THE TAX TREATMENT OF SEXUAL HARASSMENT AWARDS: CLARIFYING THE THRESHOLD FOR EXCLUSION

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I. INTRODUCTION

This article examines the excludability of the payment of monetary awards for claims of sexual harassment from federal income tax. Recent legislation narrowed the range of awards eligible for exclusion from federal income.[1] But because the Internal Revenue Service ("IRS") has yet to issue a comprehensive regulatory interpretation of the new legislation, the tax treatment of awards for many tort and "tort-like" injuries remains uncertain. The new legislation clearly grants an exclusion from taxation to tort awards where damages stem from an overt, physical injury.[2] Yet the United States Supreme Court has held that sexual harassment plaintiffs can be successful without proof of either physical or psychological harm.[3] Victims of sexual harassment, especially those claiming injuries based on a hostile work environment, can incur damages where the physical nature of their injuries is not immediately obvious and in fact quite difficult to detect. The new legislation makes clear that, if the injuries from sexual harassment do not rise above those associated with emotional distress, compensation cannot be excluded from the taxpayer's gross income.[4]

Section 104(a)(2) of the Internal Revenue Code ("Code") has an active recent history. Much of this activity is explained by the ever-growing total of monetary awards for tort claims and the consequent mounting of total income that is, at least arguably, excluded from taxation. From 1918 until the late 1980s, § 104(a)(2) of the Code allowed a broad exclusion for all recoveries for personal injury. But after seventy years of grace, Congress, the courts, and a more aggressive IRS have narrowed excludability considerably.

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1. *See* I.R.C. § 104(a)(2) (2003).
2. The Comm. on Labor & Emp. Law, *Taxability of Payments Made on Account of Employment Discrimination Claims*, 55 REC. ASS'N. B. CITY N.Y. 543, 549 (July/Aug. 2000). Here, the author decries the legislative tax preference for a "car wreck broken neck." *Id.* at 551.
3. *See* Harris v. Forklift Systems, 510 U.S. 17, 21–23 (1993).
4. I.R.C. § 104(a)(2).

The language of the Small Business Job Protection Act of 1996 raised the level of harm that a claimant must suffer before a settlement or court ordered award would be excluded from taxation. Under this new legislative threshold, Congress has twice added the qualifying word "physical." As a result, an excludable claim now must assert a "personal *physical* injur[y] or *physical* sickness."[5]

While the new legislation may have narrowed the range of excludable awards, the language did not create a bright line standard of excludability for emotional damages.[6] Yet the legislation explicitly states that payments received for injuries or sicknesses associated with "emotional distress" must be included in the taxpayer's gross income. To reach the more demanding threshold of the 1996 legislation, victims of sexual harassment must have suffered emotional injuries more damaging than emotional distress. For damages to warrant the special status of exclusion from taxation, the victim must have suffered a physical injury or a physical sickness.

Neither the new federal tax legislation nor the congressional committee report requires that the "personal physical injury or physical sickness" be the result of trauma caused by a physical blow or physical contact. When a victim of sexual harassment has suffered offensive physical contact, the injury and associated compensation should satisfy the new threshold for emotional harm that rises to the level of a physical injury or physical sickness before the award can be excluded from the taxpayer's gross income.

This article analyzes § 104(a)(2) of the Code and proposes regulatory language in an effort to clarify some of the questions surrounding the excludability of income received for claims of sexual harassment. Part II of this article provides background on the historical evolution of § 104(a)(2), including a survey of relevant caselaw that addresses the complexity and the uncertainty of excluding damage awards under this section. Part III then analyzes the legislative and judicial attempts to establish uniform guidelines on excludable damages. Lastly, Part IV proposes regulatory language aimed at clarifying the injury threshold a plaintiff must satisfy in order to allow compensatory awards to be excluded from federal taxation.

II. BACKGROUND

A. A Growing Number of Sexual Harassment Complaints

Title VII of the Civil Rights Act of 1964 bans discrimination based on an individual's sex.[7] By the early 1980s, federal courts recognized sexual harassment as a form of illegal sex discrimination prohibited by Title VII.[8] By the mid-1980s, the Supreme Court had agreed.[9] If the number of harassment complaints filed with the U.S. Equal Employment Opportunity Commission (EEOC) is an indication of the pervasiveness of sexual

5. *Id.* (emphasis added).

6. H.R. REP. No. 104-586, at 144 (1996) ("Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.").

7. 42 U.S.C. § 2000e (2003).

8. *See, e.g.*, Rogers v. EEOC, 454 F.2d 234 (5th Cir. 1971); Henson v. City of Dundee, 682 F.2d 897, 902 (11th Cir. 1982) ("hostile or offensive atmosphere created by sexual harassment can, standing alone, constitute a violation of Title VII.").

