

DOES UNCLE SAM DESERVE PART OF YOUR DISCRIMINATION AWARD? THE TAXABILITY OF BACK PAY AWARDS UNDER IRC SECTION 104(a)(2)

Litigation under federal statutes prohibiting discrimination in employment¹ has increased in recent years.² The size of awards from victorious discrimination claims has also grown.³ It is un-

1. See Civil Rights Act of 1964, 42 U.S.C. § 2000e (1988 & Supp. IV 1992) (prohibiting employment discrimination on the basis of race, religion, sex, or national origin); Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (1988 & Supp. IV 1992) (prohibiting discrimination against employees over 40 years of age); Americans with Disabilities Act of 1990, 42 U.S.C. §§ 12101-12213 (Supp. IV 1992) (prohibiting discrimination against individuals with certain disabilities); Equal Pay Act of 1963, 29 U.S.C. § 206(d) (1988) (prohibiting wage discrimination based on gender); Fair Labor Standards Act, 29 U.S.C. § 215(a)(3) (1988) (prohibiting retaliatory discharge against employee claiming discrimination); 42 U.S.C. § 1983 (Supp. IV. 1992) (prohibiting discrimination against employees who exercise their constitutional rights); 42 U.S.C. §§ 1985-1986 (1988) (punishing conspiracy to interfere with civil rights). See generally MACK A. PLAYER, *EMPLOYMENT DISCRIMINATION LAW* (1988).

2. See *Age Bias Claims Mount as Demographic, Legal, Economic Pressures Increase*, Daily Lab. Rep. (BNA) No. 53, at C-1 (Mar. 19, 1985) (noting increasing frequency of age discrimination litigation under the Age Discrimination in Employment Act).

3. See William W. Horne, *Securing a Record Settlement in Racial Discrimination Case*, AM. LAW., Mar. 1993, at 111 (noting a \$134.5 million judgment in a class action for race discrimination); John J. Keller, *AT&T Will Settle EEOC Lawsuit for \$66 Million*, WALL ST. J., July 18, 1991, at B6 (announcing AT&T's \$66 million settlement for claimed pregnancy discrimination); Wade Lambert & Milo Geyelin, *Law*, WALL ST. J., Aug. 19, 1991, at B6 (noting that Northwest Airlines agreed to settle class actions for alleged race discrimination for between \$20 and \$40 million).

Additionally, under the Clinton Administration, the Equal Employment Opportunity Commission (EEOC) plans to aggressively litigate claims under the Americans With Disabilities Act, which will be both high profile and high damage award cases. See Stuart H. Bompey, *The New Litigation Agenda Under The Clinton Administration* (PLI Litig. & Admin. Practice Course Handbook Series No. 464, 1993).

clear, however, whether awards of back pay⁴ from such claims are excluded from gross income under section 104(a)(2)⁵ of the Internal Revenue Code (IRC or the Code)⁶ as awards on account of personal injury.⁷ Prior to 1992, all discrimination awards were generally excludable if the "nature of the claim," as determined by the underlying cause of action, resembled an action for personal injury.⁸

Although courts still employ the "nature of the claim" test, the Supreme Court further developed this standard for determining taxation of discrimination awards in 1992. In *United States v. Burke*,⁹ the Court analyzed the taxability of Title VII¹⁰ awards by examining the remedies available under the statute.¹¹ By examining the remedies as a means of identifying the nature of the underlying cause of action, the Court's holding in *Burke* has created confusion.¹² In *Downey v. Commissioner (Downey II)*,¹³ the Tax Court reexamined the taxability of awards under the Age Discrimination in Employment Act of 1967 (ADEA)¹⁴ in light of *Burke*.¹⁵ Reaffirming its decision to exclude the entire award, including the back

4. *Black's Law Dictionary* defines a back pay award as the "[d]ifference between wages already paid an employee and higher wages granted retroactively. . . . Such may be awarded in employment discrimination cases." BLACK'S LAW DICTIONARY 138 (6th ed. 1990).

5. Section 104(a)(2) excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injury or sickness." 26 U.S.C. § 104(a)(2) (1988). Personal injury, distinguished from an injury to property, includes harm to one's physical person or an invasion of one's personal rights. BLACK'S LAW DICTIONARY 786 (6th ed. 1990).

6. 26 U.S.C. §§ 1-9722 (1988 & Supp. IV 1992).

7. See generally John Gardner & Susan L. Willey, *Back Pay Awards: Taxation of Back Pay Awards Is Still Uncertain*, 21 TAX'N FOR LAW. 224, 229 (1993) (finding uncertainty after *Burke* in Title VII, EPA, and ADEA awards); Franklin G. Shuler, Jr., *Burke Revisited: Taxation of Employment Related Damages*, 1993 S.C. BAR 23 (1993) (finding the issue "unsettled at best"); Howard Siegel, *Tax Clinic: Supreme Court Decides Back Pay Taxability*, 24 TAX ADVISER 172, 173 (1993) (constructing potential IRS arguments after *Burke*); Seth M. Zachary & Andrew M. Short, *Allocation of Damages May Reduce Employee's Income*, 20 TAX'N FOR LAW. 336 (1992) (summarizing disagreement leading up to the Supreme Court's opinion in *Burke*).

8. See, e.g., *Seay v. Commissioner*, 58 T.C. 32, 40 (1972). See generally *infra* notes 45-100 and accompanying text for a discussion of pre-1992 holdings.

9. 112 S. Ct. 1867 (1992).

10. 42 U.S.C. § 2000e (1988 & Supp. IV 1992). See also *supra* note 1.

11. *Burke*, 112 S. Ct. at 1872-73. For a discussion of the *Burke* majority opinion, see *infra* notes 101-10 and accompanying text.

12. See *infra* notes 116-17 and accompanying text for a discussion of questions left unanswered after *Burke*.

13. 100 T.C. 634 (1993).

14. 29 U.S.C. §§ 621-634 (1988 & Supp. IV. 1992). See *supra* note 1.

15. *Downey II*, 100 T.C. at 635.

pay, a divided Tax Court held that ADEA claims resemble a tort-like personal injury.¹⁶

The taxability of back pay awards remains unclear after *Burke* and *Downey II*.¹⁷ This Recent Development discusses the taxability of back pay awards under IRC section 104(a)(2). Part I details the history of personal injury award taxability, culminating with *Burke*. Part II analyzes the Tax Court's opinion in *Downey II*, including the concurring and dissenting opinions. Part III suggests that when courts award back pay under federal anti-discrimination statutes, courts should bifurcate the claim into a taxable quasi-contractual claim for lost wages and an excludable tort claim for legal damages awarded.

I. THE HISTORY OF TAXABILITY OF PERSONAL INJURY AWARDS

A. Gross Income and Raytheon

The IRC defines gross income as "all income from whatever source derived. . . ."¹⁸ This definition shows Congress' intent to

16. *Id.* at 637.

17. The taxability of punitive damages resulting from personal injury awards has also met debate. Congress attempted to resolve this issue in 1989 by adding the following language to § 104(a)(2): "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical illness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989) (codified at 20 U.S.C. § 104(a) (Supp. IV, 1992)). The express exclusion of *nonphysical* injury punitive damages from the § 104(a)(2) exclusion seems to imply that *physical* injury punitive damages would be covered by the § 104(a)(2) exclusion. This logical assumption is still the subject of debate.

