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Brent B. Nicholson

Associate Professor, Department of Legal Studies, Bowling Green State University

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THE TAXATION OF PREJUDGMENT INTEREST IN PERSONAL INJURY CASES

Brent B. Nicholson*

I. INTRODUCTION

Section 104(a)(2) of the Internal Revenue Code, which excludes from taxation payments made on account of personal injury or sickness, has been the scene of some significant activity in recent years. Major legislative work was done in 1982, 1989, and, most dramatically, in 1996. Supreme Court involvement has occurred in 1992, 1995, and late 1996. While all this activity has clarified some aspects of the exclusion, one of the issues that has yet to be definitively resolved is whether prejudgment interest on personal injury payments retains its taxable character as interest or whether it takes on the exclusionary coloring of damages paid on account of a personal injury or sickness.

This article, after examining the necessary background matters, discusses three relevant appellate court decisions, one from the Tenth Circuit and two from the First Circuit, rendered in 1996. Although the First Circuit still considers the issue open, the Tenth Circuit has ruled prejudgment interest to be taxable. The Sixth Circuit, without opinion, has also affirmed a Tax Court determination of taxability. The article then continues with an analytical section explaining why, in the author's opinion, the Internal Revenue Service is likely to prevail in future cases on the issue. A short concluding section ends the article.

II. BACKGROUND

A. The Relevant Code Provisions

Any analysis of an issue relating to §104(a)(2) of the Internal Revenue Code (the "Code") must necessarily begin not there, but with §61(a). That provision, which defines the term "gross income," brings within its reach income from whatever source derived, unless specifically excluded. In other words, unless

* Associate Professor, Department of Legal Studies, Bowling Green State University. The author wishes to express his gratitude to Professor Doug Chapman of the University of Toledo College of Law for his helpful comments and observations on this and other tax issues.


2. In full relevant part the section provides, "Except as otherwise provided in
otherwise excluded, all income is gross income, the genesis of taxability. The taxpayer has the burden of demonstrating to the Internal Revenue Service (the “IRS”) and, if need be, the courts, why a particular item of income is not subject to tax—the presumption is otherwise. Section 61(a) continues with a non-exhaustive list of specific items that are included in gross income. Near the top of the list is interest.

The specific exclusion relevant to this article is contained in §104(a)(2). This recently amended subsection now removes from gross income the amount of damages received “on account of” personal physical injury or sickness. Such amounts are excluded, whether obtained by lawsuit or settlement agreement. The subsection was amended by the Periodic Payment Settlement Act of 1982 (“PPSA”) to clarify that the exclusion was equally applicable to lump sums or structured settlement payments. Regulations promulgated under the provision specify that the exclusion is only available for claims based on tort or tort-type rights. Judicial gloss has restricted the exclusion to natural persons.

Litigation in the 1990s involving §104(a)(2) has focused most
prominently on two issues: the taxability of Title VII and Age Discrimination Employment Act ("ADEA") discrimination payments and the taxability of punitive damages. Three U.S. Supreme Court decisions between 1992 and 1996\(^\text{10}\) and statutory changes in 1989 and 1996 have clarified these issues to a significant extent, but not entirely.\(^\text{11}\) The 1996 legislation has, in fact, created some new issues which will be discussed in this article.

After this series of explications and changes, the state of the law is fundamentally as follows:

1. The *Commissioner v. Schleier\(^{12}\)* Supreme Court decision rendered in June, 1995, provides that in determining the taxability of a personal injury payment a two prong test must be employed.\(^{13}\) In order to meet the requirement for tax exclusion, both prongs must be satisfied. First, the underlying cause of action must be based on a tort or tort-type right.\(^{14}\) That prong is directly in sync with the Treasury Department regulation.\(^{15}\) In fact, prior to *Schleier*, many thought that was the beginning and end of the inquiry, including Justices O'Connor, Souter and Thomas.\(^{16}\) In *Schleier*, however, a majority of the Court said that the tort requirement was not coterminous with the personal injury requirement.\(^{17}\) Thus, the second prong of the test for excludability was that the payment must be "on account of" a personal injury.\(^{18}\) ADEA payments failed both tests, according to the Court.\(^{19}\) Because the ADEA did not compensate for things like pain and suffering and emotional distress, i.e., traditional tort-type injuries, the claim was not based on tort or tort-type

