," a definition that extends "broadly to all economic gains not otherwise exempted"); Comm'r v. Indianapolis Power & Light Co., 493 U.S. 203, 209 (1990) (applying the direct language from *Glenshaw Glass Co.* in defining gross income); Comm'r v. Kowalski, 434 U.S. 77, 83 (1977) (concluding that the taxpayer's meal allowance was taxable as undeniable accessions to wealth, clearly realized, over which the taxpayer had complete dominion);Westpac Pac. Food v. Comm'r, 451 F.3d 970, 975 (9th Cir. 2006) (explaining that loan transactions are not taxable income because even though the taxpayer may have complete dominion over the money, the taxpayer does not have an accession to wealth because the money must be repaid).
[32] Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (amended 1939).

that amounts received for personal injuries, and pain and suffering as a result of a suit or compromise, or under an accident insurance policy, were taxable income.[33] Soon after, however, the Secretary of the Treasury sought the opinion of the Attorney General on the issue.[34] He reasoned that accident insurance proceeds were not taxable, as they were a substitution for the injuries incurred.[35] In doing so, the Attorney General explicitly acknowledged the human body as a capital asset. To wit, he explained that "proceeds of the [insurance] policy do but substitute, so far as they go, capital which is the source of future periodical income . . . [and therefore] merely take the place of capital in human ability which was destroyed by the accident."[36] In response, the Treasury changed its initial stance, and relied on the statements of the Attorney General to conclude that damages for personal injuries were not taxable income.[37] Although Congress ultimately adopted the view then shared by both the Attorney General and the Treasury, the legislative history reveals that the result was anything but straightforward.[38]

In its final form, the exclusion provision excluded from taxable income damage awards received on account of physical as well as nonphysical injuries, and did not change significantly over time.[39] In 1996, however, apparently dissatisfied with the judicial branch's application of Section 104(a)(2) to nonphysical injuries,[40] Congress

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[33] *See* T.D. 2135, 17 Treas. Dec. Int. Rev. 39, 42 (1915); *see also* Reg. No. 33 (Rev.), Art. 4(25), 20 Treas. Dec. 126, 130 (1918); T.D. 2570, 19 Treas. Dec. 321, 323 (1917).
[34] *See* 31 Op. Att'y Gen. 304 (1918).
[35] *Id.* at 308.
[36] *Id.*
[37] T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) ("[i]t is held upon similar principles that an amount received by an individual as a result of a suit or compromise for personal injuries sustained by him through accident is not income taxable.").
[38] *See* H.R. REP. NO. 65-767 (1918), *reprinted in* 1939-1 (Pt. 2) C.B. 86, 92 ("under the present law *it is doubtful* whether amounts received through accident or health insurance, . . . and damages received on account of such injuries or sickness, are required to be included in gross income [however,] the proposed bill provides that such amounts shall not be included in gross income.") (emphasis added).
[39] *See* O'Gilvie v. United States, 519 U.S. 79, 86 (1996).
[40] *See* H.R. REP. NO. 104-737, at 142-43 (1996) (Conf. Rep.). As a justification for amending section 104(a)(2) Congress explained that

> [c]ourts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness.

amended the section so as to include in taxable income, damages received on account of nonphysical injuries.[41] Additionally, Congress explicitly determined that the exclusion should no longer apply to claims involving emotional distress alone or to claims of employment discrimination.[42]

C. Are Damage Awards Constitutionally Taxable?

When the predecessor to Section 104(a)(2) was enacted, both the Attorney General and the Secretary of Treasury were of the opinion that damage awards were not taxable. While a recent D. C. Circuit Court case has ended that debate for now,[43] it is appropriate at this point to make a few comments about the taxability of damage awards.

Money received by a taxpayer is income, unless expressly excluded by the Code.[44] Under Section 104(a)(2) only "the amount of . . . damages . . . received . . . on account of personal *physical* injuries or *physical* sickness" is excluded from taxable income.[45] Congress' taxation power originates from article I of the Constitution.[46] Additionally, Congress enacted the Sixteenth Amendment in response to the Supreme

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Id. Interestingly, the House of Representatives proposed an amendment to section 104(a)(2) already in 1989, which would have excluded only physical injuries. *See* H.R. REP. NO. 101-247, at 1355 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2825. The conference committee, however, rejected the amendment in favor of a more limited exclusion that made punitive damages taxable as income. *See* Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 7641(a), 103 Stat. 2106, 2379 (amending I.R.C. § 104(a)(2) (1986)).

[41] *See* I.R.C. § 104(a)(2) ("[gross income does not include] the amount of any damages . . . received . . . on account of personal *physical injuries* or *physical sickness*.") (emphasis added).

[42] I.R.C. § 104(a) (determining that emotional distress is not a physical injury or a physical sickness); H.R. REP. NO. 104-737 at 143 (1996) (Conf. Rep.) ("[t]he House bill . . . specifically provides that emotional distress is not considered a physical injury or physical sickness [and] . . . [therefore] the exclusion does not apply to any damages received . . . based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.").

[43] *See* Murphy v. I.R.S., 493 F.3d 170, 171 (D.C. Cir. 2007), *cert. denied*, 126 S. Ct. 2050 (2008).

[44] *See* I.R.C. § 61(a) ("[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived . . . ."); Comm'r v. Banks, 543 U.S. 426, 433 (2004) ("[t]he definition [of income in section 61(a)] extends broadly to all economic gains not otherwise exempted.").

[45] I.R.C. § 104(a)(2) (emphasis added).

[46] *See* U.S. CONST. art. I, § 8, cl. 1; U.S. CONST. art. I, § 2, cl. 3.; U.S. CONST. art. I, § 9, cl. 4. Article I, section 8 provides in pertinent part that "[t]he Congress shall have power to lay and collect taxes . . . but all duties, imposts and excises shall be uniform throughout the United States." U.S. CONST. art. I, § 8, cl. 1. This grant of power is further qualified by section 2, which requires "direct taxes [to] be apportioned among the several states." U.S. CONST. art. I, § 2, cl. 3. Additionally, section 9 states that "no capitation, or other direct tax, shall be laid, unless in proportion to the census or enumeration herein before directed to be taken." U.S. CONST. art. I, § 9, cl. 4.

Court's holding in *Pollock v. Farmers' Loan & Trust Co.*,[47] where the Court held that a tax on income from real and personal property was a direct tax subject to apportionment under article I of the Constitution.[48] The Sixteenth Amendment removed the apportionment requirement from taxes on income, a requirement that only applies to direct taxes.[49]

Moreover, Article I, section 8, clause 1 of the Constitution grants Congress the "power to lay and collect taxes."[50] Thus, even assuming that Congress cannot tax damage awards under the Sixteenth Amendment, it can still tax the award under article I, even if the tax is direct, as long as it is apportioned.[51] While the meaning and scope of the term "direct tax" remain uncertain today,[52] at least one commentator notes that taxing damage awards would not "run afoul of any apportionment limitation in [a]rticle I."[53] Lastly, according to the standard enunciated in *Glenshaw Glass*,[54] damage awards are income under the Sixteenth Amendment, because such money constitutes an accession to wealth, clearly realized, over which the recipient has complete dominion.[55]

Thus, notwithstanding the initial doubt expressed by the Secretary of Treasury and the Attorney General in 1918 as to the taxability of damage awards, the foregoing

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[47] 158 U.S. 601 (1895).
[48] *See* Eisner v. Macomber, 252 U.S. 189, 205 (1920). The Court first noted that *Pollock* held that taxes on income from real and personal property was a direct tax, and therefore had to be apportioned under Article I. *Id.* (citation omitted). It then explained that "[a]fterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished." *Id.* (citations omitted).
[49] *See* Murphy v. I.R.S., 362 F. Supp. 2d 206, 217 (D.D.C. 2005).
[50] U.S. CONST. art. I, § 8, cl. 1.
[51] *See* Sheryl Stratton, *Experts Ponder Murphy Decision's Many Flaws*, 112 Tax Notes 822, at *4 (Sept. 4, 2006), (noting that under article I, section 8 of the Constitution Congress has the power "to lay and collect taxes," and that this, in and of itself, presumably is sufficient authority for taxing Murphy's award). As further noted, it is insufficient to invalidate the taxation of the award on the basis that it does not constitute income. *Id.* It would be necessary to additionally hold that the tax is a direct one, prohibited by article I. *Id.*
[52] *See* DOUGLAS A. KAHN, FEDERAL INCOME TAX 1 (1992) [hereinafter KAHN, FEDERAL INCOME TAX].
[53] *See* posting of Marty Lederman to Balkanization, http://balkin.blogspot.com/2006_08_20_balkin_archive.html (Aug. 22, 2006, 12:41 EST) *last visited* Feb. 8, 2010; *but see* F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Damages for Mental Distress*, 49 FLA. L. REV. 725, 766 (1997) (concluding that since the victim of an injury does not realize any gain, there is no income within the Sixteenth Amendment, and consequently the taxation of damages for mental distress is unconstitutional as a direct tax that is not apportioned).
[54] 348 U.S. 426, 431 (1955)
[55] *See id*.

discussion should suffice to show that unless expressly excluded, damage awards are fully taxable.

D. The Exclusion of Nonphysical Injuries Under Section 104(a)(2)

As explained earlier, Code Section 61(a) defines taxable income, while Section 104(a)(2) excludes certain damage awards from taxation under Section 61(a).[56] Thus, if a damage award is not excluded under Section 104(a)(2), it is taxable income under Section 61(a).[57]

In *Commissioner v. Schleier*,[58] the Supreme Court sat forth a two-prong test that must be met in order for a plaintiff to successfully exclude damage awards under Section 104(a)(2). The test requires a taxpayer to demonstrate that the recovery was based on a tort or tort type right, and that the taxpayer received the award on account of a personal injury or sickness.[59] Additionally, under the amended version of Section 104(a)(2), the taxpayer must show that the personal injury or sickness was physical.[60] Even where the plaintiff suffers physical injuries, however, the plaintiff must demonstrate that the money was received because of that injury, and not because of e.g. mental pain and anguish. Only where there is a strong casual connection between the award and the injuries sustained, not a mere but-for causation, may the plaintiff exclude the award from taxable income.[61]

V. Taxation of Tort Recoveries Under Danish Law

Similarly to the analysis of Code Section 104(a)(2), an analysis of the Danish rules and principles applicable to the taxation of damage awards must begin by defining taxable income as it is to be understood under Danish law.

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[56] *See supra* Parts IV.A and IV.B.
[57] *See* Stratton, *supra* note 51, at *3 (noting that if something is not excluded under the exclusion provision, then the analysis returns to section 61).
[58] *See* 515 U.S. 323, 336-37 (1995).
[59] *See id.* at 336-37.
[60] *See* I.R.C. § 104(a)(2).
[61] *See* O'Gilvie v. United States, 519 U.S. 79, 83 (1996).

