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Murphy and the Evolution of "Basis"

Deborah A. Geier
Cleveland State University, d.geier@csuohio.edu

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taxed more heavily than other types of capital. It is true, though, that LIFO may not be the best way to achieve that goal.

The authors identify a specific shortcoming of LIFO. The protection against excessive inventory taxation provided by LIFO is effectively conditioned on the firm's inventories not declining, since any decline triggers the liquidation of a LIFO layer containing goods attributed to past low-cost purchases. The authors do not indicate how prevalent that problem is; presumably, it is less common when firms use dollar-value LIFO with broad inventory pools. The authors demonstrate that some firms have inefficiently added to inventories at year-end to avoid LIFO liquidation. Although the application of antiabuse doctrines has presumably reduced those practices, it has surely not eliminated them.[13]

But, even if LIFO is an imperfect method of preventing excessive inventory taxation, it should not be scrapped without an acceptable replacement. Stated simply, a method that occasionally induces firms to hold too much inventory to avoid LIFO liquidation is much less distortionary than a method that prompts all firms to hold too little inventory by systematically taxing inventories more heavily than other capital.[14]

Nonetheless, a method that protected against excessive taxation without requiring maintenance of inventory levels would clearly be preferable. Indexed FIFO might fill that role. Similarly, indexed depreciation over economic lifetimes would probably be better than accelerated depreciation. Those policies could be accompanied by indexation of interest income and expense and capital gains.

The best reform, however, would be a move to consumption taxation. Under a VAT, a "flat tax," or a Bradford X tax, all business costs would be expensed, including expenditures to acquire inventory, plant, and equipment and intangible capital expenditures. Setting aside state and local taxes, all business capital would face an effective tax rate of zero, ensuring neutrality within the business sector, neutrality between business capital and owner-occupied housing, and neutrality between investment and consumption. Moreover, the complications of capitalization, depreciation, amortization, and inventory accounting would be eliminated.

Until such sweeping reforms are adopted, we should at least ensure that no type of capital is singled out for heavier taxation simply because some observers view it as unproductive. We should strive to keep our imperfect tax system as neutral as possible, allowing the allocation of capital to be determined by market forces.

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[13]Kleinbard et al., *supra* note 1, at 246-247.

[14]On a less convincing note, the authors also fault LIFO for forgiving tax on inventory gains that are due to increases in the relative price of the firm's goods, Kleinbard et al., *supra* note 1, at 241. But, because LIFO also denies a deduction for inventory losses that are due to reductions in the relative price of those goods, little distortion is likely to result, at least when there are no trends in relative prices. The tax treatment of plant and equipment has a similar shortcoming because depreciation schedules do not reflect relative price changes for those assets.

Murphy and the Evolution of 'Basis'

By Deborah A. Geier

Deborah A. Geier is the Leon M. and Gloria Plevin professor of law at Cleveland-Marshall College of Law, Cleveland State University.

Marrita Murphy received compensatory damages of $45,000 for "emotional distress or mental anguish" and $25,000 for "injury to professional reputation" after bringing a complaint with the Department of Labor under various whistle-blower statutes. She alleged that the New York Air National Guard retaliated against her by "blacklisting" her and providing unfavorable employment references after she complained to state authorities about environmental hazards at a Guard air base.

Section 104(a)(2) provides that damages received (other than punitive damages) on account of "personal physical injuries or physical sickness" are excludable from gross income and further provides that "emotional distress shall not be treated as a physical injury or physical sickness." In Murphy's subsequent tax litigation, a three-judge panel of the D.C Circuit Court of Appeals unanimously held,[1] in an opinion written by Chief Judge Douglas Ginsburg, that Murphy's damages were not due to "physical" injury and thus could not be excluded under the authority of section 104(a)(2) but that the government nevertheless could not, under the Constitution, tax those damages as "income." The panel based its stated conclusion on two grounds:

> First, as compensation for the loss of a personal attribute, such as well-being or a good reputation, the damages are not received in lieu of income. Second, the framers of the Sixteenth Amendment would not have understood compensation for a personal injury — including a nonphysical injury — to be income.[2]

The government has now asked the full D.C. Circuit to hear the case *en banc* and reverse.[3]

While there are many interesting aspects of the case, I would like to focus on what I think to be the key that underlies the panel's conclusion and that should result in its reversal. Stripped to its bare essentials, the panel opinion appears to hold that our understanding of the core concept of tax basis (or capital) must be frozen as of

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[1]*Marrita Murphy v. IRS*, No. 05-5139, *Doc 2006-15916*, *2006 TNT 163-6* (D.C. Cir. Aug. 22, 2006), *rev'g and rem'g* 362 F. Supp.2d 206, *Doc 2005-6167*, *2005 TNT 58-5* (D.D.C. 2005).