The IRS argues that all punitive damages are includable in income. Rev. Rul. 84-108, 1984-2 C.B. 32, 34. See Margaret Henning, *Recent Developments In The Tax Treatment Of Personal Injury And Punitive Damage Recoveries*, 45 TAX LAW. 783 (1992) (finding punitive damages excludable in physical injury contexts but seriously criticizing the ambiguity and rationale for all § 104(a)(2) treatment); *Punitive Damages For Personal Injury Are Excludable*, 21 TAX'N FOR LAW. 360 (1993) (discussing recent cases supporting the excludability of punitive damages in physical injury contexts). *But see* Craig Day, Comment, *Taxation of Punitive Damages: Interpreting § 104(a)(2) After the Revenue Reconciliation Act of 1989*, 66 WASH. L. REV. 1019, 1039-40 (1991) (proposing that punitive damages be taxed regardless of whether the injury was physical or nonphysical); Paul C. Feinberg, *Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions*, 42 CASE W. RES. L. REV. 339, 410 (1992) (concluding that the statute should be amended to clearly tax all punitive damage awards); Brian R. Greenstein & Mark B. Persellin, *Recent Developments Provide Support for Excluding Punitive Damages From Income*, 79 J. TAX'N 108 (1993) (discussing the IRS's past and present arguments and the case law on the issue). See generally Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 TAX LAW. 755, 759-63 (1993) (explaining the case law treatment of the taxability of punitive damages).

18. 26 U.S.C. § 61(a) (1988).

exert "the full measure of its taxing power."¹⁹ The Supreme Court has defined gross income as any "accession[] to wealth."²⁰ Thus, without a statutory exclusion,²¹ any increase in wealth is taxable.²²

In 1944, in *Raytheon Production Corporation v. Commissioner*,²³ the First Circuit addressed the taxability of awards received from lawsuits.²⁴ In *Raytheon*, the Raytheon Corp. brought an antitrust suit against the Radio Corporation of America (RCA), claiming that it had lost profits due to RCA's monopolistic practices.²⁵ Raytheon received a cash settlement from RCA.²⁶ Raytheon did not list the bulk of the settlement as income.²⁷ The Internal Revenue Service (IRS) claimed that the settlement was income to Raytheon, and litigation ensued.²⁸

The case reached the Court of Appeals, where the First Circuit employed the following standard: "In lieu of what were the damages awarded?"²⁹ According to the court, an award repre-

19. *Helvering v. Clifford*, 309 U.S. 331, 334 (1940). *Clifford* examined § 22(a) of the Revenue Act of 1934, which is the predecessor to § 61(a) of the 1954 Act.

20. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

21. The Court has held that all statutory exclusions from gross income must be construed narrowly. See *United States v. Burke*, 112 S. Ct. 1867, 1878 (1992) (Souter, J., concurring) (citing *United States v. Centennial Sav. Bank F.S.B.*, 499 U.S. 573, 583-84 (1991)).

22. "[A]ny funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code." *Vincent v. Commissioner*, 63 Tax. Ct. Mem. Dec. (CCH) 1776, 1777 (1992) (citing *Glenshaw Glass*, 348 U.S. at 429-31).

23. 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

24. *Id.* at 113-14.

25. *Id.* at 111-12.

26. *Id.* at 112.

27. *Id.* After Raytheon brought suit against RCA, RCA brought suit against Raytheon for non-payment of royalties. RCA won a judgment for \$410,000. In subsequent negotiations to settle both actions, Raytheon agreed to drop its suit and provide RCA with a series of patents in exchange for \$410,000. In Raytheon's income tax return, it estimated the value of the patents as \$60,000. Thus, that amount of the settlement money was included as gross income because it constituted profit from the "sale" of the patents. Raytheon refused to include the remaining \$350,000 as income. *Id.*

28. *Raytheon*, 144 F.2d at 112.

29. *Id.* at 113. See also *Lythe v. Hoey*, 305 U.S. 188, 196-97 (1938) (exempting an amount received in compromise of an otherwise excludable inheritance claim); *Shook v. United States*, 713 F.2d 662, 668 (11th Cir. 1983) (finding that taxability of a lawsuit settlement turned on whether the nature of the claim was for release of dower rights); *Taracido v. Commissioner*, 72 T.C. 1014, 1026-27 (1979) (basing taxability of award for breach of contract on whether the claim settled represented lost profits). See also *Howard v. Commissioner*, 447 F.2d 152, 157 (5th Cir. 1971) (holding the strength of the

senting return of capital would not constitute income.³⁰ However, awards in lieu of lost profits would constitute taxable income.³¹ The court found that the settlement represented lost income, and therefore held that it was taxable.³²

B. *The Exclusion of Personal Injury Awards Under Section 104(a)(2)*

Awards considered gross income under *Raytheon* may still be exempt under statutory exclusions.³³ Section 104(a)(2) of the Code provides an exclusion for awards arising from personal injury claims.³⁴ Neither the Code nor the legislative history defines "personal injury."³⁵ The Treasury Regulations define "personal injury" as "an action based upon tort or *tort-type rights*."³⁶

underlying claim to be irrelevant as long as it was in good faith). *But see* *United States v. Gilmore*, 372 U.S. 39, 48-49 (1963) (holding the nature of legal expenses in defending an alimony suit not to be an ordinary and necessary business expense even though the effect was to retain property held for the production of income).

30. *Raytheon*, 144 F.2d at 113.

31. *Id.* The court held that "since the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in a like manner." *Id.*

The court found "the determining factor is the nature of the basic claim from which the compromised amount was realized." *Id.* at 114. This test is distinguished from the "nature of the claim" test discussed throughout this Recent Development. The *Raytheon* test looks to the nature of the individual damages received to see if they are received in lieu of otherwise taxable income. The latter "nature of the claim" test looks to the nature of the claim as a whole to determine if it fits within the definition of a § 104(a)(2) excludable "personal injury."

32. *Id.* at 113-15. The court found that the entire settlement constituted lost profits because *Raytheon* had not introduced evidence showing any cash basis or replacement of capital. *Id.* at 114.

33. *See, e.g., Vincent v. Commissioner*, 63 Tax. Ct. Mem. Dec. (CCH) 1776, 1777 (1992). For specific statutory exclusions from gross income, see 26 U.S.C. §§ 101-136 (1988 & Supp. IV 1992).

34. 26 U.S.C. § 104(a)(2) (1988 & Supp. IV 1992).

35. *See, e.g., H.R. REP.* No. 1337, 83d Cong., 2d Sess. 15 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4039-40; *S. REP.* No. 1622, 83d Cong., 2d Sess. 15-16 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4645-46. *See also* Jerome A. Erker, Note, *Keys To Effective Litigation: Equitable Exclusion of Civil Rights Damage Awards Under I.R.C. Section 104(a)(2)*, 11 *REV. LITIG.* 415, 436 (1992) (discussing the effect on federal taxation due to different definitions of "tort" and "contract" at the state level); William A. Stahr, Comment, *What Effect Should State Law Have In Defining "Personal Injury" Damages For Purposes of I.R.C. Section 104(a)(2) Exclusion?*, 29 *SAN DIEGO L. REV.* 299 (1992) (discussing the use of state law in defining "personal injury" in the *Roemer* case).

36. *Treas. Reg.* § 1.104-1(c) (1993). The complete text of the regulation is as follows:

According to Prosser and Keeton, a "tort" is "a civil wrong, *other than breach of contract*, for which the court will provide a remedy in the form of an action for damages."³⁷ This ambiguous standard has left courts to decide what types of awards are for personal injuries.³⁸

The government first interpreted section 104(a)(2)³⁹ as excluding only personal injury awards arising from *physical* injuries.⁴⁰ Courts, however, were quick to include awards arising from *nonphysical* injuries.⁴¹ The classification of a nonphysical injury award as an

Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) 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.

Id.

37. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 1, at 2 (5th ed. 1984) (emphasis added) [hereinafter KEETON].

38. For a discussion and criticism of the judicial treatment of the § 104(a)(2) exclusion cases, see Timothy R. Palmer, *Internal Revenue Code Section 104(a)(2) and the Exclusion of Personal Injury Damages: A Model of Inconsistency*, 15 J. CORP. L. 83 (1989).

39. The statutory predecessor to § 104(a)(2) was 26 U.S.C. § 213(b)(6) (current version at 26 U.S.C. § 104(a)(2) (1988)), enacted in 1919. Prior to enactment of § 213(b)(6), such income was taxable. See Henning, *supra* note 17, at 784.