A. <u>The Definition of Income</u>

Much like its U.S. counterpart, the DSTA contains one sweeping provision, pursuant to which gross income is any income, regardless of origin and regardless of form.[62] Further, much like the Code, the DSTA provides examples of what types of income is to be included in taxable income.[63] The similarities do not, however, end there. The DSTA, as does the Code, operates with a net income tax principle. Thus, only the net income is taxable income.[64]

Unlike the United States Supreme Court, however, the Danish judicial branch has not exercised a similar kind of judicial activism in its interpretation of the term taxable income. Although exclusions are continuously enacted, amended and repealed, it seems that the understanding and meaning of the term taxable income, for Danish tax law purposes, has not significantly changed over time, if at all.[65] Consequently, when an issue of whether a damage award should properly be regarded as taxable income or not is brought before a court or competent tribunal, the dispute usually revolves around a determination as to what the award is a substitution for. In SKM2001.281.LSR, for example, the issue before the tribunal was whether the damages were awarded in lieu of wage-type income or as a consequence of violations of state law. After having determined why the damages were awarded in the first place, the tribunal concluded that the award was meant as a compensation for both, thereby making it partially taxable.[66]

Although U.S. and Danish tax law are similar in many fundamental respects when it comes to defining taxable income, there are also fundamental differences between the two. In distinguishing between taxable income and capital expenditures, Danish tax literature often explains taxable income by way of an example, using an apple tree. Under this analogy or metaphor, the fruits of the tree are taxable income, while the expenditures associated with acquiring the tree, as well as its upkeep, is a capital expenditure.[67] As such, only a gain on the sale of the fruit, not a gain on the sale of the tree, is taxable income. This is fundamentally different from the way the Code treats a

[62] *See* DSTA § 4.
[63] *See* DSTA §§ 4-6.
[64] *See id.*
[65] *See* NIELS WINTHER-SØRENSEN, *et al.* SKATTERETTEN 1 148 (5th ed. 2009).
[66] *See id.*
[67] *See* HENRIK DAM, *et al*, GRUNDLÆGGENDE SKATTERET 157 (1st Ed. 2009).

sale of a capital assets. As will be discussed, the Code assigns a tax basis to all acquisition.[68] This tax basis generally equals the purchase price of the asset. Gain on the sale of the asset, even a capital asset, that exceeds it basis, will generally constitute taxable income.[69] Although laws enacted subsequent to the DSTA departs from the DSTA's starting point, bringing Danish tax laws more in accordance with its U.S. counterparts,[70] the tax free treatment on the sale of the apple tree continues to be the theoretical principle rule.

Apart from this nuance, however, Danish tax law seems to have taken a pragmatic approach to defining taxable income. An increase in wealth, save for an increase as a result of the sale of capital asset, will generally constitute gross taxable income.[71]

B. Taxation of Damage Awards

The history of the Danish provisions and principles applicable to the taxation of tort recoveries is less detailed, and far less colorful than its U.S. counterpart. As noted above, Danish law has taken a much more pragmatic approach to the taxation of money received on account of injuries sustained due to others culpable acts. Focusing on the definition of income, as defined by the DSTA,[72] tort recoveries are taxable if they are received in lieu of something otherwise taxable.[73] As will be discussed below, it is noteworthy that the United States Supreme Court from time to time has applied a similar principle in cases regarding the proper tax treatment of damage awards.[74] The DSTA only parts from this in-lieu-of principle, if the award is received as periodic payments, as opposed to being paid in one lump sum. Under the DSTA, any award being paid in

[68] *See* Part VI.B.
[69] *See, e.g.*, IRC § 61(a)(3).
[70] *See, e.g.*, Danish Personal Tax Act ("DPTA") § 4(1)(1) (making interests capital income), Danish Act on Taxation of Profit from Sale of Real Property § 6 (making certain gains on the sale of real property, taxable income).
[71] Even the DSTA departs from the theoretical rule, making gains on the sale of the apple tree taxable, if the sale is part of the taxpayer's livelihood. *See* DSTA § 5(a). For the purposes of this Paper, however, this exception will not be discussed further.
[72] *See* DSTA § 4.
[73] *See* NIELS WINTHER-SØRENSEN, *et al.*, *supra* note 65 at 175 (explaining that money awards for personal injuries represent a special category, in that DSTA §§ 4 and 5 do not apply to the taxation of a person's body, but noting that it is self-evident that recoveries for back pay and lost wages clearly is taxable under DSTA § 4, while recoveries for pain and suffering pursuant to § 5 is not).
[74] *See* note 124 and accompanying text.

periodic payments is taxable, even if paid in lieu of something otherwise not taxable.[75] The reason for this exception to the otherwise tax-free treatment of awards for personal injuries, is somewhat difficult to comprehend. Section 4(1)(c) of the DSTA lists a number of items that are properly considered taxable income, including recurring salary and support payments. The Section specifically notes that the list is non-exhaustive. It does so by making any payments that are analogous to an item on its list, similarly taxable. This has been interpreted to include damage awards being paid in periodic payments.[76] The reasoning is that periodic payments are dividends due on the capital asset, which in this instance is your body. Since yields or dividends in all other circumstances are taxable, tax symmetry requires that damage awards being paid in periodic payments, similarly are taxable.

VI. Human Capital and Taxation of Tort Recoveries

A. <u>The Issue of Human Capital</u>

According to the standard enunciated in *Glenshaw Glass*,[77] injury awards are taxable under Code Section 61,[78] because the money received is an accession to wealth, clearly realized, over which the victim has complete dominion.[79] The victim's financial situation improves as a result of the award, and this increase in wealth is taxable under Section 61. The same results follows from the general rule of the DSTA Section 4. A damage award is, as noted, an accession to wealth. A victim's purchasing power increases as a result of receiving the award, and the victim's income is greater after the receipt of the award, making it taxable income under Section 4 of the DSTA.

For U.S. purposes, Code Section 104(a)(2)'s legislative history, however, at least casts doubt as to whether this was the legislature's intent. As previously explained, the Attorney General opined that proceeds from an insurance policy "merely take the place of

[75] *See* DSTA § 4(1)(c); WINTHER-SØRENSEN, *et al. supra* note 65, at 280.
[76] *See* Christian Harlang, *Taxation of Damage Awards as a Result of a Personal Injury*, TfS 2006, 849.
[77] 348 U.S. 426, 431 (1955).
[78] *See* Roemer v. Comm'r, 716 F.2d 693, 696 n.2 (9th Cir. 1983) (noting that even though damage awards are income under the Sixteenth Amendment, "Congress in its compassion" has excluded such awards from taxable income).
[79] *See Glenshaw Glass Co.*, 348 U.S. at 431.

capital in human ability which was destroyed by the accident."[80] Yet, as one commentator explains:

> [E]ven if the [human capital] theory was the original rationale for the statutory exclusion, it is not necessary to accept the theory as the justification for *retaining* the exclusion. A statute may be adopted for a reason that is later abandoned, but the statute may be retained for quite different reasons.[81]

Relying on the theory of human capital furthermore presents a germane issue at the center of our taxation regime: how do we measure basis in human capital? Only if the injury's monetary value is equal to or greater than the award received should it be excluded under human capital theory.[82] Whether consciously or not, by embracing the in-lieu-of principle, Danish tax law has also embraced the basic principles of human capital theory. As noted above, Danish tax law operates with a net income tax principle. As such, the tax-free treatment of damage awards can only be supported on one of either two statutory approaches. Under the first approach, the law assumes that the award received does not exceed the value of the loss sustained, and therefore, in accordance with the net income tax principle, does not tax the award. Under the second approach, the law treats the human body as a capital asset, thus making any award received as compensation for a decrease in the capital assets value, tax-free.

B. Basis in Human Capital

Commentators generally agree, and the United States Court of Appeals for the Ninth Circuit has stated the fact in dictum,[83] that people do not have a basis in their

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[80] *See supra* note 35 and accompanying text; *accord* Dotson v. United States, 87 F.3d 682, 685 (5th Cir. 1996) (arguing that when Congress enacted the exclusion in 1918, compensation for personal injuries were considered a return of human capital, and was therefore not constitutionally taxable under the Sixteenth Amendment).

[81] Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 342 (1995) [hereinafter Kahn, *To Tax or Not to Tax*].

[82] *Cf.* posting of Bryan Camp to TaxProf Blog, http://taxprof.typepad.com/taxprof_blog/2006/08/tax_prof_commen.html (Aug. 23, 2006) (commenting on *Murphy v. IRS.*, and explaining that for *Murphy* to make any sense, it must assume that Murphy's recovery was equal to or not greater than her basis in her reputation and emotional well-being).

[83] *See* Roemer v. Comm'r, 716 F.2d 693, 696 (9th Cir. 1983) (noting that "[s]ince there is no tax basis in a person's health and other personal interest, money received as compensation for an injury to those interests might be considered a realized accession to wealth.").

human capital.[84] To explain why basis in human capital is either zero or nonexistent, the analysis must begin by defining the term "basis" and explain how this term is used in the Code and the DSTA. The Code defines the concept of basis as the cost of an asset.[85] If a taxpayer buys property for $10, the taxpayer's basis in that property is $10.[86] If the taxpayer later sells the property for $15, the taxpayer will be taxed on $5, since only proceeds exceeding basis is taxable.[87] This is also explained as the concept of recovery of capital or a return of capital.[88] The purchase price is the taxpayer's invested capital in the property, and that amount is to be offset against the sale price.[89] Thus, if the taxpayer in the above example sells the property for $10 or less, there is no gain or accession to wealth, and therefore no taxable income.[90] The DSTA applies a similar framework. The theoretical principle rule is that only proceeds exceeding the acquisition price of an asset are taxable income.[91]

While the Danish legislature may not have indented to incorporate principles of the human capital theory in its damage award taxation scheme, the statutory framework, together with the subsequent interpretation of the DSTA, tells a different story. Similarly, the legislative history of Code Section 104(a)(2) indicates that the U.S. Congress enacted the predecessor to Section 104(a)(2) in part by relying on human capital theory, explaining that proceeds received on account of an injury should be regarded as a return of the human capital that was destroyed.[92] In so concluding, however, Congress mischaracterized human capital theory, because only if human capital has previously been taxed, thereby providing human capital basis, should the proceeds be considered return to capital and thus tax free. The interpretation of the DSTA, as it applies to damage awards, suffers from the same flaw. If damage awards for personal

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[84] *See, e.g.*, Hobbs, *supra* note 10, at 64 (stating that "[t]he cost to the owner of "human capital" is zero."); Kahn, *To Tax or Not to Tax*, *supra* note 81, at 343 (arguing that "it is highly unlikely that a person has any basis in body parts.").
[85] I.R.C. § 1012 (2000); MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 26 (9th ed. 2002).
[86] *See* I.R.C. § 1012; JOSEPH BANKMAN ET AL., FEDERAL INCOME TAX 78 (3d ed. 2002) (using a similar example to explain the concept of basis).
[87] *See* I.R.C. §§ 1001 (2000), 1011(a) (2000), 1012; CHIRELSTEIN, *supra* note 85.
[88] BANKMAN, *supra* note 86.
[89] *See* I.R.C. §§ 1001, 1011(a), 1012, 1016 (2000); WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 105 (14th ed. 2006) (describing the same result using an example where the taxpayer purchases stock).
[90] *See* I.R.C. §§ 1001, 1011(a), 1012, 1016.
[91] *See* the DSTA §§ 4-6; NIELS WINTHER-SØRENSEN, *et al.*, *supra* note 65, at 68.
[92] *See supra* note 35 and accompanying text.

injuries are tax free, then the DSTA must either assume that the human body is a capital asset, or that the damage award does not exceed the acquisition price of the body part that was injured or destroyed. Under human capital theory as we understand it today, however, taxpayers are either born with a zero basis or acquire basis in their well-being at birth, measured by calculating the person's prospective earning capacity, and taxing that earning capacity at birth.[93] Taxpayers can increase their basis by investing after-tax dollars in items such as education, training, and health care.[94] While it might be possible to calculate a taxpayer's potential future earning capacity once the taxpayer is part of the workforce, it seems impossible to make this calculation at the taxpayer's birth.[95] This would require the Internal Revenue Service ("Service") and the Danish Tax and Customs Administration ("SKAT") to asses, based on the taxpayer's socioeconomic milieu as well as other factors, what field the taxpayer in question will engage in, and in what setting.[96] Even if a child is born into a family with a history of sending children to law school, the child might grow up to work in a large private firm, or might choose the life of a law professor, since taxpayers, based on their education and experience, do not always work at the highest available salary.[97]

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[93] *See* Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477, 1482 (1994) (arguing that under an ideal tax system the tax code should take into account the wealth a person is endowed with at birth); Lawrence Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX. L. REV. 1, 22 (1995) (suggesting that it is possible to obtain information through individualized examination of each person's earning capacity at birth, so as to calculate basis in human capital); *cf.* Laura Sager and Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and The Income Tax*, 35 HARV. J. ON LEGIS. 447, 479 (1998) (criticizing the application of the human capital theory on the ground that it is impossible to assign a basis to destroyed emotional well-being of a taxpayer, while conceding that "the starting point should be the total amount spent on the taxpayer's support since birth.").