9. Meritor Savings Bank, FSB v. Vinson, 477 U.S. 57, 59 (1986).

harassment in the American workplace, it is extensive and not diminishing. A study of sexual harassment examining the period between 1990 and 1996 showed that the number of complaints more than doubled from 6,172 in 1990 to 15,342 complaints in 1996.[10] During the same period, compensatory damage awards to victims of sexual harassment more than tripled from $7.7 million to $27.8 million.[11] Recent data indicates a more modest growth rate for both the number of sexual harassment complaints and the size of the awards.[12] In the year 2000, about 16,000 employees filed claims for sexual harassment.[13]

A growing body of literature recognizes sexual harassment as a serious problem in American organizations and documents its powerful impact on victims.[14] The ailments suffered by victims of sexual harassment can range from minor headaches and insomnia to the more severe afflictions of generalized anxiety disorder, panic-attacks, post-traumatic stress disorder, and clinical depression.[15] Characterizing and classifying the severity of injuries from sexual harassment and similar torts can be difficult. Thus, the new legislative threshold of injury necessitates an appreciation of when a settlement award is excludable and when it is not.

B. The Section 104(a)(2) Exclusion

Gross income under § 61 of the Internal Revenue Code is defined broadly and includes "all income from whatever source derived."[16] The Supreme Court acknowledges Congress's intent to exert the full measure of its taxing power and defines income as "any accession to wealth."[17] Accordingly, any receipt of monetary funds by a taxpayer is presumed to be gross income under § 61, unless the taxpayer can demonstrate that the new wealth fits into one of the narrowly construed exclusions defined in other sections of the Code.[18] For nearly seventy years, § 104(a)(2) of the Code excluded from a taxpayer's gross income all monies received as part of a judgment or settlement for "personal injuries or sickness."[19] The Internal Revenue Code of 1954 gave little direction on what a taxpayer must show as proof that the damages were received "on account of personal injuries."[20] But, consistently, the courts construed this provision broadly and allowed taxpayers to exclude from taxable income all payments for both physical and psychological injuries, including both the emotional distress and the pain and suffering associated with any and all of these injuries.[21] Even awards for economic injuries, such

10. Douglas Robson, *Huge Surge of Sexual-Harassment Cases Hits the Courts*, S.F. BUS. TIMES, May 19, 1997.

11. *Id.*

12. Kirk W. Turner & Christopher S. Thrutchley, *Employment Law and Practices Training: No Longer the Exception—It's the Rule*, SHRM LEGAL REPORT, July-Aug. 2002.

13. *Id.*

14. *See, e.g.*, Louise Fitzgerald & Jan Salisbury, *The Impact of Sexual Harassment on the Workplace and the Individual: The View From the Behavioral Sciences*, 1996 A NAT'L INST. ON SEXUAL HARASSMENT B-1.

15. *Id.* at B-6.

16. I.R.C. § 61 (1994 & Supp. 2000).

17. *See* United States v. Burke, 504 U.S. 229, 233 (1992). *See also* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955); Comm'r v. Schleier, 515 U.S. 323, 327 (1995).

18. *Schleier*, 515 U.S. at 328. *See also Glenshaw Glass Co.*, 348 U.S. at 431.

19. I.R.C. § 104(a)(2) (1994 & Supp. 2000).

20. Seay v. Comm'r, 58 T.C. 32, 36 (1972).

21. The Comm. on Labor & Emp. Law, *Taxability of Payments Made on Account of Employment Discrimination Claims*, 55 REC. ASSOC. B. CITY N.Y. 542 (July/Aug. 2000).

as lost back pay, were granted exclusion from taxation when the taxpayer showed that her or she had suffered a personal injury. Perhaps equally important, when a settlement included both taxable and non-taxable income, the IRS regularly afforded the parties substantial latitude in allocating the size of the payment that fell into the portions that would and would not be taxed.[22]

On August 20, 1996, President Clinton signed into law the Small Business Job Protection Act[23] that narrowed the exclusion of income to amounts received "on account of personal *physical* injuries or *physical* sickness."[24] To warrant exclusion, the compensation must be for a "physical" injury. Compensation for "emotional distress," without more, would not be excluded from the taxpayer's income, as it did not constitute a personal physical injury or physical sickness. The conference committee report noted that "the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."[25] Under the new legislation, money received for emotional distress, even when accompanied by symptoms of physical discomfort, will be subject to federal income tax. In Revenue Ruling 96-65, the IRS held that payments received in satisfaction of a Title VII claim for denial of a promotion due to disparate treatment employment discrimination were both income and wages. Payments received for emotional distress arising from this claim were not excludable under § 104(a)(2).[26] Where there has been no act of physical trauma, the allegation of emotional distress alone is insufficient to allow exclusion of an award for a claim of sexual harassment. In order for damages to be excludable, the commission of sexual harassment must result in psychological trauma sufficient to cause personal physical injury or physical sickness.[27]

C. The Payor's Intent and the Excludability of Damages

The courts have long held that the motivation behind a settlement agreement is a critical component in determining the excludability of the damages.[28] The settlement must be "reached 'in lieu' of the tort claim in existence at the time and 'on account of' the personal injuries underlying the claim."[29] The central factor in determining whether a settlement payment was made on account of injury or sickness is the intent of the payor at the time of entering the settlement agreement.[30] The language contained in the settlement agreement is often critical in determining the intent of the payor.[31]

When express language in a settlement agreement attributes specific dollar amounts to specific claims, the courts give the apportionment substantial weight.[32] Commonly,