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13. See id. at 333-34.
14. See id.
15. See id.; see also, Treas. Reg. §1.104-1(c) (1994) (providing in pertinent part "[t]he term 'damages received' . . . means an amount received . . . through prosecution of a legal suit or action based upon tort or tort-type rights . . . .").
16. See Schleier, 515 U.S. at 338, 344-46. Referring to the *Burke* decision Justice O'Connor said, "Every Member of the Court so understood the opinion—that the scope of §104(a)(2) is defined in terms of traditional tort principles . . . the IRS regulation is 'descriptive of the ambit of §104(a)(2) as a whole.'" Id. at 344 (internal citations omitted).
17. See id. at 333.
18. See Schleier, 515 U.S. at 333-34.
rights (therefore, failing the first prong). Further, neither the backpay nor liquidated damage awards were paid on account of a personal injury (therefore, failing the second prong). Backpay was not "linked" to a personal injury—being laid off because of age, for example, was not a personal injury or sickness—and liquidated damages were found to be punitive in nature and hence paid on account of reprehensible behavior, not on account of a personal injury.

As a result of the 1996 legislation, the only personal injury payments now excludable are those for physical personal injury or sickness. Congress explicitly stated that emotional distress is excluded from taxation payments only if it is a direct consequence of either physical injury or sickness. This physical/non-physical distinction for compensatory damages is generally effective for amounts received after August 20, 1996. Thus, discrimination awards, for example, are taxable, although an argument may be made that amounts received for sexual harassment based on a physical contact or touching are excludable. The House Ways and Means Committee Report indicates that payments made on account of physical injury to another, such as in loss of consortium and wrongful death cases, are excludable.

2. Punitive damage awards are generally taxable. Legislation in 1989 made punitives paid on account of nonphysical personal injuries taxable.
dictated the same treatment for punitives paid on account of physical personal injuries. The Small Business Job Protection Act of 1996 confirmed this tax status prospectively. The only exception provided in the bill is for punitive damages paid in states where, in wrongful death actions, the only damages available are punitive damages. Such state laws must have been in effect as of September 13, 1995. Noted author and practitioner Robert Wood has raised the intriguing question of whether punitive damages will be imputed in an otherwise silent settlement agreement reached after a judgment which contained a punitive damage component. This is one of the issues created by or remaining after the 1996 legislation.

**B. The Nature of Prejudgment Interest**

"Prejudgment interest is interest which is awarded in the judgment but which is calculated to begin accruing at some time before judgment is entered." Although not traditionally available at common law, the award of prejudgment interest is becoming more common as a means of encouraging settlements, as well as for compensating plaintiffs and removing earnings from defendants earned with money not belonging to them. Prejudgment interest on personal injury awards was not typically awarded because, at least as regards the nonpecuniary portion of such awards (pain, suffering, mental anguish), the amount was considered unliquidated and noncompensatory.

Several states have by statute or judicial decision mandated prejudgment interest for some or all types of cases. In other states, the grant of such interest is discretionary with the court. The starting point for accrual also varies from state to state, with some starting from the date of injury, some from the date of filing of the complaint, and some from the time of first

7641, 103 Stat. 2106, 2379.
32. See id. at 1838-39.
34. 1 DAN B. DOBBS, LAW OF REMEDIES § 3.6(1), at 335 (2d ed. 1993).
35. See id. § 3.6(3), at 254 and § 8.4, at 454.
36. See id. § 8.4, at 454-56.
37. See id. at 457, 460.
38. See id. at 460.
demand, among others. The source of the interest rate utilized may be the judgment rate, a special rate designated for prejudgment interest or a market rate. At common law, the interest was computed as simple interest, a position still adopted by some states today. Others provide for compounding. Remarkably, even in states that statutorily provide for prejudgment interest these computational issues may not be addressed.

C. Pre-1996 Law Regarding Prejudgment Interest

Congress has never directly considered the issue of taxing prejudgment interest. The taxpayers in Brabson v. United States made the argument that an inference of Congressional intent regarding it could be made from its treatment of periodic payments under the PPSA. That legislation specified that the entire amount of the payments received in a structured settlement were excludable even though each payment implicitly contained an interest component. The taxpayers argued that this evidenced a Congressional decision that interest on personal injury damages was excludable. The Brabson court found the argument unpersuasive. The court's "read" was that Congress merely sought to relieve taxpayers of the difficulty of segregating the interest and principal components from each payment and did not intend any general inference about the taxability of interest. Given the ease with which such segregation could be accomplished, the court's view seems equally dubious.