[94] *See* Joseph M. Dodge, *Taxing Human Capital Acquisition Costs -- Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927, 952 (1993) [hereinafter Dodge, *Taxing Human Capital*] (listing items in addition to those described through which a taxpayer's human capital should be measured); Stephan III, *supra* note 13, at 1358-59 (describing additional means by which taxpayers can increase their human capital basis).

[95] *See* Dodge, *Taxing Human Capital*, *supra* note 94 (explaining that the exclusion from taxable income of the described accessions to human capital can be justified, *inter alia*, on the ground that it is impossible to valuate); *cf.* Sager and Cohen, *supra* note 93, at 477-78 (stating that it is impossible to assign any basis to destroyed emotional well-being). *But see* Kaplow, *supra* note 93, at 1483 (arguing for the inclusion of human capital in the tax system, and noting that "the value of human capital at birth is simply the present value of future earnings.").

[96] *See* Zelenak, *supra* note 93 (suggesting ways in which one can calculate future earning capacity, and noting that " [a] leading study found that the most "successful" quintile of families could expect their sons to earn 45% to 80% more than the national average.").

[97] *See id.* at 24-25.

One scholar suggests that the solution to this problem is to adjust the basis when any uncertainties are resolved.[98] Even if this is administratively feasible, it would necessitate an entirely new calculation should the above-mentioned hypothetical child choose to become an auto mechanic instead, or end up spending the rest of its days being unemployed. Professor Kaplow suggests that this would still be resolved by adjusting basis. He explains that when the uncertainty is resolved "the expected value of future earnings changes, which implies a one-time change in wealth that results in either positive or negative income. These changes in wealth arise due to the resolution of uncertainty, not changes in the amount of earnings over time that were anticipated."[99] This argument does not, however, properly take into consideration the fact that a taxpayer's job is almost never secure, and any number of incidents could happen that would affect the taxpayer's employment. Thus, if uncertainties cannot be completely eliminated, taxpayers would never be accurately taxed on their human capital, and the theory is therefore unworkable. Professor Kaplow would probably suggest calculating basis based on the taxpayer's current occupation. However, if the uncertainty is never resolved, the taxation of the prospective taxpayer will persist to be incorrect.[100]

As noted previously, notwithstanding human capital theory, one court has stated the fact in dictum,[101] and commentators generally agree that people do not have a basis in their human capital.[102] Some scholars explain that this is so because human capital is not like other property that does have a basis.[103] Others explain that because apportionment of cost to basis cannot be done rationally, it is impossible to calculate basis in a person's

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[98] Kaplow, *supra* note 93, at 1485.
[99] *Id.*
[100] *See* John A. Litwinski, *Human Capital Economics and Income*, 21 VA. TAX REV. 183, 227 (2001) (criticizing Professor Kaplow's theory on the ground that only realization resolve the uncertainty, and arguing that the extent of someone's human capital endowment cannot be calculated until a series of realization events takes place, such as going to work); *see also* Jennifer J.S. Brooks, *Taxation and Human Capital*, 13 AM. J. TAX POL'Y 189, 191 (1996) (noting that "[n]o one argues that it is feasible to predict at birth an individual's future wage stream, although Kaplow has described a computation that increases (supercounts) actual wages by a factor reflecting deferral."); Doti, *supra* note 10, at 63 (arguing that taxing individuals at birth would be "ludicrous," and would be a direct tax requiring apportionment under the Constitution).
[101] *See* Roemer v. Comm'r, 716 F.2d 693, 696 (9th Cir. 1983) (noting that "there is no tax basis in a person's health and other personal interest.").
[102] *See, e.g.*, Hobbs, *supra* note 10 (stating that "[t]he cost to the owner of "human capital" is zero."); Kahn, *To Tax or Not to Tax*, *supra* note 81, at 343 (arguing that "it is highly unlikely that a person has any basis in body parts.").
[103] *See* Sager and Cohen, *supra* note 93, at 478.

well-being.[104] Thus, human capital basis is zero simply because attempts to assign a basis in human capital show, that it is too difficult as well as fruitless to distinguish between business and personal expenditures that affect human productivity, and to determine the proper allocation of basis to lost or injured body parts.[105] Along similar lines, because the burden of establishing basis in their human capital is on the taxpayers, and since taxpayers do not keep records of any capital expenditures they may have made in connection therewith, the basis in human capital, if any, is zero.[106] Some of these commentators do not, however, reject the proposition out right. This group of scholars contemplate that an argument could be made that expenditures that are necessary for the survival or development of the individual, such as expenditures for food, clothing, shelter, and education, could create a tax basis in the individual's body, and personal rights or attributes.[107] However, as it is further explained, tax law has never "acknowledged such an investment as constituting basis, and the practical and administrative difficulties inherent in doing so in the general case seem insurmountable."[108]

Some commentators reject the argument that human capital basis is zero solely because of the difficulty of calculating that basis.[109] Some argue that that the Code should grant intangible and unique human losses a basis "equal to the amount necessary to restore the status quo ante" when determining the taxable treatment of injury awards, instead of concluding that humans have no basis in their well-being.[110] Others argue that since it is reasonable to assume that the human capital expenditures a taxpayer makes

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[104] *See* Kahn, *To Tax or Not to Tax*, *supra* note 81, at 343-44 (arguing that "it is highly unlikely that a person has any basis in body parts [since] [m]ost expenditures that might conceivably be attributed to body parts cannot be apportioned among them on any rational basis.").
[105] *See* Thomas D. Griffith, *Should "Tax Norms" be Abandoned? Rethinking Tax Policy Analysis and The Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115, 1150 (1993).
[106] *See* Wolff, *supra* note 10, at 1486 n.133 (2000) (explaining that courts and the Service will, where basis is speculative, assign it zero value, because the burden of establishing basis is on the taxpayer, and as a result, a damage award received by the taxpayer is taxable in its entirety).
[107] *See* J. Martin Burke and Michael Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV 13, 42 (1989).
[108] *See id.*
[109] *See* Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 152 (1992) [hereinafter Dodge, *Taxes and Torts*] (stating that "the sentimentalist[s]" support this proposition even though it is inconsistent with other tax rules) (citation omitted); Sager and Cohen, *supra* note 93, at 480 (questioning the assertion that because emotional well-being is a nonmarket good it is impossible to replace).
[110] *See* Hubbard, *supra* note 53, at 765.

exceeds the amount of any damage award, the award does not constitute a taxable gain.[111] This argument is partially based on the United States Tax Court's decision in *Inaja Land Co. v. Commissioner*,[112] involving the sale of an easement as a result of a partial destruction of real property.[113] In *Inaja Land Co.*, the petitioner paid $61,000 for real property located on a river bank, together with fishing rights, the latter of which were adversely affected when the city of Los Angeles began diverting water into the river following the construction of a tunnel.[114] The petitioner threatened suit, and the matter was settled for $50,000, wherein the petitioner released the city of all claims and granted it an easement to continue to divert water.[115] The court held that since it was practically impossible under the circumstances to allocate a basis to the easement, and since petitioner's basis in the property exceeded the price of the easement, the amount received should be treated as a return of capital, and offset against petitioner's basis in the property.[116]

The argument, however, fails to address the issue of treating human capital as property.[117] To postpone the taxation of a gain when apportionment is impossible, as in *Inaja Land Co.*,[118] is sound when dealing with property, because eventually a realization event, such as an exchange or a sale, will occur. In contrast, there is no realization event for human capital, so to postpone the taxation of a gain in human capital would in effect be the same as not taxing it at all.[119] Moreover, the argument is inconsistent with both the Code's and the DSTA's regular treatment of human capital.[120] Lastly, the "argument

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[111] *See* Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries Under Federal Civil Rights Statutes: Income From Human Capital, Realization, and Nonrecognition*, 72 N.C. L. REV. 549, 562 (1994); Sager and Cohen, *supra* note 93, at 480; *see also* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 432 n.8 (1955) (noting that "departmental rulings [have held that] personal injury recoveries [are] nontaxable on the theory that they roughly correspond to a return of capital . . . .").
[112] 9 T.C. 727 (1947).
[113] *Id.*
[114] *Id.* at 727-30
[115] *Id.* at 730
[116] *Id.* at 736.
[117] *Cf.* Sager and Cohen, *supra* note 93, at 478-79.
[118] 9 T.C. at 736.
[119] *Cf.* Sager and Cohen, *supra* note 93, at 478 (explaining that the failure to tax appreciation in human capital can be explained by the absence of a realization event).
[120] *Cf.* Dodge, *Taxes and Torts*, *supra* note 109 (arguing that "[i]f a personal injury involves a loss of human capital, then it follows that there should be a deduction for *un*compensated personal injury losses; however, no such deduction exists."). Professor Dodge further notes that "if one has basis in human capital, there should be depreciation deductions to offset wages, but again none exist.) (citations omitted).

[may] produce[] nonsensical results for very young taxpayers," where the amount of a damage award may in fact exceed capital expenditures made in connection with the taxpayers human capital, if we assign zero basis at birth.[121]

Therefore, if basis in human capital is either nonexistent or equals zero, any amount received due to human capital injuries will be taxable because it is "[an accession] to wealth, clearly realized, over which the [taxpayer has] complete dominion."[122] The same conclusion follows from Section 4 of the DSTA, in as much as money received during the year, should properly be included in taxable income. As a result, unless Congress or the Danish legislature has specifically excluded certain awards from taxable income, as is the case with physical injuries pursuant to the Code,[123] and as is the case with certain tort damages paid in one lump sum under the DSTA, any award received is taxable under Code Section 61 and DSTA Section 4 respectively.[124]

An application of the so-called in-lieu test, however, could lead to a different result, at least for U.S. tax purposes. The in-lieu test mandates, similarly to the statutory scheme for taxing damages awards under the DSTA, that if an award is received in lieu of something not otherwise taxable, then it is not taxable.[125] In the U.S., the test originally only applied to business injuries. However, courts began adopting the test in disputes over the tax treatment of personal injuries as well.[126] One could argue that since neither Congress nor the Danish legislature taxes emotional well-being and good reputation, damage awards for these nonphysical injuries should not be taxable. If this reasoning is sound, however, then damages for physical injuries are similarly not taxable, because neither Congress nor the Danish legislature taxes a person's physical capacities, making at least Section 104(a)(2) obsolete, except insofar as it also excludes damages for

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[121] *See id.*
[122] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).
[123] *See* I.R.C. § 104(a)(2).
[124] *See* I.R.C. § 61(a); DSTA § 4.
[125] *See* Bagley v. Comm'r, 121 F.3d 393, 395 (8th Cir. 1997); Raytheon Production Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944) (explaining that "the question to be asked is '[i]n lieu of what were the damages awarded?'") (citations omitted).
[126] *See, e.g.*, *Bagley*, 121 F.3d at 395 ("court[s] must look beyond language of settlement to determine "'in lieu of what'" were damages paid.") (citations omitted). It is noteworthy that courts apply the test in connection with section 104(a)(2), because the section departs from the in lieu principle by excluding damages for lost earnings when the taxpayer also suffers a physical injury. *See* Sager and Cohen, *supra* note 93, at 487 (arguing that the section also departs from the principle by not excluding nonphysical injuries).

lost wages.[127] Moreover, since these nonphysical injury awards are taxable under Code Section 61(a), any award received will be in lieu of something otherwise taxable.[128]

