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# Commissioner v. Schleier: An Approach for Interpreting the Exclusion under I.R.C. Section 104 (a)(2) of Awards or Settlements in Federal Employment Discrimination Claims

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# ***Commissioner v. Schleier*: An Approach for Interpreting the Exclusion under I.R.C. Section 104(a)(2) of Awards or Settlements in Federal Employment Discrimination Claims**

## **I. INTRODUCTION**

On November 14, 1994, the Supreme Court of the United States granted certiorari in *Commissioner v. Schleier*.<sup>1</sup> In *Schleier*, the Court will attempt to resolve the continued confusion<sup>2</sup> and circuit conflict<sup>3</sup> surrounding the excludability from gross income of awards or settlements in Age Discrimination in Employment Act<sup>4</sup> ("ADEA") claims under section 104(a)(2)<sup>5</sup> of the Internal Revenue Code. The Court's resolution of this issue is pressing, not only because of the ongoing confusion, but because of the increasing number of age discrimination claims<sup>6</sup> and the nontrivial size of the awards.<sup>7</sup>

Against this background of confusion and importance, the excludability of employment discrimination awards has not gone without discussion. In 1992, the Supreme Court decided *United*

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1 26 F.3d 1119 (5th Cir.) (table), *cert. granted*, 115 S. Ct. 507 (1994) (No. 94-500).

2 See generally Robert J. Henry, *Tort and Taxes, Taxes and Tort: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 701-02 (1986) (noting that although the tax code has recognized a recovery from personal injury exclusion since 1918, confusion has increased with each new court decision).

3 See *infra* notes 100-243 and accompanying text.

4 29 U.S.C. §§ 621-34 (1988 & Supp. V 1993); see *infra* notes 86-99 and accompanying text for a discussion of the Age Discrimination in Employment Act ("ADEA").

5 I.R.C. § 104(a)(2) (1988 & Supp. V 1993); see *infra* notes 16-31 and accompanying text for a discussion of § 104(a)(2).

6 See *Age Bias Claims Mount as Demographic, Legal, Economic Pressures Increase*, Daily Lab. Rep. (BNA) No. 53, at C-1 (Mar. 19, 1985) (noting the increased frequency of litigation under the ADEA); Steven Pressman, *Older Workers Enforce their Rights with Lawsuits*, DET. FREE PRESS, Mar. 17, 1989, at 1C (remarking that since 1980 more than 95,000 age discrimination complaints have been filed with the U.S. Equal Employment Opportunity Commission).

7 See Terry Pristin, *Jury Awards \$6.1 Million in Age Bias Lawsuit*, L.A. TIMES, Nov. 12, 1991, at D2 (announcing a \$6.1 million verdict against a California real estate company in an age discrimination suit); *Con Freight Loses Suit on Age Bias*, S.F. CHRON., Aug. 1, 1992, at B1 (noting an award of \$27 million against Consolidated Freightways, Inc. in an age discrimination claim).

*States v. Burke*.<sup>8</sup> In *Burke*, the Court examined the excludability of a Title VII sexual discrimination settlement, holding that section 104(a)(2) did not exclude the settlement from gross income.<sup>9</sup> However, many commentators have criticized the *Burke* decision.<sup>10</sup> Furthermore, while not joining in the direct criticism of *Burke*, the lower courts have continued to apply differing analyses to the taxation of employment discrimination awards or settlements.<sup>11</sup> These various approaches have resulted in different tax treatment for similar employment discrimination claims, depending on the type of claim and the venue in which the taxpayer's dispute is adjudicated.

In Part II, this Note focuses on the Internal Revenue Code's (the "Code") notion of income under section 61(a) and the scope of and justification for the code's exclusion from gross income for personal injury damages under section 104(a)(2). In addition, Part II includes an examination of the recent Supreme Court decision, *United States v. Burke*. Part III briefly describes the Age Discrimination in Employment Act of 1967. The description will focus on the ADEA's purpose, designated unlawful practices, and remedial

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8 112 S. Ct. 1867 (1992); see *infra* notes 32-85 and accompanying text.

9 *Burke*, 112 S. Ct. at 1874. In *Schleier*, the underlying claim is based on the ADEA. Petitioner's Brief at 3, *Schleier*, (No. 94-500). The ADEA prohibits discrimination in the workplace based on age. 29 U.S.C. §§ 621-34 (1988 & Supp. V 1993). In *Burke*, the taxpayers based their underlying claim on pre-1991 Title VII of the Civil Rights Act of 1964, as amended. *Burke*, 112 U.S. at 1868. Title VII makes it unlawful for an employer to discriminate on the basis of race, color, religion, sex, or national origin. 29 U.S.C. § 2000e (1988 & Supp. V 1993).

10 See Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries under Federal Civil Rights Statutes: Income from Human Capital, Realization, and Nonrecognition*, 72 N.C. L. REV. 547, 551 (1994) (commenting that "the Court declined an opportunity to bring greater theoretical coherence and rationality to a difficult area of federal income tax law."); Ray A. Knight et al., *The Excludability of Damages for Personal Injury after the Supreme Court's Decision in Burke* 10 AKRON TAX J. 89, 89 (1993) ("Unfortunately, the case was decided on narrow grounds, which may only add to, rather than reduce, the conflict among the lower courts."); Kevin C. Jones, Comment, *Taxation of Personal Injury Damage Awards: A Call for a Definition of the Scope of the Section 104(a)(2) Exclusion*, 66 TEMP. L. REV. 919, 919 (1993) (asserting that "the Court's analysis assures continued confusion"); Michael J. Minihan, Note, *United States v. Burke: The Taxation of Damages Recovered in Title VII Discrimination Actions*, 13 PACE L. REV. 1043, 1044 (1994) (noting the Court's internal disagreement and describing the holding as "inconclusive"); Cathy Morris, Comment, *The Taxation of Damages and Back Pay Awards in Light of United States v. Burke: The Fog Thickens*, 18 J. CORP. L. 769, 772 (1993) (noting that the "guidance [the Court's decision] provides is limited and cloudy at best."). *Contra* David G. Jaeger, *Taxation of Back Pay Awards Under Title VII: Supreme Court Decides U.S. v. Burke*, 70 TAXES 523, 530 (1992) (stating that the *Burke* decision "provides a great deal of guidance regarding the exclusion of employment discrimination awards under § 104.").

11 See *infra* notes 100-243 and accompanying text.

scheme. Part IV explores the current circuit conflict regarding the applicability of the personal injury exclusion, section 104(a)(2), to ADEA awards or settlements. In Part V, this Note describes the various public policy arguments regarding the theoretical underpinnings of section 104(a)(2). Finally, Part VI argues that the Supreme Court, in *United States v. Schleier*, should hold that certain federal employment discrimination claims are *per se* "tort-like,"<sup>12</sup> making the resulting awards or settlements excludable from gross income as "damages . . . received on account of personal injuries" under section 104(a)(2).

## II. TAXABILITY OF PERSONAL INJURY AWARDS

### A. Gross Income: I.R.C. Section 61(a)

The definition of gross income under the Internal Revenue Code "sweeps broadly."<sup>13</sup> Section 61(a) provides that gross income includes "all income from whatever source derived," unless otherwise provided.<sup>14</sup> The Supreme Court has stated that Congress has exerted "the full measure of its taxing power and [has brought] within the definition of income any accession to wealth."<sup>15</sup> An ADEA award or settlement is clearly an "accession to wealth" and therefore income.

### B. Statutory Exemption: I.R.C. Section 104(a)(2)

As described above, any accession to wealth is includable in gross income, unless a statutory exemption specifically excludes the income.<sup>16</sup> Furthermore, the Supreme Court has held that statutory exemptions should be narrowly construed in favor of

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12 Although this Note focuses on the dispute in the context of age discrimination under the ADEA, the Note argues that the same analysis should apply to several other federal antidiscrimination statutes that prohibit discrimination in the workplace, including the Equal Pay Act of 1963, 42 U.S.C. § 206(d) (1988), Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e (1988 & Supp. V 1993), the Americans with Disabilities Act of 1990, 42 U.S.C. §§ 12101-12213 (Supp. V 1993), and employment related claims brought under 42 U.S.C. §§ 1981 (Supp. V 1993) and 1983 (1988). The issue of whether § 104(a)(2) excludes state discrimination claims from gross income is beyond the scope of this Note.

13 *United States v. Burke*, 112 S. Ct. 1867, 1870 (1992).

14 I.R.C. § 61(a) (1988).

15 *Burke*, 112 S. Ct. at 1870 (citing *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955), and *Helvering v. Clifford*, 309 U.S. 331, 334 (1940)).

16 See *Glenshaw Glass Co.*, 348 U.S. at 429-430.

taxation.<sup>17</sup> However, damages received in a personal injury claim are among those "accessions to wealth" that Congress has statutorily exempted from gross income. Section 104(a)(2) excludes "damages received . . . on account of personal injury" from gross income.<sup>18</sup>

Historically, the exclusion for damages received on account of personal injury or sickness dates back to section 213(b)(6) of the Revenue Act of 1918.<sup>19</sup> The legislative history of the original section suggests that Congress, by enacting section 213(b)(6), attempted to codify early administrative positions. These administrative positions characterized the "human body [as] a kind of capital" and payments from accident insurance as "a conversion of capital lost through . . . injury."<sup>20</sup> In other words, accident insur-

17 See, e.g., *United States v. Centennial Savs. Bank*, 499 U.S. 573, 583-84 (1991).

18 At the time of the settlement between the taxpayer and his employer in *Schleier*, § 104(a)(2) provided:

§ 104 Compensation for injuries or sickness.

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

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

I.R.C. § 104(a)(2) (1988 & Supp. V 1993). In 1989, Congress amended § 104(a)(2) to provide that punitive damages not received for physical injury or sickness are includable in gross income. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2379 (1989). The amendment applied only to amounts received after July 10, 1989. *Id.* § 7642(b)(2), 103 Stat. at 2379.

19 Section 213(b)(6) excluded from gross income:

Amounts 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.

Revenue Act of 1918, Pub. L. 65-254, ch. 18, § 213(b)(6), 40 Stat. 1057, 1065-66 (1919). Section 213(b)(6), in substantially the same form, has appeared in each intervening revenue act and codification of the Internal Revenue Code (the "Code"). For an excellent discussion of the history of § 104(a)(2) and § 213(b)(6), see J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13, 14-23 (1989).

Before 1918, Treasury Regulations provided that amounts received for personal injury or sickness were includable in gross income. See *Treas. Reg. No. 33*, Revised, art. 4 (1918) (An "[a]mount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be accounted for as income").

20 1 Op. Att'y Gen. 304, 308 (1918). Shortly after the Attorney General's opinion, the Treasury Department revoked Treasury Regulation No. 33 stating that the Code excludes "an amount received . . . as a result of suit or compromise for personal injuries sustained . . . through accident" from gross income. T.D. 2747, 20 *Treas. Dec. Int. Rev.* 457 (1918).

ance benefits were a return of human capital and therefore, beyond the scope of the income tax.<sup>21</sup>

The legislative history also suggests that Congress intended to adopt this return of capital theory. A House Report stated:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.<sup>22</sup>

In addition, early judicial decisions reflected the return of capital theory, finding damages for physical as well as nonphysical injuries excludable from gross income.<sup>23</sup>

In the adoption of the 1954 Code, Congress enacted the modern version of the personal injury exclusion, section 104(a)(2).<sup>24</sup> During the debate concerning section 104(a)(2), neither the House nor the Senate offered any explanation of what constituted a "personal injury" for purposes of the section.<sup>25</sup>

In 1960, the Internal Revenue Service ("IRS") issued regulations that linked identification of a "personal injury" with traditional tort principles.<sup>26</sup> Moreover, the *Burke* court, in applying the Treasury Regulation, held that the "essential element" of exclusion under section 104(a)(2) is whether "the income involved [is] derive[d] from some sort of tort claim against the payor . . . ."<sup>27</sup>

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21 See *Eisner v. Macomber*, 252 U.S. 189 (1920) (reaffirming the proposition that a return of capital is not taxable as income under the 16th Amendment); see also *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

22 H.R. REP. NO. 767, 65th Cong., 2d Sess. 9-10 (1918), reprinted in 1939-1 C.B. 86, 92.

23 See, e.g., *Hawkins v. Commissioner*, 6 B.T.A. 1023 (1927), acq., 7 C.B. 14 (1928) (holding that compensatory damages received in a libel and slander suit were excludable from gross income); see also *United States v. Burke*, 112 S. Ct. 1867, 1871 n.6 (1992).

24 See *supra* note 18.

25 See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 15 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 15-16 (1954).

26 *Burke*, 112 S. Ct. at 1870. The regulations provided:

The term 'damages received (whether by suit or agreement)' means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

25 Fed. Reg. 11,490 (1960); 26 C.F.R. § 1.104-1(c) (1991).

27 *Burke*, 112 S. Ct. at 1870 (quoting *Threlkeld v. Commissioner*, 87 T.C. 1294, 1305 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)).