40. Early interpretations of § 213(b)(6) found the provision only applicable where there was physical injury. Feinberg, *supra* note 17, at 367 (citing Sol. Mem. 1384, 2 C.B. 71 (1920) (recognizing alienation of affection as a personal injury but not excluding from gross income); Sol. Mem. 957, 1 C.B. 65 (1919) (refusing to exclude damages from libel action)).

41. Courts abandoned the physical/nonphysical distinction soon after Congress enacted § 213(b)(6). See *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1024-25 (1927), *acq.* 7-1 C.B. 14 (1928); see also *Roemer v. Commissioner*, 716 F.2d 693, 697 (9th Cir. 1983) (noting that the "relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries").

Since the enactment of § 104(a)(2), courts have generally excluded awards arising from physical injury claims. See, e.g., Rev. Rul. 85-97, 1985-2 C.B. 50 (acknowledging that all damages received on account of physical injury are excludable).

Two policy arguments justify this broad exclusion. First, such an exclusion avoids the administrative nightmare that would result if federal tax laws required courts to render special verdicts allocating jury awards into specific "income" and "non-income" components. Imposing such requirements on state courts could also raise constitutional questions regarding federal intrusion on state sovereignty. (These problems, however, do not arise for nonphysical injury actions under federal anti-discrimination statutes. The federal statutes already provide such a break down of the court awards. See *infra* note 151 and accompanying text for a discussion of how the ADEA requires awards to be

award on account of a personal injury depends on whether the claim resembles a tort-type (tax free) or a quasi-contractual (taxable) right. This distinction proves difficult to apply because most statutory discrimination claims contain both tort and contract characteristics.⁴² The discrimination itself invades individual rights,⁴³ while its adverse effects on the claimant's earnings invade contractual rights.⁴⁴

C. The "Nature of the Claim" Test

In 1983, the Ninth Circuit in *Roemer v. Commissioner*⁴⁵ developed the "nature of the claim" test to determine whether awards arising under anti-discrimination statutes were received on account of personal injury.⁴⁶ In *Roemer*, the taxpayer won a defamation suit and received an award that in part represented lost profits.⁴⁷ The Tax Court found this award taxable as compensation representing lost profits to the taxpayer's business rather than an injury

broken down into back pay and liquidated damages.)

The second policy reason is sympathy for the taxpayer. The government does not want to be seen as placing additional burdens on the victim. See Erker, *supra* note 35, at 441-45 (discussing the humanitarian basis for exclusion of back pay in physical injury awards and how it should apply to some, but not all nonphysical injury awards); Henning, *supra* note 17, at 78 (setting forth the traditional justifications for physical injury award exclusions).

Note that *physical* injury is not defined in the Code or legislative history of the Code. This has led to some difficulty in deciding which *physical* injuries should enjoy this favored status. See Edward J. Schnee & Jane Evans, *Punitive Awards May Be Taxed, But Compensatory Payments Retain Their Tax-Free Status*, 45 TAX'N FOR ACCT. 32 (1990) (finding that the injury "must interfere with the victim's normal everyday life").

42. See *United States v. Burke*, 112 S. Ct. 1867, 1873-74 (1992) (noting that employment discrimination could be considered a tort-like personal injury, but finding that Title VII's limited contractual remedies prevented such a statutory claim from being considered a personal injury within § 104(a)(2)).

43. "[T]he right to be free from unreasonable gender discrimination is a personal right." *Thompson v. Commissioner*, 866 F.2d 709, 712 (4th Cir. 1989) (citing *Davis v. Passman*, 442 U.S. 228, 235 n.10 (1979)).

44. In awarding back pay, a court is simply enforcing the original contract between the employer and the employee. The statutory prohibition of discrimination is merely an implied contractual right. *Id.*

45. 716 F.2d 693 (9th Cir. 1983).

46. *Id.* at 697 ("[W]e must look to the nature of the tort of defamation to determine whether the award should have been reported as gross income."). According to this test, courts should look only to the nature of the taxpayer's original claim of wrongdoing to determine if the damages received were for a personal injury within § 104(a)(2). *Id.* Note that this test differs from the test in *Raytheon v. Commissioner*, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944), which considered "in lieu of" what were the damages were awarded. For a discussion of *Raytheon*, see *supra* notes 23-32 and accompanying text.

47. The taxpayer had been accused of being an incompetent and dishonest insurance salesman. *Roemer*, 716 F.2d at 695.

to his person.⁴⁸ The Ninth Circuit reversed and rejected this distinction because it confused the actual injury with its remedial consequences.⁴⁹ The court held the award tax free on the grounds that the nature of the defamation claim was an injury to the claimant's person.⁵⁰ The Tax Court, in *Threlkeld v. Commissioner*,⁵¹ acquiesced to the *Roemer* "nature of the claim" test.⁵²

Since 1987, courts have applied the "nature of the claim" test to awards received under section 1983.⁵³ The Third,⁵⁴ Fifth,⁵⁵ and Tenth⁵⁶ Circuits held that claims brought under section 1983 for violations of First Amendment free speech rights resembled tort-like personal injury actions. Courts exempted these awards even though lost wages served as the basis for calculating the awards.⁵⁷

48. *Roemer v. Commissioner*, 79 T.C. 398, 405-06 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983). The court distinguished damages paid on account of injury to personal versus professional reputation, holding the latter to be taxable. *Id.* at 406. Within a year, the Tax Court reaffirmed this distinction in *Church v. Commissioner*, 80 T.C. 1104, 1109 (1983). In *Church*, the taxpayer received \$250,000 in compensatory damages for personal defamation, after he was labeled a "communist." *Id.* at 1105-06. The award was excluded from income because, unlike *Roemer*, the award in *Church* was not based on lost wages, but instead served as compensation for "mental pain and suffering he experienced. . . ." *Id.* at 1110.

49. *Roemer*, 716 F.2d at 697. The Ninth Circuit criticized the Tax Court for looking at the types of damages awarded in a nonphysical injury situation when no such inquiry is necessary in a physical injury context. The court said: "The relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries." *Id.* The court further noted, "[T]he nonpersonal consequences of a personal injury, such as loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of the injury should not be defined by its effect." *Id.* at 699.

50. *Id.* at 700. *Roemer* found that while the damages that flow from defamation can be both personal and professional, "[A]ll of the harm that is done flows from the same personal attack on the defamed individual." *Id.*

51. 87 T.C. 1294 (1987), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

52. *Id.* at 1307. In *Threlkeld*, the taxpayer sued for malicious prosecution under state law. The Tax Court looked to the "character" of the claim to determine if the award was for personal injuries. *Id.* at 1299. After *Roemer*, the Tax Court changed its position and applied the § 104(a)(2) exemption to awards received for damages to professional reputation. The court conceded "there is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury to professional reputation." *Id.* at 1298-99. *But see* Rev. Rul. 85-143, 1985-2 C.B. 55 (stating the refusal by the IRS to follow the Ninth Circuit in *Roemer*).

53. 42 U.S.C. § 1983 (1988). *See supra* note 1.

54. *Bent v. Commissioner*, 835 F.2d 67, 70 (3d Cir. 1987).

55. *Johnston v. Harris County Flood Control Dist.*, 869 F.2d 1565, 1579-80 (5th Cir. 1989).

56. *Wulf v. City of Wichita*, 883 F.2d 842, 870-75 (10th Cir. 1989).

57. *See supra* notes 54-56.

For example, in *Bent v. Commissioner*,⁵⁸ the Third Circuit held that the lost wages awarded did not represent an independent basis for recovery.⁵⁹ Rather, the lost wages only represented evidence to determine damages.⁶⁰

Courts have found a tort-like claim when the action arises from a statutorily created duty.⁶¹ For example, the Third Circuit in *Byrne v. Commissioner*⁶² found that the nature of a claim under the Fair Labor Standards Act (FLSA)⁶³ was tort-like because the employer's duty arose from the statute and was independent of the employer/employee contract.⁶⁴

The Tax Court,⁶⁵ along with the Third,⁶⁶ Sixth,⁶⁷ and Ninth⁶⁸ Circuits, have used the "nature of the claim" test to analyze the taxability of awards under the Age Discrimination in Employment Act (ADEA).⁶⁹ In 1990, for example, the Third Circuit in *Rickel*

58. 835 F.2d 67 (3d Cir. 1987).