39. See id. at 457.
40. See id. at 458-59.
41. See id. at 459.
42. See id. at 459-60.
43. See id. at 460.
44. See Brabson v. United States, 73 F.3d 1040, 1045 (10th Cir. 1996), cert. denied, 117 S. Ct. 607 (1996).
45. See id. at 1045-46 n.5.
47. See Brabson, 73 F.3d at 1045-46 n.5.
48. See id.
49. See id.
50. See, e.g., I.R.C. § 72(b) (1998) (providing an exclusion ratio for annuity payments. That exclusion ratio is expressed by the formula: investment amount/total expected return X annuity amount. Similarly, the amount of a structured settlement could have an exclusion ratio expressed as: personal injury award/total expected receipts X amount received. For example, plaintiff receives a $100,000 award and agrees to accept, instead of a lump sum payment, $15,000 per year for 10 years. Each year the plaintiff would exclude $10,000 from gross income ($100,000/$150,000 X $15,000). Such a scheme requires that the parties agree to the liquidated amount being deferred ($100,000 in the example)).
Actually, Congress may have been attempting to encourage structured settlements. If recipients of periodic payments had to await deferral of their payments and pay tax on the imputed interest, they would be in the same (or worse) position as a recipient of a lump sum that invested their award and paid taxes on the earnings, assuming other factors were the same. Congress thereby encouraged structured settlements specifically and settlements in general by allowing the recipient of the periodic payments to receive the payments tax free. Structured settlements were especially popular in the early 1980s because high interest rates allowed investment of comparatively small sums to fund the deferred payout. Conversely, the current arrangement can be said to either favor structured settlements or penalize lump sum payments. By excluding the entire structured settlement amount, the law clearly gives its recipient an advantage.

The most significant recent case on the taxation of prejudgment interest is *Kovacs v. Commissioner.* Kovacs concerned statutory prejudgment interest on a Michigan wrongful death award. It was decided after the Supreme Court decision in *Burke* but before its decision in *Schleier.* The Tax Court majority took a rather literal approach to the issue of whether the interest was taxable. It held that “damages” and “interest” were not synonymous and that only damages were mentioned in §104(a)(2).


2. See Kovacs, 100 T.C. at 128-30.

3. See Brabson, 73 F.3d at 1045.

4. See Kovacs, 100 T.C. at 130-31.

5. See id. at 132-33.

6. See id. at 132, (citing S. REP. NO. 97-646 (1982), 1983-1 C.B. 514-15). The court reasoned that the narrow purpose of the Act was to codify existing IRS treatment of periodic settlement payments. The IRS had excluded similar amounts in
consistency between a situation like the Kovacs' and that of someone receiving periodic settlement payments, the court stated that such problems were in Congress' domain to remedy. 57

The majority opinion invoked vigorous and lengthy dissents from Judges Halpern and Beghe. Judge Halpern argued that the PPSA intended to create consistent treatment between amounts paid in a lump sum and those paid periodically. 58 He viewed the majority position as creating a "patent inconsistency" between the two types of payments. 59 Interestingly, although the Schleier Supreme Court decision was over a year away, Judge Halpern demonstrated his prescience by viewing §104(a)(2) as requiring payments to be based on tort or tort-type rights and on account of a personal injury. He believed the interest component in Kovacs failed the second test. 60 Nevertheless, he believed the interest excludable based on the intent of the PPSA. 61

Judge Beghe penned a twenty-two page dissent that hammered at multiple points. In summary fashion, his primary reasons for excluding the prejudgment interest were: (1) prejudgment interest was a form of compensatory damages and considered as such under other provisions of the Code and Michigan law, 62 (2) exclusion was consistent with the legislative intent of the original drafters of §104(a)(2)'s predecessor (such amounts were excluded as a restoration of lost human capital, i.e., they merely made the plaintiff whole, as well as based on several Revenue Rulings. Since the Kovacs were not receiving periodic payments, the Act was not relevant, according to the court. See id.