Therefore, section 104(a)(2) excludes tort or tort-like claim recoveries from gross income but does not exclude contract claim recoveries.<sup>28</sup>

Discrimination in the workplace does not fit easily within this framework because it can arise in a variety of contexts. For example, the ADEA prohibits discrimination based on age in the hiring, discharge, compensation, training, and classification of employees.<sup>29</sup> In other words, employment discrimination can arise before, as well as after the establishment of an employment relationship. Once the employment relationship exists, the IRS has consistently argued that employment discrimination arises from an employee's contractual relationship with his or her employer.<sup>30</sup> Thus, section 104(a)(2) should not exclude awards or settlements in employment discrimination suits from gross income. On the other hand, taxpayers have argued that employment discrimination sounds in tort, similar to a dignitary tort, rather than in contract.<sup>31</sup> Therefore, section 104(a)(2) should exclude the resulting award or settlement from gross income

*C. The Supreme Court's Decision in United States v. Burke:  
Application of Section 104(a)(2) to Pre-1991 Title VII Claims*

In *United States v. Burke*,<sup>32</sup> the Supreme Court held, in a seven-two decision,<sup>33</sup> that "backpay awards received . . . in settlement of . . . Title VII claims are not excludable from gross income . . . under [section] 104(a)(2)."<sup>34</sup>

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28 See Minihan, *supra* note 10 at 1046.

29 See *infra* notes 86-99 and accompanying text.

30 See, e.g., *Schmitz v. Commissioner*, 34 F.3d 790, 793 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944) (IRS arguing that ADEA actions are basically *ex contractu*); see *infra* notes 204-25 and accompanying text for a discussion of *Schmitz*.

31 See, e.g., *Pistillo v. Commissioner*, 912 F.2d 145, 147 (6th Cir. 1990) (taxpayer arguing that ADEA actions evidence a tort-like cause of action).

32 112 S. Ct. 1867 (1992). For an excellent case comment on the *Burke* decision, see Cynthia A. Sciuto, Comment, *A Tort by Another Name: Taxation of Non-Physical Personal Injury Damages After United States v. Burke*, 38 ST. LOUIS U. L.J. 285 (1993).

33 Justice Blackmun wrote the opinion of the Court. Chief Justice Rehnquist and Justices White, Stevens, and Kennedy joined the Court's opinion. Justices Scalia and Souter concurred, each writing separately. Justice O'Connor wrote a dissenting opinion, in which Justice Thomas joined.

34 *Burke*, 112 S. Ct. at 1874.

## 1. The Majority Opinion

In *Burke*, the plaintiffs, three female employees of the Tennessee Valley Authority ("TVA"), filed a sexual discrimination suit against the TVA under Title VII.<sup>35</sup> Before trial, the parties reached a settlement.<sup>36</sup> The settlement provided that the TVA would pay \$5 million in total damages to the affected employees, which included the three female plaintiffs.<sup>37</sup> The TVA withheld federal income and FICA taxes from the settlement awards before payment was made to the employees.<sup>38</sup>

Subsequent to the TVA's payment and withholding, the plaintiffs filed a refund claim for the amounts withheld.<sup>39</sup> The IRS denied the refund claim, and the plaintiffs brought suit in the United States District Court for the Eastern District of Tennessee.<sup>40</sup>

The District Court ruled that section 104(a)(2) did not exclude the settlement from gross income as "damages received . . . on account of personal injuries."<sup>41</sup>

On appeal, the Sixth Circuit, by a divided vote, reversed the District Court's ruling.<sup>42</sup> The Sixth Circuit determined that the applicability of section 104(a)(2) depends on whether the injury and claim are "personal and tort-like in nature."<sup>43</sup> Citing authority from the Supreme Court and the Fourth Circuit, the Sixth Circuit concluded that a claim under Title VII represented a tort-like injury.<sup>44</sup> Thus, the court of appeals held that section 104(a)(2) excluded the settlement proceeds from gross income.<sup>45</sup>

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35 *Id.* at 1868-69.

36 *Id.* at 1869.

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

41 *Burke v. United States*, No. CIV-1-88-508, 1990 WL 56155 (E.D. Tenn. Mar. 20, 1990), *rev'd*, 929 F.2d 1119 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992). In determining its findings, the District Court asked, "In lieu of what were the damages awarded?" *Id.* at \*6 (citing *Church v. Commissioner*, 80 T.C. 1104, 1107 (1983)). The District Court found that the relief was in lieu of backpay because "the very core of the case was recovery of wage deficiencies . . ." *Id.* at \*7.

42 *Burke v. United States*, 929 F.2d 1119 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992).

43 *Id.* at 1121.

44 *Id.* (citations omitted).

45 *Id.* at 1123. The dissent argued that the taxpayer's recovery "was not a case in which back pay is a means of measuring loss due to a tort." *Id.* at 1126 (Wellford, J., dissenting). Rather, the taxpayer's recovery was intended to compensate the taxpayer for



The Supreme Court granted certiorari and reversed the Sixth Circuit's holding. In his majority opinion, Justice Blackmun initially noted that neither the legislative history nor the text of section 104(a)(2) offered a definition of a "personal injury."<sup>46</sup> Relying on a Treasury Regulation that interprets section 104(a)(2), the Court reasoned that a personal injury, for purposes of section 104(a)(2), is linked to traditional tort principles.<sup>47</sup>

After reviewing the basic definition of a tort, the Court reasoned that "[r]emedial principles . . . figure prominently in the definition and conceptualization of torts."<sup>48</sup> Furthermore, "one of the hallmarks of traditional tort liability is the availability of a broad range of damages . . . ."<sup>49</sup> Thus, the available remedies were the critical factor in determining the "type of claim."<sup>50</sup> In other words, if the underlying claim's remedies evidenced a tort-like broad range of damages, the claim would be for "personal injury," and the resulting damages would qualify for the exclusion under section 104(a)(2) as "damages received . . . on account of personal injuries or sickness."

The Court then examined the remedies available under Title VII. Characterizing employment discrimination as an "invidious practice which causes grave harm to its victims," the Court reasoned that this fact does not automatically imply a tort-like personal injury for federal tax purposes.<sup>51</sup> However, the Court reasoned that discrimination could be a personal injury within the meaning of section 104(a)(2) if it "evidenced a tort-like conception of injury and remedy."<sup>52</sup> The Court noted that Title VII's remedies were limited to backpay, injunctions, and equitable relief.<sup>53</sup> After examining Title VII's remedial scheme, the Court reasoned that the

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lost earnings. *Id.* Thus, § 104(a)(2) should not exclude the recovery from gross income. *Id.*

46 *United States v. Burke*, 112 S. Ct. 1867, 1870 (1992).

47 *Id.* (relying on *Treas. Reg. § 1.104-1(c)* (1991)); see *supra* note 26 and accompanying text.

48 *Id.* at 1870-71.

49 *Id.* at 1871. The Court noted that tort law may award damages larger than the amount necessary to compensate a victim for actual monetary loss. *Id.* For example, the Court remarked that physical injury victims may recover, in addition to actual expenses, damages for pain and suffering. Furthermore, victims of a nonphysical tort, such as defamation, can recover damages for loss of reputation and mental anguish. *Id.* at 1871-72.

50 *Id.* at 1872 n.7.

51 *Id.* at 1872-73 (citations omitted).

52 *Id.* at 1873 (remarking that racial discrimination could be treated as a dignitary tort) (citation omitted).

53 *Id.*; see 42 U.S.C. § 2000e-5(g) (1988 & Supp. V 1993).

scheme, other than its award of backpay and injunctive relief, did not purport to compensate for the traditional harms associated with personal injury: pain and suffering, emotional distress, harm to reputation, or other consequential damages.<sup>54</sup> Comparing Title VII to other federal antidiscrimination statutes, the Court determined that “the circumscribed remedies available under Title VII stand in marked contrast” to those available under other antidiscrimination statutes.<sup>55</sup>

In conclusion, the Court asserted that Title VII, “whose sole remedial focus is the award of backwages, [does not] redress a tort-like personal injury within the meaning of [section] 104(a)(2) . . . .”<sup>56</sup> Thus, section 104(a)(2) does not exclude a pre-1991 Title VII settlement from gross income as “damages received . . . on account of personal injuries or sickness.”<sup>57</sup>

## 2. Justice Scalia’s Concurring Opinion

In a concurring opinion, Justice Scalia agreed that section 104(a)(2) did not exclude the Title VII settlement from gross income.<sup>58</sup> However, Justice Scalia disagreed with the majority’s analysis. Initially, Justice Scalia rejected the Treasury Regulation’s “tort rights” test as “not within the range of reasonable interpretation of the statutory text” of section 104(a)(2).<sup>59</sup> Applying the “common connotation” to section 104(a)(2)’s term “personal injury” and noting the IRS’s original interpretation of the term, Justice Scalia argued that only physical and mental injuries fall within the meaning of “personal injury.”<sup>60</sup> According to Justice Scalia, the surrounding language should serve as the “critical factor” in deciding whether words go beyond their common meaning.<sup>61</sup> Furthermore,

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54 *Burke*, 112 S. Ct. at 1873.

55 *Id.* at 1873-74. For example, the Court noted that Title VIII of the Civil Rights Act of 1968 provided for the availability of jury trials. *Id.* In addition, 42 U.S.C. § 1981 provided for jury trials, compensatory damages, and punitive damages. *Id.*

56 *Id.* at 1874. The Court also addressed the taxpayer’s argument regarding the expansion, in 1991, of Title VII’s remedial scheme. *Id.* at 1874 n.12. The taxpayers argued that the expansion supported the inherent tort-like nature of Title VII. *Id.* In a statement which seemed to limit the Court’s decision, the Court noted that the expansion of remedies in the amended act “signal[ed] a marked change in . . . [the] conception of injury redressable by Title VII, and cannot be imported back into analysis of the statute as it existed at the time of this lawsuit.” *Id.*

57 *Id.* at 1874.

58 *Id.* at 1876 (Scalia, J., concurring).

59 *Id.* at 1875.

60 *Id.*

61 *Id.* Justice Scalia argued that since the word “sickness” means a physical illness,

Justice Scalia argued that his "common-sense" interpretation was supported by other language in section 104(a)(2) and the Court's rule of narrow construction of tax exemptions.<sup>62</sup>

Armed with his "common-sense" interpretation of the term "personal injuries," Justice Scalia concluded that "[t]he only harm that Title VII dignifies with the status of redressable legal injury is the antecedent economic deprivation that produced the Title VII violation . . . ."<sup>63</sup> Thus, the taxpayer did not receive the Title VII settlement on "account of personal injuries" under section 104(a)(2).<sup>64</sup>

### 3. Justice Souter's Concurring Opinion

Justice Souter joined the majority in concluding that section 104(a)(2) did not exclude the Title VII settlement from gross income. Justice Souter accepted the majority's notion that section 104(a)(2)'s exclusion required that the underlying claim be "based upon tort or tort type rights" rather than upon contract rights to qualify as an exclusion from income.<sup>65</sup> In other words, the underlying claim must be based in tort, not contract, to qualify for exclusion. Justice Souter reasoned that there were "good reasons to put a Title VII claim on the tort side of the line."<sup>66</sup> However, he asserted that Title VII's limitation of recovery to back pay was a "quintessential" contract measure of damages.<sup>67</sup> Furthermore, he characterized the rights guaranteed by Title VII, in an existing employment relationship, as essentially a "contractual term implied by law."<sup>68</sup> In conclusion, Justice Souter noted that "good reasons tug each way."<sup>69</sup>

Given the good reasons for each side, Justice Souter applied the "default rule," requiring the Court to interpret exclusions from gross income narrowly.<sup>70</sup> Thus, because there was a clear "acces-

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the phrase "personal injuries or sickness" should be interpreted to include only physical or mental injury. *Id.*

62 *Id.* at 1875-76.

63 *Id.* at 1876.

64 *Id.*

65 *Id.* at 1877 (Souter, J., concurring) (quoting Treas. Reg. § 1.104-1(c) (1991)).

66 *Id.* Justice Souter noted a parallel between a defamation action and a Title VII suit. *Id.* In addition, Justice Souter noted that the Court had recognized similarities between tort claims and other antidiscrimination claims, § 1981 and § 1983. *Id.*

67 *Id.*

68 *Id.* at 1878.

69 *Id.*

70 *Id.* (citing *United States v. Centennial Savs. Bank*, 499 U.S. 573, 583-84 (1991)).

sion to wealth” and no clear application of section 104(a)(2), Justice Souter concurred with the majority’s result.<sup>71</sup>

#### 4. Justice O’Connor’s Dissenting Opinion

Justice O’Connor, with whom Justice Thomas joined, dissented from the majority’s holding. Both justices would have held the Title VII settlement excludable from gross income as “damages received . . . on account of personal injuries” under section 104(a)(2).<sup>72</sup> Initially agreeing with the majority, Justice O’Connor noted that the majority seemed to accept the notion that workplace discrimination causes personal injury.<sup>73</sup> Furthermore, she agreed that the Treasury Regulation was a reasonable interpretation of section 104(a)(2) and therefore was the proper test for exclusion.<sup>74</sup> However, Justice O’Connor disagreed with the majority’s focus on the remedial scheme of Title VII, characterizing the focus as a “misapprehension” of the nature of the inquiry required under section 104(a)(2) and its interpretative regulation.<sup>75</sup> Justice O’Connor asserted that the proper focus should be on the “nature of the statute and the type of claim brought under it.”<sup>76</sup>

Concentrating on the nature of the claim, Justice O’Connor reasoned that a Title VII claim “fundamentally differed from contractual liability” and sounded in tort.<sup>77</sup> Furthermore, she asserted that the Court had previously found suits under antidiscrimination in employment statutes, the Civil Rights Acts of 1866 and of 1871, analogous to tort-like claims.<sup>78</sup>

In addition, Justice O’Connor attempted to refute three of the majority’s reasons for taxation. First, she viewed as unpersua-

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71 *Id.*

72 *Id.* at 1881 (O’Connor, J., dissenting).