59. *Id.* at 70.

60. *Id.* See also *Metzger v. Commissioner*, 88 T.C. 834, 846-59 (1987) (applying the exemption to claims brought under § 1983 for violation of Thirteenth and Fourteenth Amendment rights to be free from discrimination based on sex and national origin), *aff'd*, 845 F.2d 1013 (3d Cir. 1988). In *Metzger*, a woman professor of Cuban ancestry was not rehired, and she sued for breach of contract and for sex and national origin discrimination. *Id.* at 838. Noting that the Supreme Court had historically found § 1983 claims to be personal injury actions, the Tax Court exempted all of the damages awarded. *Id.* at 851.

61. See, e.g., *Byrne v. Commissioner*, 883 F.2d 211, 215 (3d Cir. 1989).

62. 883 F.2d 211 (3d Cir. 1989).

63. 29 U.S.C. § 215(a)(3) (1988). See *supra* note 1. The FLSA provides remedies to employees who are discriminated against based on their role in legal proceedings against their employer. *Id.* § 215(a). These remedies include employment, reinstatement, promotion, and lost wages. Additionally, unless the employer can demonstrate that it acted in good faith, the employee may be awarded liquidated damages equal to the amount of lost wages. *Id.* § 216(b).

64. "This 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." *Byrne*, 883 F.2d at 215. While the duty not to discriminate does not depend upon any specific contractual provisions, back pay awards under the FLSA depend on the employment contract.

65. *Downey v. Commissioner*, 97 T.C. 150, 173 (1991) (holding both liquidated and nonliquidated damages to be tax free because the nature of an ADEA claim was "personal").

66. *Rickel v. Commissioner*, 900 F.2d 655, 666 (3d Cir. 1990) (extending the "nature of the claim" standard to ADEA actions).

67. *Pistillo v. Commissioner*, 912 F.2d 145, 148-50 (6th Cir. 1990) (determining that the ADEA award of back pay is tax free under § 104(a)(2) because the nature of the claim is tort-like).

68. *Redfield v. Commissioner*, 940 F.2d 542, 547-48 (9th Cir. 1991) (exempting all damages, including back pay, because the nature of age discrimination claims is tort-like).

69. 29 U.S.C. §§ 621-634 (1988 & Supp. IV 1992). See *supra* note 1.

*v. Commissioner*⁷⁰ held that ADEA claims do not arise from the employment contract,⁷¹ but rather arise from an invasion of individual rights.⁷² Thus the awards were on account of personal injury.⁷³

D. *Title VII Awards: Examining the Remedy to Determine the Nature of the Claim*

Prior to the Civil Rights Act of 1991 (the CRA),⁷⁴ Title VII allowed the limited remedies of back pay and reinstatement, but did not allow compensatory or punitive damages.⁷⁵ Some courts looked to the limited back pay remedy, in addition to the nature of the original claim, to decide whether the cause of action was sufficiently tort-like.⁷⁶ For example, the Tax Court in *Hodge v. Commissioner*⁷⁷ concluded that back pay under Title VII was taxable, holding that the nature of a Title VII claim was not the same as the nature of a personal injury claim.⁷⁸ Noting that the taxpayer had sued *only* for back pay, the court found that the award did not resemble damages.⁷⁹ Rather, the award was part of the statutory equitable remedy requiring the employer to repay the employee for wages that he had lost.⁸⁰ Thus, the cause of action did not resemble a personal injury claim.⁸¹

70. 900 F.2d 655 (3d Cir. 1990).

71. *Id.* at 662.

72. *Id.* at 660.

73. *Id.* at 666.

74. Pub. L. No. 102-166, 105 Stat. 1071 (1991).

75. The CRA amended Title VII to allow compensatory and punitive damages in cases of intentional discrimination. 42 U.S.C. § 2000e-5(g) (Supp. IV 1992).

76. *See, e.g., Johnston v. Harris County Flood Control Dist.*, 869 F.2d 1565, 1579-80 (5th Cir. 1989) (remanding for factual determination of whether award was received under a tax free § 1983 claim or a taxable Title VII claim).

77. 64 T.C. 616 (1975).

78. *Id.* at 619. The taxpayer claimed he was not promoted because of his race. *Id.* at 617.

79. *Id.* The taxpayer did raise the issue of psychic, mental, and emotional damages, but failed to raise such claims until three years after the complaint was filed and they were never incorporated into the actual complaint. *Id.* at 620. Also, the actual settlement agreement was a lump sum described as "back pay and damages." The court held that the taxpayer could not prove that the award was for anything but back pay. *Id.* The court noted that it did not make a decision on the taxability of any part of damages received under Title VII not designated as back pay because those damages were not at issue. *Id.* at 619 n.7.

80. According to the court, back pay was "an integral part of the statutory equitable remedy." *Id.* at 619 (citing *Johnson v. Georgia Highway Express, Inc.*, 417 F.2d 1122, 1125 (5th Cir. 1969)).

81. *Hodge*, 64 T.C. at 619.

In *Thompson v. Commissioner*,⁸² the Fourth Circuit examined an award received under both the Equal Pay Act⁸³ and Title VII.⁸⁴ The Equal Pay Act allows both back pay and an equivalent amount of liquidated damages upon a finding of intentional discrimination.⁸⁵ While the court acknowledged that sex discrimination was a tort-type action, the Fourth Circuit excluded only the liquidated damages from taxation.⁸⁶ According to the court, back pay does not resemble an award from an unexpected personal injury claim, but rather is intended to compensate the claimant for regular income not received.⁸⁷ Exempting this back pay from taxation would give claimants an advantage over their taxpaying coworkers.⁸⁸

In *Burke v. Commissioner*,⁸⁹ the Sixth Circuit disagreed with

82. 866 F.2d 709 (4th Cir. 1989).

83. 29 U.S.C. § 206(d) (1988). The Equal Pay Act provides in relevant part that:

No employer having employees subject to any provisions of this section shall discriminate, within any establishment in which such employees are employed, between employees on the basis of sex by paying wages to employees in such establishment at a rate less than the rate at which he pays wages to employees of the opposite sex in such establishment for equal work on jobs the performance of which requires equal skill, effort, and responsibility, and which are performed under similar working conditions, except where such payment is made pursuant to (i) a seniority system; (ii) a merit system; (iii) a system which measures earnings by quantity or quality of production; or (iv) a differential based on any other factor other than sex. . . .

Id. § 206(d)(1).

84. Employees subject to sexual discrimination in the form of unequal pay are entitled to back pay under both the Equal Pay Act and Title VII provided they do not receive overlapping relief. *Thompson v. Commissioner*, 866 F.2d 709, 711 (4th Cir. 1989) (quoting *Thompson v. Boyle*, 499 F. Supp 1147, 1171 (D.C. Cir. 1979) (citing *Laffey v. Northwest Airlines, Inc.*, 567 F.2d 429, 445 (D.C. Cir. 1976), *cert. denied*, 434 U.S. 1086 (1978))).

Multiple claims commonly arise. When a settlement is received under a tort and a contract claim, the recipient can generally choose to classify the award under either claim. The House Ways and Means Committee Report found "[n]o allocation of damages is required among multiple claims if more than one type of claim is alleged in a personal injury action." H.R. REP. No. 247, 101st Cong., 1st Sess. 1, 1355 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1907, 2825. *See also Madson v. Commissioner*, 55 T.C.M. (CCH) 1351, 1354 (1988) (refusing to allocate settlement between breach of contract and equal protection claims); *Evans v. Commissioner*, 40 T.C.M. (CCH) 260, 263 (1980) (allocating complete settlement to the tort claim).

85. 26 U.S.C. § 216(b) (1988 & Supp. IV 1992).

86. *Thompson*, 866 F.2d at 712.

