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Commissioner v. Schleier: Adding Insult to Personal Injury

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Commissioner v. Schleier: Adding Insult to "Personal Injury?"

Prior to the 1992 Supreme Court decision in *United States v. Burke*,[1] the federal income tax treatment of damages received under the Age Discrimination in Employment Act[2] seemed well-settled as numerous courts of appeals had held that such amounts were entirely excludable from income as "damages received . . . on account of personal injuries" under § 104(a)(2)[3] of the Internal Revenue Code.[4] In holding that back pay received in settlement of a sex discrimination claim brought under the pre-1991 version of Title VII of the Civil Rights Act of 1964[5] was taxable,[6] the *Burke* Court reasoned that the type of personal injury action contemplated by § 104(a)(2) is one that provides a broad range of remedies to compensate the victim.[7] Although apparently intended to supply a new, clear direction for courts to handle taxation of discrimination awards, *Burke* instead created chaos in the ADEA context as various courts applied the reasoning of this decision in differing ways to reach totally opposite results.[8] In fact, taxpayers who recovered damages under the same ADEA class settlement against United Air Lines received completely different federal income tax treatment depending on the judicial circuit in which they resided.[9]

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1. 504 U.S. 229 (1992).

2. Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (1994) [hereinafter referred to as the ADEA].

3. I.R.C. § 104(a)(2) (1994). Section 104(a)(2) provides, in relevant part, that gross income does not include "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." *Id.*

4. Redfield v. Insurance Co. of N. Am., 940 F.2d 542 (9th Cir. 1991); Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990); Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990); Downey v. Commissioner, 97 T.C. 150 (1991), *aff'd on reh'g*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995).

5. 42 U.S.C. §§ 2000e to 2000e-17 (1988), *amended by* Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071 (codified in scattered sections of 42 U.S.C.).

6. *United States v. Burke*, 504 U.S. 229, 241-42 (1992).

7. *See id.* at 234-37.

8. *See infra* notes 171-72 and accompanying text.

9. *Compare* Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994) (holding that United settlement is taxable), *cert. denied*, 115 S. Ct. 2576 (1995) *with* Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994) (holding that United settlement is not taxable), *vacated*, 115 S. Ct. 2573 (1995) (mem.) *and* Schleier v. Commissioner, 26 F.3d 1119 (5th Cir. 1994) (opinion not officially reported) (same), *rev'd*, 115 S. Ct. 2159 (1995).

In *Commissioner v. Schleier*,[10] the Supreme Court affirmatively ended this confusion by holding, six to three, that back pay and liquidated damages received in settlement of an ADEA lawsuit were not excludable from gross income under § 104(a)(2).[11] The Court revealed that § 104(a)(2) contains two independent requirements that must be met before exclusion is allowed, and it found that ADEA damages fail to satisfy either since they are not recovered through a tort or tort type cause of action and are not received on account of personal injuries.[12]

This Note begins by summarizing the facts behind the ADEA settlement award at issue in *Schleier*[13] and proceeds to explain the reasoning in the majority[14] and dissenting[15] opinions. Next, the Note outlines the history and development of § 104(a)(2), discussing the recent expansion of the scope of the statute with respect to damages received for nonphysical injuries.[16] The Note then analyzes the standard utilized by the *Schleier* Court for measuring compliance with § 104(a)(2)'s first requirement that the underlying claim giving rise to the damages award must be based upon "tort or tort type rights," concluding that the Court's approach leads to disparate income tax treatment of similarly situated individuals.[17] This Note also examines the Court's justifications for adopting a second restrictive requirement under § 104(a)(2) that damages must be received "on account of" personal injuries and concludes that such a result is inconsistent with the language of the statute and its underlying Treasury regulation.[18] Finally, this Note explores the Court's application of § 104(a)(2)'s two requirements in *Schleier* and suggests the possible ramifications for damages received outside of the ADEA context.[19]

Erich Schleier worked as a pilot for United Air Lines until his employment was terminated at age sixty in accordance with an established company policy.[20] Schleier brought suit under the

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10. 115 S. Ct. 2159 (1995).
11. *Id.* at 2167.
12. *Id.*
13. *See infra* notes 20-32 and accompanying text.
14. *See infra* notes 33-65 and accompanying text.
15. *See infra* notes 66-86 and accompanying text.
16. *See infra* notes 87-174 and accompanying text.
17. *See infra* notes 175-96 and accompanying text.
18. *See infra* notes 197-227 and accompanying text.
19. *See infra* notes 228-53 and accompanying text.
20. *Schleier*, 115 S. Ct. at 2161. Federal Aviation Administration regulations bar individuals from serving as pilots on a commercial aircraft upon reaching age 60, but they do not preclude such persons from serving as second officers (i.e., flight engineers). *See*

ADEA,[21] and his claim was later joined in a class action brought by similarly situated employees challenging the United policy.[22] The plaintiffs prevailed in the lower court, where a jury found that United had committed a willful violation of the ADEA,[23] but that judgment was later reversed on appeal.[24] The parties then entered into a settlement agreement under which Schleier personally received $145,629, half of which was attributed to back pay and half to liquidated damages.[25]