73 *Id.* at 1878.

74 *Id.*

75 *Id.* at 1879.

76 *Id.*

77 *Id.* In arguing that employment discrimination sounds in tort, Justice O’Connor noted that Title VII employment discrimination is actionable without regard to a contractual arrangement between the parties. *Id.* For example, an interviewee may bring a claim under Title VII for discrimination during a job interview. In this situation, no employment contract exists between the parties. In addition, Justice O’Connor argued that like tort damages, “monetary relief for violations of Title VII serves a public purpose beyond offsetting specific losses.” *Id.*

78 *Id.* at 1879-80 (citing *Wilson v. Garcia*, 471 U.S. 261, 277 (1985), and *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987)).

sive the majority's emphasis on the fact that Title VII plaintiffs receive money that would have been taxable absent the discrimination.<sup>79</sup> Justice O'Connor argued that excluding discrimination awards from gross income simply puts the victims on "equal footing" with other victims of personal injury torts.<sup>80</sup> Second, she implied that the majority's reliance on the unavailability of a jury trial in Title VII claims was misplaced.<sup>81</sup> Justice O'Connor asserted that the unavailability of a jury trial was irrelevant to the inquiry of whether the taxpayer had suffered a personal injury.<sup>82</sup> Finally, she disagreed with the Court's "fundamental change" characterization of the 1991 amendments to Title VII's remedial scheme, noting that Congress added the remedies to "effectuate an [already] established goal of Title VII."<sup>83</sup> Justice O'Connor argued that the "protection afforded under Title VII has always been expansive . . .", even before the 1991 amendments to Title VII's remedial scheme.<sup>84</sup>

In conclusion, Justice O'Connor asserted that "Title VII offers a tort-like cause of action," and therefore, section 104(a)(2) excluded Title VII awards or settlements from gross income.<sup>85</sup>

### III. AGE DISCRIMINATION IN EMPLOYMENT ACT

Congress enacted the Age Discrimination in Employment Act of 1967 to prevent age discrimination in the workplace.<sup>86</sup> Congress's stated purpose in enacting the ADEA was "to promote employment of older persons . . . ; to prohibit arbitrary age discrimination . . . ; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment."<sup>87</sup>

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79 *Id.* at 1880. The majority had implied that by not taxing the backpay award, the taxpayer would receive a windfall because the Code does not exclude earned wages from gross income. See *Burke*, 112 S. Ct. at 1874 n.13.

80 *Burke*, 112 S. Ct. at 1880 (O'Connor, J., dissenting).

81 *Id.* at 1880-81. The majority had argued that a lack of jury trials in Title VII claims distinguished Title VII from Title VIII of the Civil Rights Act of 1968 and 42 U.S.C. § 1981. See *id.* at 1873-84; *supra* note 55.

82 *Burke*, 112 S. Ct. at 1880-81 (O'Connor, J., dissenting).

83 *Id.* at 1881. The majority asserted that in 1991 Congress made a "marked change" in its notion of the injury redressable under Title VII. See *id.* at 1874 n.12.

84 *Burke*, 112 S. Ct. at 1881 (O'Connor, J., dissenting).

85 *Id.*

86 Pub. L. No. 90-202, 81 Stat. 602 (1967) (codified as amended at 29 U.S.C. §§ 621-634 (1988 & Supp. V 1993)). For an excellent general discussion of the ADEA, see JOSEPH E. KALET, AGE DISCRIMINATION IN EMPLOYMENT LAW (1990).

87 29 U.S.C. § 621(b) (1988 & Supp. V 1993).

The ADEA, in a broad sense, "prohibits arbitrary discrimination in the workplace based on age."<sup>88</sup> More specifically, the antidiscrimination prohibitions extend to hiring, discharge, compensation, training, and classification decisions regarding employees of at least age 40.<sup>89</sup> The ADEA's broad prohibitions, however, contain exceptions. For example, the ADEA exempts employment decisions based on age when age serves as a reasonably necessary bona fide occupational qualification.<sup>90</sup> As another example, the ADEA allows an employer to mandate retirement at age 65 for certain executives or high policy makers.<sup>91</sup>

Initially, the Fair Labor Standards Act of 1945 ("FLSA") served as a model for the ADEA's remedial scheme.<sup>92</sup> Accordingly, both the FLSA and the ADEA authorize a private cause of action for unpaid wages plus an equal amount of liquidated damages.<sup>93</sup> The ADEA provides for liquidated damages only when the plaintiff proves a willful violation of the Act.<sup>94</sup> Importantly, the ADEA neither expressly provides for punitive damages as a method of punishment nor compensatory damages as relief for pain or suffering.<sup>95</sup>

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88 *Lorillard v. Pons*, 434 U.S. 575, 577 (1978).

89 29 U.S.C. § 623(a)(1)-(2); *id.* § 631(a)-(b). An employer may not "fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, term, condition, or privileges of employment, because of such individual's age." *Id.* § 623(a)(1). In addition, an employer may not "limit, segregate, or classify his employees in any way which would deprive . . . any individual of employment opportunity . . ." *Id.* § 623(a)(2).

90 29 U.S.C. § 623(f)(1) (1988).

91 *Id.* § 631(c)(1).

92 *See id.* § 626(b) (1988). The applicable FLSA provisions are found at 29 U.S.C. §§ 211(b), 216, 217 (1988 & Supp. V 1993). For an excellent discussion of the ADEA's legal and equitable remedies, see KALET, *supra* note 86 at 105-57.

93 Compare 29 U.S.C. § 216(b) (1988) (the FLSA remedial scheme) with 29 U.S.C. 626(b), (d) (1988) (the ADEA remedial scheme).

94 *Id.* § 626(b); *see Trans World Airlines, Inc. v. Thurston*, 469 U.S. 111, 126-27 (1984) for a definition of the term "willful" under the ADEA. In comparison, an aggrieved employee may receive liquidated damages under the FLSA unless the court finds that the employer has proven that it acted in good faith and has reasonable grounds for believing that it was not violating the FLSA. 29 U.S.C. § 260 (1988).

95 *See KALET, supra* note 86 at 129-30. "The conference report accompanying the 1978 ADEA amendments indicates congressional disapproval of [compensatory awards] . . . on the ground that liquidated damages provide full relief for damages, such as emotional or psychological distress, that are difficult to prove." *Id.* at 130; *see H.R. CONF. REP. NO. 950*, 95th Cong., 2d Sess. 14 (1978), *reprinted in* 1978 U.S.C.C.A.N. 528, 535.

In addition to legal remedies, the ADEA's remedial scheme includes equitable relief.<sup>96</sup> The ADEA grants courts the jurisdiction to "effectuate the purposes of the Act" through any legal or equitable remedy, including the award of attorney's fees.<sup>97</sup> For example, the court may enforce a judgment "compelling employment, reinstatement or promotion."<sup>98</sup> Furthermore, whether an action is brought in law or equity, the ADEA entitles the parties to a trial by jury.<sup>99</sup>

#### IV. THE SPLIT IN THE CIRCUITS

The circuit courts of appeals have not uniformly agreed on the issue of whether section 104(a)(2) excludes ADEA awards or settlements from gross income as "damages received . . . on account of personal injuries or sickness."<sup>100</sup> Before the Supreme Court's decision in *Burke*, the Third and Sixth Circuits held that section 104(a)(2) excluded ADEA settlements or awards from gross income. After the *Burke* decision, the Fifth and Ninth Circuits also held that section 104(a)(2) excluded ADEA settlements or awards from gross income. However, the Seventh Circuit held, in a decision issued after *Burke*, that ADEA settlements or awards are not excludable from gross income. A detailed description of the underlying facts, procedure, and analysis in each circuit that has considered the issue follows.

##### A. *The Third Circuit*

In *Rickel v. Commissioner*,<sup>101</sup> the Third Circuit held that section 104(a)(2) excluded wage-related and liquidated damages paid on account of an ADEA claim from gross income.<sup>102</sup> In *Rickel*, Malsbary Manufacturing Company ("Malsbary") employed the taxpayer as a general sales manager.<sup>103</sup> In 1979, when the taxpayer turned 56 years old, the position of Malsbary president became available.<sup>104</sup> Malsbary did not award the taxpayer the position of

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96 29 U.S.C. § 626(c) (1988).

97 *Id.* § 626(b); 29 U.S.C. §§ 216 (b), 217 (1988 & Supp. V 1993).

98 29 U.S.C. § 626(b) (1988).

99 *Id.* § 626(c)(2).

100 *See supra* note 18.

101 900 F.2d 655 (3d Cir. 1990).

102 *Id.* at 663-64.

103 *Id.* at 656.

104 *Id.*

president.<sup>105</sup> Subsequently, the new president, a person twenty years younger than the taxpayer, terminated the taxpayer because of a desire to have someone younger in his position.<sup>106</sup>

The taxpayer brought suit against his employer alleging a violation of the ADEA.<sup>107</sup> In his complaint, the taxpayer requested reinstatement, back wages, liquidated damages, and attorney's fees.<sup>108</sup> During the trial, the parties reached a settlement that provided for an immediate payment of \$80,000 plus payment of \$25,000 for each of the next four years.<sup>109</sup>

On his tax return, the taxpayer excluded the settlement from gross income.<sup>110</sup> Subsequently, the IRS determined that the entire amount of the settlement was includable in gross income, arguing that the settlement proceeds represented either back pay or punitive damages. The taxpayer petitioned the Tax Court for a redetermination of the claimed deficiency.

In review of the case, the Tax Court determined that the ADEA provided for recoveries based on contract and tort claims.<sup>111</sup> The Tax Court held that: (i) liquidated damages awarded under the ADEA "are intended to compensate for those difficult to measure [tort-type] injuries that are the consequence of age discrimination" and therefore section 104(a)(2) excluded them from gross income; and (ii) wage-related damages are based on breach of contract elements and therefore not excludable under section 104(a)(2).<sup>112</sup> Because the settling parties did not allocate the settlement payments between contract and tort claims, and the ADEA equates the amount recoverable under the two types of claims,<sup>113</sup> the Tax Court allocated one-half of the settlement to a tort-like claim and the other half to a contractual claim.<sup>114</sup> Therefore, section 104(a)(2) excluded the tort-like por-

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105 *Id.*

106 *Id.*

107 *Id.*

108 *Id.* at 657.

109 *Id.* at 656-57. The settlement did not allocate the damages to the taxpayer's request for back wages, liquidated damages, or attorney's fees.

110 *Id.* at 657.

111 *Rickel v. Commissioner*, 92 T.C. 510, 522 (1989), *aff'd in part, rev'd in part*, 900 F.2d 655 (3d Cir. 1990).

112 *Id.*

113 See *supra* notes 92-99 and accompanying text for a description of the ADEA remedial scheme.

114 *Rickel*, 92 T.C. at 522.



tion of the claim but did not exclude the contractual portion of the claim.

Reversing the Tax Court's decision in part, the Third Circuit held that section 104(a)(2) excluded all of the damages from gross income.<sup>115</sup> The *Rickel* court applied the "nature of the claim" test adopted by the Tax Court in *Threlkeld v. Commissioner*.<sup>116</sup> Thus, in order "to determine whether the damages were paid on account of personal injuries [and therefore excludable from gross income under section 104(a)(2)] . . . we must look to the nature of the claim and not to the consequences that result from the injury."<sup>117</sup> The *Rickel* court noted that the Tax Court's analysis, determination of the nature of the claim and examination of its consequences, had gone too far.<sup>118</sup> The court stated that "once [the Tax Court] found that age discrimination was analogous to a personal injury and that the taxpayer's ADEA action amounted to the assertion of a tort type right" the analysis should have ended.<sup>119</sup> The court asserted that the Tax Court had "correctly characterized age discrimination as more analogous to a personal injury tort than a breach of contract."<sup>120</sup> In support of this proposition, the Third Circuit relied on a long history of other decisions that characterized workplace discrimination as a tort claim.<sup>121</sup> In addition, the *Rickel* court rejected the government's

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115 *Rickel v. Commissioner*, 900 F.2d 655, 664 (3d Cir. 1990).

116 *Id.* at 661 (noting that the Tax Court had correctly stated the *Threlkeld* test). The *Threlkeld* court described the test as follows:

Section 104(a)(2) excludes from income amounts received as damages on account of personal injuries. Therefore, whether the damages received are paid on account of "personal injuries" should be the beginning and the end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim, and not to the consequences that result from the inquiry.

*Threlkeld v. Commissioner*, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

117 *Rickel*, 900 F.2d at 661 (quoting *Rickel*, 92 T.C. at 516).

118 *Id.*

119 *Id.* (noting that the *Threlkeld* test was made up of only one determination: whether the damages were paid on account of a personal injury).

120 *Id.* at 662.