87. *Id.*

88. *Id.*

89. 929 F.2d 1119 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992).

this treatment of Title VII awards.⁹⁰ Because such discrimination has historically been treated as a tort-like injury, the court found that Title VII actions are claims for personal injuries under section 104(a)(2) of the Code.⁹¹ The court refused to examine the remedies available under Title VII.⁹² The dissent argued that the remedies were relevant to determine the "nature of the claim."⁹³

The D.C. Circuit criticized *Burke* in *Sparrow v. Commissioner*.⁹⁴ Examining the distinction between legal and equitable remedies,⁹⁵ the court found two parts to the section 104(a)(2) exclusion: First, the award must constitute damages;⁹⁶ second, the award must be on account of personal injury or sickness.⁹⁷ The court reasoned that damages were a remedy at law, as opposed to a remedy in equity.⁹⁸ Criticizing *Burke* for bypassing the damages requirement,⁹⁹ the court noted that Title VII allowed only equitable remedies; not damages.¹⁰⁰

The inconsistent tax treatment of Title VII awards prompted the Supreme Court to grant certiorari in *Burke*.¹⁰¹ By a seven to two vote, the Court reversed the Sixth Circuit.¹⁰² Like the Tax Court in *Hodge*, the Court considered the remedies available

90. "Courts have long held that injuries resulting from invidious discrimination, be it on the basis of race, sex, national origin or some other unlawful category, are injuries to the individual rights and dignity of the person." *Id.* at 1121 (citing *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1986)).

91. *Id.* at 1123.

92. *Id.*

93. *Burke*, 929 F.2d at 1125 (Wellford, J., dissenting). The dissent disagreed with the analysis in the ADEA cases on which the majority based its opinion. Instead, the dissent would have applied the bifurcation logic used in *Thompson*. *Id.* See *supra* notes 82-88 and accompanying text for a discussion of the bifurcation approach.

94. 949 F.2d 434 (D.C. Cir. 1991).

95. See *supra* notes 77-81 and accompanying text for a summary of the *Hodge* discussion of legal and equitable remedies.

96. Commentators have suggested a separate damage requirement when they define a tort as "a civil wrong, other than a breach of contract, for which the court will provide a remedy in the form of an action for damages." KEETON, *supra* note 37, at 2 (emphasis added).

97. *Sparrow*, 949 F.2d at 436.

98. *Id.* at 437. Neither the original statute nor the legislative history to 26 U.S.C. § 104 defined "damages." Presently, and also at the time of the enactment of § 104, case law defined damages as a remedy at law. According to the court in *Sparrow*, "We think these authorities make it clear that the term 'damages' as used in section 104(a)(2) embodies a monetary amount originally awarded at law, not in equity." 949 F.2d at 437.

99. *Id.* at 439 ("[T]he Sixth Circuit leapfrogged over the damages requirement directly to the personal injury inquiry . . .").

100. *Id.* at 438.

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

102. *Id.* at 1868.

under Title VII to decide whether the claim was tort-like.¹⁰³ To qualify for the section 104(a)(2) exclusion, the Court found that the statute must address a tort-like injury.¹⁰⁴ Examination of the types of damages available was essential to make this determination.¹⁰⁵ Significantly, the Court held that a broad range of available damages was a “hallmark” of a tort action.¹⁰⁶

Applying these standards, the Court noted that Title VII (before the CRA) allowed only back pay and equitable relief, including injunctions.¹⁰⁷ Title VII did not provide relief for intangibles such as pain and suffering, emotional distress, and harm to reputation — bases of damages usually available in tort actions.¹⁰⁸ The Court contrasted these limited remedies with broad remedies available under other federal anti-discrimination statutes, including Title VII as amended by the CRA.¹⁰⁹ Because Title VII’s limited remedies did not address tort-like injuries, awards under the statute as it existed did not meet the section 104(a)(2) definition of personal injury.¹¹⁰

103. *Id.* at 1872-74.

104. *Id.* at 1870.

105. *Id.* at 1870-71.

106. “Indeed, one of the hallmarks of traditional tort liability is the availability of a broad range of damages.” *Burke*, 112 S. Ct. at 1871. While recognizing that employment discrimination could constitute a tort, the Court found “the concept of ‘tort’ is inextricably bound up with remedies — specifically damage actions.” *Id.* at 1872 n.7.

107. *Id.* at 1873. The Court also found it important that, prior to the CRA of 1991, Title VII plaintiffs were not entitled to a jury trial, a remedy generally available in tort actions. *Id.* at 1872.

108. *Id.* at 1873.

109. *Id.* at 1873-74. The Supreme Court implied that the new CRA does provide the requisite broad range of damages. *Id.* A federal district court in California followed this dicta when it held a post-CRA Title VII award to be on account of a tax-free personal injury. *Stender v. Lucky Stores*, 1993 U.S. Dist. LEXIS 18271 (N.D. Cal. Dec. 15, 1993).

110. *Burke*, 112 S. Ct. at 1874. Justices Scalia and Souter concurred. Justice Scalia expressed the view that the § 104(a)(2) exemption is limited to *physical* injury awards. Scalia reasoned that “personal injury and sickness” should be read as one phrase. *Id.* at 1875-77 (Scalia, J., concurring). According to Justice Scalia, because the statute excludes “any damages received . . . on account of personal injuries or sickness,” the majority inappropriately separated the phrase “personal injuries” from sickness. Scalia analogized the majority’s interpretation to the notion that “‘five feet, two inches’ refers to pedal extremities.” *Id.* at 1875.

Justice Scalia’s argument loses merit in light of the fact that the House Ways and Means Committee suggested that very interpretation during the 1989 amendment to § 104(a)(2), but did not adopt it in the Conference Agreement. See Peter J. Ennis & Judee A. Smolarek, *Tax Consequences of Court Awards and Settlement Payments Received In Employment Cases*, 6 LAB. LAW. 395, 414-15 (1990) (citing H.R. REP. No. 247, 101st Cong., 1st Sess. 1354-55 (1989), reprinted in 1989 U.S.C.C.A.N. 2824-25 (describing proposed legislation ad-

Justice O'Connor's dissent, joined by Justice Thomas, argued that taxability of discrimination awards should be determined irrespective of the types of remedies available.¹¹¹ The dissent argued that the purpose and operation of Title VII was to eradicate discrimination, not merely to provide the equitable remedy of restitution.¹¹² They found the distinction between legal and equitable remedies inappropriate because section 104(a)(2) encompasses both remedies.¹¹³

II. AFTER *BURKE*: THE TAX COURT'S DECISION IN *DOWNEY II*

While *Burke*'s ultimate holding bears limited application,¹¹⁴ the

vocating the taxation of all nonphysical injury awards)). See *supra* notes 40-41 for a discussion of the abandonment of the physical/nonphysical distinction.

Justice Souter concurred but disagreed with the majority's position that tort-like character should turn solely on whether the plaintiff can recover for intangible injuries. *Burke*, 112 S. Ct. at 1877 (Souter, J., concurring). Nonetheless, Souter found taxation appropriate because of the contractual nature of back pay. He compared Title VII's ban on discrimination to "a contractual term implied by law." *Id.* at 1878 (Souter, J., concurring).

111. *Id.* at 1878 (O'Connor, J., dissenting). According to the dissent: [F]ederal civil rights suits [are] analogous to personal injury tort actions not at all because of the damages available to civil rights plaintiffs, but because federal law protected individuals against tort-like personal injuries. Discrimination in the work-place being no less injurious than discrimination elsewhere, the rights asserted by persons who sue under Title VII are just as tort-like as the rights asserted by plaintiffs in actions brought under §§ 1981 and 1983.

Id. at 1880 (citing *Goodman v. Lukens Steel Co.*, 482 U.S. 656 (1987); *Wilson v. Garcia*, 471 U.S. 261 (1985)).

See also William Wroblewski, Note, *Application of the Personal Injury Exclusion to Awards for Sex Discrimination Under Title VII: U.S. v. Burke*, 112 S. Ct. 1867 (1992), 71 NEB. L. REV. 1272 (1992) (supporting Justice O'Connor's view that the focus should be solely on the injury and not on the types of damages).