57. See id. at 133.
58. See id. at 134-35 (Halpern, J., dissenting) (suggesting that "Congress intended to disregard any difference between the two methods of payment").
59. See id. at 137 (Halpern, J., dissenting).
60. See id. at 139 (Halpern, J., dissenting) (stating that Michigan law provided for prejudgment interest to compensate for the time value of money, to encourage settlement, and mitigate the plaintiffs litigation expense, but not to compensate for the personal injury).
61. See id. (Halpern, J., dissenting).
62. See id. at 141-50 (Beghe, J., dissenting). In this portion of his dissent, Judge Beghe referenced two cases that were overturned and one which was modified by subsequent Supreme Court decisions. He cited to Burke for the proposition that as long as a payment was made based on tort or tort-like rights it was excludable. See id. at 157. (Beghe, J., dissenting). That rule was modified by the Schleier two prong test. See Schleier, 515 U.S. at 337. Horton v. Commissioner, 100 T.C. 93 (1993), aff'd, 33 F.3d 625 (6th Cir. 1994), which held punitive damages to be excludable, was rejected in O'Givie. See O'Givie, 117 S. Ct. at 454. The Tax Court decision cited by Judge Beghe, Downey v. Commissioner, 97 T.C. 150 (1991), was reversed by the Seventh Circuit, Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994), and the taxability of ADEA awards confirmed in Schleier. See Schleier, 515 U.S. at 336-37.

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compassion for the victim); and (3) exclusion was consistent with the legislative intent evidenced in the total exclusion of periodic settlement payments under §104(a)(2) and the exclusion of life insurance proceeds of death under §101(a). Judge Beghe also distinguished cases cited by the majority as either involving post-judgment interest, which he agreed was taxable, or not involving personal injury cases. Finally, he urged his colleagues to ignore the Riddle and Aames cases to the extent they supported inclusion in light of more recent decisions excluding ADEA awards. The decisions cited by Judge Beghe, however, were all effectively overruled by the Supreme Court in Schleier.

III. RECENT DEVELOPMENTS

A. Brabson v. United States

With this paucity of applicable case law and the lack of legislative history, the 10th Circuit decided in favor of the taxability of prejudgment interest in January of 1996. It is the most thorough opinion on the issue to this point.

Mary Brabson and her children were awarded personal and property injury damages after a jury trial resulting from a gas leak and explosion in their home. Prejudgment interest was automatically added to the verdict and both sums were paid to the Brabsons by the defendants. After initially paying tax deficiencies on the excluded interest, the Brabsons sought a refund from the IRS, claiming the interest was not taxable. The district court agreed, finding that the interest was a component of the personal injury damages. The government appealed.

63. See Kovacs, 100 T.C. at 150-51 (Beghe, J., dissenting).
64. See id. at 151-53 (Beghe, J., dissenting).
67. 73 F.3d 1040 (10th Cir. 1996), cert. denied, 117 S. Ct. 607 (1996).
68. See Brabson, 73 F.3d at 1041.
69. See id. at 1041-42.
70. See id. at 1042.
71. See id. (citing Brabson v. United States, 859 F. Supp. 1360 (D. Colo. 1994)).
The Tenth Circuit began its opinion with several concessions, an ominous sign for the taxpayers. It conceded the general merit of the taxpayers' argument, that the underlying claim was based in tort (the first prong of the Schleier test) and that under the relevant state (Colorado) law, prejudgment interest was an element of compensatory damages. Unlike the district court, however, the circuit court did not end its analysis there. The court found that the compensatory nature of the interest under Colorado law was related to the time value of money, not the injury. The court then questioned whether such a compensatory amount was within the ambit of the §104(a)(2) exclusion as damages paid on account of a personal injury.

In addressing that issue, the court began its analysis at the logical starting point, the statutory language, but found no assistance there. It said the language provided no guidance as to what was meant by "damages . . . on account of personal injury." Next, it looked to the regulations. They indicated that the exclusion applies to amounts received based on tort or tort-type rights. The court conceded that might include something like prejudgment interest. The problem, however, was the "on account of" requirement of the statute and regulation. The regulation, like the statutory language, did not definitively indicate the meaning of that phrase. Lacking satisfaction with the code and regulations, the court sought guidance in legislative history. Once again, it found none. The most commonly accepted reason for the existence of §104(a)(2) was that the type of payments covered by the provision do not represent an accession to wealth but rather a restoration of lost human capital, i.e., the "make whole" argument (which could include prejudgment interest). Despite that, the court instead focused on the fact that the issue of prejudgment interest was not specifically considered by Congress. Hence, the court was on its own.