22. *Id.*
23. Pub. L. No. 104-408, 110 Stat. 1838 (1996).
24. *Id.* (codified at I.R.C. § 104(a)(2) (2003) (emphasis added)).
25. STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., GEN. EXPLANATION OF TAX LEGIS. ENACTED IN THE 104TH CONG. 224 (Joint Comm. Print 1996). *See* I.R.C. § 104(a) (2003) (stating emotional distress shall *not* be treated as a physical injury or physical sickness).
26. *See* Rev. Rul. 96-65, 1996-2 C.B. 6.
27. *See* Church v. Comm'r, 80 T.C. 1104, 1106 (1983); *see also* Stocks v. Comm'r, 98 T.C. 1, 9 (1992).
28. *See* Greer v. United States, 207 F.3d 322, 329 (6th Cir. 2000). *See also* Bent v. Comm'r, 87 T.C. 236, 244 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987); Nagourney v. Comm'r, 57 T.C.M. (CCH) 954 (1989).
29. *Greer*, 207 F.3d at 329 (*citing* Kroposki v. Comm'r, 74 T.C.M. (CCH) 1434 (1997)).
30. *See* Kurowski v. Comm'r, 917 F.2d 1033, 1036 (7th Cir. 1990); Agar v. Comm'r, 290 F.2d 283, 284 (2d Cir. 1961).
31. *See* Whitehead v. Comm'r, 49 T.C.M. (RIA) 2173, 2175 (1980).
32. *See* Kroposki v. Comm'r, 74 T.C.M. (CCH) 1434 (1997); Naqvi v. Rossiello, 746 N.E.2d 873, 877,

however, courts are confronted with only broad language reciting that the settlement agreement is for "any and all actions and claims." Absent explicit allocations to specific claims, judges will look to any and all of the facts and circumstances that may indicate the "intent of the payor as to the purpose in making the payment."[33] Indications of an employer's intent may be found in the amount of money paid to this specific claimant, in the amounts paid by this defendant in agreements with similar facts, as well as any other factual conditions leading to the parties' agreement.[34] The Tax Court ruled that, if a claimant *fails to show* that the payment allocated to the tort or tort-like damages is compensation for personal injuries, the entire award is presumed *not* to be excludable.[35]

For an award to be excludable from taxation, plaintiffs and other claimants must clearly allege the existence of a tort in both their claims and initial pleadings and an actual dispute must have existed at the time of reaching the settlement agreement.[36] In this requirement, plaintiffs making an allegation of sexual harassment against an employer can rely on the 1986 Supreme Court decision of *Meritor Savings Bank, FSB v. Vinson*, which makes it quite clear that an allegation of sexual harassment is such a tort.[37]

D. Evolving Judicial Interpretations of Excludability

The 1918 version of § 104 of the Code excluded from income "[a]mounts received, through accident or health insurance or under workmen's compensation acts, 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."[38] While the 1996 amendments to § 104(a)(2) narrow the exclusion, several cases decided under the broader 1918 standard continue to frame important considerations for excludability.

1. *Metzger v. Commissioner*: Awards from Income for "Invasions of Personal Rights"

A frequently cited case for the excludability of payments for personal injuries in an unlawful termination of employment is *Ana Maria Metzger v. Commissioner*.[39] In *Metzger*, an associate college professor was not recommended for a tenured faculty position. When her teaching position at the college was terminated, she alleged that the college's decision to deny her tenure constituted a breach of contract and a violation of both constitutional and Title VII statutory rights to be free from discrimination on the basis of sex and national origin. She sought an award of back pay, reinstatement, a grant of tenure, damages, and declaratory and injunctive relief. Metzger's complaint did not specifically allege that the damages were for personal injuries.

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880 (Ill. App. 2001).

33. Knuckles v. Comm'r, 349 F.2d 610, 613 (10th Cir. 1965). *See also* Lubart v. Comm'r, 154 F.3d 539, 541 (5th Cir. 1998) (indicating "[t]he intent of the employer determines the treatment of the payment").

34. Greer v. United States, 207 F.3d at 329 (*citing* Pipitone v. United States, 180 F.3d 859, 864–65 (7th Cir. 1999)); *see also Knuckles*, 349 F.2d at 613.

35. Wise v. Comm'r, 75 T.C.M. (CCH) 1514, 1517 (1998).

36. *See Pipitone*, 180 F.3d at 862.

37. 477 U.S. 57 (1986).

38. Reese v. United States, 24 F.3d 228, 233 (Fed. Cir. 1994) (quoting Pub. L. No. 65- 254, § 213(b)(6), 40 Stat. 1057, 1066 (1919)).

39. 88 T.C. 834 (1987), *aff'd*, No.87-1428 (3d Cir. Mar. 25, 1988).