121 *Id.* at 662-63. In noting this proposition, the *Rickel* court relied on the characterization of another federal antidiscrimination statute, the Fair Labor Standards Act ("FLSA"), in *Byrne v. Commissioner*, 883 F.2d 211 (3d Cir. 1989). The *Byrne* court stated that a FLSA anti-discrimination claim "alleges the violation of a duty owed the plaintiff by the defendant employer which arises by operation of the [FLSA]. The duty is independent of any duty an employer might owe his employee pursuant to an express or implied employment contract; it arises by operation of law." *Rickel*, 900 F.2d at 662 (quoting *Byrne*, 883 F.2d at 215).

argument that a successful plaintiff in an ADEA suit would make out better, in terms of federal income tax liability, than a person who had not been the victim of discrimination.<sup>122</sup> In rejecting this argument, the court noted that “the successful ADEA plaintiff is being treated no better (or worse now) than the typical tort victim who suffers a physical injury.”<sup>123</sup> In conclusion, the *Rickel* court held that: (i) the taxpayer’s ADEA claim “was analogous to the assertion of a tort type right to redress a personal injury”; and (ii) section 104(a)(2) excludes all damages received by the taxpayer from gross income.

### B. *The Sixth Circuit*

In *Pistillo v. Commissioner*,<sup>124</sup> the Sixth Circuit held that section 104(a)(2) excluded all damages received in an ADEA claim from gross income.<sup>125</sup> In *Pistillo*, the Cleveland Tool & Supply Company (“Cleveland Tool”) employed the taxpayer as a commissioned salesman.<sup>126</sup> Cleveland Tool terminated the taxpayer at 57 years of age and replaced him with a younger worker.<sup>127</sup> After termination, the taxpayer felt as if he had been a “victim of age discrimination.”<sup>128</sup>

After an unsuccessful attempt to conciliate, the taxpayer filed a claim against Cleveland Tool alleging a violation of the ADEA.<sup>129</sup> A jury heard the case.<sup>130</sup> After the court instructed

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In addition, the court relied on numerous other cases including: *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987) (holding that 42 U.S.C. § 1981 bars racial discrimination, which is a “fundamental injury to the individual rights of a person”); *Wilson v. Garcia*, 471 U.S. 261, 277 (1985) (holding that a violation of the Civil Rights Acts of 1871 “is an injury to the individual person”); and *Dillon v. AFBIC Development Corp.*, 597 F.2d 556, 562 (5th Cir. 1979) (holding that a suit brought under the Fair Housing Act and the Civil Rights Act of 1866 is “essentially an action in tort”). *Rickel*, 900 F.2d at 662-63.

122 *Rickel*, 900 F.2d at 664.

123 *Id.*

124 *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990).

125 *Id.* at 150-151.

126 *Id.* at 146.

127 *Id.* According to the evidence at trial, the taxpayer’s manager had often made disparaging remarks about the taxpayer’s work and reputation. These remarks included comments that the taxpayer was “old,” had “gray hair,” and was unable to relate to his younger clients. *Id.*

128 *Id.*

129 *Id.* at 146. The taxpayer’s complaint sought the following: (1) a declaration that Cleveland Tool had discriminated against him on the basis of age; (2) a preliminary and permanent injunction enjoining Cleveland Tool from abridging his rights; (3) reinstatement to his previous position and payment of backpay, including overtime; and (4) reim-

the jury that the taxpayer's award would not be subject to taxation, the jury returned a verdict for the taxpayer.<sup>131</sup> During appeal to the Sixth Circuit, the parties reached a settlement, which did not specify whether the payment was intended in lieu of backpay or liquidated damages.<sup>132</sup>

On his 1982 tax return, the taxpayer excluded the settlement from gross income, reasoning that section 104(a)(2) excluded the settlement proceeds.<sup>133</sup> On November 6, 1986, the IRS issued a notice of deficiency, asserting that the taxpayer received the settlement award in lieu of lost wages, not personal injury.<sup>134</sup> The taxpayer petitioned the Tax Court for a redetermination of the deficiency.<sup>135</sup>

The Tax Court, relying on its decision in *Rickel*, reaffirmed that the ADEA provided for recoveries based on contractual and tort claims.<sup>136</sup> The Tax Court examined numerous factors to determine if Cleveland Tool made the payment for a breach of contract, e.g., lost wages, or the violation of a tort-type right, e.g., liquidated damages.<sup>137</sup> After examining the factors, the Tax Court held that the taxpayer must include the entire settlement payment in gross income.<sup>138</sup>

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bursement for reasonable attorney's fees. *Id.* at 146-47.

130 *Id.* at 147.

131 *Id.* at 147. The jury awarded the taxpayer \$55,000 in "compensatory" damages. The district court awarded the taxpayer \$22,432.83 for attorney's fees. *Id.*

132 *Id.* The parties settled for \$81,562.58. The settlement included: \$58,000 for the taxpayer; \$22,706.18 for attorney's fees; and \$856.40 for court reporter fees. *Id.*

133 *Id.*

134 *Id.*

135 *Id.*

136 *Pistillo v. Commissioner*, T.C.M. (P-H) ¶ 89,329, at 1627 (1989), *rev'd*, 912 F.2d 145 (6th Cir. 1990); *see also Wirtz v. Commissioner*, T.C.M. (P-H) ¶ 89,139, at 650 (1989) (holding that § 104(a)(2) excludes ADEA liquidated damages but does not exclude the portion of payment for compensatory damages from gross income).

137 *Pistillo*, T.C.M. (P-H) ¶ 89,239, at 1626-29. The Tax Court noted that the most important factor in determining the nature of the claim is "whether the . . . settlement agreement contains express language stating that the payment was (or was not) made on account of personal injury." *Id.* at 1626 (citing *Byrne v. Commissioner*, 90 T.C. 1000, 1007 (1988)). In addition, the Tax Court examined the following arguments made by the taxpayer: (i) the settlement resolves potential tort claims which could have been included in the ADEA suit; (ii) back pay should be an evidentiary factor, that is, the best measure of loss, for computing the extent of tort injury; (iii) the failure of Cleveland Tool to withhold federal income or social security taxes demonstrates an intent to compensate for personal injury rather than lost wages; and (iv) informal, telephone advice given by an IRS representative is binding. *Id.* at 1628-29.

138 *Id.* at 1629-30. The IRS maintained that gross income included the entire settlement, \$81,526.58 [sic]. *Id.* at 1625. However, the IRS conceded that § 212 allowed the taxpayer a deduction for the amounts paid as attorney's fees, \$22,706.18, and court

On appeal, the Sixth Circuit reversed the Tax Court's decision that section 104(a)(2) excluded the entire settlement from gross income.<sup>139</sup> Utilizing its holding in *Threlkeld v. Commissioner*<sup>140</sup> and the Third Circuit's holding in *Rickel v. Commissioner*,<sup>141</sup> the court concluded that an ADEA claim is "analogous to the assertion of a tort-type right to redress personal injuries."<sup>142</sup> The court stated that the taxpayer had "not brought separate actions to seek back pay damages for his pain and suffering."<sup>143</sup> In addition, the court determined that "whether Cleveland Tool paid [the taxpayer] a portion of the settlement award to compensate him for pain and suffering or lost back pay is irrelevant to the inquiry."<sup>144</sup> Finally, the court noted that its decision would render the taxpayer better off, in terms of federal tax liability, than if he had not been a victim of age discrimination. However, the court stated that the taxpayer was "entitled to receive federal tax treatment equal to that received by the typical tort victim who suffers a physical injury . . . ."<sup>145</sup> In conclusion, the Sixth Circuit held that section 104(a)(2) excluded the entire settlement received by the taxpayer from gross income.<sup>146</sup>

### C. The Seventh Circuit

In *Downey v. Commissioner*,<sup>147</sup> the Seventh Circuit held that

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reporter's fees, \$846.40. *Id.* The taxpayer had previously deducted \$850.00 for court reporter's fees. *Id.* Thus, the IRS asserted that the taxpayer should have included the net amount, \$58,850.00, in income for 1982. *Id.* Although the Tax Court held that the taxpayer was required to include only \$58,850.00 in income, the court effectively held that the taxpayer must include the entire settlement in income. *Id.* at 1629-30.

139 *Pistillo v. Commissioner*, 912 F.2d 145, 148 (6th Cir. 1990).

140 848 F.2d 81 (6th Cir. 1988).

141 900 F.2d 655 (3d Cir. 1990).

142 *Pistillo*, 912 F.2d at 149.

143 *Id.* at 150.

144 *Id.* at 150 n.6 (determining whether or not the damages are paid on account of a personal injury is the beginning and the end of the inquiry) (citation omitted).

145 *Id.* at 150. The *Pistillo* court reasoned that:

Just as the common law punishes tort-feasors, the ADEA punishes employers who practice age discrimination — regardless of whether the discrimination manifests itself in express acts of ageism or through more subtle and evasive forms. To effectuate the purpose of both the ADEA and the IRC, we must make the victims of arbitrary age discrimination whole by providing equal recognition to the substantial indignities and personal injuries they have suffered.

*Id.*

146 *Id.* at 150-51.

147 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5,

section 104(a)(2) does not exclude ADEA damages from gross income because the damages do not compensate the taxpayer for a personal injury.<sup>148</sup> In *Downey*, United Air Lines, Inc. ("United") employed the taxpayer as an airline captain.<sup>149</sup> After the taxpayer turned 60 years old, United retired the taxpayer against his will, although FAA rules would have permitted him to continue to serve as a member of a flight crew.<sup>150</sup>

The taxpayer filed suit claiming that United willfully violated the ADEA.<sup>151</sup> Before trial, the parties entered into a settlement agreement.<sup>152</sup> The settlement agreement provided for a \$120,000 payment by United to the taxpayer as consideration for the release of all claims arising out of the employment relationship.<sup>153</sup> The settlement agreement specifically allocated one-half of the payment to nonliquidated damages, that is back pay, and one-half to liquidated damages.<sup>154</sup>

On his tax return, the taxpayer reported \$60,000 of income attributable to the nonliquidated damages, but he excluded the remaining \$60,000 attributable to the liquidated damages.<sup>155</sup> After an examination of the taxpayer's return, the IRS issued a notice of deficiency asserting that the taxpayer should have included the \$60,000 of liquidated damages in gross income.<sup>156</sup> Subsequently, the taxpayer petitioned the Tax Court for a redetermination of the assessment, arguing that section 104(a)(2) excluded both the reported nonliquidated damages, as well as the liquidated damages, from gross income.<sup>157</sup>

In a departure from its holdings in *Rickel* and *Pistillo*,<sup>158</sup> the

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1994) (No. 94-999).

148 *Id.* at 840.

149 *Downey v. Commissioner*, 97 T.C. 150, 153 (1991) [hereinafter *Downey I*], *aff'd on motion for reconsideration*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

150 *Id.* at 153-54. The Federal Aviation Administration Regulation, the Age 60 Rule, precludes a person over the age of 60 from serving as an airline captain or first officer. The regulation does not prohibit service as a second officer. However, United forbade employees that had served as a captain from serving in any other flight crew position. *Id.*

151 *Id.* at 154-55. The taxpayer's complaint sought "reinstatement, retroactive seniority rights, employee benefits as if [plaintiff's] employment had not been interrupted, back pay plus interest, and liquidated damages." *Id.* at 154.

152 *Id.* at 155.

153 *Id.*

154 *Id.* The agreement also stated that the \$60,000 payment for nonliquidated damages would be subject to employment taxes. *Id.*

155 *Id.* at 156.

156 *Id.*

157 *Id.*

158 See *supra* notes 101-46 and accompanying text for a discussion of *Rickel* and

Tax Court overruled its prior decisions and held that section 104(a)(2) excluded both nonliquidated and liquidated damages from gross income.<sup>159</sup> Before the Tax Court, the taxpayer argued that section 104(a)(2) excluded the damages, whether liquidated or nonliquidated, from gross income.<sup>160</sup> On the other hand, the government argued that the nonliquidated damages represented a claim for back pay, not a claim for personal injury.<sup>161</sup> In addition, the government asserted the equivalency of ADEA liquidated damages to punitive damages.<sup>162</sup> Thus, section 104(a)(2) does not exclude nonliquidated or liquidated ADEA damage awards from gross income.

In its decision, the Tax Court first reviewed the history of the section 104(a)(2) exclusion.<sup>163</sup> Noting that Congress limited the exclusion to damages received on account of personal injury, the Tax Court determined that exclusion depends on the nature of the underlying claim rather than the claim's consequences.<sup>164</sup> Thus, if (i) the "claim is tort or tort-like" and (ii) the "nature of the injury is personal," section 104(a)(2) will exclude the award from gross income.<sup>165</sup> In applying this two-part test, the Tax Court stated that "age discrimination claims brought under the ADEA have been found to be in the nature of tort or tort-like claims."<sup>166</sup> Furthermore, the Tax Court determined that "courts have held that invidious discrimination, including age discrimination, is a personal injury for purposes of section 104(a)(2)."<sup>167</sup> Finding the nature of the claim tort-like and the nature of the injury personal, the Tax Court determined that section 104(a)(2) excluded both types of damages, liquidated and nonliquidated, from gross income.<sup>168</sup> In its determination, the Tax Court specifically overruled its prior decisions in *Rickel* and *Pistillo*.<sup>169</sup>

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*Pistillo*.

159 *Downey I*, 97 T.C. at 173.

160 *Id.* at 156.

161 *Id.* at 156-57.

162 *Id.* at 157.

163 *Id.* at 157-59.

164 *Id.* at 161; see *Threlkeld v. Commissioner*, 87 T.C. 1294, 1297, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

165 *Downey I*, 97 T.C. at 161 (citing *Burke v. United States*, 929 F.2d 1119, 1121, 1123 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992)).