[2]*Id.* at 23.

[3]*See Doc 2006-20817* or *2006 TNT 194-14*.

1913, when the Sixteenth Amendment was adopted and the first tax on income was enacted under it. I think that this holding is not only unwise but inconsistent with prior Supreme Court precedent in *Taft v. Bowers*.[4]

I. The *Murphy* Decision Is Premised on 'Basis'

The *Murphy* panel concluded: "We hold section 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation."[5] As an initial matter, that phrasing is not the correct way to state the panel's conclusion. Section 104 does not require the inclusion in gross income of anything. Rather, section 104 is nothing more than statutory authority to *exclude* what would otherwise be includable in gross income under section 61. What the panel must have intended to say was that an interpretation of the residual clause in section 61 that would require inclusion of Murphy's damages is unconstitutional.

Section 61(a) begins: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items," and then it lists 15 items of gross income. If an item is gross income, the introductory language ("except as otherwise provided in this subtitle") means that it can be excluded only if statutory authority to exclude it can be found. Damage awards, whether compensatory or punitive, are not found in that list. With the parenthetical "but not limited to," however, Congress has clearly indicated its intent that the 15 listed items do not exhaust the universe of what constitutes "gross income." That phrasing necessarily means that the residual clause — "gross income means all income from whatever source derived" — must have substantive content. That is to say, there must be items of gross income that are not among the 15 items listed but rather constitute gross income only because they fall within the ambit of the residual clause.

The residual clause is inherently opaque, even circular. This very ambiguity has provided courts with some ability to reach a "no gross income" result when they are convinced that Congress would not have intended taxation of the receipt. That most often occurs when consumption received in kind is not compensation, a dividend, or any other type of specifically listed item of gross income. For example, the Fifth Circuit held that the value of a trip provided in kind (airfare, hotels, meals, and so on) did not rise to the level of residual gross income because the trip's "primary benefit" ran to the payer rather than the payee and the trip was primarily controlled by the payer, even though the taxpayer would have been prevented from deducting the cost of the trip had he paid for it himself.[6] In that case, Volkswagen Germany paid for a trip to Germany for someone who (the company hoped) might invest in an American car dealership. The taxpayer spent his days in Germany on tours around the VW factory and similar activities.

[4]278 U.S. 470 (1929).

[5]*Murphy*, *supra* note 1, at 23.

[6]*See United States v. Gotcher*, 401 F.2d 188, *reh'g denied* (5th Cir. 1968).

But cash is not in-kind consumption. Cash *always* qualifies as residual gross income (and thus is includable absent a specific statutory exclusion enacted by Congress to exempt this otherwise includable gross income) unless (1) it has, in effect, been previously taxed to the recipient, that is, is a recovery of basis, (2) it is borrowed money that must be repaid,[7] or (3) it is a government welfare payment or similar government payment.[8] For example, in *Commissioner v. Glenshaw Glass*,[9] the Supreme Court determined that cash punitive damages, which are not listed as an item of gross income in section 61, fall within

[7]Because of the offsetting obligation to repay, the borrower is not considered any wealthier for having received the borrowed cash. In *Glenshaw Glass* terms, the borrower realizes no "accession to wealth." *See infra* notes 9-10 and accompanying text. But the borrower will be taxed at some point, either on repayment (because the repayment is made with nondeductible dollars) or when the obligation to repay disappears (creating either debt discharge income or gain). *See infra* note 16.