On his 1986 federal income tax return, Schleier reported the back pay portion of the United settlement as gross income but excluded the liquidated damages entirely.[26] When the IRS challenged exclusion of the liquidated damages, Schleier responded by filing suit in the Tax Court.[27] In addition to claiming he had properly excluded the

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14 C.F.R. § 121.383(c) (1995). In contrast, the United policy prohibited pilots age sixty or older from holding any position in the flight crew, including that of a second officer. Monroe v. United Air Lines, Inc., 736 F.2d 394, 398 (7th Cir. 1984), *cert. dismissed*, 469 U.S. 1198, *and cert. denied*, 470 U.S. 1004 (1985); Downey v. Commissioner, 97 T.C. 150, 153 (1991), *aff'd on reh'g*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995). Pilots such as Mr. Schleier contested United's refusal to allow them to transfer to second officer positions upon turning 60 years old in lieu of mandatory retirement. *See Monroe*, 736 F.2d at 397; *Downey*, 97 T.C. at 154.

21. The ADEA "broadly prohibits arbitrary discrimination in the workplace based on age." Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 120 (1985) (quoting Lorillard v. Pons, 434 U.S. 575, 577 (1978)); *see also* 29 U.S.C. § 621(b) (1994) (stating that the purpose of the ADEA is "to promote employment of older persons based on their ability rather than age [and] to prohibit arbitrary age discrimination in employment"). Among other things, the ADEA makes it unlawful to refuse to hire or to discharge an individual who is at least 40 years old, or to otherwise discriminate against such individual with respect to employment circumstances, because of such individual's age. 29 U.S.C. §§ 623(a)(1), 631(a) (1994).

22. *Schleier*, 115 S. Ct. at 2161-62.

23. *Id.* at 2162. For a summary of the facts and holding of the case, see *Monroe*, 736 F.2d at 397-99.

24. *Monroe*, 736 F.2d at 409.

25. *Schleier*, 115 S. Ct. at 2162. Such an allocation is consistent with the remedial structure of the ADEA, which permits recovery of lost wages and, when the violation is willful, liquidated damages of an equal amount. 29 U.S.C. §§ 216(b), 626(b) (1994). These remedial provisions are borrowed from the Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (1994) (hereinafter referred to as the FLSA), and are incorporated by reference into the ADEA. §§ 216(b), 626(b). However, although liquidated damages are automatically available upon *any* violation of the FLSA, § 216(b), they are available under the ADEA only upon the occurrence of a *willful* violation, § 626(b). The otherwise mandatory award of liquidated damages under the FLSA can nevertheless be avoided or reduced at the court's discretion if the employer demonstrates that it acted in good faith and had reasonable grounds for believing its action was not a violation of the Act. 29 U.S.C. § 260 (1994).

26. *Schleier*, 115 S. Ct. at 2162.

27. *Id.*

liquidated damages from his income, Schleier argued that the back wages should also be excludable.[28] The Tax Court held that the entire settlement proceeds were excludable from gross income by way of § 104(a)(2),[29] and that decision was affirmed by the Fifth Circuit Court of Appeals.[30] Due to the varying federal income tax treatment of ADEA recoveries among the courts of appeals,[31] the Supreme Court granted certiorari to resolve the conflict below.[32]

The Supreme Court reversed the Fifth Circuit's decision, holding that neither the back pay nor the liquidated damages portion of Schleier's ADEA settlement qualified for exclusion from gross income under § 104(a)(2).[33] Justice Stevens, writing for the majority,[34] explained that two independent requirements must be met before § 104(a)(2) is applicable: (1) the underlying cause of action giving rise to the damages recovery must be "based upon tort or tort type rights;" and (2) the damages must be received "on account of personal injuries or sickness."[35] Reasoning that the "on account of personal injuries" phraseology is found in both the "plain language" of the statutory text and again in the first sentence of the underlying Treasury regulation,[36] the Court concluded that "[t]he regulatory

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28. *Id.*

29. Schleier v. Commissioner, No. 22909-90, 1993 WL 767976 (T.C. July 7, 1993).

30. Commissioner v. Schleier, 26 F.3d 1119 (5th Cir. 1994) (opinion not officially reported). A copy of the court's opinion can be found at 74 A.F.T.R.2d (RIA) ¶ 94-5049 (5th Cir. 1994) (per curiam). The Fifth Circuit relied exclusively on its prior decision in Purcell v. Seguin State Bank & Trust Co., 999 F.2d 950 (5th Cir. 1993), for purposes of its per curiam disposition of the case. 74 A.F.T.R.2d (RIA) ¶ 94-5049. *Purcell* in turn simply relied on the Tax Court's decision in Downey v. Commissioner, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995), in holding that ADEA damages were nontaxable for purposes of reviewing the amount of a judgment for ADEA violations. 999 F.2d at 960-61. As this succession illustrates, the Fifth Circuit never performed its own analysis with respect to the applicability of § 104(a)(2) to ADEA damages.

31. *See supra* note 9.

32. Commissioner v. Schleier, 115 S. Ct. 507 (1994) (mem.) (granting the petition for certiorari).

33. *Schleier*, 115 S. Ct. at 2167.