166 *Id.* at 165 (citing *Pistillo v. Commissioner*, 912 F.2d 145, 149-50 (6th Cir. 1990)).

167 *Id.* (citing *Burke v. United States*, 929 F.2d 1119, 1121-22 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992) and *Pistillo v. Commissioner*, 912 F.2d 145, 150 (6th Cir. 1990)).

168 *Downey I*, 97 T.C. at 165.

169 *Id.* at 168-70 (noting that the Third and Sixth Circuit opinions that overruled the

Finally, the Tax Court determined that Congress intended and the courts have interpreted the ADEA's liquidated damages to serve both a compensatory and a punitive function, even though the employer views the damages as purely punitive.<sup>170</sup> The Tax Court specifically rejected the government's argument of the equivalency of ADEA liquidated damages to punitive damages.<sup>171</sup> Thus, the Tax Court held that the ADEA liquidated damages "are intended to compensate the victim . . . for certain nonpecuniary losses and, thus, are excludable from gross income under section 104(a)(2)."<sup>172</sup>

In light of the Supreme Court's decision in *United States v. Burke*, the government motioned the Tax Court for reconsideration of its decision in *Downey I*.<sup>173</sup> Upon rehearing, the Tax Court reaffirmed its earlier holding.<sup>174</sup> In the majority opinion, the Tax Court noted that *Burke* demonstrated that "discrimination could constitute a 'personal injury' for purpose of section 104(a)(2) if the relevant cause of action evidenced a tort-like conception of injury and remedy."<sup>175</sup> In addition, the Tax Court noted that the *Burke* decision stated the rule that, although employment discrimination causes harm to an individual, it does not automatically imply the existence of a tort-like "personal injury."<sup>176</sup> Using the *Burke* decision as background, the Tax Court distinguished ADEA claims from pre-1991 Title VII claims.<sup>177</sup> Unlike pre-1991 Title VII claims, the Tax Court argued that the ADEA offered a "range of remedies," including back pay and liquidated damages.<sup>178</sup> Citing *Downey I* and *Burke*, the Tax Court noted that liquidated damages under the ADEA serve as compensation for nonpecuniary losses, a remedy traditionally associated with

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Tax Court's prior opinions in *Rickel* and *Pistillo* were "more consistent" with the *Threlkeld* opinion).

170 *Id.* at 171-72.

171 *Id.* at 171-73.

172 *Id.* at 170 (citing *Rickel v. Commissioner*, 92 T.C. 510, 521-22 (1989), *rev'd on other grounds*, 900 F.2d 655 (3d Cir. 1990)).

173 *Downey v. Commissioner*, 100 T.C. 634 (1993) [hereinafter *Downey II*], *rev'd*, 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999); see *supra* notes 32-85 and accompanying text for a discussion of *Burke*.

174 *Downey II*, 100 T.C. at 637.

175 *Id.* at 635 (citing *United States v. Burke*, 112 S. Ct. 1867, 1873 (1992)).

176 *Id.* (citing *Burke*, 112 S. Ct. at 1872-73).

177 *Id.* at 636-37.

178 *Id.* at 637. At the time of the *Burke* decision, Title VII's remedial scheme included back pay, injunctions, and other equitable relief. *Burke*, 112 S. Ct. at 1873 n.3.

tort-type claims.<sup>179</sup> Unlike a claim under pre-1991 Title VII which had a limited remedial scheme, an ADEA claim evidenced a broad range of tort-type remedies.<sup>180</sup> Thus, the Tax Court reaffirmed that section 104(a)(2) excluded all ADEA damages from gross income.<sup>181</sup>

Although the Tax Court's decision in *Downey II* reaffirmed its earlier holding, the opinion was not unanimous.<sup>182</sup> In a concurring opinion, Judge Cohen would have held that the taxpayer received only the liquidated damages on account of a tort-like injury.<sup>183</sup> Judge Cohen believed that *Burke* did not support the majority's result.<sup>184</sup> Judge Cohen stated that "two categories of statutory remedies do not" constitute a range as envisioned by *Burke*.<sup>185</sup> Finally, Judge Cohen concurred because *Burke* did not provide a "clear-cut" reason for changing the result in *Downey I*.<sup>186</sup>

In his concurrence, Judge Halpern criticized the majority's opinion as "overbroad."<sup>187</sup> He asserted that the majority opinion found "in all instance[s], the remedies available under the ADEA are sufficiently broad to evidence 'a tort-like conception of injury' and that, therefore, in all instances 'discrimination under the ADEA constitutes a tort-like personal injury.'"<sup>188</sup> Judge Halpern noted that because the ADEA provides for liquidated damages only in cases of willful discrimination, the ADEA provides "two mutually exclusive causes of action: [o]ne for willful discrimination, and one for nonwillful discrimination."<sup>189</sup> He argued that an ADEA suit not involving willful discrimination, that is, no liquidated damages, would not evidence a tort-like concept of injury and remedy under *Burke*.<sup>190</sup> Because *Downey I* involved a cause of

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179 *Downey II*, 100 T.C. at 637.

180 *Id.*

181 *Id.*

182 Eleven judges joined in the *Downey II* majority opinion. Two judges concurred in the result, and one concurred in part and dissented in part.

183 *Downey II*, 100 T.C. at 638 (Cohen, J., concurring).

184 *Id.*

185 *Id.*

186 *Id.* at 638-39.

187 *Id.* at 639 (Halpern, J., concurring). Judge Halpern opined the majority opinion in *Downey I*.

188 *Id.* at 640 (quoting the majority opinion).

189 *Id.* at 641. Section 7(b) of the ADEA provides that "liquidated damages shall only be payable in cases of willful violations of the Act." 29 U.S.C. § 626(b)(1988).

190 *Downey II*, 100 T.C. at 641 (Halpern, J., concurring). In a nonwillful action, the ADEA provides only for recovery of backwages. *Id.* Backwages are the only recovery al-



action for willful discrimination, "for which injury the sufficiently broad range of remedy of liquidated damages is available," Judge Halpern concurred in the majority's result.<sup>191</sup>

In a separate opinion, Judge Laro concurred in part and dissented in part.<sup>192</sup> Arguing that the taxpayer's settlement should have been bifurcated between tort and contract claims, Judge Laro would have found the liquidated damages attributable to a tort claim, therefore excludable from gross income.<sup>193</sup> However, Judge Laro would have attributed the taxpayer's back pay award to a contract claim, finding it not excludable from gross income.<sup>194</sup> Furthermore, Judge Laro noted that a nonwillful ADEA suit, where the plaintiff's recovery is limited to back pay, is analogous to the Title VII case in *Burke* in which the Supreme Court did not find the requisite tort-like personal injury needed for exclusion.<sup>195</sup>

In a decision to reverse the Tax Court, the Seventh Circuit held that section 104(a)(2) did not exclude any portion of the ADEA settlement from gross income.<sup>196</sup> Applying the Treasury Regulation drafted to interpret section 104(a)(2), the Seventh Circuit examined whether an ADEA claim is based on a tort-type right.<sup>197</sup> Although the *Downey* court stated that other circuits had considered whether an ADEA claim was tort-like, it limited its discussion to *Burke* as "the most pertinent teaching on the mat-

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lowed in a Title VII suit. *Id.* Because both suits entitle the taxpayer to only one remedy, recovery of back pay, Judge Halpern inferred that the *Burke* court would not find a nonwillful ADEA suit distinguishable from a Title VII case. *Id.*

191 *Id.* at 643.

192 *Id.* (Laro, J., concurring in part and dissenting in part).

193 *Id.* at 647.

194 *Id.*

195 *Id.* at 649.

196 *Downey v. Commissioner*, 33 F.3d 836, 840 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999).

197 *Id.* at 838-39. Although not expressly adopting Justice Scalia's concurring opinion in *Burke*, the *Downey* court recognized it as "cogently argued" and with "considerable attraction." *Id.* at 838. In *Burke*, Justice Scalia argued that the plain meaning of § 104(a)(2) excluded only awards relating to injuries of a taxpayer's physical or mental health. *Id.* (citing to *United States v. Burke*, 112 S. Ct. 1867, 1874 (1992) (Scalia, J., concurring)); see *supra* notes 58-64 and accompanying text for a discussion of Justice Scalia's concurrence. In other words, § 104(a)(2) does not exclude non-physical damages, including damages awarded for age discrimination under the ADEA, from gross income.

Moreover, Justice Scalia suggested that the Court should not give judicial deference to the Treasury Regulation meant to enforce § 104(a)(2) because it is not within the reasonable interpretation of the statutory text. *Burke*, 112 S. Ct. at 1874; see *supra* notes 59-62 and accompanying text.

ter.”<sup>198</sup> Interpreting *Burke*, the Seventh Circuit stated that “the hallmark of tort liability is the availability of a broad range of damages . . . .”<sup>199</sup> In addition, the court noted that although tort damages are often described in compensatory terms, they usually “redress *intangible* elements of injury.”<sup>200</sup> Therefore, the court stated that:

[w]e believe that *Burke* stands for the proposition that a federal anti-discrimination statute must provide compensatory damages for intangible elements of personal injury (such as pain and suffering, emotional, distress, or personal humiliation) to constitute a tort-type personal injury and receive tax exempt treatment under § 104(a)(2).<sup>201</sup>

The Seventh Circuit determined that ADEA litigants, whether receiving liquidated or nonliquidated awards, could “not recover the broad range of compensatory damages . . . that characterize tort-type personal injury . . . .”<sup>202</sup> Asserting that an ADEA claim “lack[s] the essential element of a tort-type claim,” the Seventh Circuit held that section 104(a)(2) does not exclude an ADEA award or settlement from gross income as “damages . . . received on account of personal injury.”<sup>203</sup>

#### D. The Ninth Circuit

In *Schmitz v. Commissioner*,<sup>204</sup> the Ninth Circuit, on materially identical facts to *Schleier* and *Downey*, held that section 104(a)(2) excluded ADEA wage-related and liquidated awards from gross income.<sup>205</sup> In *Schmitz*, United Air Lines, Inc. settled an age discrim-

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198 *Downey*, 33 F.3d at 838. In addition, the Seventh Circuit noted that the Third Circuit’s opinion in *Rickel* and the Sixth Circuit’s opinion in *Pistillo* predated the Supreme Court’s decision in *Burke*. *Id.*

199 *Id.* at 839.

200 *Id.* (quoting *Burke*, 112 S. Ct. at 1871).

201 *Id.*

202 *Id.* The *Downey* court noted that under the ADEA litigants could not recover damages for pain and suffering or emotional distress. *Id.* In addition, liquidated damages, whether characterized as punitive or contractual remedies, “do not compensate for the intangible elements of a personal injury.” *Id.* at 840.

203 *Id.*

204 34 F.3d 790 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944).

205 *Id.* at 796; *see also* *Redfield v. Insurance Co. of N. Am.*, 940 F.2d 542, 548 (9th Cir. 1991) (holding pre-*Burke* that § 104(a)(2) excludes economic damages awarded in an ADEA action from gross income). *See supra* notes 149-54 and accompanying text for a discussion of the facts in *Downey*; *infra* notes 227-31 and accompanying text for a discus-

ination suit with an involuntarily retired airline captain.<sup>206</sup> The settlement agreement provided that one-half of the award represented back pay and one-half represented liquidated damages.<sup>207</sup>

On their tax return, the taxpayers reported the back pay portion of the settlement as income but excluded the liquidated damages portion.<sup>208</sup> After the Commissioner issued a notice of deficiency, the taxpayers filed a Tax Court petition arguing that section 104(a)(2) excluded both components of the settlement, back pay and liquidated damages, from gross income.<sup>209</sup>

Reaffirming its earlier holdings in *Downey I* and *Downey II*, the Tax Court, in an unpublished order, granted summary judgment in favor of the taxpayers.<sup>210</sup>

On appeal, the Ninth Circuit affirmed the Tax Court's grant of summary judgment.<sup>211</sup> Applying a two-part test adopted by the Ninth Circuit in *United States v. Hawkins*,<sup>212</sup> the *Schmitz* court concluded that the ADEA creates a "tort-like" cause of action and the taxpayer's damages were received "on account" of a personal injury.<sup>213</sup>

First, the *Schmitz* court determined that the ADEA created a tort-like cause of action. The court noted that the *Burke* court would have held an award excludable under section 104(a)(2) if it "evidenced a tort-like conception of injury and remedy."<sup>214</sup> The court believed that the Supreme Court limited its holding in *Burke*

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sion of the facts in *Schleier*.

206 *Schmitz*, 34 F.3d at 791.

207 *Id.* (quoting the settlement agreement).

208 *Id.*

209 *Id.*

210 *Id.*; see *supra* notes 158-195 and accompanying text for a discussion of *Downey I* and *Downey II*.

211 *Id.* at 796.

212 30 F.3d 1077 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3487 (U.S. Dec. 9, 1994) (No. 94-1041). In *Hawkins*, the Ninth Circuit held that § 104(a)(2) excludes damages received in a suit if the taxpayer demonstrates that: (i) the underlying cause of action is tort-like within the meaning of *Burke* and 26 C.F.R. § 1.104-1(c) and (ii) the damages were received "on account of" a personal injury. *Id.* at 1083.

213 *Schmitz*, 34 F.3d at 792. In a concurring opinion, Judge Trott agreed with the outcome of the majority opinion but disagreed with the two-part *Hawkins* test. *Id.* at 796-97 (Trott, J., concurring). Judge Trott believed that the court should focus solely on whether the ADEA redresses a tort-like personal injury claim. *Id.* at 797. Judge Trott argued that if the court had properly applied the *Hawkins* test, it would have treated the ADEA liquidated damages as taxable punitive damages. *Id.* at 799.