[8]*See, e.g.*, Rev. Rul. 71-425, 1971-2 C.B. 76 ("workfare" requirement does not bar exclusion of government welfare payments). The justification for the exclusion of government welfare payments has never been fully and adequately explored by the government, but it may be premised on the fact that taxation of those payments would be circular and simply make government administration more difficult, because the government need-based payment would have to be increased to deliver the same after-tax benefit to the recipient.

The only cash receipt (other than borrowed cash, a government welfare payment, or basis recovery) that the Supreme Court has held to be not gross income within the residual clause is a support payment. *See Gould v. Gould*, 245 U.S. 151 (1917). The receipt in that early case was alimony, which was not specifically listed in the predecessor to section 61 (which was not meaningfully different from the current version of section 61) but could conceivably have fallen within the residual clause. In an opaque decision, the Court concluded that the cash was not residual gross income. The reasoning was not very clear, but the Court's primary reason appeared to be that the payee could not be taxed because the payer's tax base was not reduced by the same amount. The Court seemed to be saying that it did not believe that Congress would have *intended* amounts paid as alimony to be taxed twice to the payer/payee pair. Because the Court cannot create deductions as a matter of common law, it interpreted the residual clause to exclude the receipt. Congress has since enacted sections 71 and 215 to require inclusion by the payee of amounts qualifying under the tax definition of "alimony" and deduction for the payer of the same amount. In other words, the best way to view the payment of alimony is not as a "what is income" question (which analyzes the payee's receipt and the payer's payment independently of each other, asking the payee if she has been enriched and asking the payer if the outlay constitutes nondeductible personal consumption) but rather a "whose income is it" question. The government will get its tax; the only issue is whether the payer's or payee's marginal rate bracket will apply. The alimony context therefore provides little insight into the scope of the residual clause in section 61, which views the recipient in isolation of the payer. *See generally* Deborah A. Geier, "Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce," 55 *Tax Law.* 363 (2002); *earlier version at* Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, JCS-3-01, Vol. III (Academic Papers), April 2001, at 19.

[9]348 U.S. 426, *reh'g denied*, 249 U.S. 925 (1955).

the residual clause because they constitute "undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion."[10] In short, cash that is not the proceeds of a loan, a government welfare or similar payment, or a recovery of income that has been previously taxed to the recipient (a recovery of basis) is a clear wealth accession and thus income within the meaning of the residual clause.

The D.C. panel disagreed with that assertion when it said "not all receipts of money are income"[11] without qualifying the statement by any reference to basis. Indeed, it concluded that if a cash receipt is received "in lieu of" something that would normally not be includable as gross income, the cash in-lieu-of payment is not itself includable, regardless of whether the payment constitutes basis recovery. That was the first of the reasons quoted above for nontaxation. It said:

> It is clear from the record that the damages were awarded to make Murphy emotionally and reputationally "whole" and not to compensate her for lost wages or taxable earnings of any kind. The emotional well-being and good reputation she enjoyed before they were diminished by her former employer were not taxable as income. Under this analysis, therefore, the compensation she received in lieu of what she lost cannot be considered income and, hence, it would appear that the Sixteenth Amendment does not empower the Congress to tax her.[12]

The Court cited *Raytheon Production Company v. Commissioner*[13] for that proposition. Properly understood, however, the *Raytheon* in-lieu-of test applies only to determine whether cash is not gross income because it is a recovery of basis in destroyed property (and to characterize the inclusion of any cash award in excess of basis as capital gain or ordinary income). That was the inquiry in *Raytheon* itself. Raytheon sued RCA under the federal antitrust laws and eventually settled the suit for a payment of $140,000. The First Circuit stated the issue squarely as a return-of-basis question: "This case presents the question whether an amount received by the taxpayer in compromise settlement of a suit for damages under the Federal Anti-Trust laws is a non-taxable return of capital or income."[14] More specifically, the issue in the case was whether the damage award was received as compensation for destroyed property in the nature of goodwill. If it was, then the damage award would be gross income only to the extent of the cash received in excess of Raytheon's basis in its goodwill, if any. The court concluded that the award was indeed compensation for the destruction of Raytheon's goodwill, but it rejected Raytheon's proof of basis as inadequate. Indeed, it noted that "the record is devoid of evidence as to the amount of that basis."[15] Thus, the entire award was includable anyway (for lack of basis).