Metzger and the college settled the litigation for $75,000, without the college admitting to any liability. The college preferred that the total settlement amount be characterized as wages, subject to withholding taxes, in order to protect itself against a later charge that it had failed to comply with tax withholding obligations under the Code. Conversely, Metzger preferred that only a minimal amount of taxes be withheld. The parties finally agreed that the settlement would designate that half of the $75,000 proceeds were paid to her as back wages with the taxes withheld. While Metzger's complaint did not include an allegation of "personal injuries," the settlement agreement did.[40] The claimant and the college had agreed to settle "all and in all manner of presently existing actions, and causes of action, suits, debts, and claims" and agreed that those claims included "claims for reemployment, wages, compensatory damages for personal injuries, punitive damages, and reasonable attorneys' fees."[41]

In deciding whether the half of the settlement proceeds not attributable to wages were excludable under § 104(a)(2) of the Code, the Tax Court in *Metzger* noted that the petitioner made her claims under state and federal civil rights laws and looked closely at the terms of the settlement agreement. After determining that $37,500 of the proceeds paid by the college constituted "damages received on account of personal injuries," the *Metzger* court concluded that this amount was excludable under § 104(a)(2).[42] Courts have consistently held that the central test for establishing if a personal injury exists was whether the violations were invasions of "personal rights."[43]

Throughout the 1980s and early 1990s, several courts ruled that § 104(a)(2) allowed taxpayers to exclude awards received for claims made under a broad range of state and federal laws as damages received "on account of personal injuries."[44]

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40. *Id.* at 843.

41. *Id.*

42. *Id.* at 860.

43. Thompson v. Comm'r, 89 T.C. 632, 648–649 (1987) (noting "[s]ince the right to be free from gender or sex discrimination is a personal right as the Supreme Court has held it follows that payments of damages made for violation of that right are damages for personal injuries."). *See, e.g.*, Bent v. Comm'r, 87 T.C. 236 (1986), Cannon v. University of Chicago, 441 U.S. 677, 690–693 (1979).

44. *See* Roemer v. Comm'r, 716 F.2d 693 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982), *nonacq.*; Rev. Rul. 85-143, 1985-2 C.B. 55 (holding damages received on account of injury to professional or business reputation); Bent v. Comm'r, 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987) (addressing settlement payment in action brought under 42 U.S.C. § 1983); Threlkeld v. Comm'r, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988) (finding damages received for injury to professional or business reputation); Metzger v. Comm'r, 88 T.C. 834 (1987), *aff'd* No.87-1428 (3d Cir. Mar. 25, 1988) (concerning payment received in settlement of claims of sexual discrimination under 42 U.S.C. §§ 1981, 1982, 1983, 1985(3), 1986, 2000e-5 and state discrimination laws); Thompson v. Comm'r, 89 T.C. 632 (1987), *aff'd*, 866 F.2d 709 (4th Cir. 1989) (concerning liquidated damages awarded under Equal Pay Act); Byrne v. Comm'r, 883 F.2d 211 (3d Cir. 1989), *aff'g and rev'g* 90 T.C. 1000 (1988) (finding entire payment received on account of termination allegedly in violation of Fair Labor Standards Act (FLSA) and state wrongful discharge law); Rickel v. Comm'r, 900 F.2d 655 (3d Cir. 1990), *rev'g in part* 92 T.C. 510 (1989) (addressing amounts awarded under Age Discrimination in Employment Act (ADEA)); Hill v. United States, 733 F. Supp. 88 (D. Kan. 1990) (concerning damages awarded for misrepresentation); Pistillo v. Comm'r, 912 F.2d 145 (6th Cir. 1990), *rev'g* T.C.M. 1989-329 (regarding back pay award under ADEA); Downey v. Comm'r, 100 T.C. 634 (June 29, 1993) on reconsideration of 97 T.C. 150 (1991) (concerning back pay and liquidated damages under ADEA); Keller v. Comm'r, 62 T.C.M. (CCH) 401 (1991) (same), *aff'd*, No. 92-70787 (9th Cir. Aug. 29, 1994); Stocks v. Comm'r, 98 T.C. 1 (1992) (holding portion of settlement proceeds allocable to charge of race discrimination); Paton v. Comm'r, 64 T.C.M. (CCH) 1150 (1992) (addressing payment from employer of late husband to widow).

2. *United States v. Burke*: Claims Sounding in Tort

The United States Supreme Court first addressed § 104(a)(2) in 1992. In *United States v. Burke*, employees of the Tennessee Valley Authority (TVA) filed a discrimination lawsuit under Title VII of the Civil Rights Act of 1964.[45] The parties eventually entered into a settlement agreement. When the TVA withheld federal income taxes from the award amount, the employees filed claims with the IRS requesting refunds. The IRS denied the refund request and the employees filed suit. Ultimately, the case reached the Supreme Court, where the Court ruled that back pay awards for sex discrimination under Title VII are not excludable from gross income under § 104(a)(2) as damages received on account of personal injury.[46] It is important to note that the parties in *Burke* had made claims under Title VII prior to its amendment by the Civil Rights Act of 1991.[47] The Court acknowledged that employment discrimination can cause grievous harm to its victims, yet it did not necessarily follow that a personal injury qualifying under § 104(a)(2) had occurred. To be eligible for exclusion, the Court required that the statute under which taxpayers brought suit must provide traditional tort remedies for its violation.[48] The pre-1991 version of Title VII authorized only the recovery of back pay. So, this statute had a much narrower conception of injury and remedy than did a traditional tort. This early version of Title VII allowed recovery for the economic injury of wrongfully denied back pay, but had no provision for compensatory damages for medical expenses or for the emotional distress or other injuries that might result from discrimination.[49]

Interestingly, some courts construed *Burke* as allowing the exclusion of all recoveries for claims sounding in traditional tort theories.[50] The IRS concurred with this interpretation and issued an expansive revenue ruling in 1993 permitting the exclusion of both back pay and compensatory damages if the traditional, broad range of tort remedies were available in the statute used in the taxpayer's claim.[51] The revenue ruling made specific reference to the present version of Title VII, the Americans with Disabilities Act, and the Old Civil Rights Acts as statutory claims that would qualify for exclusion.[52]