214 *Id.* (quoting *United States v. Burke*, 112 S. Ct. 1867, 1873 (1992)). The *Schmitz* court believed that the *Burke* Court based its holding on the fact that Title VII did not provide for jury trials, compensatory damages, or punitive damages. *Id.*

to pre-1991 Title VII claims.<sup>215</sup> Rejecting the government's argument equating an ADEA suit to a contract action, the *Schmitz* court reasoned that the ADEA created a tort-like duty not to discriminate.<sup>216</sup> Furthermore, the court distinguished an ADEA claim from a *Burke*-type Title VII suit, noting that the ADEA allowed for a greater amount of tort-like remedies.<sup>217</sup> Because of the greater availability of tort-like remedies and because discrimination had long been recognized as a personal injury, the *Schmitz* court held that an ADEA action evidenced a tort-like cause of action.<sup>218</sup>

Second, the *Schmitz* court reasoned that the taxpayer received liquidated damages "on account of" a personal injury.<sup>219</sup> Initially, the court agreed with the government's position that section 104(a)(2)'s "on account of" language implied that section 104(a)(2) does not exclude damages unless "they have some compensatory purpose and bear some relationship to the taxpayer's underlying personal injury."<sup>220</sup> However, the *Schmitz* court disagreed with the government's position that ADEA liquidated damages are solely punitive and bear no relationship to the underlying injury.<sup>221</sup> Noting that courts have traditionally awarded liquidated damages to compensate victims for obscure damages, the court stated that "[i]f Congress said 'liquidated,' we will assume that Congress meant 'liquidated' and not punitive."<sup>222</sup> Furthermore, the court characterized ADEA damages, unlike punitive damages, as bearing a relationship to the underlying personal injury of a taxpayer: "[t]hey must equal the plaintiff's total pecuniary loss."<sup>223</sup> Believing that "Congress' use of the term *liquidated* is

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215 *Id.* at 793-94 ("[The *Burke* Court] held only that the pre-1991 version of Title VII, with its 'circumscribed remedies', did not evidence a tort-like conception of personal injury.").

216 *Id.* at 793 (noting that the duty not to discriminate exists whether or not a contractual agreement exists).

217 *Id.* at 793-94 (noting that the ADEA allowed for jury trials, liquidated damages, compensatory damages, and punitive damages).

218 *Id.* at 794.

219 *Id.* at 796.

220 *Id.* at 794 (citing *United States v. Hawkins*, 30 F.3d 1077, 1084 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3487 (U.S. Dec. 9, 1994) (No. 94-1041)). In addition, the court noted that the government apparently conceded that if the ADEA does create a tort-like cause of action the taxpayer's back pay settlement is "on account of" a personal injury and excludable from gross income under § 104(a)(2). *Id.* at 794 n.4.

221 *Id.* at 794.

222 *Id.* at 795.

223 *Id.* (noting that under the ADEA, the more severe a plaintiff's economic damage,

dispositive," the court reasoned that "liquidated damages are traditionally compensatory; punitive damages are not."<sup>224</sup> Therefore, the Ninth Circuit concluded that section 104(a)(2) excluded ADEA liquidated damages from gross income because an ADEA action evidences a tort-like cause of action and the taxpayer received ADEA damages on account of a personal injury.<sup>225</sup>

### E. The Fifth Circuit

In *Schleier v. Commissioner*, the Fifth Circuit affirmed, without opinion, an unreported Tax Court order holding that section 104(a)(2) excluded an airline employee's settlement for back pay and liquidated damages under the ADEA from gross income.<sup>226</sup> In *Schleier*, United Air Lines, Inc. employed the taxpayer as an airline captain. Pursuant to an established policy, United involuntarily terminated the taxpayer at age sixty.<sup>227</sup>

After being terminated, the taxpayer filed suit alleging age discrimination under the ADEA.<sup>228</sup> Subsequently, the taxpayer consolidated his ADEA claim within a class action suit with other similarly situated United employees.<sup>229</sup> Before the trial, the parties agreed to settle.<sup>230</sup> The agreement provided that one-half of the settlement represented backpay and one-half represented liquidated damages.<sup>231</sup>

On their tax return, the taxpayers reported the backpay portion but not the liquidated damages portion of the settlement.<sup>232</sup> After receiving a notice of deficiency asserting failure to pay taxes on the liquidated damages, the taxpayer filed a petition for redetermination in the Tax Court.<sup>233</sup> The taxpayer's petition alleged

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the greater the liquidated damage award). In addition, the *Schmitz* court recognized that the liquidated damages would likely have a punitive effect on the employer. *Id.* However, the court emphasized that "the mere fact that liquidated damages are available . . . does not transform them into punitive damages or eliminate their compensatory purpose." *Id.*

<sup>224</sup> *Id.* at 796.

<sup>225</sup> *Id.*

<sup>226</sup> *Schleier v. Commissioner*, 26 F.3d 1119 (5th Cir.) (table), cert. granted, 115 S.Ct. 507 (1994) (No. 94-500); see also Paul M. Barrett, *Supreme Court to Rule if Settlements In Age-Bias Lawsuits Can Be Taxed*, WALL ST. J., Nov. 15, 1994, at A4.

<sup>227</sup> Petitioner's Brief at 3, *Schleier* (No. 94-500).

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> *Id.* at 4.

<sup>233</sup> *Id.*

that section 104(a)(2) excluded the liquidated damages and the previously reported backpay from gross income.<sup>234</sup> Thus, the taxpayer sought a determination of overpayment from the Tax Court.<sup>235</sup>

Based on its holdings in *Downey v. Commissioner*,<sup>236</sup> the Tax Court, in an unpublished order, granted the taxpayer's motion.<sup>237</sup> The Commissioner appealed.<sup>238</sup>

While the suit was pending on appeal, the Fifth Circuit, in *Purcell v. Seguin State Bank & Trust Co.*,<sup>239</sup> adopted the Tax Court's holding in *Downey I & II*.<sup>240</sup> Given the Fifth Circuit's holding in *Purcell*, the Commissioner requested an *en banc* review of the appeal.<sup>241</sup> The Fifth Circuit rejected the Commissioner's request.<sup>242</sup> Without opinion, the Fifth Circuit then affirmed the Tax Court's order.<sup>243</sup> In effect, the Fifth Circuit held pursuant to *Purcell* that all damages received in an ADEA claim were "received . . . on account of personal injuries" under section 104(a)(2) and therefore excludable from gross income.

## V. THE PUBLIC POLICY ALTERNATIVES

The established principles and policies that underlie the definition of income and the interpretation of exclusions are seemingly straightforward. For example, the Supreme Court has defined income broadly and exclusions from income narrowly.<sup>244</sup> Al-

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234 *Id.*

235 *Id.* The taxpayer's request for a refund was authorized by I.R.C. § 6512(b) (1988).

236 See *supra* notes 158-95 and accompanying text for a discussion of *Downey I* and *Downey II*.

237 Petitioner's Brief at 7, *Schleier* (No. 94-500).

238 *Id.*

239 999 F.2d 950 (5th Cir. 1993). In *Purcell*, the Fifth Circuit addressed a damages issue in connection with a private cause of action under the ADEA. *Id.* at 955. The United States was not a party to the suit. *Id.* While deciding whether an ADEA backpay award should be augmented to reflect the employee's increased tax liability, the *Purcell* court held that "ADEA claims are tort-like." *Id.* at 961. Thus, the *Purcell* court determined, relying on the Tax Court's rulings in *Downey I & II*, that § 104(a)(2) excluded an ADEA award from gross income as "damages . . . received on account of personal injuries or sickness." *Id.*

240 Petitioner's Brief at 7, *Schleier* (No. 94-500).

241 *Id.*

242 *Id.*

243 *Id.*

244 See *United States v. Burke*, 112 S. Ct. 1867, 1870 (1992) (stating that the Code's definition of income "sweeps broadly"); *United States v. Centennial Savs. Bank*, 499 U.S. 573, 583-84 (1991) (stating that statutory exemptions should be construed narrowly);

though the exclusion under section 104(a)(2) fits within this framework, the courts arguably have had a difficult time interpreting section 104(a)(2) because Congress has never precisely defined the specific policies underlying the exclusion. Given the imprecision of the policy underlying section 104(a)(2), commentators have argued that Congress intended the exclusion to be based on one or more of the following justifications: (i) the humanitarian or compassion theory; (ii) the bunching of income theory; (iii) the return of capital theory; and (iv) the burdensome allocation theory.<sup>245</sup> Taking it one step further, some commentators have called for the repeal or amendment of the exclusion. A brief discussion of each of these theories and the calls for amendment or repeal follows.

#### A. *Humanitarian or Compassion Theory*

Some courts and commentators, as well as the taxpayers in *Schleier*, have argued that Congress enacted section 104(a)(2) out of compassion for the victims of personal injury.<sup>246</sup> In his dissenting opinion in *Norfolk & Western Ry. Co. v. Liepelt*, Justice Blackmun noted that "Congress may have intended to confer a humanitarian benefit on the victim or victims of [personal injuries]" by enacting section 104(a)(2).<sup>247</sup> Similarly, the Ninth Circuit has described the humanitarian theory as "a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump-sum award."<sup>248</sup> In *Schleier*, the taxpayers argue that the compassion theory is the best justification for excluding, in appropriate circumstances, backpay from gross income.<sup>249</sup> Furthermore, the taxpayers reason that the humanitarian theory's focus "further[s] the humanitarian objectives of [employment antidiscrimination statutes]."<sup>250</sup>

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*supra* notes 13, 17 and accompanying text.

245 For an excellent discussion of the policy alternatives, see Heen, *supra* note 10, at 560-67, and Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damages Recoveries*, 45 TAX LAW. 783, 795-99 (1992).

246 See Respondent's Brief at 21-22, 24, *Schleier* (No. 94-500); Burke & Friel, *supra* note 19, at 43-44; Heen, *supra* note 10, at 561; Henning, *supra* note 245, at 798-97; Henry, *supra* note 2, at 728-29.

247 *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 501 (1980) (Blackmun, J., dissenting).

248 *Roemer v. Commissioner*, 716 F.2d 693, 696 (9th Cir. 1983).

249 Respondent's Brief at 24, *Schleier* (No. 94-500).

250 *Id.*

Some commentators have criticized the humanitarian or compassion theory. Professors Burke and Friel have argued that "not all damages on account of involuntary personal injuries—and perhaps relatively few—warrant" exclusion under section 104(a)(2).<sup>251</sup> In addition, some commentators have questioned why Congress would have afforded "humanitarian" tax treatment only to compensated victims, rather than to the truly needy, the uncompensated victims.<sup>252</sup>

### B. *Bunching of Income Theory*

Personal injury awards or settlements often result in the taxpayer receiving a lump sum payment. Especially in the case of backpay, a taxpayer would have received the lump sum payment over a period of years. The bunching of income theory argues that "it is unfair to subject such an award [or settlement] to the progressive rate structure of federal income tax, since the bunching usually forces the recipient into a higher marginal tax bracket."<sup>253</sup> As further justification, the Tax Reform Act of 1986 eliminated the Code's income averaging provisions, which allowed taxpayers to even the flow of taxable income for computing their tax liability.

As an example of the effect of income bunching, consider this example, which assumes that section 104(a)(2) does not exclude ADEA awards or settlement from gross income.<sup>254</sup> Suppose that a single individual is fired from his or her job. The employee then sues the employer for age discrimination under the ADEA. Before trial, the parties settle the claim for a sum which includes

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251 Burke & Friel, *supra* note 19, at 43. Another commentator has asserted that given the proliferation of nonphysical torts, e.g. age discrimination and sex discrimination, Congress would not have intended nonphysical tort awards to receive favorable tax treatment. Henning, *supra* note 245, at 797 n.114.

252 Henning, *supra* note 245, at 797 n.114; Henry, *supra* note 2, at 728-29.

253 Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 49 (1987-88); see also Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 714-19 (1977) (examining the bunching of income theory).

254 This highly simplified example assumes that the damage award is the sole income of the taxpayer during the current year, and that the taxpayer has no offsetting deductions other than a personal exemption and a standard deduction. The calculations reflect only 1994 tax rates, personal exemption, and standard deduction amounts. The calculations do not reflect the personal exemption phaseout. Even though the computations do not reflect inflation adjustments for 1990-93, the example demonstrates the practical effect of income bunching. For a similar example, see Yorio, *supra* note 253, at 716.



\$200,000 in backpay for the years 1990-93. The \$200,000 is paid in 1994. Since the Code taxes settlements in the year of receipt,<sup>255</sup> the taxpayer's tax liability for 1994 is \$59,462.<sup>256</sup> In contrast, if the taxpayer had earned \$50,000 over the four years from 1990-93, the total tax liability would have been \$37,172.<sup>257</sup> Thus, because of the lump sum payment the taxpayer paid an additional \$22,290 of tax.