34. *Id.* at 2161. Chief Justice Rehnquist and Justices Kennedy, Ginsburg, and Breyer joined the majority opinion. *Id.* Justice Scalia concurred in the judgment but did not author a separate opinion. *Id.*

35. *Id.* at 2167.

36. *Id.* at 2165-66. The regulation provides:

> 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 . . . 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

requirement that the amount be received in a tort type action is not a substitute for the statutory requirement that the amount be received 'on account of personal injuries or sickness'; it is an additional requirement."[37] The Court was not troubled that the IRS had previously taken the position that the second sentence of the regulation superseded the first, although the Court purportedly did not give deference to the Service's contrary interpretation of the regulation here because of this inconsistency.[38]

Moreover, the Court indicated that a two-step analysis is not inconsistent with its application of § 104(a)(2) in *United States v. Burke*,[39] where it considered only the first requirement of the statute and made no mention of any additional requirement.[40] The majority explained that

> [al]though *Burke* relied on Title VII's failure to qualify as an action based upon tort type rights, [the *Burke* Court] did not intend to eliminate the basic requirement found in both the statute and the regulation that only amounts received 'on account of personal injuries or sickness' come within § 104(a)(2)'s exclusion.[41]

The Court also refused to consider a recent revenue ruling in which the IRS implied a contrary interpretation of *Burke*;[42] the majority simply dismissed the pronouncement as lacking authority in the face of plain statutory language.[43]

The Court next applied the requirements of its two-prong test and first sought to determine whether the respective elements of Schleier's ADEA settlement were received "on account of personal injuries."[44] Rather than adopting a standard or rule to guide this

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such prosecution.

Treas. Reg. § 1.104-1(c) (as amended in 1970).

37. *Schleier*, 115 S. Ct. at 2166.

38. *Id.* at 2166 n.7. Ordinarily, the Service's interpretation of a Treasury regulation, if reasonable, is entitled to deference from the court. *E.g.*, Jewett v. Commissioner, 455 U.S. 305, 318 (1982); Norwest Corp. v. Commissioner, 69 F.3d 1404, 1408 (8th Cir. 1995).

39. 504 U.S. 229 (1992).

40. *See Schleier*, 115 S. Ct. at 2167.

41. *Id.*

42. *See* Rev. Rul. 93-88, 1993-2 C.B. 61, *suspended*, I.R.S. Notice 95-45, 1995-34 I.R.B. 20. In this ruling, the IRS followed *Burke* but applied only a "tort or tort type" cause of action requirement, holding that all compensatory damages, including back pay, received from discrimination claims brought under certain federal statutes (not including the ADEA) would be excludable from gross income under § 104(a)(2). *Id.*

43. *Schleier*, 115 S. Ct. at 2167 n.8 (citing Bartels v. Birmingham, 332 U.S. 126, 132 (1947)).

44. *Id.* at 2163-65.

inquiry, Justice Stevens illustrated how to apply the requirement by way of a hypothetical example in which a victim is physically injured in an automobile accident and recovers a settlement for medical expenses, lost wages (recompensing for time out of work due to the injuries), and pain, suffering, and emotional distress.[45] In such a case, the Court indicated, the entire settlement would represent damages received "on account of" personal injuries.[46]

Unlike the lost wages recovered in the automobile accident hypothetical, however, Schleier's ADEA back wages were adjudged not to be recovered "on account of" any personal injury.[47] The Court's words here are crucial to an understanding of this revelation:

> Whether one treats [Schleier's] attaining the age of 60 or his being laid off on account of his age as the proximate cause of [his] loss of income, neither the birthday nor the discharge can fairly be described as a "personal injury" or "sickness." Moreover, though [Schleier's] unlawful termination may have caused some psychological or "personal" injury comparable to the intangible pain and suffering caused by an automobile accident, it is clear that no part of [his] recovery of back wages is attributable to that injury. Thus, in our automobile hypothetical, the accident causes a personal injury which in turn causes a loss of wages. In age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury.[48]

This reasoning can be briefly summarized as follows. The automobile accident causes its victim a physical disability or impairment, which constitutes a personal injury under § 104(a)(2).[49] Moreover, this physical impairment may prevent the victim from working for a period of time. Hence, any recovery for lost wages is received "on account of" the victim's personal injury. Similarly, age discrimination causes its victim various intangible harms (e.g., loss of

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45. *Id.* at 2163-64.

46. *Id.* at 2164. The hypothetical was apparently intended to be self-explanatory as the Court said little beyond its conclusory declaration that these particular damages were received "on account of" personal injuries. In regard to the damages for pain, suffering, and emotional distress, the Court reiterated the well-settled position that § 104(a)(2) includes recoveries for both tangible and intangible injuries. *Id.* at 2164 n.4; *see also infra* notes 97-98 and accompanying text.

47. *Schleier*, 115 S. Ct. at 2164.

48. *Id.*

49. *See infra* note 97 and accompanying text.

dignity) that can also constitute personal injury.[50] However, these intangible harms are not what causes the victim's loss of employment; rather, the employer's wrongful discharge and refusal to allow the victim to work can be said to be the cause of any lost wages in this context. Therefore, according to Justice Stevens, back wages recovered from an age discrimination claim are not received "on account of" the personal injuries caused by such discrimination.