3. *Commissioner v. Schleier*: A Two-Pronged Test for Excludability

Three years after *Burke*, the Supreme Court re-examined § 104(a)(2) in *Commissioner v. Schleier*.[53] Expanding upon the *Burke* decision, it held that while the existence of a tort or a tort-like claim was a necessary condition for excludability, it was not a sufficient condition.[54] The Court added a second prong to the test for exclusion. First, a tort or tort-type claim must be made at the time of the initial claim; and second, the tax-

45. 504 U.S. 229 (1992).
46. *Id.* at 245–46.
47. Pub. L. No. 102-166, 105 Stat. 1071 (1991).
48. *Burke*, 504 U.S. at 235.
49. *Id.* at 238–40.
50. *See* Horton v. Comm'r, 100 T.C. 93 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994); O'Gilvie v. United States, 519 U.S. 79 (1996) (holding punitive damages received by petitioners were not excluded from income taxation because damages were not received on account of personal injuries).
51. Rev. Rul. 93-88, 1993-2 C.B. 61.
52. *Id.* at p. 8–9.
53. 515 U.S. 323 (1995).
54. *Id.* at 336–37.

payer must demonstrate that the damages or settlement proceeds were received on account of personal injury or sickness.[55] The Court noted that the claim alleged must be a bona fide claim, but not necessarily a sustainable or valid claim.[56]

In *Schleier*, the taxpayer was a former employee of United Airlines. Pursuant to company policy, United terminated Schleier's employment when he reached the age of sixty.[57] Schleier then filed a complaint in federal district court alleging that United had violated the Age Discrimination in Employment Act of 1967 (ADEA).[58] Schleier's complaint was consolidated with complaints filed by other similarly-situated taxpayers as part of a class action. The class action plaintiffs and United entered into a settlement agreement. Under the settlement, one half of each settlement award was attributed to back pay and the other half was attributed to the liquated damages available under the ADEA.[59]

When filing his 1986 income tax return, Schleier included as gross income the back pay, but not the payment of the ADEA liquidated damages.[60] The Commissioner issued a deficiency notice asserting that the liquidated damages amount should be included as income. Schleier objected and initiated tax court proceedings contesting the Commissioner's ruling.[61] In these proceedings, Schleier contended that the entire award, including the back pay, was excludable from gross income under § 104(a)(2) and, based on *Downey v. Commissioner*,[62] he prevailed in the Tax Court. The Court of Appeals for the Fifth Circuit affirmed the decision for the taxpayer. As evidence of the inconsistent interpretations coming from the courts, the Courts of Appeals for the Ninth and Seventh Circuits shortly thereafter reached opposite conclusions on whether recoveries under the ADEA were excludable under § 104(a)(2).[63]

The Supreme Court's decision in *Schleier* held that liquated damages recovered under the ADEA were not excludable from gross income under § 104(a)(2).[64] The Court made clear that if a taxpayer suffers personal injury and recovers damages for: (a) medical expenses not previously deducted; (b) lost wages; and (c) pain and suffering and emotional distress, and if each of these payments is received "on account of personal injury," the award would be excludable from gross income.[65] Yet, Schleier's recovery of both back wages and liquidated damages did not fall within the §104(a)(2) exclusion because neither satisfied the critical requirement of being "on account of personal injury or sickness." The court reasoned, "[w]hether one treats [Schleier's] attaining the age of 60 or his being laid off on account of his age as the proximate cause of [Schleier's] loss of income, neither the birthday nor the discharge can fairly be described as a 'personal injury' or 'sickness.'"[66]

55. *Id.*
56. *See* Sodoma v. Comm'r, 96 T.C.M. (RIA) 275 (1996); Foster v. Comm'r, 96 T.C.M. (RIA) 276 (1996).
57. *Schleier*, 515 U.S. at 325.
58. 29 U.S.C. § 621 (2003).
59. *Schleier*, 515 U.S. at 326.
60. *Id.* at 323.
61. *Id.*
62. 100 T.C. 634 (1993).
63. *See* Schmitz v. Comm'r, 34 F.3d 790 (9th Cir. 1994) (holding ADEA recovery excludable) and Downey v. Comm'r, 33 F.3d 836 (7th Cir. 1994), *rev'g* 100 T.C. 634 (1993) (ADEA recovery taxable). Noting the conflict among the circuits, the Government petitioned for a writ of certiorari.
64. *Schleier*, 515 U.S. at 328–29.
65. *Id.* at 330.
66. *Id.*

The Court added that while the "unlawful termination may have caused some psychological or 'personal' injury comparable to the intangible pain and suffering caused by an automobile accident, it is clear that no part of [Schleier's] recovery of back wages is attributable to that injury."[67] "[B]ecause the recovery of back wages was not 'on account of' any personal injury and because no personal injury affected the amount of back wages recovered," § 104(a)(2) does not permit their exclusion.[68] Further, the liquidated damages provision of the ADEA allowed a much narrower range of remedies than those allowed in a traditional tort. Neither payment of the back pay or the liquidated damages under the ADEA qualified for exclusion. The Court emphasized that an award could be excluded from taxation "only when it both (i) was received through prosecution or settlement of an action based upon tort or tort-type rights . . . and (ii) was received 'on account of personal injuries or sickness.'"[69]