112. *Burke*, 112 S. Ct. at 1879 (O'Connor, J., dissenting). The dissent emphasized that the nature of a Title VII claim is defined by its purpose and operation. The primary purpose of the Title VII back pay award is not merely to provide contract-like restitution, but to be a catalyst for employers to re-evaluate their current employment practices. *Id.* According to the dissent, this is supported by the 1991 amendment to Title VII, which authorized compensatory and punitive damages to effectuate the eradication of discrimination. *Id.* at 1881. *But see id.* at 1874 n.12 (explaining the majority's view of the 1991 amendment as a "marked change in its conception of the injury redressable by Title VII").

113. *Id.* at 1881 (O'Connor, J., dissenting). Justice O'Connor disagreed with the distinction made in *Sparrow* between legal and equitable remedies in defining damages. She found that the IRS regulation § 1.104(c) abandoned any such distinction when it defined § 104 damages as "'an amount' recovered through [an] action . . . based upon 'tort or tort type rights'." *Id.* at 1880-81 (O'Connor J., dissenting) (emphasis in original).

114. *Burke* held that awards under Title VII, before the CRA amended Title VII, were not on account of personal injuries. *Id.* at 1872 n.8.

decision modified the “nature of the claim” test by considering remedies when examining the nature of the claim.¹¹⁵ However, *Burke*’s mandate to consider available remedies left the following questions unanswered: (1) What constitutes a “broad range of damages”?¹¹⁶ and (2) If this “broad range” is found, should *all* damages, including back pay, be exempt?¹¹⁷ Applying the *Burke* analysis to ADEA awards, the Tax Court addressed these questions in *Downey v. Commissioner (Downey II)*.¹¹⁸

In *Downey II*, the plaintiff received an award including back pay and liquidated damages¹¹⁹ as the result of a finding of intentional age discrimination.¹²⁰ In a decision pre-dating *Burke*, the Tax Court in *Downey v. Commissioner (Downey I)*¹²¹ excluded the entire award.¹²² The Tax Court found the types of remedies irrelevant in determining the nature of the claim.¹²³ After *Burke*, the Tax Court reheard the case (*Downey II*) to consider whether the quasi-contractual back pay and the tort-like liquidated damages¹²⁴ created a “broad range of damages” allowing an ADEA action to resemble a tort cause of action.¹²⁵ The majority

115. *Id.* at 1872 (“We agree with the Court of Appeals’ analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents’ damages award.”). See *supra* notes 101-13 and accompanying text for a discussion of the Supreme Court’s decision in *Burke*.

116. *Burke* limited its guidance to the finding that back pay, injunctions, and other equitable remedies did not meet the requisite “broad range.” *Id.* at 1874. See *supra* note 106 and accompanying text. This limited holding also leaves unresolved the situation where tort-type damages were available, but only quasi-contractual damages were awarded.

117. This issue was not reached in *Burke* because the Court never found a broad range of damages. *Burke*, 112 S. Ct. at 1873.

118. 100 T.C. 634 (1993).

119. *Id.* at 635. The ADEA provides for the recovery of lost wages resulting from age discrimination. Additionally, if the discrimination is found to be intentional, the court may award liquidated damages equal to the amount of back pay awarded. 29 U.S.C. §§ 621-634 (1988 & Supp. IV 1992). See *supra* note 1.

120. *Downey*, 100 T.C. at 634.

121. 97 T.C. 150 (1991).

122. *Id.* at 173.

123. *Id.* at 163-64.

124. *Downey II*, 100 T.C. at 637 (citing *Rickel v. Commissioner*, 92 T.C. 510, 521 (1989), *rev’d on other grounds*, 900 F.2d 655 (3d Cir. 1990)). The court found that the liquidated damages were both compensatory and punitive. *Id.* See also *supra* notes 85-86 and accompanying text for a discussion of *Thompson*’s finding that liquidated damages are compensatory damages; H.R. REP. NO. 950, 95th Cong., 2d Sess. 13-14, *reprinted in* 1978 U.S.C.A.N. 528, 535 (describing liquidated damages as “legal relief” compensating victims for nonpecuniary losses). *But see* *Trans World Airlines v. Thurston*, 469 U.S. 111, 125 (1985) (reading legislative history as classifying ADEA’s liquidated damages as punitive); *Gardner & Willey*, *supra* note 7, at 228 (finding that the liquidated damages issue remains undecided).

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

found that the availability of both liquidated damages and back pay differentiated this case from *Burke*, and satisfied the "broad range of damages" test.¹²⁶ The Tax Court declared both the liquidated damages and the back pay award tax exempt.¹²⁷

Judge Cohen disagreed with the majority's interpretation of *Burke*, although he concurred on other grounds.¹²⁸ He asserted that the broad range of available remedies contemplated by *Burke* required more than the two categories of remedies found by the majority.¹²⁹ Furthermore, he did not read *Burke* to say that adding liquidated damages to the award would change the taxable character of the back pay award.¹³⁰

Judge Halpern's concurrence noted that in *willful* age discrimination, a broad range of remedies existed, thus making all damages excludable.¹³¹ But liquidated damages were not available for *nonwillful* age discrimination claims,¹³² so that preventing taxation of awards stemming from nonwillful age discrimination should not be allowed.¹³³

Judge Laro's dissent¹³⁴ advocated division of the award into a

126. *Id.*

127. *Id.* at 638 (Cohen, J., concurring). This decision has been followed by several lower courts. *See, e.g.,* *Cassino v. Commissioner*, 67 T.C.M. (CCH) 2193 (1994) (finding all ADEA awards to be on account of a personal injury based on *Downey II* and *Fite*); *Bennett v. United States*, 30 Cl. Ct. 396 (1994) (finding that the ADEA addresses a tort-like injury because of its broad remedial structure); *Fite v. Commissioner*, 66 T.C.M. (CCH) 1588 (1993) (holding awards under the ADEA tax-free after *Downey II*).

128. Judge Cohen argued for bifurcation of the back pay and liquidated damages claims as in *Downey I*. *Id.* (Cohen, J., concurring) (citing *Downey I*, 97 T.C. at 177-78). Judge Cohen had dissented in part in *Downey I* on grounds that he did not believe that back pay was excludable. 97 T.C. at 175-80 (Cohen, J., concurring in part and dissenting in part). In *Downey II*, Judge Cohen affirmed his concern expressed in *Downey I*, but concurred with the majority judgment in *Downey II* because *Burke* did not provide "a clear-cut reason for changing the result in *Downey I*, and all presently extant authorities dealing specifically with ADEA claims support [taxpayer's] position." *Id.* at 638-39 (Cohen, J., concurring).

129. *Id.* at 638 (Cohen, J., concurring). *See also* *Wilson v. Monarch Paper Co.*, 939 F.2d 1138, 1144 (5th Cir. 1991) (finding that damages for pain and suffering are not available under the ADEA).

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

131. *Id.* at 641-43 (Halpern, J., concurring).

132. "[L]iquidated damages shall be payable only in cases of willful violations of this chapter." 29 U.S.C. § 626(b) (1988).

133. 100 T.C. at 642-43. (Halpern, J., concurring). Judge Halpern concluded that the ADEA "implicitly creates two mutually exclusive causes of action: One for willful discrimination, and one for nonwillful discrimination." *Id.* at 641 (Halpern, J., concurring) (emphasis in original).

134. Judge Laro essentially reaffirmed Judge Cohen's dissenting opinion as expressed in the original 11 to 6 *Downey I* decision. *Id.* at 643-50 (Laro, J., dissenting). *See Downey I*, 97 T.C. at 174-80 (Cohen, J., concurring in part and dissenting in part).

quasi-contractual claim¹³⁵ for back pay, and a tort claim for liquidated damages.¹³⁶ As a result of this distinction, the availability of tort-like remedies does not change the quasi-contractual nature of the back pay.¹³⁷ Judge Laro criticized the majority for treating the two distinct remedies alike.¹³⁸

III. A PROPOSAL: TREATING BACK PAY AS A SEPARATE CLAIM

Courts should adopt Judge Laro's bifurcation analysis articulated in *Downey II*.¹³⁹ Back pay is not awarded on account of personal injury if it is intended to represent quasi-contractual claims for wages owed. Doctrinal authority and policy considerations support such a conclusion.