Throughout the opinion in Brabson, the court at several points acknowledged the potential tenability of the taxpayers'
arguments. The three judges admitted the merit of the arguments, conceded the compensatory nature of prejudgment interest under state law and that the taxpayers' position could even conceivably fit within the language of the statute, the regulations and the legislative history. But it was not enough. Instead, the court formulated three brief arguments in favor of taxability.

First, the court said that prejudgment interest was not typically available in personal injury cases at the time the predecessor to §104(a)(2) was enacted in 1918. As an argument in favor of taxability it is unpersuasive; while that may explain an absence of discussion of the issue in the legislative history, the court's observation does not address the substantive issue of its taxability.

Second, "a direct link" was said to be required by Schleier between the injury and the damages. The link between the injury and prejudgment interest was indirect—it was time, not injury based, said the court. In fact, however, the court's point is only partially true. The amount of prejudgment interest a plaintiff receives is a function of three factors. Clearly, time is one. The others are the amount of the award, which is directly related to the injury, and the interest rate. By focusing just on the time component, the court was engaging in some misdirection.

Finally, and ultimately most convincingly, the court found the interest taxable under the venerable rule of construction that exclusions from income under the Code are to be construed narrowly. This is the corollary to the rule that "income" is to be construed broadly. It is a useful rule for those occasions, like Brabson, where there are credible arguments on both sides. The United States Supreme Court denied certiorari on December 16, 1996.

B. Delaney v. Commissioner

The First Circuit decision in Delaney is a case that deals
more extensively with an issue of related significance to the prejudgment interest issue—settlement agreement allocations—and somewhat secondarily with the issue of prejudgment interest itself.

The basic facts of the case are straightforward. The Delaneys were awarded $175,000 by a jury in a personal injury case. Under the governing Rhode Island law, prejudgment interest totaling $112,000 was automatically added to the verdict. While on appeal, the case was settled for $250,000. The settlement agreement did not mention interest at all, but a stipulation of dismissal contained the language, "No interest. No costs." When the Delaneys did not pay any tax on the proceeds, the IRS treated 39 percent as prejudgment interest ($112,000/$287,000) and taxed accordingly. The Tax Court agreed with this approach. 89

On appeal, the First Circuit was faced with two issues: whether to allocate any of the settlement amount to interest and, if so, whether any of that interest was taxable. Both questions were answered affirmatively. 90

The larger portion of the opinion deals with the allocation (or lack of allocation) problem: Confirming that the Tax Court was not bound by the mere language of the parties ("No interest. No costs."), the circuit court endorsed the lower court's search for the "true nature of the settlement." 91 Curiously, the only extrinsic evidence utilized by the Tax Court to ascertain this "true nature" mentioned by the circuit court was the self-serving statement of the Delaneys' attorney that the agreement was not tax driven and a letter to the defendants encouraging settlement by noting that interest was continuing to accrue on the judgment, i.e., post judgment interest. 92 Ultimately, it seems this issue was decided the way it was because the IRS took a reasonable position and the taxpayers were unable to overcome the IRS's presumption of correctness. 93

The taxpayers fared no better in arguing that the prejudgment interest of $97,561 (39 percent of the $250,000 settlement) was excludable from income. The First Circuit declined to hear their attack on Kovacs (because it was not raised in the Tax

89. See Delaney, 99 F.3d at 22.
90. See id. at 23.
91. See id. at 24.
92. See id. at 25.
93. See id. at 25-26.
Court), and refused to let them argue that the interest was nevertheless excludable under Schleier. The court conceded that the first prong of Schleier was satisfied (claim based on tort or tort-type rights), but again asserted a failure by taxpayers to preserve on appeal their argument that the interest was paid on account of a personal injury. Significantly, the panel expressly stated that the issue of excludability was still open.

C. Forest v. Commissioner

This case also involved a settlement following a jury verdict to which prejudgment interest had been added. Like Delaney, the case involved Rhode Island law and, also like Delaney, there was no allocation in the settlement agreement. Apparently, tax and interest issues were not discussed. When the taxpayer did not include any of her $2,000,000 settlement in taxable income, the Service redetermined her tax by ascertaining that $560,000 of the $2,000,000 was taxable interest. That was the difference between the settlement amount and the final judgment award. The Tax Court would have found a greater portion of the award to be interest but was bound by the amount in the deficiency notice.