4. *LeFleur v. Commissioner*: Dishonoring the Allocation Reached by Parties

While the IRS has given substantial weight to the allocations contained in settlement agreements to which it was not a party, it has never been bound by these agreements.[70] The allocation among the various claims included in a settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement.[71]

In *LeFleur v. Commissioner*,[72] the Tax Court addressed the allocation issue in a case seeking compensatory and punitive damages for claims of breach of contract, fraud and personal injury arising out of the tort of intentional infliction of emotional distress. The taxpayer, a vice-president of a Blount subsidiary about to be sold, voiced reservations about the parent company's commitment to a promised bonus and severance package and was terminated. In an out-of-court written settlement, the parties allocated the million dollar settlement as: $200,000 for breach of contract, $800,000 for the personal injury claim, and zero dollars to the claims for fraud and punitive damages.[73] The taxpayer excluded the $800,000 from income under § 104(a)(2). The IRS disregarded the terms of the written settlement agreement and reallocated the $800,000 between contract and punitive damages, both of which are included in the taxpayer's gross income.[74] In upholding the IRS reallocation, the Tax Court stated, "the allocation did not accurately reflect the realities of the petitioner's underlying claims."[75] Negotiations clearly considered the tax effects of the allocation and the settlement agreement did not reflect counsels' estimates of the probability of success on the merits of the various claims. In determining that the $800,000 was not excludable under § 104(a)(2), the court stated: "In

67. *Id.*

68. *Id.* at 331.

69. *Id.* at 333–34.

70. *See* Robinson v. Comm'r, 102 T.C. 116 (1994), *rev'd in part on other grounds*, 70 F.3d 34 (5th Cir. 1995).

71. *See* Phoenix Coal Co., Inc. v. Comm'r, 231 F.2d 420 (2d Cir. 1956); Bagley v. Comm'r, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997). *See also* Hemelt v. United States, 122 F.3d at 208 (4th Cir. 1997) (finding "the characterization of a settlement cannot depend entirely on the intent of the parties" (citation omitted)).

72. LeFleur v. Comm'r, 74 T.C.M. (CCH) 37 (1997).

73. *Id.* at 12–13.

74. *Id.* at 33.

75. *Id.* at 29.

light of the facts and circumstances, we conclude that petitioner suffered no injury to his health that could be attributed to the actions of the defendants, and we are not persuaded that such injury was the basis of any payment to him by Blount."[76]

The LeFleur decision makes clear that a settlement must reflect the actual damages suffered by the plaintiff and that an aggressive allocation to exclude damages will face the scrutiny of both the IRS and the courts.

5. *Robinson v. Commissioner*: Parties Must be Adversarial on Allocation Issue

In *Robinson v. Commissioner,*[77] the taxpayer successfully sued a bank for failing to release a lien on his property. The jury awarded Robinson nearly $60 million in damages that included $6 million for lost profits, $1.5 million for personal injuries and $50 million for punitive damages.[78] The parties then agreed to settle the matter for $10.7 million.[79] Through Robinson's urging, the settlement allocated 95% of the damages to personal injuries and the trial judge entered a final judgment in accordance with the terms of the settlement agreement.[80] The Commissioner disagreed with the allocation in the court order and determined only five percent of the settlement proceeds should be attributable to personal injury damages and excludable. The Tax Court agreed and found that the trial court's final judgment did not accurately reflect the underlying settlement, nor did the court independently review the allocation contained in the settlement.

More recently, when reviewing the allocation of an award, the IRS ruled that a settlement is binding for tax purposes so long as "the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith."[81] However, if the parties are adversarial with respect to the dollar amount, but not adversarial on the issue of the allocation, neither the IRS nor the federal courts will be bound by a settlement allocation, even when it is included in a final judgment of a court.[82]

III. ANALYSIS

While substantial uncertainty still surrounds the limits of the exclusion under § 104(a)(2) of the Code, there is a developing body of law that helps clarify the central definitions of a qualifying injury, a tort-type right and the damages eligible for exclusion.

A. Defining a Personal Physical Injury or Physical Sickness

In 1992, when the Supreme Court wrote its decision in *Burke*, neither the courts nor the IRS recognized a distinction between physical and nonphysical injuries in defining

76. *Id.* at 32.
77. 102 T.C. 116 (1994), *rev'd in part on other grounds*, 70 F.3d 34 (5th Cir. 1995).
78. *Id.* at 12–14.
79. *Id.* at 17.
80. *Id.*
81. Tech. Adv. Mem. 200244004 (June 19, 2002), *citing* Threlkeld v. Comm'r, 87 T.C. at 1306–07 (1986); Fono v. Comm'r, 79 T.C. at 680, 694 (1982), *aff'd without pub. opinion*, 749 F.2d 37 (9th Cir. 1984).
82. Robinson v. Comm'r, 70 F.3d 34, 37 (1995); *see also* Bagley v. Comm'r, 105 T.C. 396 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997); Threlkeld v. Comm'r, 87 T.C. 1294, 1306–07 (1986), *aff'd* 848 F.2d 81 (6th Cir. 1988).