If the court had determined that the award was not made to compensate Raytheon for the destruction of its goodwill, the award would have represented lost business profits. In that case, the award would have been made in lieu of an item (business profits) that would have been taxable had the tortious interference not occurred. But there is no legal significance to that fact in the case. *Raytheon* certainly does not stand for the proposition that a damage award made in lieu of an item that would *not*, itself, be taxable is *not* gross income — except to the extent that it can be shown to be a recovery of basis (the inquiry in *Raytheon* itself). In short, the in-lieu-of test asks only whether the damage award replaces an item of property that may have basis and, for that reason, would not be gross income within the meaning of the residual clause to the extent of that basis.

Indeed, any extension of *Raytheon*'s in-lieu-of test to mean, as the D.C. Circuit panel interpreted it, that an award is not gross income if it replaces something that would not itself be taxable (unrelated to the basis inquiry) is belied by the Supreme Court's result in *Glenshaw Glass*. Punitive damages are awarded because of the particularly egregious conduct of the defendant. In the hands of Glenshaw Glass, the cash represented not business profits but a payment in lieu of being free from the defendant's particularly egregious behavior. Being free from a defendant's egregious conduct would not constitute gross income, and yet Glenshaw Glass's punitive damages were held by the Court to be gross income under the residual clause because they were not a recovery of basis. Similarly, leisure is untaxed. But that does not render compensation for services, which is a payment in lieu of the taxpayer's leisure, not gross income.

Properly understood, the in-lieu-of test requires that Murphy's damages be includable unless they are a recovery of (that is, in lieu of) basis. Hence, basis analysis is at the heart of *Murphy*.

II. The Modern Role of Tax Basis

Tax basis is the core structural concept that implements an income tax in the modern sense. Two fundamental tenets that distinguish an income tax from, say, an ad valorem property tax are that (1) the same dollars should not be taxed to the same taxpayer more than once and (2) the same dollars should not provide a double tax benefit to the same taxpayer. The chief role of basis is to implement those tenets by keeping track of previously taxed dollars and dollars that have not yet provided a tax benefit through either an exclusion or a deduction. The two ways that basis can be created are (1) the inclusion of

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[10] *Id.* at 431.
[11] *Murphy*, *supra* note 1, at 24.
[12] *Id.* at 17.
[13] 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).
[14] *Id.* at 110.
[15] *Id.* at 114. Most goodwill has a zero basis because the amounts expended to create it would generally be deductible as current business expenses under section 162 as paid. Only if a going concern with goodwill is purchased in a taxable transaction will a portion of the purchase price be allocable to the goodwill, creating basis in that goodwill.

gross income, such as on the receipt of property in kind, and (2) the making of a nondeductible capital expenditure.[16]

Thus, for example, if Mary receives Blackacre, valued at $100,000, from her employer as compensation for services rendered, Mary must include the value of Blackacre in her gross income under section 61(a)(1). If it increases in value to $150,000 before she sells it for that amount, we do not require her to include in gross income the entire $150,000 of cold, hard cash that she receives on the sale. Rather, $100,000 of her receipt is a tax-free recovery of her basis, representing the $100,000 on which she was previously taxed when she received Blackacre in kind. Only the $50,000 of new wealth that she realizes on Blackacre's sale is included in her gross income on the sale. In this way, wealth accessions are taxed, but only once, as they are realized. (In contrast, the value of Blackacre might be taxed to Mary multiple times, year after year, in the case of an ad valorem property tax, as opposed to an income tax.)

Notice that Mary cannot argue that she realizes no wealth accession because the property that she gave up was worth exactly the cash received. (Some tax protesters who do not understand that point argue that compensation is not gross income because the worker gives up services exactly equal in value to the cash receipt.) If that were true, no exchange of equal value could create gross income. The relevant inquiry, however, is not whether what was given up in the exchange is equal in value to what was received. (That will usually be the case in a market exchange with both parties bargaining at arm's length.) Rather, the only relevant inquiry is the extent to which what is received represents wealth that has not yet been taxed to the taxpayer. The measurement of what has been previously taxed to the taxpayer is basis.