Yet, the reason for awarding any money at all is an attempt to make the victim whole, that is, to compensate the victim for something that was taken away. Such a view could mandate that both physical as well as nonphysical injury awards be excluded from taxable income, because they attempt to restore the victim to the situation he or she was in prior to the injury. However, as the United States Courts of Appeals for the First Circuit in *Raytheon Production Corp.*[129] explained, "to say that the recovery represents a return of capital . . . is not to conclude that it may not contain a taxable benefit."[130] Thus, if a compensation for a loss exceeds the basis in the damaged property, the excess amount is a taxable gain.[131] The same results follows from the DSTA's net income tax principle. An application of the principle of a return of capital therefore requires a calculation of human capital basis, so as to ensure that the value of an award does not exceed that basis. Yet, *Raytheon* also recognized the principle illustrated earlier with reference to *Inaja Land Co.*,[132] that a gain is not currently taxable where apportionment of a recovery to basis is impracticable or impossible.[133] However, this reasoning would still necessitate an attempt to calculate basis, so as to show that apportionment is either impracticable or impossible.[134]

C. Restoration of Human Capital

The application of the human capital theory, and its principle of restoration of human capital, involves many controversial issues, one being the calculation of basis or acquisition price. Even assuming that it is feasible for the Service and SKAT to

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[127] *See* Comm'r v. Schleier, 515 U.S. 323, 329 (1995) (explaining that a recovery for lost wages is excludable, as long as the recovery is awarded on account of a personal injury).
[128] *See* Murphy v. IRS, 362 F. Supp. 2d 206, 218 (D.D.C. 2005).
[129] 144 F.2d 110.
[130] *See id.* at 114.
[131] *Id.* (explaining that the loss of the corporation's "good will in excess of its cost is gross income.").
[132] 9 T.C. 727 (1947).
[133] *See id.*; *see also supra* notes 113- 116 and accompanying text (elaborating on the facts of *Inaja Land Co.*).
[134] *See Raytheon Production Corp.*, 144 F.2d at 114 (explaining that if it is impossible to calculate the basis of stolen property, it is also impossible to determine whether a monetary recovery of that property represents a gain, and therefore the gain, if any, is purely conjectural and consequently not taxed) (citations omitted); *Inaja Land Co.*, 9 T.C. at 736.

administer a system where certain expenditures are a non-taxable return of human capital, it is not feasible for the Service, SKAT, the courts, Congress or the Danish legislature to draw a non-arbitrary line between taxable and non-taxable returns of human capital.[135] As one commentator hypothetically asks:

> [b]y 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?[136]

For example, some courts have held that taxpayers realize taxable income when they sell their blood for profit, even though blood is part of the taxpayer's human capital.[137] Arguably, the sale of blood is a return of human capital in that the money received by the taxpayer equals the monetary value of the blood. Consider also the conversion of an organ into a monetary value. If a taxpayer's organ is injured in an accident, a subsequent damage award is excluded from taxable income under Section 104(a)(2), as well as under the DSTA.[138] Under human capital theory this is rightly so, because under the concept of human capital, the total reimbursement a taxpayer receives for injuries sustained is not income, because the taxpayer is "compensated for losses to his/her birthright - an uninjured body and mind . . . [so] [t]here is no gain, since money damages are intended to put the victim back in the same position as before the accident."[139] In other words, the money represents a return of lost human capital. If the same taxpayer instead chose to sell the organ, however, the purchase price would be taxable to the seller under the same principles that the sale of blood constitutes taxable

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[135] *See* Dodge, *Taxes and Torts*, *supra* note 109, at 153 (asserting that since it is impossible to keep track of cost, and since human capital raises conceptual problems, it should not "be treated as a conventional asset with basis.").
[136] *Id.*
[137] *See, e.g.*, Lary v. United States, 787 F.2d 1538, 1540 (11th Cir. 1986) (denying the taxpayer a charitable deduction for the donation of his blood, because taxpayers cannot take a charitable deduction if the property donated would have resulted in ordinary income had the property been sold); Green v. Comm'r, 74 T.C. 1229, 1232 (1980) (holding that the taxpayer, upon the sale of her blood, clearly realized income).
[138] *See* I.R.C. § 104(a)(2); DSTA §§ 4-6.
[139] *See* Doti, *supra* note 10.

income.[140] And what about the tax treatment of the recipient of the organ? The recipient purchases the organ, and the purchase price is the taxpayer's basis in the organ. However, presumably the organ is a replacement for the taxpayer's similar nonfunctioning organ. Under human capital theory, the taxpayer is likely to have a basis in the now non-functioning organ that must be offset against the basis in the new organ, in order to calculate taxable income on any future damage awards.

The comparison between the injury of an organ and the sale of that same organ shows how the application of human capital theory leads to arbitrary results under our current system, in that both situations involve a return of human capital, yet only one of them is tax-free.[141] One justification for treating the two different situations involving a conversion of an organ into a monetary value, is that one is voluntary while the other is not.[142] The ordinary wage earner makes a voluntary decision to enter the work force, in contrast to the injured victim who generally does not voluntarily consent to the injury.[143] Since the involuntary conversion of tangible property is not, however, treated in the same favorable manner, it seems that involuntariness alone is not a sufficient justification for the exclusion.[144]

Yet another issue is the administrative burden the theory's application would place on the Service and SKAT. For taxpayers to demonstrate that an amount received is a non-taxable restoration of human capital, they would have to submit receipts to show the total amount spent on the taxpayers' support since birth.[145] For the Service and SKAT to verify the taxpayers' claims, they would be required to go through each receipt to determine whether a given expense should be taken into account in calculating basis or

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[140] *See* Douglas A. Kahn, *Taxation of Damages After Schleier - Where are We and Where Do We Go From Here?*, 15 QUINNIPIAC L. REV. 305, 312 (1995) [hereinafter Kahn, *Taxation of Damages After Schleier*] (where the example is taken from).
[141] *Cf.* Sager and Cohen, *supra* note 93, at 481 (criticizing the analogy between wages and pain and suffering, which claims that since both wages and pain and suffering are a substitute for something that would be enjoyed without producing taxable income, both should be excluded from taxable income).
[142] *Cf.* Sager and Cohen, *supra* note 93, at 481.
[143] *See id.*
[144] *See, e.g.*, Danish Act on Taxation of Profit from Sale of Real Property § 2; Kahn, *Taxation of Damages After Schleier*, *supra* note 140, at 314.
[145] *See* Sager and Cohen, *supra* note 93 (asserting that the calculation of a taxpayer's basis should begin with the amount spent on the taxpayer since birth).

acquisition price.[146] This is so, because the cost of maintenance and repair cannot be capitalized as basis or added to the purchase price, but is currently deductible.[147] The United States Department of the Treasury defines such repairs and maintenance as "incidental repairs[,] which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition."[148] A similar definition is applicable pursuant to the DSTA, under which, expenses that are paid in the ordinary course of an ongoing business for the purpose of producing income, must be currently deducted.[149] In contrast, expenditures that must be capitalized as basis or added to the acquisition price, add to the value of the property, and prolong its life.[150] As one commentator notes, to distinguish between the two is easier said than done.[151]

Even courts sometimes find the distinction hard to apply. In *Midland Empire Packing Co. v. Commissioner*, the taxpayer, in order to avoid the shut-down of its meat packing plant due to seepage of oil from a nearby refinery, lined its basement with concrete.[152] The tax court held that this was a repair that merely permitted the taxpayer to continue doing business. In *Mt. Morris Drive-In Theater Co. v. Commissioner,* however, the taxpayer installed a drainage system to stop run-off to neighboring land, and the court held that because the system added to the value of the land for the use to which it had been put, the cost of the system had to be capitalized.[153] Similarly, in UfR 1976.60H both the High Court and a minority of the Supreme Court concluded that the expenses in question were not currently deductible, but the majority of the Supreme Court concluded otherwise.

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[146] *See* Kahn, *To Tax or Not to Tax*, *supra* note 81, at 343-44 (explaining that human capital expenditures such as food, clothing, and medical care cannot rationally be apportioned, but that in the event it is feasible, expenditures allocated to specific body parts are generally considered to be maintenance and repair, and can therefore not be capitalized as basis).

[147] *See* KAHN, FEDERAL INCOME TAX, *supra* note 52, at 341; HENRIK DAM, *et al*, GRUNDLÆGGENDE SKATTERET *supra* note 67, at 234; Kahn, *To Tax or Not to Tax*, *supra* note 81, at 343-44 (explaining that human capital expenditures such as food, clothing, and medical care allocated to specific body parts are generally considered to be maintenance and repair, and can therefore not be capitalized as basis).

[148] Treas. Reg. § 1.162-4 (1960).

[149] *See* NIELS WINTHER-SØRENSEN, *et al.* SKATTERETTEN 1, *surpra* note 65, at 235.

[150] KAHN, FEDERAL INCOME TAX, *supra* note 52, at 341; NIELS WINTHER-SØRENSEN, *et al.* SKATTERETTEN 1, *surpra* note 65, at 234.

[151] *See id.* (noting as a caveat that the distinction is much easier to explain than it is to apply).

[152] 14 T.C. 635 (1950), *acq.* 1950-2 C.B. 3.

[153] 238 F.2d 85 (6th Cir. 1956).

To illustrate the arbitrariness of having to apply the distinction under the human capital theory, consider the removal of tonsils, a procedure known as tonsillectomy.[154] For taxpayers with low immune systems, where infections could lead to dire results, the removal of tonsils can arguably prolong their life. The removal of tonsils in taxpayers with strong immune systems, however, can be characterized as a repair under the above-mentioned definition.[155] Lastly, it will be difficult, if not impossible, for the Service and SKAT to articulate a non-arbitrary standard to distinguish between those expenditures that add to the value of human capital, and those that do not.[156]

Thus, the tax systems herein analyzed cannot fairly or even correctly administer and apply human capital theory to calculate taxable income. It is therefore "better that the income tax system simply ignore human capital—as is presently the case—than attempt to account for it in a highly selective manner."[157]

VII. To Exclude or Not To Exclude Damage Awards, That Is the Question

Rejecting human capital theory as a justification for excluding tort recoveries from taxable income, leads to a state of limbo. If the theory should be disregarded, Section 104(a)(2) should be repealed, the principles deduced from the DSTA Sections 4-6 should be rethought, and all damage awards should be taxable, unless another theory of taxation can justify the existence of an exclusion. This Paper, however, agrees with at least two other scholars who have concluded that no single theory of taxation can support excluding damage awards from taxable income.[158] Nevertheless, as the discussion that follows will show, retaining the exclusion can be supported on policy grounds. The starting point for the analysis ought to be accretion theory of taxation, taxing increases in

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[154] *See* PROFESSIONAL GUIDE TO DISEASES, 1238-39 (Springhouse, 7th ed. 2001) (explaining that in the case of chronic tonsillitis—the inflammation of the tonsils—tonsillectomy may be required).
[155] *See* Treas. Reg. § 1.162-4.
[156] *See* Dodge, *Taxing Human Capital*, *supra* note 94, at 153 (arguing that there is no coherent principle by which one would be able to distinguish between capital expenditures, and the expense portions of food and education, which, according to the author, is not a capital expenditure).
[157] *Id.* at 929; *accord* Dodge, *Taxes and Torts*, *supra* note 109, at 155 (arguing that basis in human capital should be disregarded). *But cf.* Hobbs, *supra* note 10 (suggesting that the Court in *Glenshaw Glass Co.* sanctioned the return of human capital rationale).
[158] *See* Wolff, *supra* note 10, at 1408; Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?,* 38 Case W. Res. 43, 51 (1988).

wealth when received, and excluding imputed income.[159] Imputed income is generally understood to include the use of personal assets, services performed by oneself for oneself, and leisure activities.[160] It is advisable to exclude imputed income, because taxable income ought to be limited to actual increases in purchasing power.[161] Wealth increase should properly be limited to actual increased power to acquire goods and services from someone other than oneself.[162] Imputed income, such as performing services for oneself, does not increase this purchasing power.[163] Rather, self-performed services save purchasing power such that it may be used to acquire goods or services in the future, and thus merely represent an exercise of choice as to how and when purchasing power should be spent.[164]

A damage award is money, and its receipt therefore increases the victim's wealth and purchasing power. As such, in order to retain the exclusion for damage awards from taxable income in some form or other, we must justify deviating from the norm. The discussion that follows immediately below will present arguments for and against taxation of damage awards, and conclude that exclusion is the most compelling alternative, thereby justifying deviating from our baseline.