exclusions under § 104(a)(2).[83] All damages awarded for sexual harassment and other forms of discrimination under the Civil Rights Acts of 1964, the Fair Housing Act, and the present (post-1991) Title VII were highlighted by the Court as clearly qualifying for exclusion.[84] Yet, the 1996 Small Business Job Protection Act introduced a requirement that the award be for an injury or sickness that is "physical."[85] Once the "physical" threshold is reached, compensation for a broad range of psychological and emotional damages can be excluded from the taxpayer's income.[86] The legislation does not require a physical trauma, a wound or even physical contact. But, in a sexual harassment case where there is no physical contact, the result of the psychological harm to the claimant must be sufficient to constitute a physical injury or sickness. Congress made clear that the injury must be more severe than emotional distress and that the psychological harm must be accompanied by physical symptoms more dramatic than headaches, insomnia or stomach disorders.[87]

In the absence of a physical injury, the new standard concludes that emotional distress is too subtle, too ephemeral or, perhaps, too easily feigned to warrant exclusion. There are many disappointments in the workplace, and employees adversely impacted by the actions of others often suffer bad feelings and distress. The 1996 amendments presume that a victim of illegal sexual harassment will "get over" the emotional distress she has suffered, that emotional distress alone is a "soft" injury leaving little or no enduring or permanent loss. Yet, an impressive body of medical evidence documents that some victims of sexual harassment suffer psychological trauma sufficient to result in diagnoses of post-traumatic stress disorder, generalized anxiety disorder, panic-attacks and even clinical depression.[88] These medical conditions are accompanied by sufficiently dramatic physical symptoms to constitute a physical injury or physical sickness. Psychological trauma resulting in a diagnosable psychological disorder is qualitatively different than the "emotional distress" specifically removed from the exclusion.

The statutory requirement that the injury or sickness be "physical" implies that claims of psychological trauma or psychological disorder be substantiated by medical examinations performed by appropriately trained medical personnel. These psychiatric and psychological examinations must establish a medical record substantiating the presence of an enduring or persistent condition impairing the claimant's psychological health. By adding the word "physical" to the "personal injury or sickness" threshold for exclusion in § 104(a)(2), Congress intended that the psychological damage from torts like sexual harassment must rise above the short-lived distress of a headache or upset stomach to a level of persistence or permanence more akin to a broken bone or a scar.

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83. United States v. Burke, 504 U.S. 229, 235–36 (affirming in the text, as well as in a lengthy footnote, the exclusion in I.R.C. § 104(a)(2) was meant to include both physical *and* nonphysical injuries).

84. *Id.* at 239–40.

85. Pub. L. No. 104-188, § 1605, 110 Stat. 1838 (1996) (codified at I.R.C. § 104(a)(2)).

86. If an action has its origin in physical injury or physical sickness, even damages paid to another person as loss of consortium are excluded from gross income. H.R. REP. NO. 104-586, at 143–44 (1996).

87. *See* Pub. L. No. 104-188, § 1605, 110 Stat. 1838 (1996).

88. *See, e.g.*, Louise Fitzgerald & Jan Salisbury, *The Impact of Sexual Harassment on the Workplace and the Individual: The View From the Behavioral Sciences*, 1996 A NAT'L INST. ON SEXUAL HARASSMENT B-1.

B. Defining a Tort or Tort-Type Right

For income to be excludable, it must be from an award for the violation of a tort or tort-type right. The Supreme Court has equated these rights to claims where a full range of remedies is available. In *Burke*, the back pay limitation under pre-1991 Title VII, and in *Schleier*, the liquidated damages available under the ADEA, the claim did not rise to the level of tort or tort-type rights eligible for exclusion under § 104(a)(2). The Court did not articulate a clear rationale as to why, as a matter of policy or logic, the range of remedies available for a particular claim should determine whether the resulting damages should be taxable.[89] In the absence of a precise rationale for equating exclusion to the range of remedies available when a right has been violated, lower courts have looked to a variety of criteria, such as the right to a jury trial or the availability of a specific remedy as critical in determining whether a settlement award is excludable.[90]

When the Supreme Court denied exclusion for the back pay and liquidated damages recovered through the limited statutory torts in *Burke* (pre-1991 Title VII) and *Schleier* (ADEA), both of these awards constituted the replacement of compensation that, if the employer had not committed the discriminatory act, would quite clearly have been taxable as wages. Arguably, in its rulings on § 104(a)(2), the Court established a standard where exclusion is reserved for awards that constitute the "return of human capital" lost to a tortfeasor and not merely the replacement of lost compensation.[91] Taxing an award for pay unfairly denied by discrimination avoids a windfall to the taxpayer. The delayed pay awarded to the victim of discrimination would ordinarily be taxable and does not merit the special status of exclusion. Conversely, when an award compensates a victim of discrimination for a physical injury or sickness, excluding the income from taxation allows the full return of human capital and leaves the taxpayer whole.