Similarly, basis is the crucial tool in measuring a loss in the income tax sense. Thus, for example, suppose that John buys a building to house his business for $100,000 and takes depreciation deductions of $20,000, but then the building burns to the ground when it could clearly be shown to be worth $150,000. Suppose further that John's building is uninsured. John suffers a "loss" in both the tax and economic senses. In the *economic* sense, John's "loss" may be said to equal $150,000 if that was the building's real economic value. Indeed, if John described his loss to a person who is not a tax expert, he would surely describe his loss in terms of the fair market value of the building that he has lost. But in the *tax* sense, John's loss is limited to his *basis* in the building under section 165(b) to ensure that John does not enjoy a double tax benefit for the same dollars.

His original basis in the building was $100,000 because his purchase was a nondeductible capital expenditure (as opposed to a current loss of wealth, termed an "expense"). John simply changed the form in which he held his wealth when he took $100,000 in cash and purchased Greenacre; he is not any less wealthy for having made the purchase. Denying a deduction for the purchase of Greenacre means that the $100,000 used to purchase Greenacre remains in John's tax base and is thus taxed. We memorialize this by assigning a basis in Greenacre of $100,000 to keep track of those previously taxed dollars. When John properly deducts $20,000 of his original basis under the depreciation provisions (representing the fact that an irretrievable part of John's investment is lost as time passes and the building gets one year closer to the end of its useful life, even as other factors cause its value to temporarily increase), John must reduce his basis to $80,000 to ensure that this portion of his original basis cannot provide him a second tax benefit for the same dollars in the future (such as through a loss deduction or as an offset against the sale price if sold). When the building then burns to the ground, John's tax loss is limited to his $80,000 basis. The $20,000 that he previously deducted of his purchase price as depreciation cannot be deducted a second time. And the $50,000 of appreciation in economic value that occurred since his original purchase cannot be deducted because he never included in gross income that appreciation in value under the realization requirement. Allowing him to both exclude that appreciation in value from gross income as it occurs over time and deduct that appreciation when it is destroyed would provide a double tax benefit for the same dollars to John, which is inconsistent with a tax on income. John's tax basis was, in short, the tool that allows us to properly measure income and loss.

Dozens of code provisions are designed to keep this running record of previously taxed dollars that is basis. Thus, permanent improvements or betterments to property already owned constitute nondeductible capital expenditures (as opposed to expenses) that increase the taxpayer's basis in the improved property (to reflect the undeducted dollars that are thus taxed). Depreciation and loss deductions reduce basis to ensure that this basis does not provide a second tax benefit for the same dollars when the property is sold. Subchapters K and S, which provide for passthrough taxation of a partnership's or

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[16]Under *Crane v. Commissioner*, 331 U.S. 1 (1947), borrowed money used to purchase property is included in the cost basis of that property, even though borrowed money is not included in gross income on receipt. That rule might seem at first glance to be inconsistent with the assumption that the core role of basis is to keep track of previously taxed dollars. But borrowed funds are taxed at the time of repayment by denying deduction for the repayment of principal (or by creating includable debt-discharge income or gain if the obligation to repay disappears). Thus, *Crane* allows only the *acceleration* of basis creation (mostly for administrative ease) in anticipation that the borrowed dollars will be taxed one way or another. It does not allow basis creation out of thin air when there is no anticipation that the dollars representing basis will, in fact, be taxed through repayment. For example, "sham" debt that will never be repaid cannot create basis. *See, e.g, Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). The one, true deviation from the rule that basis represents taxed dollars is section 1014, which provides a fair market value basis for property received by reason of death, even though the built-in gain is not taxed to the transferor. (The gain thus disappears from the income tax system.) But that is a *statutory* deviation from general principles. It originally arose when basis was *always* assumed to mean "fair market value" (*see infra* Part III) and was probably preserved on the assumption that taxation under the estate tax (enacted in 1916) justified the continued deviation from income tax norms.

corporation's income to its owners, direct that the owners' basis in their ownership interests is increased as their share of the business's income is included on their tax returns and is decreased as they withdraw cash or property from the business that represents their previously taxed income. Similarly, income earned abroad by a controlled foreign corporation that is currently taxed to its parent under subpart F increases the parent's basis in its CFC stock, and when the CFC later distributes the income as a dividend, the dividend will not be included in gross income but rather will be treated as a recovery of stock basis, reducing that stock basis. The receipt of "boot" in nonrecognition transactions (such as like-kind exchanges and corporate reorganizations) — which causes gain to be partially recognized — creates additional basis in the property received to ensure that this gain is not taxed a second time when the property is sold. Today's IRC is so suffused with such basis rules that it would be difficult to argue that the "core" function of basis in the modern world is other than to keep track of previously taxed (not yet deducted) dollars.