A. Arguments for Inclusion

First, as noted above, if the baseline for taxation is accretion, then damage awards should be fully taxable. This conclusion would also be consistent with both Supreme Court precedent on what constitutes taxable income,[165] as well as DSTA Section 4. When a person receives a monetary award as compensation for injuries sustained, that person's financial situation improves. Absent an exclusion or other exception, tort recoveries should be taxable like any other income or wealth accretion.

Along similar lines, one may ask what makes damage awards so special that they warrant being excluded from taxable income. Yes, the victim was injured. Yes, the

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[159] *See* Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 67 OR. L. REV. 561, 568 (1988).
[160] *Id.; see also* Danish Tax Assessment Act § 7(26) (pursuant to which, the value of self-performed service are excluded from taxable income).
[161] *See id.* at 591.
[162] *See id.*
[163] *See id.* at 592; *see also* DTAA § 7(26).
[164] *Id.*
[165] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

victim should be compensated to the extent possible for that injury. Yet, since many physical injuries heal themselves over time, a broken leg for example, the money received do not take the place of the injured body part, but instead may be to assist the victim in getting by until the wounds are healed. In looking only at the U.S. tax regime for a moment, the argument becomes even more compelling in cases involving wrongful termination, where the award includes compensation for back pay. These types of damages actually take the place of compensation the victim would have earned, had the victim not been fired or laid off. As such, they directly take the place of wages. Since everyone else is taxed on wages earned, why should tort victims be treated any differently?

Lastly, notwithstanding the theoretical principles of human capital theory, receipt of money as compensation for an injury cannot be said to constitute a like-kind exchange such that the policy of Code Section 1031 or the Danish Act on Taxation of Profit from Sale of Real Property Section 10, would apply to defer any taxable income.[166] While the money may assist the victim in paying expenses associated with the injury, the victim cannot purchase a replacement body part. As such, any money received on account of an injury should be included in taxable income.

B. <u>Arguments for Exclusion</u>

a. Avoiding Increase in Award to Account for Taxes.

One argument for excluding tort recoveries from taxable income focuses on the tortfeasor as opposed to the victim. Tort recoveries should be excluded from taxable income, because absent an exclusionary provision, victims will receive an amount in excess of the monetary value of the injury to account for the amount of tax the victim is required to pay on the receipt of the award.[167] As one commentator argues, however, if the concern was higher awards absent an exclusionary provision, the better approach

[166] *See* I.R.C. § 1031 (excluding from taxable income any gain realized on the exchange of, *inter alia*, investment property for other investment property). Under the Danish Act on Taxation of Profit from Sale of Real Property Section 10, insurance proceeds received on account of damages to real property can be deferred, if they are reinvested in property similar to the one that was damaged or destroyed.

[167] *See* Kahn, *To Tax or Not to Tax*, *supra* note 81 at 340 (characterization the argument as one dealing with containment of the size of damage awards).

would have been an income-averaging system.[168] As Professor Kahn further notes, excluding the award in an attempt to contain its size is contrary to a fundamental tort law principle, namely "to encourage tort-free behavior by placing on tortfeasors the full costs of their wrongs."[169] This reasoning would perhaps also take the eggshell plaintiff principle too far.

Notwithstanding Professor Kahn's arguments, a recent case from the United States Third Circuit Court of Appeals addressed this very issue. In *Eshelman v. Agere Systems, Inc.*, the District Court granted the plaintiff's post-trial motion seeking an increase in the award for unlawful discrimination, to account for the adverse tax consequences of receiving a lump sum back pay award.[170] The plaintiff argued, that she was entitled to the increase, because the taxes she was subject to on account of receiving a lump sum for back pay were higher than the those she would have been subject to had she earned the money in the regular course of employment.[171] On appeal, the Circuit Court explained that the policy behind employment discrimination statutes was "to restore the employee to the economic status quo that would exist but for the employer's conduct."[172] The only way to restore the employee to that status quo, was to take into account the increased tax burden the employee would face upon receipt of the lump sum.[173] Consequently, the Circuit Court correctly upheld the District Court's determination as to the increased award to cover the adverse tax consequences.[174]

Similar considerations govern the size of damage awards under the Danish Tort Act, that is, the main objective is to make the victim hole. As such, absent an exclusion, when reaching a settlement as to the size of a given award, which is the predominant

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[168] *Id.* at 341.
[169] *Id.*
[170] No. 05-4895 slip op at *18-19 (3d Cir. Jan. 30, 2009).
[171] *Id.* at *19.
[172] *Id.*
[173] *Id.* at 22.
[174] *See id.* In so holding, the court explicitly rejected the D.C. Circuit's reasoning in Dashnaw v. Pena, and sided with the Tenth Circuit's arguments in Sears v. Atchison, Topeka & Santa Fe Ry. Co. *See Eshelman*, at * 21 n. 8; *Dashnaw*, 12 F.3d 1112, 1116 (D.C. Cir. 1994) (per curiam); *Sears*, 749 F.2d 1451, 1456 (10th Cir. 1984). In *Dashnaw*, the D.C. Circuit held that no authority could support a gross-up of back pay to account for the victim's increased tax burden. 12 F.3d at 1116. In *Sears*, however, the Tenth Circuit upheld the District Court's award of additional compensation to account for the increased tax burden the plaintiff would face on the receipt of a lump sum for 17 years of back pay. 749 F.2d at 1456.

method through which tort disputes are settled in Denmark, the parties should take into consideration the tax value of the award.[175]

The Tenth Circuit's reasoning in *Eshelman* is equally applicable to compensation for physical injuries. If, for example, we assume that a fully functional leg is worth $2,000, and that in the event the leg is broken, its value decreases by $1,000. If damage awards are fully taxable at 25%, and victim V suffers a broken leg in an automobile accident, V should be awarded $1,333 to take into account the tax on the receipt of the award. This is so, because if we determine that V's leg has decreased in value by $1,000 as a result of the injury, all things being equal, V should end up receiving $1,000. Since the award in the example is subject to 25% tax, V would end up with only $750, if we fail to account for the adverse tax consequences of receiving the award. Thus, we must increase the award by approximately $333 so that when the dust settles, V has been compensated in full by the decrease in value of the leg.[176]

b. Involuntary Conversion

Another possible argument for excluding damage awards from taxable income, finds it support in the notion that the injury sustained by the victim was involuntary. According to this argument, it would be wrong for the government to collect a piece of the pie a victim receives after having involuntarily suffered damages to a personal right or body part. As one commentator phrases it, "[when we consider the involuntariness of the injury,] it seems rapacious to tax damages received as compensation for such a personal loss." [177]

The argument is further substantiated by relying on the principle found in Code Section 1033, which allows for deferral of gain when a taxpayer acquires a new property to take the place of property that has been destroyed, provided that the conversion proceeds from the destroyed property do not exceed the cost of the new property (a similar principle is found in Section 10 of the Danish Act on Taxation of Profit from Sale

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[175] *See* Michael Fonsmark and Thomas Præstgaard, *Taxation of Damage awards – Is It Possible to Pay a Damage Award as an After-tax Amount That Will be Binding on SKAT?*, TfS 2007, 552.
[176] Kahn, *To Tax or Not to Tax*, *supra* note 81 at 340 (explaining that in order to compensate the victim in full, the damage award would have to be increased to cover the taxes due on receipt of the award). Professor Kahn ultimately rejects that this argument was the driving force behind Section 104(a)(2).
[177] *Id.* at 347.

of Real Property).[178] Since the victim similarly suffered an "involuntary conversion" as a result of the injury sustained, damage awards should not be taxable, as they take the place of what was destroyed. Moreover, since the award is aimed at making the victim whole, it should equal the decrease in value of the victim's body, such that the conversion proceeds will never exceed the value it is meant to replace.

c. Compassion

When people suffer injuries, be they physical or nonphysical, the natural human reaction for most is compassion. We feel sorry for the victim, and may want to do what we can to make the victim whole again. Consistent with this notion, we may look with disapproval on governmental interference with the victim's recovery process.[179] We expect compassion from our fellow human beings, so we should expect nothing less from our government. One court has in fact implied that compassion is one driving force behind Section 104(a)(2)'s exclusion. In *Roemer v. Commissioner*, the court, in concluding that damage awards are taxable income within the meaning of the Sixteenth Amendment, noted that "Congress in its *compassion*" has excluded such awards from taxable income.[180] Moreover, as professor Kahn describes, since money can never take the place of an injured body part, taxing damage awards may be viewed as being "analogous to feeding off of the flesh of a dismembered arm or leg . . . ."[181] As such, our compassion towards our fellow human being compels us not to unreasonably interfere with the healing process of an injured individual.

d. Equity

Equity principles of taxation are often subdivided into two categories, namely horizontal and vertical equity. The basic meaning of horizontal equity is equal treatment

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[178] *See* I.R.C. § 1033.
[179] *Cf.* Kahn, *To Tax or Not to Tax*, *supra* note 81 at 349 (arguing that taxing damage awards would be seen as a heartless act on the part of the government who would profit from tort law's attempt to compensate an injured victim).
[180] 716 F.2d 693, 696 n.2 (9th Cir. 1983) (emphasis added).
[181] Kahn, *To Tax or Not to Tax*, *supra* note 81 at 349.

of taxpayers who are similarly situated.[182] In contrast, vertical equity means equity between taxpayers at different economic levels.[183] Horizontal equity provides an argument for excluding damage awards from taxable income. The injured taxpayer cannot be said to be similarly situated as the non-injured taxpayer, because of the costs associated with an injury in general, and the possible reduced earning capacity suffered by the victim. As such, we should treat the two differently, by taxing the non-injured taxpayer, while letting the injured taxpayer go free. Such treatment may also help alleviate the adverse consequences of the injury, and may help bring the injured taxpayer back to the horizontal level the taxpayer was in prior to the injury.

Vertical equity similarly provides a rational basis for not taxing damage awards. As a result of the injury, the victim is arguably placed in a worse economic situation than the victim was in prior to the injury. This is so, because the injury will presumably result in a number of expenses on the part of the victim. Thus, we must treat the injured taxpayer differently than the non-injured taxpayer, because their economic situation is different. If damage awards are taxable, then, in addition to paying taxes that is otherwise due, and having additional expenses as a result of the injury sustained, the victim must now also pay tax on the award. Although the victim has more economically as a result of the award, the economic improvement is meant to cover monetary obligations associated with the injury. Where those obligations are equal in value to the award, taxing the victim would place him or her in a worse situation, and cause the victim to bear a greater tax burden than was the case prior to the receipt of the award. Consequently, damage awards should be excluded from taxable income.