### C. *Return of Capital Theory*

As discussed in Part II.B., Congress originally enacted the exclusion under section 104(a)(2) with a view of the human body as a type of capital.<sup>258</sup> Under this argument, awards or settlements in personal injury cases were seen as a tax-free recovery of human capital and therefore not "income."<sup>259</sup> This argument assumes that each taxpayer has a basis in themselves, consisting of the taxpayer's expenditures for food, education, medical attention, exercise, etc.<sup>260</sup>

Commentators have widely criticized the notion that awards or settlements in personal injury cases are merely a return of human capital.<sup>261</sup> First, commentators have noted that the Code has nev-

255 *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) (holding that if a recovery is taxable, it must be included in income during the year of recovery, not in the year of the loss).

256 I.R.C. § 1(c) (1988 & Supp. V 1993) (\$31,040 plus 36% of the excess of gross income over \$115,000).

257 *Id.* (\$3,413 plus 28% of the excess of gross income over \$22,750 or \$9,293 per year).

258 See *supra* notes 19-23 and accompanying text.

259 See Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 766-68 (1988); see also Burke & Friel, *supra* note 19, at 42.

Gross income includes "gains derived from dealings in property." I.R.C. § 61(a)(3) (1988). Gains are calculated by subtracting an asset's basis from the amount realized. *Id.* § 1001(a). The basis of an asset is its "tax cost," *id.* § 1012, and the amount realized is the "sum of any money received plus the fair market value of the property (other than money) received," *id.* § 1001(b).

Presumably, under the human capital theory, a taxpayer would realize no gain because his basis in human capital would exceed the amount realized.

260 See generally Paul B. Stephan, III, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357 (1984) (discussing a basis in human capital and its relevant components).

261 See Burke & Friel, *supra* note 19, at 42 (asserting that the human capital approach suffers from "severe limitations"); Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 152-53 (1992) (arguing that the human capital theory is not coherent). *Contra* Brooks, *supra* note 259, at 805 (arguing that human capital approach should be the "touchstone" for the policy behind § 104(a)(2)); Heen, *supra* note 10, at 606-617 (asserting that the Burke "tort-like" standard should be replaced with a human capital ap-

er recognized a basis in human capital.<sup>262</sup> Second, assuming that the Code recognized a basis in human capital, commentators have argued that the basis would be nearly impossible to calculate.<sup>263</sup> Third, commentators note that the human capital theory assumes the award or settlement does not exceed the taxpayer's basis in human capital.<sup>264</sup> Finally, some courts have argued that the human capital argument fails when the award or settlement includes items that are not return of capital, such as backpay or punitive damages.<sup>265</sup>

#### D. *Burdensome Allocation Theory*

Personal injury claims often consist of several components, taxable and nontaxable. The burdensome allocation theory argues that allocation of these components "poses too great a burden on taxpayers."<sup>266</sup> Furthermore, some supporters of the theory presume that it is "too difficult if not impossible to determine" the proper allocation of taxable and nontaxable components.<sup>267</sup>

Most commentators have criticized the burdensome allocation theory as meritless. Noting that there are numerous situations where the taxpayer and the government make difficult alloca-

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proach).

262 See Dodge, *supra* note 261, at 153 (arguing that "human capital should not be treated as a conventional asset with basis.").

263 See Burke & Friel, *supra* note 19, at 42 ("the practical and administrative difficulties inherent in [accounting for human capital] seem insurmountable"); Dodge, *supra* note 261, at 153 (asserting that "it is impossible to keep track of costs" associated with human capital).

264 See Yorio, *supra* note 253, at 712 ("[I]f a damage recovery does . . . compensate for the destruction of human capital, it would seem that the excess of recovery over the taxpayer's basis in the human capital should be taxable.").

265 See Downey v. Commissioner, 97 T.C. 150, 159 (1991), *aff'd on motion for reconsideration*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999) ("We doubt whether the return of capital theory justifies the exclusion from income the full range of damages found to be excludable under § 104(a)(2), particularly damages received in lieu of lost income."). *But see* Hawkins v. Commissioner, 30 F.3d 1077 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3487 (U.S. Dec. 9, 1994) (No. 94-944) (using the "return of capital" metaphor to distinguish the exclusion of compensatory damages from the taxation of purely punitive damages).

266 Henning, *supra* note 245, at 797; *see also* Henry, *supra* note 2, at 726 ("since a single unallocated judgment often consists of several components, some taxable, some tax free, a successful plaintiff would have difficulty determining the taxable amount."); Malcom L. Morris, *Taxing Economic Loss Recovered in Personal Injury Actions: Towards a Capital Idea?*, 38 U. FLA. L. REV. 735, 742, 744 (1986) (describing the argument as "avoidance of administrative convenience").

267 Morris, *supra* note 266, at 742.

tions,<sup>268</sup> Professor Morris argues that "[t]he addition of one more would not cause the system to collapse."<sup>269</sup> Furthermore, the courts as well as the IRS have provided the taxpayer with ample guidance in the allocation process.<sup>270</sup>

### E. Calls for Repeal or Amendment

Some commentators have argued for the repeal or amendment of section 104(a)(2). The commentators that favor repealing section 104(a)(2) argue that tax policy simply does not justify the exclusion of personal injury awards or settlements from income.<sup>271</sup> Other commentators have urged amending section 104(a)(2) to respond to the continued judicial confusion and to reflect reasoned tax policy. These suggestions have included amending section 104(a)(2) to not exclude from gross income: nonphysical injuries,<sup>272</sup> lost earnings,<sup>273</sup> punitive damages,<sup>274</sup> and all economic losses.<sup>275</sup> Furthermore, other commentators have suggested that Congress draft a uniform standard for applying section 104(a)(2).<sup>276</sup>

## VI. A PROPOSAL

Against this confused and convoluted background, the Supreme Court, in *Commissioner v. Schleier*, should hold that federal employment discrimination claims are "tort-like." Under this approach, a federal employment discrimination claim, whether based

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268 As an example, Professor Morris points out the difficulty, under § 162, in allocating between personal and business travel expenses. *Id.* at 744.

269 *Id.*

270 See Henning, *supra* note 245, at 797 n.119 (citing to numerous cases and IRS revenue rulings in support of this conclusion).

271 See Cochran, *supra* note 253, at 64-65; Lawrence A. Frolik, *Personal Injury Compensation as a Tax Preference*, 37 ME. L. REV. 1, 35-39 (1985); Susan K. Matlow, *Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?*, 44 VAND. L. REV. 369, 392 (1991); see also Burke & Friel, *supra* note 19, at 46; Douglas K. Chapman, *No Pain - No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407, 428 (1986-87).

272 Stephan I. McIntosh, Comment, *Defining the Intersection of Tort and Tax Law: Recent Developments Regarding the Exclusion of Personal Injury Damages*, 6 VA. TAX REV. 425, 454 (1986).

273 Chapman, *supra* note 271, at 428; Lorraine S. Boss, Note, *Taxation and Personal Injury Awards: The Search for a Workable Guidelines*, 62 ST. JOHN'S L. REV. 628, 646 (1988).

274 Chapman, *supra* note 271, at 428.

275 Morris, *supra* note 266, at 747.

276 *Id.* at 787-88; David D. Willoughby, Recent Developments, *The Taxation of Defamation Recoveries: Toward Establishing Its Reputation* 37 VAND. L. REV. 621, 643 (1984).

on the ADEA,<sup>277</sup> the Americans with Disabilities Act ("ADA"),<sup>278</sup> Title VII of the Civil Rights Act of 1964, as amended,<sup>279</sup> the Equal Pay Act ("EPA"),<sup>280</sup> or the employment-related provisions of the Civil Rights Act of 1866 and the Civil Rights Act of 1871, codified respectively at 42 U.S.C. § 1981 ("section 1981")<sup>281</sup> and 42 U.S.C. § 1983 ("section 1983"),<sup>282</sup> would *per se* qualify as a tort-like claim. Thus, the resulting settlement or award, excluding punitive damages,<sup>283</sup> would qualify for exclusion from gross income under section 104(a)(2) as "damages received . . . on account of personal injuries or sickness."

This approach is advantageous for a number of reasons. First, the majority of case law supports the *per se* approach. This body of case law holds that the nature of a federal employment discrimination claim involves tort-like injury to personal rights. Second, public policy supports the *per se* approach. For example, the humanitarian and bunching of income theories justify the *per se* rule. In addition, adoption of the *per se* approach would effectuate the purposes of equal opportunity laws, promote consistent outcomes, and alleviate continued litigation. Finally, the Supreme Court's adoption of a *per se* rule would remain consistent with its holding in *United States v. Burke*. A more detailed examination of this reasoning follows.

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277 See *supra* notes 86-99 and accompanying text for a discussion of the ADEA.

278 42 U.S.C. §§ 12101-12213 (Supp. V 1993) (prohibiting employment discrimination against employees with disabilities).

279 42 U.S.C. § 2000e (1988 & Supp. V 1993) (making it unlawful for an employer to discriminate in hiring, discharge, or promotions based on race, color, religion, sex, or national origin).

280 29 U.S.C. § 206(d) (1988) (prohibiting sexual discrimination based on the payment of disparate wages).

281 42 U.S.C. § 1981 (Supp. V 1993) (proscribing discrimination in the workplace by prohibiting racial discrimination in the making or enforcing of contracts).

282 42 U.S.C. § 1983 (1988) (prohibiting a violation of constitutional or statutory rights under color of state law).

283 The issue of whether punitive damages with respect to nonphysical injuries are excludable under § 104(a)(2) is beyond the scope of this note. Since the 1989 amendment to § 104(a)(2), the issue has created a split in the circuits. Compare *Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3487 (U.S. Dec. 9, 1994) (No. 94-944), *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994) and *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990) (holding that pre-1989 punitive damages do not qualify for the exclusion in § 104(a)(2)) with *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994) (excluding pre-1989 punitive damages from income under § 104(a)(2)).

### A. *Prior Case Law*

The Supreme Court as well as the lower courts have long held, without question, that employment discrimination is an "invidious practice that causes grave harm to its victims."<sup>284</sup> Given the implicit notion of grave personal harm in employment discrimination, the Supreme Court and the lower courts have consistently held that federal employment antidiscrimination claims are tort-like and personal in nature.<sup>285</sup> Moreover, the *Burke* court explicitly left the door open for future tort-like interpretations by stating that there is "[n]o doubt [that] discrimination could constitute a 'personal injury' for purposes of § 104(a)(2) . . . ."<sup>286</sup> The following is a discussion showing that the majority of courts, which have considered the issue, have concluded that federal antidiscrimination suits are personal in nature; therefore, awards or settlements received for such suits are excludable under section 104(a)(2) as "damages received . . . on account of personal injuries or sickness."

In ADEA cases, the Fifth and Ninth Circuits, the Tax Court, the Court of Federal Claims, and several district courts have concluded after *Burke* that section 104(a)(2) excludes damages or settlements under the ADEA gross income.<sup>287</sup> In cases decided before *Burke*, the Third, Sixth, and Ninth Circuits also held that section 104(a)(2) excludes ADEA damages from gross income.<sup>288</sup>

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284 See, e.g., *United States v. Burke*, 112 S. Ct. 1867, 1872-73 (1992) (citing *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971)); *id.* at 1878-79 (O'Connor, J. dissenting) (citing *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987)).

285 See *infra* notes 287-302 and accompanying text for examples of courts holding that awards or settlements in federal discrimination were excludable from income because they were awarded on account of personal injury.

286 *Burke*, 112 S. Ct. at 1874.

287 *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3462 (U.S. Nov. 23, 1994) (No. 94-944); *Schleier v. Commissioner*, 26 F.3d 1119 (5th Cir.) (table), *cert. granted*, 115 S. Ct. 507 (1994) (No. 94-500); *Purcell v. Seguin State Bank & Trust Co.*, 999 F.2d 950 (5th Cir. 1993); *Bennett v. United States*, 30 Fed. Cl. 396 (1994), *appeal filed*, Fed. Cir. No. 94-5107; *Rice v. United States*, 834 F. Supp. 1241 (E.D. Cal. 1993), *aff'd in unpublished opinion*, 35 F.3d 571 (9th Cir. 1994); *Klein v. Sec. of Transportation*, 807 F. Supp. 1517 (E.D. Wash. 1992); *Downey v. Commissioner*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999); *Renner v. Commissioner*, T.C.M. (P-H) ¶ 94,263 (1994). But see *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, 63 U.S.L.W. 3476 (U.S. Dec. 5, 1994) (No. 94-999); *Drase v. United States*, 866 F. Supp. 1077 (N.D. Ill. 1994); *Shaw v. United States*, 853 F. Supp. 1378 (M.D. Ala. 1994); *Maleszewski v. United States*, 827 F. Supp. 1553 (N.D. Fla. 1993).

288 *Redfield v. Insurance Co. of N. Am.*, 940 F.2d 542 (9th Cir. 1991); *Pistillo v.*

In addition, several circuits, while deciding other issues, have implicitly concluded that ADEA damages were excludable from gross income.<sup>289</sup>

In the only Equal Pay Act case after *Burke*, the Tax Court, in *Bennett v. Commissioner*,<sup>290</sup> addressed the issue of excludability of awards or settlements under section 104(a)(2). In *Bennett*, the Tax Court concluded that section 104(a)(2) excluded EPA liquidated damages from gross income.<sup>291</sup>

In post-1991 Title VII claims, the IRS, in Revenue Ruling 93-88, ruled that "amounts received in satisfaction of claims of disparate treatment discrimination . . . are excludable under section 104(a)(2) of the Code."<sup>292</sup> Perhaps because of the IRS's ruling, few courts have examined whether section 104(a)(2) excludes awards received under amended Title VII from gross income.<sup>293</sup>

Similar to amounts awarded under amended Title VII, the IRS, in Revenue Ruling 93-88, ruled that "amounts received in satisfaction of claims under the Americans with Disabilities Act are also excludable" under section 104(a)(2).<sup>294</sup> Currently, no court has addressed the exclusion issue in the context of the ADA. Given the fact that the ADA's remedial scheme tracks amended Title VII's remedial scheme, the courts should find that section 104(a)(2) excludes ADA awards from gross income.<sup>295</sup>

The Supreme Court, in *Wilson v. Garcia*,<sup>296</sup> held that section 1983 violations are an "injury to the individual rights of a person."<sup>297</sup> Utilizing *Wilson's* interpretation of the essence of a sec-

Commissioner, 912 F.2d 145 (6th Cir. 1990); *Rickel v. Commissioner*, 900 F.2d 655 (3d Cir. 1990).