Allowing Murphy to exclude her cash receipt as a tax-free recovery of basis or capital is wrong under modern basis concepts in that there are no previously taxed dollars to recover tax-free here. She made no nondeductible capital expenditure that created her bodily integrity, emotional well-being, and professional reputation. Any outlays that she incurred to keep her body and mind in good operating condition are current expenses (current net wealth decreases, as opposed to capital expenditures). Most of those expenses would be "personal" within the meaning of section 262(a) and thus nondeductible for that reason. Except in the case of a personal expense that is refunded, nondeductible expenses do not generally create basis, or else they could provide a delayed tax benefit that is inconsistent with the nondeductibility of the personal expense.[17] Any outlays made solely to further her business reputation would have already been deducted under section 162 as business expenses, which similarly means that she would have no basis. Further, we do not value psychic pleasure and enjoyment in life and require it to be included in gross income,[18] which would be the only other way to create basis (previously taxed dollars). Allowing her to both exclude the enjoyment she had in life before the injury (as we do) and deduct that loss in enjoyment as a basis offset against the settlement proceeds is wrong for the same reason that it would be wrong to allow John, our building owner above, to deduct the full economic loss that he could be said to incur instead of only the previously taxed dollars that he had remaining in his basis in that building.

Under modern basis theory, the *Murphy* result simply makes no sense. The only way that it can be defended, in my view, is if *Murphy* is read to require that *antiquated* notions of basis present in 1913 must control. I believe that this is what the panel was attempting to say when it cited early rulings pertaining to damage recoveries and concluded that an "originalist" conception of income requires that Murphy escape taxation on her cash receipt under the Constitution.

III. The Early Conception of Basis

In the modern use of the term, capital (when it is used in connection with the income tax) is synonymous with basis. Thus, a return of capital means a (tax-free) recovery of basis. In the early days of the income tax, however, basis (or capital) was *not* well understood as having the core function of being a running record of previously taxed dollars. Indeed, the term "income" had no early *tax* meaning of its own. But the terms "income" and "capital" had developed meanings in the worlds of business accounting and trust accounting, and some early tax authorities seemed to borrow from those fields in trying to determine the meaning of income for purposes of the income tax, until it became apparent that the different purposes of those other fields ill served a tax purpose.

For example, trust accounting distinguished between capital receipts and income receipts. A trust might provide that its income be distributed to Mary for life, with the remainder to John. Under early trust accounting principles, a nonperiodic lump sum contribution to the trust would not be considered income to be distributed to Mary but rather a capital receipt that would be invested (and which would eventually go to John) to produce future income (for distribution to Mary). Moreover, if the trust purchased stock for $100, sold it for $150, and bought new stock for $150, the $50 gain might not be considered income to be distributed to Mary but rather capital to be invested to produce future income.

Notice that the role of the term "income" in those contexts had nothing to do with ensuring that dollars were not twice taxed, or doubly deducted or exempted, from a tax. The trust principles were simply a set of rules that determined who got what from the trust between the life estate and the remainder. It took time for the term "income" to evolve as a *tax* concept. Thus, basis (or

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[17]When a nondeductible personal expense is refunded, the transfer and repayment can be analogized to a loan. For example, assume that a taxpayer properly owes $10,000 in federal income tax but has paid (because of, say, withholding from his paycheck) $11,000. Even though the payment of a federal income tax is a nondeductible expense under section 275, a refund of the $1,000 excess tax paid is a tax-free recovery of basis. In the more straightforward loan situation, when a lender transfers the principal of a loan to a borrower, the transfer is a nondeductible capital expenditure because the lender is not any less wealthy for having transferred the cash in view of the repayment obligation incurred by the borrower. Thus, the transfer creates basis for the lender equal to the loaned amount, which is recovered free of tax as principal repayments are made (reducing the lender's basis, dollar for dollar). Similarly, the refunded expense outlay in the case of the federal income tax turns out (with hindsight) to have been nothing more than the equivalent of a loan.