Burke stated that if a sufficiently broad range of remedies was present, then the *entire* statutory claim would be on account of personal injury.¹⁴⁰ But *Burke* did not address the taxability of back pay under a statute that provides both legal and equitable remedies.¹⁴¹ Thus, it is not clear that the holding in *Burke* to exclude the entire award was intended to apply when the court awards both type of remedies.¹⁴² *Burke* should not apply in these situations.

The quasi-contractual back pay claim should be viewed as a separate taxable claim. While the Supreme Court did not address such a bifurcation in *Burke* (the Court found *all* of the Title VII

135. Judge Laro reaffirmed the Supreme Court's finding in *Burke* that back pay itself was a contractual remedy. *Id.* at 649-50 (Laro, J., dissenting) (citing *United States v. Burke*, 112 S. Ct. 1867, 1874 (1992)).

136. *Id.* at 648 (Laro, J., dissenting).

137. "The fact that the right to recover the back pay arises from a statute, such as the ADEA, . . . does not change the essential nature of the case." *Id.* (citing *Rogers v. Exxon Research & Eng. Co.*, 550 F.2d 834, 838-42 (3d Cir. 1977)).

138. *Downey II*, 100 T.C. at 648 (Laro, J., dissenting). Judge Laro emphasized that the majority should not be hesitant to bifurcate such an award. The bifurcation approach has strong support in prior Tax Court decisions. *Id.* at 649 (Laro, J., dissenting) (citing *Stocks v. Commissioner*, 98 T.C. 1, 17 (1992); *Downey I*, 97 T.C. at 175-80 (Cohen, J., concurring in part and dissenting in part)).

139. *See id.* at 643-50.

140. The Supreme Court agreed with the Sixth Circuit's focus on the nature of the statutory claim as a whole. *Burke*, 112 S. Ct. at 1872. *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, 84 (1992) (reading *Burke* to imply that *all* nonpunitive damages should be tax exempt).

141. *Burke* involved a discrimination award under Title VII, which provided *only* limited equitable remedies. *Burke*, 112 S. Ct. at 1873.

142. *Id.* at 1872.

remedies contractual),¹⁴³ its decision struck at the foundation of prior cases that disapproved of separating the back pay claim.¹⁴⁴ The *Roemer* line of cases ignored actual damages and looked to whether there was an injury to the person¹⁴⁵ or a statutory duty.¹⁴⁶ By not considering the types of remedies awarded, there was only one claim to exempt. Because *Burke* now requires courts to examine the types of remedies,¹⁴⁷ courts should disregard the one claim view.

Burke opens the door to bifurcation as suggested in *Thompson* and *Sparrow*. These cases relied on the distinction between legal and equitable remedies, treating the quasi-contractual equitable remedy as a separate taxable claim.¹⁴⁸ The *Burke* majority recognized this legal/equitable distinction when it declared that a broad range of [legal] damages was necessary to make a claim tort-like.¹⁴⁹

Furthermore, most federal anti-discrimination statutes distinguish between legal and equitable remedies.¹⁵⁰ For example, legal and equitable remedies under the ADEA are triggered by separate criteria. Back pay is allowed upon a finding of age discrimination, but liquidated damages are allowed only upon a finding of willfulness.¹⁵¹ The Equal Pay Act also limits the remedy to back pay absent intentional discrimination.¹⁵² Similarly, the CRA requires the plaintiff to prove intent before the additional legal remedies are made available under Title VII.¹⁵³

143. *Id.* at 1874.

144. See Mark B. Persellin & Brian R. Greenstein, *Back Pay Awarded in Employment Discrimination Dispute is Taxable*, 24 TAX ADVISER 214, 219 (1993) (acknowledging that the Supreme Court is rejecting the *Roemer* theory).

145. See *supra* notes 45-60 and accompanying text for an explanation of the case law foundation for the original "nature of the claim" test.

146. See *supra* notes 61-64 and accompanying text.

147. *Burke*, 112 S. Ct. at 1872.

148. See *supra* notes 82-88, 94-100 and accompanying text for a discussion of separate equitable claims for back pay.

149. *Burke*, 112 S. Ct. at 1871. *But see* William J. Mertens v. Hewitt Assoc., 113 S. Ct. 2063, 2068 (1993) (finding that compensatory damages do not fit within the ERISA definition of equitable relief).

Justice Souter's concurrence went even further towards treating back pay as a separate equitable claim when he argued taxation was appropriate under Title VII because back pay is "quintessentially" a contractual remedy. *Burke*, 112 S. Ct. at 1877 (Souter, J., concurring). For a discussion of Justice Souter's concurring opinion, see *supra* note 110.

150. See generally Helleloid & Mattson, *supra* note 140 (reviewing taxability of awards received under federal discrimination statutes after the Supreme Court's opinion in *Burke*).

151. 29 U.S.C. § 626(b) (1988).

152. 26 U.S.C. § 216(b) (1988).

153. "Compensatory damages awarded under this section shall not include

In addition, bifurcation is necessary to achieve equity among taxpayers.¹⁵⁴ The fundamental principle of horizontal equity is that similarly situated people should be treated in a like manner.¹⁵⁵ Excluding back pay violates this principle.¹⁵⁶ Claimants who receive awards of back pay representing lost wages are made better than whole if the award is not taxed; they would receive tax advantages not available to their co-workers, who are required to pay tax on all of their wages.¹⁵⁷

back pay.” 42 U.S.C. § 1981a(b)(2) (Supp. IV 1992). See also Merrick T. Rossein, *Tax Liability with Settlements and Court Awards in Employment Discrimination*, C780 A.L.I. - A.B.A. 1025, 1033 (1993) (suggesting that the IRS may argue taxability in disparate impact cases because of the unavailability of compensatory and punitive damages). See generally Eric Schnapper, *Statutory Misinterpretations: A Legal Autopsy*, 68 NOTRE DAME L. REV. 1095 (1993) (discussing the changes and implications of the 1991 amendments to Title VII).

154. See Douglas K. Chapman, *No Pain — No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407, 427-31 (1986-87) (concluding that the exemption of back pay under § 104(a)(2) is not justified under traditional tax policy); Susan V. Matlow, Note, *Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?*, 44 VAND. L. REV. 369, 393-94 (1991) (suggesting strict limitations on the excludability of nonpersonal injury awards because sympathy does not justify this inequity). But see Thomas D. Griffith, *Should “Tax Norms” be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115 (arguing for the abandonment of traditional equity justifications of tax policy in the personal injury area).

155. JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 5 (1983).

156. Inequity becomes apparent when *Downey II* is compared to the fact situation in which intent was not found and *only* back pay was awarded. An example will illustrate this concern. Both *A* and *B* were denied promotions by company *X* because of their age. *A* was able to prove that this discrimination was intentional and received both back pay and an equal amount of liquidated damages under ADEA. *B*, however, failed to prove intent and received only a back pay award. According to *Downey II*, all of *A*'s award, including the back pay, would be excludable because a “broad range” of damages was awarded. On the same theory, because *B*'s only remedy was back pay, he would not be eligible for the exclusion. Both *A* and *B* received the same back pay and yet the Tax Court believes that only *B* should be taxed on it.

Note that the majority in *Downey II* did not specifically hold that the unavailability of “liquidated damages” for unintentional ADEA discrimination would make the nature of the claim contractual. The contractual nature of such damages was expressed in Judge Halpern's concurring opinion. *Downey II*, 100 T.C. at 634 (Halpern, J., concurring). A recent district court opinion also corroborates the view that a successful claim of unintentional discrimination under the ADEA does not constitute a broad range of damages. *Maleszewski v. United States*, 827 F. Supp 1553 (N.D. Fla. 1993). The *Maleszewski* opinion further suggested that even a claim for intentional discrimination under the ADEA does not offer a sufficiently “broad range” of available damages. According to the district court, “The relief available to a successful ADEA claimant is essentially the same as that afforded Title VII claimants, with the exception of the liquidated damages provision.” *Id.* at 1556.