C. Bringing It All Together

Reasonable minds may always disagree, and exclusions or preferences in the applicable tax statute ultimately come down to a value judgment.[184] The arguments for exclusion, however, seem more compelling than those supporting inclusion. Damage

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[182] *See* Eric A. Lustig, *Taxation of Prepaid Tuition Plans and the 1997 Tax Provisions -- Middle Class Panacea or Placebo? Continuing Problems and Variations on a Theme*, 31 AKRON L. REV. 229, 266-67 (1997).
[183] *Id.*
[184] *See* Kahn, *To Tax or Not to Tax*, *supra* note 81 at 352.

awards are not like other income. One does not generally receive such awards as a result of having engaged in conduct purposefully targeted towards receiving such monetary income. While one cannot purchase replacement body parts, and while money in many instances can never make up for the injury sustained, we cannot ignore the fact that damage awards are an attempt at making the victim whole. It is basics human instinct to feel compassion towards someone who has broken or lost a limb, suffers anxiety attacks, has been scarred for life both physically and emotionally, all because of someone else's wrongdoing. It seems wrong to first compensate someone for an injury, only to see the government take away some of what was given. Thus, while no single argument standing alone may be able to justify excluding damage awards from taxable income, as a whole, they amply support the general notion of excluding damage awards from taxable income. The whole thereby becomes greater than the sum of its parts.

Notwithstanding the fact that we may generally conclude that damage awards should be excluded from taxable income, a closer look at the components of an award may alter that conclusion slightly. More specifically, as the section that follows immediately below demonstrates, because of the nature of the damage award components, Section 104(a)(2) should be limited in scope so as to only exclude part, but not all, of a damage award from taxable income. Interestingly, this will generally bring Section 104(a)(2) more in accordance with the principles currently applicable to the taxation of damage awards under Sections 4-6 of the DSTA. As will be explained in Part VIII, Danish tax law must also, however, move towards U.S. tax law. More precisely, both lump sum and periodic payments for personal injuries should be tax free under the DSTA.

D. Components of a Damage Award and Their Proper Tax Treatment

Generally, a damage award consists of four components: (i) lost wages, (ii) punitive damages,[185] (iii) increased expenses due to injuries sustained, and (iv) pain and suffering.[186] As for the first component, excluding lost wages when received pursuant to

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[185] Punitive damages can only be awarded under the U.S. tort system, not under Danish law. Nevertheless, their sheer size makes them relevant for a brief analysis in this part of the Paper.
[186] *See* RESTATEMENT (SECOND) OF TORTS §§ 282.2, 924 (1979); *see also* Harlang, *supra* note 76.

a damage award makes little sense, because this component is paid to the victim as a consequence of the victim not being able to work. Had the victim not been injured, he or she would have gone to work, earned a paycheck, and paid taxes on those wages. While one may argue that our compassion towards the injured victim should result in preferential treatment of money received by the victim, because we are trying to make the victim whole, other components of the award are aimed at exactly this aspect. Judging this component in relation to our baseline, it consists of money received, and thus represents a direct increase in purchasing power. Consequently, unless we can posit a reason as to why wages when received as part of a damage award should be treated differently than wages received in the ordinary course, the wage component of a damage award should be fully taxable.

As will be argued immediately below, there are a number of reasons why we should exclude at least some components of a damage award, namely those components that are aimed at making the victim whole. These reasons are not applicable to the wage component of a damage award. This component is paid by the tortfeasor in lieu of the victim earning a paycheck, and therefore somewhat incidental to the actual injury sustained. Under all other circumstances, receipt of the paycheck would constitute taxable income under our baseline. Calculating the amount of this component requires a determination as to how much the victim would have earned, but for the injury, as well as a determination of how much, if any, the value of the victim's future services have diminished because of the injury, in the event the victim will return to the workforce.[187] For all intents and purposes, this component is a direct substitute for the wages the victim would have earned but for the injury, and there is no reason why it should receive preferential tax treatment.[188] Taxing the lost wage component would also be in accordance with equity principles of taxation. Consider two taxpayers, T1 and T2, who

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[187] RESTATEMENT (SECOND) OF TORTS § 924, comment c and d.

[188] *See* James Serven, *The Taxation of Punitive Damages: Horton Lays an Egg?*, 72 DENV. U.L. REV. 215, 230 (1995) (arguing that the theoretical correct treatment of the lost wages components is to tax it in full because it represents a substitute for wages)*; but see* Douglas A. Kahn, *The Constitutionality of Taxing Compensatory Damages for Mental Distress When There Was No Accompanying Physical Injury*, 4 FLA. TAX REV. 128, 136 (1999) (positing that one reason Section 104(a)(2) also excludes the lost wage component of a damage award is because the component is not an actual substitute for lost wages, but rather an identifiable number used to value the overall loss suffered by the victim). Professor Kahn does note, however, that the effect of Section 104(a)(2) is to exclude an otherwise taxable item. *Id.*

are equal in all respects. T1 earns a paycheck and pays taxes on the income received. T2 instead suffers an injury, and receives, as part of the damage award, compensation for lost wages. If the lost wage component receives tax-free treatment, T2 is better off than T1, because the latter pays tax on the income received, while the former does not. Thus, for all the foregoing reasons, the lost wage component of a damage award should be fully taxable.

Notwithstanding the fact that we should tax the lost wage component, because it is a substitute for the wages the victim would have earned absent the injury, thereby representing an increase in purchasing power, taxing this component without further inquiry would ignore the important timing issue related to the taxation of wages. If the victim had not been injured, and instead earned the wages over time, the tax implications would have been different than the tax treatment the lost wage component will receive once we decide to tax it.[189] As such, in order to provide relief from the progressive tax system applicable both in the U.S. and Denmark, we could implement an income-averaging device,[190] or subject the component to a maximum rate.[191] We might be able to subject the tax treatment of the lost wage component to further sophistication by e.g. permitting the victim to invest some of the funds in a retirement vehicle. We could then subject the invested funds to the rules otherwise applicable to investment vehicles, and only subject the excess, if any, of the lost wage component to the rules herein described. In determining the size of the lost wage component, due consideration may be given to the difference in tax treatment between wages earned in the ordinary course, and the effect of receiving one lump sum as the lost wage component.[192] It is acknowledged, that only in the rarest of circumstances will such a tax treatment lead to the lost wage component being treated identical to wages earned in the ordinary course. Nevertheless, from an efficiency and fairness standpoint, this outcome should be preferred over a system that allows something that would otherwise be taxable, to be received tax free

[189] *See* Serven, *supra* note 188, at 296-97.
[190] *See* Kahn, *To Tax or Not to Tax*, *supra* note 81, at 254-55.
[191] *See* Serven, *supra* note 188, at 297.
[192] *See id.*; *cf. supra* notes 170-174 and accompanying text (discussing *Eshelman v. Agere Systems, Inc.*, where the Tenth Circuit held that in order to place the plaintiff in the situation she was in prior to the injury, the size of the award should be adjusted upward in order to account for the adverse tax consequences of receiving a lump sum payment, as opposed to earning wages over time).

under certain circumstances, as is the case with Section 104(a)(2). Lastly, as noted previously, tax-free treatment of the lost wage component would be inconsistent with our baseline.

As for the second component, this too should not be excluded from taxable income. Punitive damages are not meant as compensation to the injured party, but rather to punish the tortfeasor and deter the tortfeasor and others from engaging in similar conduct.[193] If the money received as punitive damages do not depend on the injury or extent of the suffering experienced by the victim, it makes little sense to exclude the money from taxable income. This is so, because in awarding punitive damages, our focus is the tortfeasors conduct, not the conduct's impact on the victim. This would similarly be in accordance with our baseline. The component increases purchasing power, and since it is not aimed at compensating for the injury, there is no justification for deviating from the norm, and the component should therefore be taxable. Note, that under the current version of Section 104(a)(2) this is in fact the tax treatment punitive damages receive,[194] and most likely also the tax treatment they would receive in Denmark, if punitive damages could be awarded pursuant to Danish law.

The third component of the award – increased expenses due to injuries sustained – unlike punitive damages, is directly aimed at covering the increased costs the victim has and will incur in the future. If we determine that the total increased costs of an injury to a given victim equal $100, it makes little sense to tax that $100. This is so, because such taxation would result in the victim having less after-tax dollars to pay for the costs associated with the injury. As such, the system would be sending mixed signals. On the one hand, we want to make sure that the victim has enough money to cover the costs of the injury, i.e. we want to compensate the victim for any increased expenses. On the other hand, were we to tax this component, the effect would be less than complete compensation of the increased expenses. Additionally, the policy consideration discussed earlier in support of excluding damage awards in general, similarly support excluding this component from taxable income for the reason previously discussed.[195] Deviating from

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[193] RESTATEMENT (SECOND) OF TORTS § 908.
[194] I.R.C. § 104(a)(2).
[195] *See infra* Part VII.B.

the norm is therefore justifiable, and this element of the award should be received tax free.

The fourth and final component – pain and suffering – shares many similarities with the third. The victim lost something as a result of the injury, has suffered because of it, and may continue to suffer for the rest of his or her life. By awarding damages for pain and suffering, we are putting a price on what the victim has lost, and we intend, as best as money can, to make the victim whole again. For the same reasons that component three of the award should be excluded from taxable income, including those reasons presented earlier for excluding damage awards in general,[196] so too should component four be excluded. Again, it would make little sense to say that in order to put the victim in the same position he or she was in prior to the injury, we must give the victim $100, only to turn around and tax those $100. If that were the case, we would be making the victim less than whole.

Notwithstanding the arguments previously presented as to why damage awards should generally be excluded from taxable income,[197] as an alternative to excluding components three and four, we could include them, and allow an upward adjustment to account for the tax consequences. Such a result, however, would in essence further punish the tortfeasor separate and apart from punitive damages. It is acknowledged that taxing the lost wage component raises the same objection, but the compelling reasons for including this component in taxable income outweighs this consideration. Moreover, absent the injury, the victim would not have received money for components three and four. Taxing these components would therefore allow the government to cash in on the misfortunes of its citizens. Components three and four are meant to compensate for the injuries sustained, not as a revenue-raising device for the government. Even though punitive damages would similarly not be awarded absent the injury, the fact that they are by nature not compensatory amply supports treating them differently than components three and four. Lastly, since the focus of punitive damages is the torfeasor’s conduct, not the victim’s injuries, any amount awarded as punitive damages would be unaffected by its tax treatment.

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[196] *See id.*
[197] *See id.*

a. Feasibility of Separating the Award Into Its Components.

Notwithstanding the fact that the above discussion has shown that it is possible, in theory, to separate a damage award into its various components, doing so in practice may prove substantially more difficult. In fact, the United States Supreme Court has noted that this is the reason why the lost wage component receives tax-free treatment under the current version of Section 104(a)(2).[198] Yet, while the either-tax-it-all-or-tax-nothing approach certainly relieves much of the administrative burden associated with taxing only some components of the award, accepting this approach merely seems like choosing the easy way out.[199] We do not share the same concerns over separating an award between its compensatory (e.g. increased expenses due to injury) and noncompensatory (e.g. punitive damages) items under U.S. law. If we can divide an award into two parts, why can we not further subdivide one of those two parts?

Arguably, the lost wage component of a damage award should be easy enough to identify and value. This is so, because a determination of the size of this component should follow a relatively straightforward mechanical approach. First, determining the amount of wages the victim has lost from the date of injury until the time the victim is estimated to return to the workforce, should merely involve an analysis of how many hours per day the victim worked or was able to work and at what rate.[200] The victim's most recent tax return could be introduced to aid in this determination. That amount should then be multiplied by the amount of time that has passed and will pass between the injury and the time the victim will return to the workforce. This would then determine the total amount of lost wages during the given period, denoted in the following formula by Lw^1:

$$(Hd \cdot Rd) \cdot T^1 = Lw^1,$$

[198] *See See* O'Gilvie v. United States, 519 U.S. 79, 88-89 (1996); *see also* Kahn, *To Tax or Not to Tax*, *supra* note 81, at 355.
[199] *See* Kahn, *To Tax or Not to Tax*, *supra* note 81, at 355 (noting that administrative feasibility "perhaps overestimates the degree of inconvenience that would result from taxing [the lost wages component].").
[200] *See* James B. Smith, Jr. and Jack A. Taylor, *Injuries and Loss of Earnings*, 57 Ala. Law. 176, 176 (1996).

where Hd denotes the hours per day the victim worked or was able to work, Rd denotes the daily rate of the victim's services, and T^1 denotes the time between the injury and the time the victim is estimated to return to work.