Before applying the on account of personal injuries test to ADEA liquidated damages, the Court first had to identify the intended purpose of this particular remedy. Relying on its prior decision in *Trans World Airlines, Inc. v. Thurston*,[51] the Court restated its belief that "Congress intended for [ADEA] liquidated damages to be punitive in nature."[52] The Court was not persuaded by the taxpayer's argument that because liquidated damages under the Fair Labor Standards Act were determined by the Supreme Court to serve a compensatory purpose,[53] Congress, by incorporating this FLSA remedial provision into the ADEA, must have therefore intended for ADEA liquidated damages to also operate, at least in part, as a compensatory device.[54] In cursory fashion, Justice Stevens indicated

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50. *See infra* note 56.

51. 469 U.S. 111 (1985).

52. *Schleier*, 115 S. Ct. at 2165 (quoting *Thurston*, 469 U.S. at 125). The *Thurston* Court made this statement in the context of defining the standard for willfulness under the ADEA. *Thurston*, 469 U.S. at 125-26. It relied on excerpts from the *Congressional Record* relevant to the original adoption of the ADEA, in which legislators suggested that a liquidated damages provision would provide a more effective deterrent to willful violations of the Act than the criminal penalty originally proposed. *Id.* Apparently, the Court attributed this justification to the entire enacting Congress by the fact that the liquidated damages provision was ultimately incorporated into the ADEA instead of the criminal sanctions found in the original version of the bill. *See id.* The *Schleier* majority found solace in this prior determination in *Thurston* because ADEA liquidated damages are only available in situations where the employer acts willfully. *Schleier*, 115 S. Ct. at 2165 n.5 ("If liquidated damages were designed to compensate ADEA victims, we see no reason why the employer's knowledge of the unlawfulness of his conduct should be the determinative factor in the award of liquidated damages.").

53. In Overnight Motor Transp. Co. v. Missel, 316 U.S. 572 (1942), the Court observed that FLSA liquidated damages "are compensation, not a penalty or punishment by the Government," and that such damages might compensate for "damages too obscure and difficult of proof for estimate other than by liquidated damages." *Id.* at 583-84; *accord* Brooklyn Sav. Bank v. O'Neil, 324 U.S. 697, 707 (1945).

54. The text of the legislative history accompanying the 1978 amendments to the ADEA states that the purpose of ADEA liquidated damages is to "*compensate* the aggrieved party for nonpecuniary losses arising out of a willful violation of the ADEA." H.R. CONF. REP. NO. 950, 95th Cong., 2d Sess. 13 (1978), *reprinted in* 1978 U.S.C.C.A.N. 528, 535, *reprinted in* 1978 U.S.C.C.A.N. at 535 (emphasis added). The report continues:

that both Schleier's argument and the ADEA legislative history were included in the briefs presented to the *Thurston* Court, and thus the Court's statement of congressional intent can only mean that they were rejected.[55] After determining that ADEA liquidated damages were entirely punitive in nature, the Court held, without further explanation, that such damages were also not received "on account of" any personal injury.[56]

At this point it seems the Court could have ended its discussion, given that both parts of Schleier's ADEA settlement failed to satisfy one of § 104(a)(2)'s essential elements. Nonetheless, the majority proceeded to examine the other requirement of § 104(a)(2) and held that an ADEA claim is not one that is "based upon tort or tort type rights."[57]

For purposes of this second inquiry, the Court followed the reasoning of its decision in *United States v. Burke*.[58] The primary characteristic of an action based upon tort or tort type rights, as conceived by *Burke*, is the "availability of compensatory remedies."[59] Specifically, the Court suggested that a tort-like cause of action must provide compensation for "any of the other traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages."[60]

Against this background, the Court held that an ADEA claim is not based upon tort or tort type rights due to the absence of compensatory relief in the remedial scheme of the Act.[61] Like the

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> The ADEA as amended by this act does not provide remedies of a punitive nature. . . . [T]he Supreme Court has made clear [in *Missel*] that an award of liquidated damages under the FLSA is not a penalty but rather is available in order to provide full *compensatory* relief for losses that are "too obscure and difficult of proof for estimate other than by liquidated damages."

Id. at 14 (emphasis added) (citation omitted).

55. *Schleier*, 115 S. Ct. at 2165 & n.5.

56. *Id.* at 2165. Although ADEA back wages and liquidated damages did not qualify for exclusion under § 104(a)(2), the majority did recognize that the intangible harms of discrimination can constitute a personal injury within the meaning of the statute and that any compensation received on account of such harms may be excludable from income. *Id.* at 2165 n.6.

57. *Id.* at 2166-67.

58. 504 U.S. 229 (1992). See *infra* notes 157-68 and accompanying text for a complete discussion of *Burke*.

59. *Schleier*, 115 S. Ct. at 2166. The Court emphasized its statement in *Burke* that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff fairly for injuries caused by the violation of his legal rights." *Id.* (quoting *Burke*, 504. U.S. at 235).

60. *See id.* at 2167 (quoting *Burke*, 504 U.S. at 239).