Continuing its similarity with Delaney, the taxpayer argued first that none of the settlement amount was interest and, second, even if a portion was interest, the interest was not taxable. Here again the First Circuit upheld as reasonable the Tax Court's determination of the interest portion. The

94. See id.
95. See id.
96. See id. at 27.
97. See id.
98. See id. ("As it is neither necessary nor practicable to do so in this case . . . we do not consider whether statutory prejudgment interest may ever be excludable from gross income under §104(a)(2), an important question left for another day.")
100. See 79 A.F.T.R.2d 346, 347.
102. See id. at 348. The Tax Court calculated the interest as $1,065,420.56 which it computed by multiplying the $2,000,000 settlement by a rate of interest of 12% per annum times the 9 1/4 years from the injury until the settlement. See id.
103. See id. at 349.
104. See id. at 350.
agreement's silence allowed the Tax Court a wide-ranging freedom to look at all the facts and circumstances of the underlying case. That examination revealed a jury award and assessment of prejudgment interest both before and after a court-ordered remittitur. Further, the Stipulation of Dismissal indicated that the judgment “plus interest and costs” was satisfied. Perhaps most importantly, the taxpayer offered nothing of substance to overcome the presumptions favoring the IRS and the Tax Court finding. It is noteworthy that the circuit court did not question or discuss the Tax Court's or the IRS' method of allocation.

Proceeding to the taxpayer's backup argument, the court again agreed with the Tax Court in finding the prejudgment interest taxable on the same grounds utilized in Delaney: the taxpayer could not argue that Kovacs was a flawed decision or argue that prejudgment interest was paid on account of her personal injuries because these arguments were being raised on appeal for the first time, and, also, under Rhode Island law, such interest was not a part of personal injury damages. The Delaney and Forest cases were easier cases for the First Circuit than Brabson was for the Tenth Circuit because the underlying state law in Brabson did hold prejudgment interest to be compensatory in nature.

IV. ANALYSIS

The question of whether to tax prejudgment interest on personal injury payments is one which does not lend itself to a clear or easy answer. It is a question for which there are credible arguments on both sides and for which the Code does not provide definitive resolution or even illuminating guidance. The difficulty of cases concerning the issue is often compounded by the involvement of payments made pursuant to settlement agreements that do not indicate their component parts. They may arguably in-

105. See id. at 349. Importantly, though, there was no evidence of the intent of the payor in making the payment. See id. at 350. That has been cited in several cases as being of some importance. See, e.g., Robinson v. Commissioner, 102 T.C. 116, 127, aff'd in part, rev'd in part, 70 F.3d 34 (5th Cir. 1995), cert. denied, 117 S. Ct. 83 (1996); Agar v. Commissioner, 290 F.2d 283, 284 (2d Cir. 1961); Metzger v. Commissioner, 88 T.C. 834, 847-48 (1987), aff'd, 845 F.2d 1013 (3d Cir. 1988); Fono v. Commissioner, 79 T.C. 680, 696 (1982), aff'd, 749 F.2d 37 (9th Cir. 1984).
106. See Forest, 79 A.F.T.R.2d at 349.
107. See id. at 350.
108. See id.
109. See id. at 351.
clude settlement of both tort and non-tort claims, and punitive damages as well as prejudgment interest. As the Delaney and Forest cases indicate, the first task for the court may be to determine if prejudgment interest is even involved. Specifying the allocation of settlement payments is a matter which should be addressed by the plaintiff's tax and litigation counsel at the time of drafting the settlement agreement. Taxpayer-plaintiffs should be mindful that overly aggressive allocations may be ignored by the IRS and the courts.

Taxpayer-plaintiffs should also be aware that the authority on taxation of prejudgment interest war is favoring the IRS at this point in time. They have won a clear victory in the Tenth Circuit and at least temporary victories in the First and Sixth Circuits. The small consolation afforded taxpayers in the First Circuit is that the substantive issue was not confronted because of some procedural problems and was specifically said to still be alive. In the Sixth Circuit there was no written opinion in its affirmance of the Tax Court decision in Kovacs. In fact, the closeness of the issue is demonstrated by the strong, lengthy and multiple dissents in the Kovacs Tax Court decision which were echoed by the district court judge in Brabson.