C. Excludability of Back Pay and Other Economic Damages

The Supreme Court majority in *Schleier* added a second prong to the test for excludability and required a link between the cause of action and the damages recovered.[92] In *Schleier*, the Court found an award for back pay ineligible for exclusion under § 104(a)(2), even when the tortfeasor's conduct caused a personal injury.[93] While Mr. Schleier may well have suffered emotional distress as a result of his firing, the award of back pay was for compensation not received, not for his psychological distress. To qual-

89. *See generally* Carolyn F. Kolks, Note, *United States v. Burke — Does it Definitively Resolve the Analytical Confusion Created by the Section 104(a)(2) Personal Injury Exclusion?*, 46 ARK L. REV. 657 (1993); Michael C. Witte, Note, *Tax Ramifications of Age Discrimination in Employment Act Awards Under the Section 104(a)(2) Exclusion*, 57 U. PITT. L. REV. 181 (1995).

90. Compare Downey v. Comm'r, 33 F.3d 836 (7th Cir. 1994) (holding that the ADEA does not afford a broad range of remedies and therefore, under Burke, damages were taxable) *with* Schmitz v. Comm'r, 34 F.3d 790 (9th Cir. 1994) (holding that the ADEA does afford a broad range of remedies and therefore, under Burke, damages were excludable).

91. *See* F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725, 738–44 (1997).

92. *Schleier*, 515 U.S. at 337.

93. *See* Frank J. Doti & Peter J. Rimel, *Does the U.S. Supreme Court's Schleier Decision Limit the Personal Injury Exclusion to Physical Injuries?*, CAL. TAX LAW, Spring 1996, at 46; *see also* Robert M. Elwood, *Supreme Court Ruling on Taxation of Discrimination Damages Provides Little Resolution*, 83 J. TAX'N 148 (1995) (discussing continuing ambiguities and problems left unresolved by the Schleier court).

ify for exclusion, the award must be linked to a personal injury caused by the violation of a tort or tort-type right.[94]

Remuneration for employment constitutes wages even though at the time the remuneration is paid, the relationship of employer and employee no longer exists.[95] The Supreme Court has made clear that the term "remuneration for employment" is not limited to payments made for work actually performed, but includes the entire employer-employee relationship for which the employer pays compensation to the employee.[96] Awards for economic injuries associated with sexual harassment, such as back pay or front pay, will face a rough road to exclusion.

Settlement awards for economic injuries to an individual or business reputation, lost economic potential, or lost future earning power all seem a far stretch from the statutory requirement of a "physical" injury and should fairly be included in the taxpayer's gross income.[97]

IV. PROPOSAL: A NEED FOR REGULATORY CLARIFICATION AND ESTABLISHMENT OF A CLEAR STANDARD

Conflicting judicial opinions coupled with the difficulty of equating the psychological harm in sexual harassment and comparable torts to physical injuries highlight the need for regulatory clarification of the standard for excludability. The IRS can address these problems through a regulatory ruling that establishes clear guidelines as to the types of harm that meet and do not meet the statutory threshold for exclusion of a "personal physical injury and physical sickness." These guidelines should also clarify that damage awards for lost wages and other economic injuries do not qualify for exclusion when, had they not been improperly withheld, they would clearly have been subject to income taxation.

We propose that the following regulatory language be adopted:

> Gross income shall include compensatory damages received for back wages, front or forward wages, lost economic potential and lost future earning potential.
>
> Gross income shall include compensatory damages received for injury to individual or business reputation.
>
> Gross income shall include compensatory damages received for personal injury or sickness resulting from emotional distress that causes headaches, stomach disorders,

94. *See Schleier*, 515 U.S. at 330.

95. *See* 26 C.F.R. § 31.3121(a)-1(i) (2003).

96. *See* Social Sec. Bd. v. Nierotko, 327 U.S. 358, 365–66 (1946); *see also* Hemelt v. United States, 122 F.3d 204, 209–11 (4th Cir. 1997).

97. *See* Fabry v. Comm'r, 223 F.3d 1262 (11th Cir. 2000); It should be noted that when damages are excludable from a taxpayer's gross income under § 104(a)(2), they are not subject to employment taxes. *See* 26 C.F.R. § 32.1 (2003). But, the full range of employment taxes (FICA, FUTA, etc.) must be paid when an amount received in settlement of a dispute is "remuneration for employment." *See* Alexander v. Internal Revenue Service, 72 F.3d 938, 942 (1st Cir. 1995) (finding the test for purposes of determining the character of a settlement payment for tax purposes "is not whether the action was one in tort or contract but rather the question to be asked is 'in lieu of what were the damages awarded'") (citations omitted); Hort v. Comm'r, 313 U.S. 28 (1941) (holding that an amount received upon cancellation of a lease was a substitute for the rent which would have been paid under the lease and, thus, was taxable as ordinary income).

> insomnia, stress, mental anguish, self-doubt, embarrassment, and other physical and psychological discomfort.
>
> Gross income shall *not* include compensatory damages received for personal physical injury or physical sickness, including those damages caused by a psychological trauma or psychological disorder sufficient to result in a medical diagnosis of post-traumatic stress disorder, generalized anxiety disorder, panic-attacks, or clinical depression.

Adoption of the regulatory language proposed here should assist in clarifying the types of injuries that qualify an award for exclusion from gross income under § 104(a)(2). A broad range of interested parties should benefit from the clarification. Damages for sexual harassment are inherently complex, and the continuing uncertainty surrounding these awards should compel the IRS to address the nature of the injuries that are excludable.