61. *Id.*

pre-1991 version of Title VII at issue in *Burke*, the ADEA does not provide relief for "any of the other traditional harms associated with personal injury"[62]—back wages were described as being of an "economic character" and ADEA liquidated damages had been adjudged to lack any compensatory function.[63] Moreover, the fact that a jury trial[64] and punitive damages (i.e., liquidated damages) are available under the ADEA was not sufficient to alter this result despite the emphasis placed on the absence of these factors in *Burke*. The Court noted:

> It is true . . . that we emphasized in *Burke* the lack of a right to a jury trial and the absence of any provision for punitive damages as factors distinguishing the pre-1991 Title VII action from traditional tort litigation. We did not, however, indicate that the presence of either or both of those factors would be sufficient to bring a statutory claim within the coverage of the regulation.[65]

Justice O'Connor, writing for the dissent,[66] attacked the majority's reasoning on two separate grounds. She first decried their "on account of personal injuries" analysis as restricting the scope of a personal injury under § 104(a)(2) to tangible physical and mental injuries only,[67] a result contrary to the majority's affirmation that the statute also applies to intangible injuries[68] such as those flowing from illegal discrimination.[69] Pointing specifically to the statement that neither Mr. Schleier's sixtieth birthday nor his wrongful discharge constitutes a personal injury,[70] Justice O'Connor argued that this reasoning "is not reconcilable with the Court's recognition that the intangible harms of illegal discrimination constitute 'personal injuries' under § 104(a)(2)."[71]

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62. See *supra* text accompanying note 60 for a representative list of these "other" harms.

63. *Schleier*, 115 S. Ct. at 2167.

64. 29 U.S.C. § 626(c)(2) (1994); Lorillard v. Pons, 434 U.S. 575, 585 (1978).

65. *Schleier*, 115 S. Ct. at 2166 (citation omitted).

66. *Id.* at 2167 (O'Connor, J., dissenting). The dissenting opinion was joined by Justice Thomas in full and Justice Souter in part. *Id.* (O'Connor, J., dissenting).

67. *Id.* at 2169-70 (O'Connor, J., dissenting).

68. *See supra* note 46.

69. *See supra* note 56.

70. *See supra* text accompanying note 48.

71. *Schleier*, 115 S. Ct. at 2170 (O'Connor, J., dissenting). Justice O'Connor referred to this as the "fundamental defect" in the majority's analysis. *Id.* (O'Connor, J., dissenting). In a separate footnote devoted especially to the dissent's remarks, the majority replied as follows: "[T]o acknowledge that discrimination may cause intangible harms is not to say that the ADEA compensates for such harms, or that any of the

Justice O'Connor seemingly preferred the pre-*Burke* standard in *Threlkeld v. Commissioner*[72] for applying § 104(a)(2),[73] as she also renewed her criticism of *Burke*'s focus on the remedies available to the plaintiff for purposes of determining whether a claim represents a tort-like cause of action.[74] The *Threlkeld* court held that a personal injury occurs any time an individual's personal rights are violated,[75] and Justice O'Connor argued that age discrimination "surely" constitutes a personal injury under this standard.[76] Once this type of personal injury is established, Justice O'Connor contended that all damages received for such discrimination are received on account of personal injuries and should therefore be excludable from income under § 104(a)(2).[77]

In addition, the dissent separately argued that the taxpayer's ADEA settlement would still qualify for § 104(a)(2) exclusion under the principles of *Burke*.[78] To establish that an ADEA claim falls within *Burke*'s definition of a tort-like personal injury action, the dissent directed its analysis at distinguishing the broader remedial scheme of the ADEA from the pre-1991 Title VII claim at issue in *Burke*, which effectively allowed back wages as the only monetary remedy.[79] First, Justice O'Connor indicated that the ADEA offers plaintiffs a trial by jury as contrasted to pre-1991 Title VII, which did not.[80] More importantly, in addition to just back wages, the ADEA

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damages received were on account of those harms." *Id.* at 2165 n.6. Justice O'Connor's response was simple: "The logic of this argument is rather hard to follow. If the harms caused by discrimination constitute personal injury, then amounts received as damages for such discrimination are received 'on account of personal injuries' and should be excludable under § 104(a)(2)." *Id.* at 2170 (O'Connor, J., dissenting).

72. 87 T.C. 1294 (1986) (en banc), *aff'd*, 848 F.2d 81 (6th Cir. 1988). See *infra* notes 109-19 and accompanying text for a complete discussion of *Threlkeld*.

73. *See Schleier*, 115 S. Ct. at 2168-70 (O'Connor, J., dissenting).

74. *Id.* at 2169 (O'Connor, J., dissenting) ("[T]he remedies available . . . do not fix the character of the right they seek to enforce.") (quoting United States v. Burke, 504 U.S. 229, 249 (1992) (O'Connor, J., dissenting)).

75. *Threlkeld*, 87 T.C. at 1308.

76. *Schleier*, 115 S. Ct. at 2168 (O'Connor, J., dissenting). Justice O'Connor supported this position by citing several Supreme Court decisions, many of which were her own concurring or dissenting opinions, that essentially characterized employment discrimination in all forms as an invasion of the victim's personal rights and dignity. *Id.* Note, however, that these cases involved the prosecution of the discrimination claim itself and not the income tax consequences of the resulting damages award.

77. *Id.* at 2170 (O'Connor, J., dissenting).