This is an issue where the government is likely to continue to prevail absent Congressional intervention, which seems improbable, given all its attention to the subsection. The government is likely to prevail for several reasons.

First, initial circuit court decisions are favoring the government. As mentioned, the Tenth Circuit tackled the issue squarely and favorably for the government. That case even involved a state prejudgment interest statute that was interpreted as being compensatory in nature. The Sixth Circuit, while arguably ambiguous in its silence, came down against the taxpayers. Again, the First Circuit has left the issue open but its decisions in Delaney and Forest can hardly be considered pro-taxpayer decisions. On a difficult issue such as this it seems likely that other circuits examining the issue will go along with initial precedents. Obviously, this argument cannot ignore the willingness of the other circuits to assert their independent conclusions, however.

Second, while a finding that state law deems prejudgment interest to be compensatory in nature might make a stronger

case for exclusion, such is not necessarily the case, as demonstrated in Brabson. Further, there are other functions served by prejudgment interest that have nothing to do with compensating plaintiffs. They include the encouragement of prompt settlements and the removal from defendants of gains made with plaintiffs’ money. As pointed out by Professor Dobbs, interest on pain and suffering has not, in fact, been considered compensatory because of the lack of pecuniary loss.

Third, the policy behind the PPSA, often argued by taxpayers is, at best, ambiguous and, ultimately, unstated. Beyond a desire to simply codify existing law there is no evidence Congress was attempting to exempt the prejudgment interest component of lump sum payments. Congress is deemed aware of the decisions in Kovacs and Brabson, which were rendered prior to its amendment to §104(a)(2) in mid-1996. The taxpayers in both cases argued that the PPSA supported exclusion and were rebuffed by their respective courts. By inference, Congress must have supported those courts’ interpretations since they did not modify the Code provision to rectify them, despite making other major changes to that very provision. The best that taxpayers can say on this is that the courts’ interpretations create an inconsistency of treatment between periodic and lump sum payments.

Fourth, the Supreme Court decision in Schleier, as applied in O’GIlvie, does not seem to support exclusion. The second prong of the Schleier test, payment “on account of” a personal injury, apparently requires a stronger nexus than exists with prejudgment interest. In O’GIlvie, a majority of the Court rejected utilizing a simple “but for” test for this prong. Under such a test, the punitive damages in that case probably would have been excluded. With prejudgment interest it seems more likely (never certain) that the interest would be perceived as being paid for the lost time value of money, not directly for the personal injury itself. Even Judge Halpern, who dissented in Kovacs, did not believe prejudgment interest satisfied the second prong of the Schleier test. It also may be more than coincidence that taxpayers have lost the last three cases involving §104(a)(2) in the High Court.

Finally, the government has the powerful “default” rules on its side. Specifically, these rules interpret income broadly and exclusions narrowly, as well as provide that IRS determinations of taxation are presumptively correct and that the taxpayer has the burden of disproving those determinations. On difficult issues
with persuasive arguments on both sides like this, these rules may decide the case. Arguably, it decided Brabson.

V. CONCLUSION

While much has now been decided, either by congressional action or Supreme Court adjudication, some issues surrounding the exclusion from taxable income for amounts received on account of a personal injury or sickness remain. In fact, some new issues have been created by the Small Business Job Protection Act of 1996, such as whether sex discrimination cases based on physical contact are excludable and what degree of nexus need exist between the claim and physical injury. A second lingering issue that has remained throughout the legislative and judicial molding of §104(a)(2) is whether prejudgment interest is taxable when paid as part of a personal injury.

Because of the general unavailability of prejudgment interest in personal injury cases historically, it has not been a tax issue until the last several years. The Tax Court decision in Kovacs in 1994 was the seminal case on the issue. That opinion, favoring taxability, presaged the appellate decisions in Brabson, Delaney and Forest. In this author's view, that trend is likely to continue in any future cases. An often related and predicate issue in these cases is the allocation of taxable and nontaxable components, including interest, in lump sum settlement payments.

Ideally, Congress will legislate an answer to the question of whether prejudgment interest on personal injury payments is taxable. Such a resolution seems unlikely in the short term in light of Congress' significant activity in §104(a)(2) in 1996. So, for now, the taxability of prejudgment interest will remain in the domain of the courts.