[18]*See* Joseph M. Dodge, J. Clifton Fleming Jr., and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure and Policy* (3d ed. 2004) at 226-228.

capital) was initially (and crudely) thought to be essentially synonymous with value — simply because *purchased* property took a cost basis (as under current section 1012), which was essentially a basis equal to value.

In reaching its conclusion that personal injury damages were not understood to constitute income in 1913 when the Sixteenth Amendment was ratified and thus could not constitutionally be taxed today, the D.C. Circuit panel cited a 1918 opinion of the attorney general[19] and a subsequent Treasury decision of the same year[20] concluding that proceeds of an accident insurance policy were not income. I believe it was this antiquated notion that basis meant the taxpayer's FMV in his body, which could be recovered free of tax as a "return of capital," that led to those early decisions. The crucial language in the attorney general opinion provides:

> In a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore "capital" as distinguished from "income" receipts.

Thus, the opinion smacked strongly of the distinction between "capital" receipts and "income" receipts that had developed in trust accounting. This nonperiodic lump sum was like the trust contribution that does not go to the life estate recipient as "income" but rather is "capital" that will be invested to produce future "income" (or will be distributed to the remainderman). The way to capture this nontax notion in the tax world was to conclude that it was a tax-free return of "capital," with the taxpayer's body being the capital, and its basis being FMV, determined by the damage award itself.[21] In short, the notion of "tax-free return of capital" was not yet well understood to mean a return of previously taxed dollars.

Similarly, under those early notions pertaining to capital receipts and basis, property received as a gift (and excluded under the predecessor to section 102) was permitted to take a "cost" basis under the predecessor to section 1012 equal to FMV. Propertied families realized that periodically making *inter vivos* gifts of appreciated property among family members resulted in a fresh, FMV basis to the recipient on each gift, even though the transfer was not a realization event to the transferor. That allowed the recipient to sell the gifted property at no gain (or at a gain equal only to the appreciation occurring since the gift), just as Murphy argues that her FMV basis in her body allows her to receive the damage award as a tax-free return of capital.

Congress began to appreciate that basis or capital as a *tax* term of art (as opposed to its meaning in trust or business accounting) must reflect only dollars that have already been taxed. It therefore, in 1921, enacted the predecessor to section 1015, which generally requires a carryover basis (previously taxed dollars) to the recipient when appreciated property is transferred as an *inter vivos* gift, not an FMV basis. It wasn't long before a taxpayer argued that Congress's enactment was unconstitutional under the Sixteenth Amendment in that it deprived the recipient of an FMV basis in the capital receipt. In *Taft*,[22] however, the Supreme Court upheld the constitutionality of the new basis rule that allowed basis to reflect *only* previously taxed dollars, despite prior practice.

The taxpayer's counsel made the argument that the receipt of the gift was a "capital" receipt that must, under the Constitution, take an FMV basis to prevent any part of the value from creating gain (and thus income) when converted to cash:

> Until the Revenue Act of 1921 became effective, the Department laid down the rule that gain on the sale of property acquired by gift could be computed only by taking into consideration the value of the gift when it was acquired. This was an express recognition by the Treasury Department that a gift is a capital transaction . . . and that the donee can have "gain" only to the extent that the proceeds in his hands exceed the *value of his capital* at the time of acquisition.[23]

And later:

> The corpus of the gift is capital in the hands of the donee at the time of its receipt. But the mere conversion of such capital into money does not constitute income. . . . An amount sufficient to restore the *capital value* that existed at the commencement of the taxing period must be withdrawn from the gross proceeds in order to determine whether there has been a gain or loss, and the amount of the gain, if any.[24]

But the Court upheld the constitutionality of the new basis rule, even though it was inconsistent with early notions of income and capital that were borrowed from business and trust accounting. The term "capital" was permitted to evolve as a *tax* concept that protected tax values. The new rule meant that "capital" was synonymous with "basis," a tax-free return of capital meant only a tax-free return of basis, and basis meant previously taxed dollars. Thus, the Sixteenth Amendment does not require that basis must equal FMV that can be recovered tax-free just because in 1913 it was commonly thought so. Rather, Congress is empowered to change the basis rule to ensure that it reflects only previously taxed dollars; the Sixteenth Amendment is no bar.