78. *Id.* at 2170-72 (O'Connor, J., dissenting).

79. *See id.* at 2170 (O'Connor, J., dissenting).

80. *Id.* (O'Connor, J., dissenting).

also allows recovery of liquidated damages.[81] Even if the purpose of these damages is punitive as the majority asserts, Justice O'Connor argued that punitive damages are traditionally available only in tort actions.[82] The dissent concluded that these distinguishing features sufficed to qualify an ADEA claim as a tort-like personal injury action under *Burke*.[83]

Moreover, Justice O'Connor explained that this should be the end of the inquiry under *Burke*, and accordingly she took exception to the majority's adoption of a two-prong test that, in her belief, is contrary to the Service's formal and consistent position over the last thirty-five years that the second sentence of § 1.104-1(c)[84] conclusively establishes the only requirement of § 104(a)(2).[85] Justice O'Connor was disturbed by the Court's nonchalant dismissal of the Service's reasonable interpretation of the regulation in favor of "the plain language of a statute" whose language is "anything but plain."[86]

When viewed in light of the contemporary history of § 104(a)(2), the Supreme Court's decision in *Schleier* represents a subtle yet radical change in the scope of the statute that was hardly self-evident. Although the earliest administrative pronouncements endorsed a restrictive interpretation of the predecessor to § 104(a)(2), suggesting that it applied only to damages received for physical injuries,[87] this exclusion developed over time into a much broader provision that would eventually come to embrace myriad nonphysical injuries, including recoveries from dignitary torts[88] and employment discrimination claims.[89] At this point, it is useful to examine these developments in further detail in order to appreciate the implications of *Schleier* in this area.

The starting point for imposition of the federal income tax on individuals is section 61 of the Internal Revenue Code, which broadly

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81. *Id.* (O'Connor, J., dissenting).
82. *Id.* (O'Connor, J., dissenting).
83. *Id.* (O'Connor, J., dissenting).
84. See *supra* note 36 for the relevant text of the regulation.
85. *Schleier*, 115 S. Ct. at 2170-72 (O'Connor, J., dissenting).
86. *Id.* at 2171-72 (O'Connor, J., dissenting).
87. *See* Sol. Mem. 1384, 1920-2 C.B. 71 (holding that damages received for alienation of affections are not excludable from income under the predecessor to § 104(a)(2) and interpreting the statutory phrase "personal injuries" to mean physical injuries only), *revoked*, Sol. Op. 132, I-1 C.B. 92 (1922); Sol. Mem. 957, 1919-1 C.B. 65 (holding that damages received for libel are taxable), *modified*, Sol. Op. 132, I-1 C.B. 92 (1922).
88. *See infra* notes 98-119 and accompanying text.
89. *See infra* notes 120-23, 129-42 and accompanying text.

defines gross income to encompass "all income from whatever source derived" unless excluded elsewhere in the Code.[90] Judicial recognition has been given to the sweeping scope of this section as courts have stated that Congress, in defining gross income, intended to use the "full measure of its taxing power" to "tax all gains except those specifically exempted."[91] Consistent with the broad effect given to the definition of gross income, statutes providing for exclusions therefrom must be narrowly construed.[92]

The specific exclusion relevant here, § 104(a)(2),[93] traces its roots back to the Revenue Act of 1918[94] and has remained in substantially the same form ever since.[95] The prevailing rationale for § 104(a)(2) has historically been that "[d]amages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights—because, in effect, they restore a loss to capital."[96]

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90. I.R.C. § 61(a) (1994).

91. *E.g.,* Commissioner v. Kowalski, 434 U.S. 77, 82-83 (1977); Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-30 (1955).

92. *E.g.,* United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 583 (1991); Commissioner v. Jacobson, 336 U.S. 28, 49 (1949); *cf.* Andress v. United States, 198 F. Supp. 371, 376 (N.D. Ohio 1961) (noting that while statutes allowing deductions from gross income are generally to be strictly construed, courts are "liberal in construing . . . enactments intended to give tax relief to injured or sick employees").

93. For a comprehensive discussion of § 104(a)(2), see BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 7.3 (2d ed. 1995 & Supp. 1996).

94. Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1065-66 (1919) (codified as amended at 26 U.S.C. § 104(a)(2) (1994)).

95. The original version of the statute provided that gross income does not include "[a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness." § 213(b)(6), 40 Stat. at 1066.

96. Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962); *see also* BITTKER & MCMAHON, JR., *supra* note 93, ¶ 7.3[1], at 7-6 to 7-7 ("The rationale for the exclusion . . . is presumably that the recovery does not generate a gain or profit but only makes the taxpayer whole by compensating for a loss."). *But see* Roemer v. Commissioner, 716 F.2d 693, 696 n.2 (9th Cir. 1983) (suggesting that while a recovery for personal injuries technically falls within the modern definition of gross income, Congress in its "compassion" allows the § 104(a)(2) exclusion to remain). For excellent discussions of the various justifications for allowing personal injury damages to be excluded from income, see Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 723-29 (1986), and Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701 (1977). After scrutinizing the various justifications, many commentators have concluded that a satisfactory explanation for the § 104(a)(2) exclusion does not exist. *See, e.g.*, Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 64-65 (1987); Henry, *supra*, at 723-24, 742. Some have even gone so far as to advocate full or