To determine any diminished future earning capacity as a result of the injury, would require first a determination as to whether the victim will be able to return to the workforce. If this is answered in the negative, calculation of lost future earnings, denoted here as Lw^2, could be determined as follows:

$$((Hd \cdot Rd) \cdot Rg\%) \cdot T^2 = Lw^2,$$

where Rg% represent the estimated wage growth percentage, and T^2 represents the number of years remaining in the victim's work life.[201] If the victim will return to the workforce, albeit in a diminished capacity, we must determine the difference between what the victim would have earned during his or her work life under status quo, and what the victim will actually earn once he or she returns to the workforce.[202] We have already determined the first number under the second formula. The second number can be determined using the same formula, by changing the values of Hd, Rd, and Rg% in accordance with the new set of facts. The difference between these two numbers should represent the diminished value of the victim's services, and should be taken into account in calculating the lost wages suffered by the victim as a result of the injury. One additional variable must be added to the equation to account for the time value of money. Receipt of future earnings now must be discounted to reflect the value of receiving dollars or kroner of tomorrow today. It should be noted, that in the event the victim is able to return to the job held prior to the injury, and if the injury has no effect on work performance or the value of services, the amount of the lost wage component should be limited to that calculated under the first formula, i.e. Lw^1.

If the victim is in school at the time of injury, the impact of past, present and future education on future earning capacity can be determined by reviewing school

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[201] *Cf.* Smith, Jr. and Taylor, *supra* note 200 (explaining a similar method to determine lost earnings as a result of an injury).
[202] *See id.* at 177.

records, the nature of the current and potential future education, extracurricular activities indicating future employment preferences, and educational levels of parents and siblings.[203] If the victim has not yet begun an education, some of these same elements can still be used to determine future earning capacity. There are other items that could impact the results in the above formulae, such as expected sick-days, maternity leave, or estimated periods of unemployment.[204] Since these items will merely impact numerical values, there is no reason why they could not be taken into account under the above formulae to determine each variable. Additionally, even where the victim returns to the job he or she held prior to the injury, if there is too large of an unemployment gap, the market might discount the value of the person's services. To rectify this situation, we would have to determine the difference between the market value of the victim's services without the unemployment gap and the value with the gap, and add this number to each of the formulae.

Thus, while determining the amount of each damage award that constitutes lost wages certainly complicates matters, valuing the lost wage component is far from insurmountable. Excluding this component because of administrative convenience therefore "overestimates the degree of inconvenience that would result from taxing [it]."[205] As such, since the lost wage component constitutes an accretion of wealth thereby increasing purchasing power, and no justification exists to support a deviation from our baseline, we must further subdivide the compensatory item of a damage award between its taxable (lost wages) and tax-excludable (increased expenses due to injury, and pain and suffering) components.

Implementing this or a similar mechanical approach to determine and tax only the lost wage component may leave the system open for abuse. Damage awards are often received on account of a structured settlement. In those instances, the victims may assign a value to lost wages that is lower than what it would have been under a proper analysis. For example, it is possible to underestimate the time that will pass between the injury and the victim returning to work. Similarly, one may be tempted to calculate the future lost

[203] *See id.* at 176.
[204] *See id.*
[205] Kahn, *To Tax or Not to Tax*, *supra* note 81, at 355.

wage amount based on the premise that the victim will return to the same position held prior to the injury, even though this may not be case. Such an approach should not result in the victim receiving a smaller total award than would otherwise have been the case, because just as easy as it is to underestimate one component, it should be fairly straightforward to overestimate another. The motivation for doing so would of course be to make the amount of the award that is subject to tax as low as possible.

The system can be structured in such a way, however, so as limit the possibility for abuse. Taxing the lost wage component would necessarily require the victim to report the amount as income to the taxing authorities. Instead of requiring the victim to merely report a dollar amount, we could require that in settlement situations, the victim submit necessary information for the taxing authorities to make an independent valuation of the lost wage component. The mere possibility of an audit, however small, should decrease the likelihood of settlement awards undervaluing the lost wage component. Moreover, we should not underestimate the ethical obligations the lawyers who negotiate these settlements are subject to. Thus, while the proposed solution to taxing the lost wage component is not without its faults, it should be preferred over a system that might make something otherwise taxable tax-free when received as part of a damage award.

VIII. Arbitrary and Illogical Distinctions

Having determined that some components of damage awards should be excluded from taxable income, two questions remain when looking at the empirical analysis of U.S. and Danish law. First, it must be determined whether the exclusion should be limited to damage awards received on account of a physical injury. To put it another way, should damage awards for physical injuries receive a different tax treatment than damage awards for nonphysical injuries, as is currently the case under Section 104(a)(2), but not the result under the DSTA? Second, having concluded that human capital theory cannot support the exclusion, thus rejecting the logic that the human body is similar to other investment property or capital assets, it must be determined whether the DSTA's distinction between lump sum and periodic payments should be upheld.

A. The Logic of Distinguishing Between Physical and Nonphysical Injuries.

At the outset we may note that damage awards for nonphysical injuries consist of the same four components identified earlier in this Paper, namely (i) lost wages, (ii) punitive damages, (iii) increased expenses due to injuries sustained, and (iv) pain and suffering.[206] As noted below, while a nonphysical injury may be harder to prove, it too causes increased expenses directly connected to the injury, as well as pain and suffering.[207] Similarly, once the injury has been proved, substantiating a claim for lost wages or punitive damages should not differ from a claim based on physical injuries.[208] As such, if nonphysical injuries receive the same general treatment under tort law, there seems to be no reason why this equal treatment should not be similarly extended to tax law.

Various explanations exist as to why it is necessary to treat physical injuries different from nonphysical injuries, yet no theory adequately justifies the distinction. Some commentators suggest that the legitimacy of distinguishing between physical and nonphysical injuries has its origin in tort law.[209] Under the impact rule of U.S. tort law, a plaintiff can recover damages for emotional distress, only if the plaintiff also suffers a physical injury.[210] The rule further dictates that a cause of action for emotional distress alone cannot lie.[211] This argument, however, ignores the medical research that has demonstrated that emotional and physical pain is not quantitatively different.[212] Others suggest that since physical harm generally arouses more public sympathy than nonphysical harm, it is proper to distinguish between the two.[213] A third suggested

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[206] *See supra* Part III.D. Again, receiving punitive damages is not currently an option under Danish tort law.
[207] *See* RESTATEMENT (SECOND) OF TORTS § 46.
[208] *Cf. Id.* at comment b (noting that the emotional distress has been recognized as a separate and distinct basis of tort liability).
[209] *See* Wolff, *supra* note 10, at 1473-74, 1479 (discussing the impact rule of tort law and its correlation to Code section 104(a)(2)) (citation omitted).
[210] *E.g.*, Conrail v. Gottshall, 512 U.S. 532, 547 (1994) ("[u]nder the physical impact test, a plaintiff seeking damages for emotional injury stemming from a negligent act must have contemporaneously sustained a physical impact"); Nelson v. Metro-North Commuter R.R., 235 F.3d 101, 107 (2d Cir. 2000) ("[the impact rule requires] a physical impact due to the defendant's negligence before [the plaintiff can] recover emotional damages").
[211] *E.g.*, *Conrail*, 512 U.S. at 547; *Nelson*, 235 F.3d at 107.
[212] Wolff, *supra* note 10, at 1454, 1479; Whittington, *supra* note 10, at 185.
[213] Kahn, *To Tax or Not to Tax*, *supra* note 81, at 357. *But see* Sager and Cohen, *supra* note 93, at 501-02 (rejecting Professor Kahn's argument, and explaining that nonphysical injuries can arouse as much

reason for the distinction is that physical injuries are easier to prove, in that they are visible to the naked eye.[214] In contrast, claims for nonphysical injuries are at times scrutinized due to a belief that they might be fraudulent.[215] In fact, the impact rule of tort law is based on courts' skepticism about the reliability of the evidence in claims for emotional distress.[216] It is interesting to note, that the Danish Supreme Court recently issued a verdict explicitly acknowledging that the term bodily injury, apart from encompassing physical injuries, also independently encompasses nonphysical injuries.[217] As such, Danish tort law allows for a cause of action based solely on nonphysical injuries.

Regardless of whether one sympathizes with any of the rationales for distinguishing between physical and nonphysical injuries, the distinction creates, for tax purposes, unfair results.[218] Ignoring for the moment that only part of a damage award should be excluded from taxable income, if T1 is physically injured in an automobile accident, and recovers $100,000 in compensatory damages, the award, under both Danish and U.S. tax law, is excludable from taxable income.[219] However, if T2 recovers the same amount in damages for libel, or for a tort-based racial or age-based discrimination claim, the award is taxed in its entirety under U.S. tax law.[220] One of the main principles of the tax system is fairness.[221] As noted earlier, this principle requires equal treatment of taxpayers who are similarly situated, an element also known as horizontal equity. There are two basic similarities between T1's and T2's claim above. Both suffered an injury, and both recovered damages for that injury. The only difference seems to be that

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sympathy as physical ones, such as the situation where someone burns a cross on the lawn of a house belonging to an African American); Wolff, *supra* note 10, at 1344 (noting that physicians, lawyers and social scientist today acknowledge that racial discrimination can cause nonphysical injuries that may be more enduring that physical injuries).

[214] *Cf.* Wolff, *supra* note 10, at 1473 (noting that earlier cases held that since mental disturbance could not be measured in monetary value, the injuries could not serve as a basis for a claim for relief) (citation omitted).

[215] *See id*.

[216] *See* Doti, *supra* note 10, at 77.

[217] UfR 2010.1609H.

[218] *Cf.* Sager and Cohen, *supra* note 93, at 507 (concluding that the tax law's distinction between physical and nonphysical injuries is arbitrary).

[219] *See* KLEIN ET AL., *supra* note 89, at 142-43 (where the example is taken from).

[220] *See id.*

[221] *E.g.*, Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615, 631 (1998); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 26 (1992).

T1 was "fortunate" enough to be physically injured so that T1's award is excluded from taxable income, and this result seems unfair. How, if at all, can the differential tax treatment between T1 and T2 be justified?