IV. Conclusion

Murphy can be understood only as a basis case. The in-lieu-of test cited by the D.C. Circuit panel as one

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[19] 31 Op. Att'y Gen. 304, 308 (1918).

[20] T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

[21] The notion that personal injury damage awards were tax-free capital receipts was not uniform, however. As the petition for rehearing *en banc* points out, there were other authorities in this early period that concluded that personal injury damages were, indeed, includable in gross income. *See* Appellees' Petition for Rehearing *En Banc*, at 6-8 (citing T.D. 2135, 17 Treas. Dec. 39, 42 (1915), and T.D. 2570, 19 Treas. Dec. 321, 323 (1917)).

[22] *Supra* note 4.

[23] *Id.* at 471-472 (emphasis added).

[24] *Id.* at 476 (emphasis added).

ground justifying Murphy's "no gross income" result was improperly applied. As crafted in the case that created the test, that test asks only whether the amount received is in lieu of basis recovery (previously taxed dollars) and thus tax-free for that reason alone. It does not ask whether it is in lieu of anything else that might have been free of tax. *Glenshaw Glass* itself required inclusion of punitive damages, even though freedom from the egregious conduct of the tortfeasor (in lieu of which punitive damages are awarded) would not be gross income. Because Glenshaw Glass could have no basis in its right to be free from the egregious conduct of the defendant, every dollar of the damage award constituted gross income within the residual clause in section 61.

Similarly, the second ground cited by the D.C. Circuit panel — that early (though inconsistent) rulings to the effect that some personal injury damages were not gross income indicate that those damages were not considered income within the meaning of the Sixteenth Amendment — necessarily relies on the concept of basis. Those early rulings arose when income as a purely *tax* concept was just beginning to evolve. The "no gross income" result of the early rulings was justified on the grounds that the damages were a tax-free return of capital in the sense of human capital. Today, however, a tax-free return of capital necessarily entails basis — previously taxed dollars — which no one can create in his own body or mind. Because Murphy had no basis in her human capital, the entirety of the cash she received was gross income within the meaning of the residual clause in section 61. At that point, it is for Congress to decide the circumstances under which that gross income should, for whatever policy reasons, be free from tax.[25]

At bottom, therefore, the D.C. Circuit panel necessarily asserts that antiquated notions of basis that can be found floating around (though not consistently) in the early days of the income tax must be frozen in time as of 1913. Any interpretation of the residual clause in section 61 that instead uses modern basis theory runs afoul of the Sixteenth Amendment. That is not only wrongheaded as a matter of policy, in my view, but also clearly inconsistent with the Supreme Court's decision in *Taft*, which necessarily held that notions of capital and basis for tax purposes are not limited to 1913 concepts borrowed from other disciplines but can evolve over time to serve tax values.

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[25]Many others have noted the difficulties in articulating a satisfactory rationale for the section 104(a)(2) exclusion. For example, businesses have lobbied for expansive exclusion under section 104 and were disappointed when the exclusion was narrowed in 1996 to apply to damages awarded only for "physical" injuries, as exclusion for the victim reduces their settlement costs — a result that might be seen as being inconsistent with tort policy. Moreover, it is hard to see why the most fortunate subset of injured parties — those fortunate enough to receive a recovery of some sort — should be the ones blessed with a tax benefit. If we are going to deviate from gross income principles on "policy" grounds, why not let those who are unlucky enough to be injured by a natural disaster or by individuals without insurance deduct their loss of human capital, even though they have no basis to deduct and even though it would be a personal loss? While that result seems absurd on its face, exclusion and deduction are equally problematic in this context as a matter of tax theory. In any event, the point to be made is that, once theory is set aside, the policy decision regarding the scope of any exclusion is Congress's to make once it is understood that the damage award otherwise constitutes gross income because of a lack of basis to recover free of tax.