In situations where an individual recovers compensatory damages for physical injuries, it has been invariably clear that all amounts received, including lost wages, are excludable from gross income pursuant to § 104(a)(2).[97] Likewise, it has long been accepted that nonphysical injuries can also constitute "personal injuries" within the meaning of the statute.[98] However, the exclusion as it pertained to certain nonphysical injuries like defamation was originally more limited in scope. In such cases, the Tax Court would often engage in an initial inquiry to determine whether the consequences of the defamation resulted in injury to the taxpayer's personal or professional (i.e., business) reputation; exclusion under § 104(a)(2) was then allowed only for those damages received on behalf of the former.[99]

In *Roemer v. Commissioner*,[100] the Ninth Circuit recognized this disparate treatment of physical and nonphysical injuries and firmly rejected it: "The relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries."[101] The court rationalized that when damages are recovered for a physical injury, the amount received is not allocated between the "personal aspects of the injury and the economic loss occasioned by the personal injury."[102] Accordingly, no such al-

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partial repeal of the statute on this basis. *See* Cochran, *supra*, at 65; Lawrence A. Frolik, *Personal Injury Compensation as a Tax Preference*, 37 ME. L. REV. 1, 39-40 (1985).

97. *E.g.*, Threlkeld v. Commissioner, 87 T.C. 1294, 1300 (1986) (en banc), *aff'd*, 848 F.2d 81 (6th Cir. 1988); Rev. Rul. 85-97, 1985-2 C.B. 50; Henry, *supra* note 96, at 704-05.

98. *E.g.*, United States v. Burke, 504 U.S. 229, 235 n.6 (1992); Rickel v. Commissioner, 900 F.2d 655, 658 (3d Cir. 1990); BITTKER & MCMAHON, JR., *supra* note 93, ¶ 7.3[2], at 7-7. *But cf. Burke*, 504 U.S. at 242-46 (Scalia, J., concurring in the judgment) (arguing under principles of statutory interpretation that "personal injury" as used in § 104(a)(2) should be construed to mean only tangible physical and mental injuries). *See generally* 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) (discussing in considerable depth the origin and development of the exclusion from income of damages received for nonphysical injuries).

99. *See* Church v. Commissioner, 80 T.C. 1104, 1109-10 (1983); Roemer v. Commissioner, 79 T.C. 398, 405-06 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983); Glynn v. Commissioner, 76 T.C. 116, 120 (1981), *aff'd without published opinion*, 676 F.2d 682 (1st Cir. 1982). The IRS endorsed this position also. *See* Rev. Rul. 58-418, 1958-2 C.B. 18, 19, *superseded*, Rev. Rul. 85-98, 1985-2 C.B. 51.

100. 716 F.2d 693 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982). In *Roemer*, the taxpayer had recovered damages in a defamation lawsuit brought as a result of a grossly defamatory credit report. 79 T.C. at 400. The Tax Court found that the taxpayer's compensatory damages were received for injury to his professional reputation (e.g., lost business income), *id.* at 406, and held that such amounts must be reported as income, *id.* at 407.

101. *Roemer*, 716 F.2d at 697.

102. *Id.*

location should be performed when nonphysical injuries are at issue.[103]

The court then examined applicable state law and determined that defamation causes a personal injury[104] for which all damages received—both for injury to personal reputation and injury to professional reputation—can be excluded from income under § 104(a)(2).[105] The court reasoned that "[w]hile some of these relationships may be personal and some may be professional, all of the harm that is done flows from the same *personal* attack" on the victim's good name:[106]

> This injury to the person should not be confused with the derivative consequences of the defamatory attack, *i.e.,* the loss of reputation in the community and any resulting loss of income. The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect.[107]

The Ninth Circuit's decision in *Roemer* introduced a new manner of applying § 104(a)(2) to damages received for nonphysical injuries.[108] In *Threlkeld v. Commissioner*,[109] the Tax Court was again confronted with the issue of whether damages awarded for injury to professional reputation were taxable.[110] After reflecting on the Ninth Circuit's reasoning in *Roemer* and the prior Tax Court opinions

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103. *Id.* at 696-97 ("[W]e have concluded that the tax court's analysis of this matter confuses a personal injury with its consequences and illogically distinguishes physical from nonphysical personal injuries.").

104. Specifically, the court referred to the "Personal Rights" section of the state civil code, where the statutory provisions recognized a general personal right to be protected from defamation. *Id.* at 699. This methodology is exemplary of what it means to examine the "nature of the claim" to ascertain whether a personal injury exists. *See 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.").

105. *Id.* at 697-700.

106. *Id.* at 700 (emphasis added).

107. *Id.* at 699.

108. Despite its defeat in *Roemer*, the IRS refused to concede its position and announced that it would not follow the Ninth Circuit's decision, electing instead to embrace the Tax Court's reasoning that a defamatory statement that causes loss of business income is an injury to the business as distinguished from a personal injury. Rev. Rul. 85-143, 1985-2 C.B. 55.