157. In *Burke*, the Supreme Court recognized this inequity and suggested

Bifurcation also promotes clarity and administrative convenience.¹⁵⁸ The decision to litigate often depends on whether the various awards are taxable.¹⁵⁹ Currently, discrimination statutes

that Congress, in enacting Title VII, did not intend such disparate treatment. According to the Court, "Congress declined to recompense Title VII plaintiffs for anything beyond the wages properly due them — wages that, if paid in the ordinary course, would have been fully taxable." *Burke*, 112 S. Ct. at 1874. See Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 724 (1986) (suggesting the recipient of tax-free back pay is made better than whole); see also Rev. Rul. 72-341, 1972-2 C.B. 32 (explaining the IRS position that Title VII back pay is taxable because the award is in lieu of otherwise taxable earnings); see generally Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform*, 56 TENN. L. REV. 661 (1989) (exploring potential for taxpayer abuse of the § 104(a)(2) exclusion and recommending legislative changes).

This "better than whole" argument has been criticized on the grounds that back pay in *physical* injury awards is exempt. This criticism fails to consider the favored treatment traditionally given only to physical injury awards. See *supra* notes 40-41 and accompanying text for a discussion of the reasons given for the favored status of physical injury awards.

In 1989, Congress amended the text of § 104 to exclude its applicability to punitive damage awards "with a case not involving physical injury." P.L. 101-239, 103 Stat. 2106 (1989) (codified at 26 U.S.C. § 104(a) (Supp. IV 1992)). This implies that § 104 only excludes punitive damages in cases of physical injuries, thus recognizing their preferred status. But see *supra* note 17 for a discussion of the current debate over whether punitive damages are ever excludable.

158. The confusion surrounding § 104(a)(2) has led to problems for Donald Livingston, general counsel for the EEOC. In a March 1, 1993 memorandum, he responded to queries on the taxability of damages under the CRA and the Americans with Disabilities Act. He explained that they were *likely* tax-free, but he could not be sure. Livingston said: "We have discussed the matter with the [Internal Revenue] Service and they neither agree [n]or disagree." Rita L. Zeidner, *Taxing Questions Pending on Employment Discrimination Awards*, 93 TAX NOTES TODAY 75-10. The IRS has commenced a revenue ruling project with the central question "whether you can bifurcate backpay [sic] from other types of damages." *Id.*

159. Employers are fearful of becoming defendants in future litigation with either the former employee or the IRS as plaintiff. If the employer does withhold taxes out of the employee's award, the employee may sue the employer for not fully satisfying the settlement. If the employer does not withhold taxes, the IRS may sue the employer for the amount of taxes due plus a 100% penalty equal to the employee's portion of the employment taxes. William L. Raby, *Withholding Tax on Severance and Wrongful Discharge*, 57 TAX NOTES 1555, 1557 (1992). See generally 26 U.S.C. § 3403 (1988) (imposing liability on the employer for tax required to be withheld from employee earnings); *id.* § 3102(b) (exempting the employer from liability to the employee for the amount of compensation that the Code required to be withheld); 26 U.S.C. § 3509 (1988 & Supp. IV 1992) (determining percentage of taxable employee compensation to be withheld by the employer); *id.* § 6672 (imposing penalties on the employer for failure to withhold required tax from employee's compensation).

offer various packages of remedies.¹⁶⁰ It may take years before courts agree on which statutes allow a broad range of damages. Bifurcation would provide an immediate solution to this confusion. If all back pay is taxable, courts need only determine the portion of the award representing back pay.¹⁶¹ Although this can be a difficult factual question, courts already have the basic legal standards necessary to make this determination.¹⁶²

160. See *supra* note 1 for a listing of federal statutes prohibiting discrimination.

161. Note that all of the parties to the settlement agreement have strong incentives to classify the award as something other than back pay. If the award is taxed as back pay, the employee is liable for federal income taxes, state income taxes, Social Security taxes, and Medicare taxes. The employer is also liable for Social Security taxes, Medicare taxes, and unemployment taxes. Finally, the employer may also be liable for the employee's taxes if they did not properly withhold taxes from the settlement. See generally Catherine M. Waltz & Robert L. Cohen, *Tax Clinic: Personal Injury Recoveries After Burke*, 23 TAX ADVISER 819 (1992) (explaining the treatment of employment taxes on personal injury awards); see also *supra* note 159 for a discussion of the potential employer liability for employment taxes.

The incentive for collusion is best evidenced by example: *A* sued employer *X* for sex discrimination. *X* settles with *A* for \$100,000 which represents 5 years of underpayment at \$20,000 per year.

Situation 1: The settlement agreement classifies the money as compensating for pain and suffering, excludable under § 104(a)(2).

- *A* receives the full \$100,000 tax free.
- *X* pays out \$100,000 to *A*.

Situation 2: The money is correctly classified as back pay, taxable under my suggested interpretation of § 104(a)(2).

• *A* receives net distribution of only \$62,000 (\$100,000 less \$24,000 (estimated federal income tax), \$4500 (estimated state income tax), \$7650 (estimated Social Security) and \$1450 (estimated Medicare)).

• *X* pays out a total of \$112,000 (\$100,000 plus \$7650 (estimated Social Security), \$1450 (estimated Medicare), and \$2900 (estimated unemployment)).

The above example does not consider attorney's fees paid by the employee in the lawsuit. The taxpayer/employee is allowed a deduction for the percentage of attorney's fees that represents the proportion of the back pay received to the total settlement received. If half of the settlement is taxable, the taxpayer is allowed a deduction for half of the attorney's fees paid. See *Stocks v. Commissioner*, 98 T.C. 1, 9-10 (1992). The example also presumes that the employer will receive a full deduction for the payment of back pay or tort damages as an ordinary and necessary business expense under 26 U.S.C. § 162 (1988 & Supp. IV 1992) or § 212 (1988).

162. Courts will generally look at the express language of the agreement to determine what the settlement represents. *Metzger v. Commissioner*, 88 T.C. 834, 850 (1987), *aff'd*, 845 F.2d 1013 (3d Cir. 1988) (disregarding the general rule where settlement agreement designated half of award to personal injuries "for tax purposes only"). If the agreement is silent or ambiguous, courts then look to the intent of the payor. *Agar v. Commissioner*, T.C.M. (CCH) 116 (1960), *aff'd*, 290 F.2d 283 (2d Cir. 1961). Note that the taxpayer bears the burden of proving that the damages received should be excluded under § 104. Rules of Practice and Procedure of the United States Tax Court, Rule 142(a),

CONCLUSION

Burke changed the method of analyzing the taxability of non-physical personal injury awards. The majority in *Downey II* did not recognize this change when it failed to bifurcate the ADEA awards of back pay and liquidated damages into a quasi-contractual claim and a tort claim. Judicial precedent, statutory authority, horizontal equity, and the need for clarity demand such a division. Either judicial or legislative action should characterize back pay received as an award under federal anti-discrimination statutes as a separate taxable claim.

*Steven R. Schneider**

12 Stand. Fed. Tax Rep. (CCH) ¶ 43,002 (1990).

One commentator listed several steps that can be taken to persuade the court that the damages are in tort rather than for back pay: (1) Document in the settlement agreement that the amount is for § 104(a)(2) excludable tort damages; (2) document in the settlement agreement that both parties agree to give tax treatment to the damages consistent with number one above; (3) have the employer not issue a Form 1099 or W-2 for the damages; (4) have both parties refer to the payment as "damages" instead of "wages," "pension," or "interest." Robert Wood, *Patterns & Practices; Predicting Taxes*, RECORDER, Sept. 7, 1993, at 16.

* J.D. 1994, Washington University.

COMMENTS