The United States Congress explained, that because many nonphysical injury suits are based on employment discrimination and injury to reputation that generally consists of compensation for lost wages or lost profits, Section 104(a)(2) should only apply to physical injuries.[222] This seems sound under the in-lieu test, and provides a rational basis for distinguishing between physical and nonphysical injuries, as profits and wages are considered taxable income under both Code Section 61(a),[223] and under our baseline. This again demonstrates, however, that Section 104(a)(2) is not in accordance with the principle of horizontal equity. Nonphysical injury awards "often include significant compensation for pain and suffering," that would not be taxed, but for the lack of a physical injury.[224] Moreover, if the taxable treatment of compensation for lost wages was the concern, it is anomalous that Congress did not provide for the taxation of lost wages in cases involving physical injuries, which, as noted, continues to be excluded under Section 104(a)(2).[225]

At least one commentator justifies the exclusion of the wage component on the basis of administrative convenience.[226] However, as Professor Kahn notes, the solution is to separate the award or settlement between its taxable and non-taxable components.[227] He further explains, that it would not be difficult to ascertain the taxable portion in the typical case, but that in cases involving compensation for a victim's diminished future earning capacity, the compensation "is highly speculative and virtually impossible to determine with any confidence."[228] Additionally, because wages are usually earned over a period of years, the taxation of the entire component relating to lost wages would often

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[222] *See* H.R. REP. NO. 104-737, at 142-43 (1996) (Conf. Rep.).
[223] *See* I.R.C. § 61(a) and (b).
[224] *See* Sager and Cohen, *supra* note 93, at 500 (criticizing Congress' reason for distinguishing between physical and nonphysical injuries).
[225] *See* Comm'r v. Schleier, 515 U.S. 323, 329 (1995) (explaining that a recovery for lost wages is excludable, as long as the recovery is awarded on account of a personal injury); Doti, *supra* note 10 (emphasizing the fact that the tax free treatment of lost wages for victims of physical injuries has confused courts regarding the applicable scope of Section 104(a)(2)).
[226] Kahn, *To Tax or Not to Tax*, *supra* note 81, at 353-54.
[227] *Id.*
[228] *Id.* at 354.

cause "the tax rate to be much higher than would have been the case if the income had been earned over many years."[229] However, these objections to the taxation of lost wages where physical injuries are involved, are inadequate to justify or explain the distinction between physical and nonphysical injuries.[230] Moreover, this Paper has suggested an approach through which all of these concerns can be addressed.[231]

Thus, the current version of Section 104(a)(2) departs from the tax system's principle of horizontal equity, and the distinction between physical and nonphysical injuries is unjustified. Yet, as some commentators explain, the Code makes many arbitrary distinctions, such as allowing interests on home equity indebtedness to be deductible, while denying deductions for interests on other personal consumptions loans.[232] Nevertheless, the distinction between physical and nonphysical injuries is invidious, because one of its principal effects is, ironically, to discriminate against victims of discrimination.[233]

B. The Logic of Distinguishing Between Lump Sum Payments and Periodic Payments.

As explained earlier, the DSTA taxes damage awards that are paid in periodic payments, even if the award is a substitute for something otherwise not taxable. The reasoning is that the periodic payments represent yields on a capital asset, i.e. the human body. As this Paper has shown, however, the human body is not like any other capital asset or investment property. It is therefore flawed logic to conclude that periodic payments for damage awards should be treated like all other periodic payments, and thus included in taxable income.

Even assuming, however, that the reasoning is correct, the tax system should not be allowed to pick and choose between the applicability of its rules. If the human body is a capital asset, then it follows that periodic payments should be taxable. Yet, if the human body is capital asset, then it also follows that one should be allowed deductions

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[229] *Id.*
[230] *See* Sager and Cohen, *supra* note 93, at 499.
[231] *See supra* Part VII.D.
[232] *See* Sager and Cohen, *supra* note 93, at 507.
[233] *Id.*

for expenses that are properly considered a necessary upkeep of the body. This, however, is not how the DSTA treats such expenses. In 1981-1-163.LSR, for example, a conductor argued that he should be allowed a deduction for dental expenses. The conductor explained, that as a direct result of being a horn musician, his teeth had become very loose, which had made it impossible for him to play his instrument, as well as conduct the orchestra. The dental procedure in question had been performed solely for the purpose of allowing the conductor to continue his work, as he could have led a normal life, though not as a musician, absent the procedure. Thus, according to the conductor, the expenses had been paid in order to secure and maintain his income.[234] Interestingly, the tribunal did acknowledge that, had this been regular business expenses, no deduction would have been allowed, because the expenses related to the income-producing capital asset. Thus, the tribunal implicitly embraced the notion that the human body is capital asset, thereby embracing human capital theory. If the body was treated like any other capital asset, however, the expenses should have been added to the acquisition price or tax basis of the human body. The tribunal concluded, however, that the expenses could not be deducted, already because they concerned a private expense, namely the upkeep of the human body. It simply makes no sense for the DSTA, the tax authorities and courts, to argue, that for purposes of taxing periodic payments, the human body is a capital asset like any other capital asset, but for deduction purposes, the human body is something private, and therefore not a capital assets.

This Paper has argued that certain components of a damage award should be excluded from income. It should make no difference how these awards are being paid, which is why an exception for periodic payments must be made, as they relate to damage awards. To enact an exception to these kinds of periodic payments would not be farfetched. The law has created at least one exception for periodic payments in other circumstances. To wit, it follows from the Danish Tax Assessment Act Section 12(B), that periodic payments agreed upon in a contractual relationship to some extent is tax free. Under Section 12(B), the parties to the contract must capitalize the value of the periodic payments. Next, each party must maintain an account of the payments made

[234] *Cf.* DSTA § 6.

pursuant to the agreement. Each year, each party's account is decreased in accordance with the payments made. Only in the year where the account becomes negative are the payments taxable and deductible, respectively. In the event the payments cease prior to the account reaching zero or a negative balance, the payee can deduct an amount equal to the remaining balance, and the payor must include the remaining balance in taxable income.

Perhaps a similar approach could be utilized in taxing periodic payments for damage awards. Such an approach would, however, be inequitable, as it would be a departure from the horizontal equity principle. Under the current rules, if T1 is injured and receives a lump sum payment of $100,000 for his injured body parts, the award is tax free. If T2 is injured and receives periodic payments for his injured body parts that eventually equal $100,000, the entire amount will be taxable income. If we then introduced principles from Section 12(B) of the Danish Tax Assessment Act, the result might still differ, giving T1 an advantage. Capitalizing the value of periodic payments is very difficult, especially in situations where the payments may depend on such an unstable variable as the health of the human body.[235] If, due to the margin of error, the capitalized value is set at $85,000, as opposed to $100,000, T2 will be taxed on $15,000, while T1's entire $100,000 is tax free. Both suffered the same type of injury, both suffered equally, and the method of payment should therefore not affect the tax treatment. More importantly, the human body is not a capital asset, and the tax law generally does not treat it as such.[236] As noted, if the human body was like any other capital asset, depreciation deductions should be permissible, but they are not. As with other capital assets, ordinary maintenance and repair expenses of the human body should be fully deductible, which they are not. Thus, the taxation of periodic payments for damage awards is a tax anomaly.

C. Rectifying the Arbitrariness and the Illogical.

When Congress amended Section 104(a)(2) in 1996, it simply did not fully appreciate the similarities between physical and nonphysical injuries, nor the extent to

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[235] *Cf.* NIELS WINTHER-SØRENSEN, *et al.*, *supra* note 65 at 718.
[236] *Cf.* Dodge, *Taxes and Torts*, *supra* note 120.

which victims of nonphysical injuries may suffer. Across the pond, their Danish brethren had decades earlier similarly injured the damage award tax exclusion. Periodic damage award payments seek, to the same extent as lump sum payments, to make the victim whole. Against our baseline, and the considerations for excluding certain aspects of damage awards from taxable income, it is irrelevant whether an award is received as a lump sum or through periodic payments. As such, provided that the award, or part of it, should properly be excluded from taxable income, it should be so excluded whether paid as a lump sum or through periodic payments.

Considering all the arguments presented in this Paper, Congress ought to amend Section 104(a)(2), and the Danish legislature ought to enact a new provision, both of which should read as follows: [Gross income does not include] the amount of any damages, other than punitive damages, and damages consisting of compensation for lost wages or profits, received, whether by suit or agreement and whether as lump sums or as periodic payments, on account of personal physical and nonphysical injuries or sickness.[237]

IX. Conclusion.

In developing a new framework through which to properly tax damage awards, this Paper conducted an empirical analysis using Danish and U.S. tax law. That analysis revealed something very profound about tort recovery taxation. Calculated on the basis of an individual's increase in wealth during an accounting period, taxes are a system through which the government redistributes this wealth. Whether damage awards should be taxable, either in part or in full, therefore goes to the heart of any tax system. As much as taxing these awards can be seen as a question of enacting an inclusion or exclusion, it might therefore also be viewed as an issue of diverging views of whether they should be considered taxable income at all. Proving the truth and veracity of that statement, however, would necessitate an empirical analysis that includes other countries, as well as a more thorough analysis of the definition of taxable income, than allowed for in this Paper.

[237] The proposed amendment is in large part based on the current version of Section 104(a)(2).

What was proven, however, is that when Congress originally enacted the exclusion from taxable income of damage awards, it did so based on a somewhat incomplete understanding of human capital theory. Across the pond, the Danish legislature and commentators, perhaps unintentionally, similarly embraced human capital principles in designing a tax scheme for damage awards. As this Paper has argued, however, the hurdles that stand in the way of properly taxing human capital in practice, cannot be overcome, even though modern interpretation of human capital theory could support many of the conclusions reached herein. As such, if we are to retain an exclusion for damage awards under either country's tax system, we must adopt a baseline other than human capital. That baseline ought to be accretion tax theory, excluding imputed income for the reasons previously explained.

Application of this baseline means that as a starting point, damage awards are fully taxable. As has been shown, however, when we take a closer look at the components a damage award consists of, there are number of justifications that support deviating from the norm. Specifically, tax policy favors excluding payments for increased expenses due to the injury, and pain and suffering, because these components are aimed at making the victim whole. Policy justifications do not similarly support deviating from the norm for payments of lost wages and, where applicable, punitive damages. By taking a closer look at the damage award components, this Paper was also able to throw into sharp relief the distinction between physical and nonphysical injuries as it applies in the context of Section 104(a)(2). That in turn amplified the similarities between physical and nonphysical injury awards, and why both should receive equal tax treatment. It is therefore imperative that Congress once again amends Section 104(a)(2), this time to make it equally applicable to both physical and nonphysical injuries, while excluding payments for lost wages and punitive damages. Additionally, this Paper has exposed the flaws in the DSTA's taxation of damage awards paid through periodic payments. That discussion also showed the Danish tax system's arbitrary application of capital asset taxation in relation to the human body. The only logic conclusion is for the Danish legislature to enact a provision similar to Code Section 104(a)(2).

When Congress amended Section 104(a)(2) in 1996, the amendment represented a step back for tax equity, and a misunderstanding of, and a lack of appreciation for, the impact nonphysical injuries can have on the human body and spirit. Additionally, the amendment failed to consider the types of expenses nonphysical injury awards are meant to cover. Even though Congress, through its words, left Section 104(a)(2) bruised and battered, the power of its words will allow Congress to once again rectify the situation. Although its Danish equivalent did not undergo similar changes, the taxation of personal injury awards under the DSTA rests on an unsound justification, and creates an arbitrary tax regime. Only by enacting a personal injury exclusion can the situation be rectified, thereby making Danish tax law that much easier for both Albert Einstein and the rest of us to understand.

X. Summary

In 1904, Adam Smith in his *Wealth of Nations*, likened the human body to a machine, arguing that investments in the body, such as educational expenses, were analogous to investments in capital assets, such as machines. In so doing, Smith planted the seed to what was later to become the modern theory of human capital. In economic terms, human capital means the present value of the flow of future satisfactions that one can command during the course of ones lifetime. In relation to tax theory and policy, it has subsequently been theorized that human capital can be used as a basis for taxable income, taxing the net changes in value of that capital over an accounting period, rather than the value of the human capital at any given time. It was this idea that shaped taxation of tort recoveries in both the U.S. and Denmark.

This Paper examines how damage awards for personal injuries should be taxed, that is, whether they should be taxable in part, in full or not at all. It does so, not through a comparative analysis between the tax laws of Denmark and the U.S., but through an empirical policy analysis, using those two countries. In the process, the Paper analyses whether human capital theory should properly be used as a basis for taxing damage awards, answering this question in the negative. It does so for a number of reasons, namely because the human body should not be considered a capital asset. Even assuming arguendo that it should be so considered, however, taxing human capital cannot be done, because no system can accurately value that capital. Moreover, administering a tax system based on human capital is too much of a daunting task.

In order then to create a scheme for taxing personal injury awards that is not based on human capital theory, the Paper analizes a number of tax theories and policies that each partly supports excluding personal tort recoveries from taxable income. Arguing that as a whole, these policies amply support excluding damage awards from taxable income, the analysis then proceeds by identifying the components of damage awards, demonstrating why they should nevertheless only partially be excluded from taxable income. On this basis, the Paper suggests amending U.S. and Danish tax law to bring it in accordance with the conclusions herein reached, thereby properly excluding parts of a personal injury award from taxable income.

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