289 *Reese v. United States*, 24 F.3d 228, 234 (Fed. Cir. 1994); *Commissioner v. Miller*, 914 F.2d 586, 591 n.8 (4th Cir. 1990).

290 T.C.M. (P-H) ¶ 94,190 (1994).

291 *Id.* at 964. The *Bennett* court did not determine if § 104(a)(2) excluded the taxpayer's backpay award from gross income because the taxpayer did not contest its taxability. *Id.* at 962. Before *Burke*, the Tax Court, in *Thompson v. Commissioner*, 89 T.C. 632 (1987), *aff'd* 866 F.2d 709 (4th Cir. 1989), held that § 104(a)(2) excluded liquidated damages but not backpay awarded under the EPA from gross income.

292 Rev. Rul. 93-88, 1993-2 C.B. 61.

293 See *Stender v. Lucky Stores*, No. C-88-1467 MHP, 1993 U.S. Dist. LEXIS 18721, at \*6-7 (N.D. Cal. December 20, 1993) (holding that "[i]t follows from *Burke* that settlement awards under post-Act Title VII must be excluded from gross income.").

294 Rev. Rul. 93-88, 1993-2 C.B. 61.

295 The remedial scheme of the ADA tracks that of Title VII. Compare 42 U.S.C. §§ 1981a(a)(2) (Supp. V 1994) and 12117 (Supp. V 1994) (ADA) with 42 U.S.C. §§ 1981a(a)(1) (Supp. V 1994) and 2000e-5(g) (Supp. V 1994) (Title VII).

296 471 U.S. 261 (1985).

297 *Id.* at 277. In *Wilson*, the Court, looking at the essence of the claim, determined

tion 1983 claim, the Third and Tenth Circuits as well as the Tax Court have held pre-*Burke* that section 104(a)(2) excluded section 1983 awards from gross income.<sup>298</sup>

In *Goodman v. Lukens Steel Co.*,<sup>299</sup> the Supreme Court determined that a section 1981 suit is a claim based on a "fundamental injury to the individual rights of a person."<sup>300</sup> Consistent with this notion, the IRS, in Revenue Ruling 93-88, ruled that "amounts received in satisfaction of claims of disparate treatment discrimination . . . under section 1981 are excludable under section 104(a)(2)."<sup>301</sup> Furthermore, the sole district court to consider the issue after *Burke* held that "settlement awards under section 1981 are excludable from gross income, as awards derived from tort-like causes of action."<sup>302</sup>

### B. Public Policy

The adoption of the *per se* approach is consistent with sound public policy. As previously discussed in Part V., some commentators have argued that sound tax or public policy does support the section 104(a)(2) exclusion.<sup>303</sup> However, this Note argues that the compassion or humanitarian theory, the bunching of income theory, as well as other theories justify the exclusion of federal employment discrimination awards from gross income under section 104(a)(2). A brief description of this reasoning follows.

First, the purposes of the equal employment opportunity laws support the *per se* approach. The Court has long held that the purpose of the equal employment opportunity laws is "to achieve equality of employment opportunities and remove barriers that have operated in the past to favor an identifiable group of . . . employees over other employees."<sup>304</sup> In addition, Congress enact-

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that § 1983's closest state analog was a claim for personal injury. *Id.*

298 *Wulf v. City of Wichita*, 883 F.2d 842, 873 (10th Cir. 1989) (holding § 1983 award not taxable); *Bent v. Commissioner*, 835 F.2d 67, 70 (3d Cir. 1987) (holding that settlement amounts received in lieu of damages for mental pain and suffering; emotional distress; and lost wages were excludable from gross income); *Metzger v. Commissioner*, 88 T.C. 834, 858 (1987), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988).

299 482 U.S. 656 (1987).

300 *Id.* at 661. In *Goodman*, the Court, looking at the essence of the claim, determined that § 1981's closest state analog was a claim for personal injury. *Id.*

301 Rev. Rul. 93-88, 1993-2 C.B. 61.

302 *Stender v. Lucky Stores*, No. C-88-1467 MHP, 1993 U.S. Dist. LEXIS 18721, at \*6 (N.D. Cal. December 20, 1993).

303 See *supra* notes 244-70 and accompanying text for a discussion of the public policy alternatives.

304 See, e.g., *Griggs v. Duke Power Co.*, 401 U.S. 424, 429-30 (1971) (stating Congress'

ed the federal antidiscrimination statutes to prevent the human suffering associated with prejudice in the workplace. For example, Congress enacted the ADEA "to promote employment of older persons based on their ability rather than age."<sup>305</sup> In other words, Congress enacted the ADEA to ensure equal opportunity of employment for older workers and to prevent the basic human suffering associated with unfounded age prejudice. By adopting the *per se* approach, the Supreme Court would effectuate its goal of "eradicat[ing employment] discrimination throughout the economy."<sup>306</sup> In addition, the Court would further the humanitarian objectives of the federal equal opportunity employment laws as well as the section 104(a)(2) personal injury exclusion.<sup>307</sup>

Second, the adoption of a *per se* rule would end the on-going confusion that results from using the "case-by-case" or "facts and circumstances" approach to determine whether section 104(a)(2) excludes employment discrimination awards from gross income. Congress enacted the predecessor to section 104(a)(2) as well as section 104(a)(2) before the advent of federal employment discrimination claims. Without the knowledge of future antidiscrimination statutes, Congress was unable to foresee the present problems of interpreting section 104(a)(2) in the employment discrimination context.<sup>308</sup> These interpretative problems have resulted in divergent rulings. For example, the same court has held that an EPA (gender discrimination in the payment of wages) award was taxable and implied that an ADEA (age discrimination) award was non-taxable even though both actions were based on the violation of federal antidiscrimination statutes with similar purposes, the eradication of employment discrimination.<sup>309</sup> By adopting the *per se* approach, the Supreme Court would provide consistent tax treatment to victims of discrimination under federal antidiscrimination laws.

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objective in enacting Title VII).

305 29 U.S.C. § 621(b) (1988).

306 *Albermarle Paper Co. v. Moody*, 422 U.S. 405, 421 (1975).

307 See Respondent's Brief at 24, *Schleier* (No. 94-500); see also *supra* notes 246-52 and accompanying text for a discussion of the humanitarian policy underlying § 104(a)(2).

308 See *supra* notes 19-28 and accompanying text for a discussion of § 104(a)(2)'s historical background.

309 Compare *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989) (holding that EPA liquidated damages are not excludable under § 104(a)(2)) with *Commissioner v. Miller*, 914 F.2d 586, 591 n.8 (4th Cir. 1990) (implying that ADEA damages are fully excludable from gross income under § 104(a)(2)).



Third, a *per se* approach would eliminate the potential manipulation of settlements, damage awards, and claims. Currently, commentators suggest that the forward thinking practitioner, in employment discrimination suits, should plead multiple claims.<sup>310</sup> The commentators suggest that these claims should allege a violation of the federal antidiscrimination laws as well as violations of state tort-like claims, such as defamation or intentional infliction of emotional distress. By pleading state and federal claims, the alleging party increases the likelihood of exclusion under section 104(a)(2). For example, a plaintiff sues for employment discrimination under the ADEA and for intentional infliction of emotional distress under state law, knowing that the facts may not fully support his claim for the latter. At the conclusion of the trial, the jury awards the plaintiff \$10,000, which has not been allocated between the claims. In this case, the plaintiff is in a position to argue for allocation to the nontaxable state claim even though the jury may have awarded the damages solely as compensation for the ADEA claim. Congress' intent in enacting section 104(a)(2) was not to promote this type of manipulation; a *per se* rule would help to eradicate the perceived need for such crafty strategies.

Finally, a *per se* approach would encourage settlements in employment discrimination cases, thereby promoting judicial and administrative efficiency. Currently, the law discourages settlement between the parties because the IRS usually challenges allocations made solely between the parties, but not allocations made by the courts.<sup>311</sup> A *per se* rule would eliminate this risk. By alleviating some of the risk of settlement, the Court would promote negotiations and settlement prior to trial between the parties.

### C. Consistency with *United States v. Burke*

The adoption of a *per se* rule is consistent with the Court's holding in *United States v. Burke*. In *Burke*, eight of the Justices endorsed the Treasury Regulation's tort-like standard as the proper test for determining whether damages were received on account of personal injury.<sup>312</sup> A *per se* rule would not require the Court to

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310 See Richard T. Helleloid & Lucretia S.W. Mattson, *Has the Scope of the Personal Injury Exclusion Been Changed by the Supreme Court?*, 77 J. TAX'N 82, 86 (1992); Knight et al., *supra* note 10, at 108-109.

311 See Knight et al., *supra* note 10, at 109 (asserting that it is "unlikely that the IRS will successfully challenge a court allocation" of damages).

312 In *Burke*, Justice Scalia rejected the "tort-like" standard as not within the range of reasonable interpretation of § 104(a)(2). See *supra* notes 59-62 and accompanying text; cf.

discard the *Burke* tort-like standard for determining whether a claim was a "personal injury" claim under section 104(a)(2). Furthermore, neither the government nor the taxpayers have argued to discard, either in the Supreme Court or below, the tort-like standard.<sup>313</sup> In addition, the Court could find that *Burke* was decided narrowly and applies only to claims based on pre-1991 Title VII. Congress amended Title VII in 1991, and *Burke* involved a underlying claim based upon pre-1991 Title VII.<sup>314</sup> Many courts and commentators have argued that the amendments, coupled with the Court's remarks in *Burke*, effectively limit *Burke*'s precedential value.<sup>315</sup> More to the point, while the Court seemed to implicitly limit its holding by refusing to "import" amended Title VII into its analysis,<sup>316</sup> the IRS in 1993 expressly ruled that section 104(a)(2) excludes all amounts received in connection with a post-1991 Title VII disparate treatment claim from gross income.<sup>317</sup>

## VII. CONCLUSION

Statistics show an increase in the size and number of federal employment discrimination suits.<sup>318</sup> In *Commissioner v. Schleier*, the

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Heen, *supra* note 10, at 606 ("The 'tort-like' standard should be replaced with an alternative human capital approach."); Sciuto, *supra* note 32, at 307 (characterizing Justice Scalia's approach as the most "common-sense" interpretation of § 104(a)(2)). *But see* *United States v. Burke*, 112 S. Ct. 1867, 1878 (1992) (O'Connor, J., dissenting) (referring to the Court's deference to the Treasury Regulations as "proper"). Since the *Burke* decision, Justices Blackmun and White, both members of the majority in *Burke*, have retired from the Court. After the retirement of Justices Blackmun and White, Justices Ginsburg and Breyer joined the Court. Neither Justice Ginsburg nor Justice Breyer has previously stated an opinion on whether § 104(a)(2) excludes federal employment discrimination awards from gross income.

313 Petitioner's Brief, *Schleier* (No. 94-500); Respondent's Brief, *Schleier* (No. 94-500); *see* *United States v. Burke*, 112 S. Ct. 1867, 1877 (1992) (Scalia, J., concurring) ("I must acknowledge that [discarding the IRS regulation] . . . has not been argued by the United States, here or below.").

314 *See supra* note 35 and accompanying text. In the Civil Rights Act of 1991, Congress amended Title VII to provide for a jury trial and additional remedies. The additional remedies include punitive damages and compensatory damages for future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses. Pub. L. No. 102-166, 105 Stat. 1073 (codified as amended in scattered sections of 29 U.S.C.).

315 *See supra* note 10 and accompanying text.

316 *Burke*, 112 S. Ct. at 1874 n.12; *see id.* at 1881 (O'Connor, J., dissenting) (remarking that the case was decided narrowly).

317 Rev. Rul. 93-88, 1993-2 C.B. 61.

318 *See supra* notes 6-7 and accompanying text.

Supreme Court should take a constructive step forward by presumptively deciding that section 104(a)(2) excludes certain federal employment discrimination awards or settlements from gross income. One commentator has asserted that the *Burke* Court decided narrowly, "hoping that Congress [would] sit up, take notice," and provide clarification.<sup>319</sup> Three years later, Congress has not acted. Furthermore, the lower courts, as shown in divergent opinions, have not provided a consistent interpretation of section 104(a)(2).

To alleviate continued litigation, promote consistent and predictable results, and effectuate the underlying purpose of the federal equal opportunity laws, the Supreme Court should adopt a *per se* approach providing that federal employment discrimination claims are tort-like, and therefore constitute a claim for "personal injury" under section 104(a)(2). By adopting a *per se* rule, the Supreme Court will have taken a constructive first step.

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319 Sciuto, *supra* note 32, at 308.

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