109. 87 T.C. 1294 (1986) (en banc), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

110. In *Threlkeld*, the taxpayer settled a state action for malicious prosecution, and the parties labeled a portion of the proceeds as consideration for the taxpayer's release of any claims for injury to his professional reputation. *Id.* at 1294-97.

recognizing the personal/professional reputation dichotomy, the full Tax Court rejected this distinction.[111]

Perhaps the most significant aspect of the *Threlkeld* decision was its methodology for determining excludability under § 104(a)(2) outlined as follows:

> Section 104(a)(2) excludes from income amounts received as damages on account of personal injuries. Therefore, whether the damages 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 injury.[112]

As is evident from the language above, the Tax Court, like the Ninth Circuit in *Roemer*,[113] defined a personal injury by looking to the "nature of the claim."[114] The Tax Court also integrated the regulations under § 104(a)(2)[115] into its analysis by recognizing that "common law tort concepts are helpful in deciding whether a taxpayer is being compensated for a 'personal injury.' "[116] Broadly stated, the *Threlkeld* analysis reveals that "[e]xclusion under § 104 will be appropriate if compensatory damages are received on account of any invasion of the rights that an individual is granted by virtue of being

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111. *Id.* at 1298-1305. To justify its conclusion, the court offered an analytical demonstration of the illogical result that follows from its disparate treatment of physical and nonphysical injuries. *Id.* at 1300-01. In a hypothetical situation in which a surgeon loses a finger due to the tortious conduct of another, all would agree that in addition to excluding any recovery for personal losses such as physical and mental pain and suffering, the victim could also exclude damages compensating for professional losses like lost future income. *Id.* However, when a nonphysical injury caused by a dignitary tort such as defamation occurred, the court would have previously "ignored the personal nature of the claim and delved into an inquiry regarding the nature of the consequences of the injury," the ultimate result being that damages for injury to personal reputation were excludable while damages for injury to professional reputation were not. *Id.* The Tax Court termed this inconsistency between physical and nonphysical injuries "analytically irreconcilable." *Id.* at 1301.

112. *Id.* at 1299 (citations omitted). Many courts would come to follow this analysis in deciding the tax status of damages received under federal statutes proscribing various forms of employment discrimination. *See, e.g.*, Burke v. United States, 929 F.2d 1119, 1121 (6th Cir. 1991), *rev'd*, 504 U.S. 229 (1992); Pistillo v. Commissioner, 912 F.2d 145, 148 (6th Cir. 1990); Rickel v. Commissioner, 900 F.2d 655, 659 (3d Cir. 1990).

113. *See supra* note 104.

114. *See Threlkeld*, 87 T.C. at 1305 ("The determination of whether damages are received on account of a personal injury properly depends on the nature of the claim.").

115. Treas. Reg. § 1.104-1(c) (as amended in 1970). See *supra* note 36 for the relevant text of the regulation.

116. *Threlkeld*, 87 T.C. at 1305.

a person in the sight of the law."[117] Applying this standard, the court determined that the nature of the claim at issue, malicious prosecution, was an action to redress personal injuries under state law[118] such that all compensatory damages received, including those for harm to professional reputation, were excludable from gross income under § 104(a)(2).[119]

In the wake of *Threlkeld*, § 104(a)(2) was expanded beyond the common law dignitary tort context to encompass recoveries under various federal statutory causes of action predominantly related to employment discrimination.[120] In several of these cases, the courts rejected the IRS's argument that damages for an economic loss such as back wages were not received as compensation for personal injuries.[121] Rather, the courts examined the nature of the claim,

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117. *Id.* at 1308.

118. *Id.* at 1306-07. To discover the "nature of the claim," the court relied on the fact that malicious prosecution was recognized as a distinct tort under state law and that the statute of limitations applicable to this type of claim generally concerned personal tort actions. *Id.* at 1307.

119. *Id.* at 1308.

120. *E.g.*, Burke v. United States, 929 F.2d 1119, 1123 (6th Cir. 1991) (holding that back wages received in settlement of pre-1991 Title VII sex discrimination claim were excludable from income), *rev'd*, 504 U.S. 229 (1992); Byrne v. Commissioner, 883 F.2d 211, 215 (3d Cir. 1989) (holding that damages, including back wages, received in settlement of FLSA retaliatory discharge and state law wrongful discharge claims were excludable from income); Bent v. Commissioner, 835 F.2d 67, 70 (3d Cir. 1987) (holding that damages, including back wages, received in settlement of § 1983 claim for violation of constitutional right to free speech were excludable from income); Metzger v. Commissioner, 88 T.C. 834, 858 (1987) (holding that damages allocable to claims of employment discrimination on the basis of sex and national origin brought under §§ 1981, 1982, 1983, 1985(3), 1986, and Title VII were excludable from income), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988); *cf.* Thompson v. Commissioner, 866 F.2d 709, 712 (4th Cir. 1989) (holding that back wages recovered in settlement of sex discrimination claim brought under Title VII and Equal Pay Act (EPA) were not excludable from income since they represent a contract claim for earned but unpaid wages, as contrasted to traditional tort actions where back wages are paid for inability to earn income due to tortious conduct of another, but also holding that EPA liquidated damages were excludable from income since designed in part to compensate victim for intangible losses). *But see* Sparrow v. Commissioner, 949 F.2d 434, 440 (D.C. Cir. 1991) (holding that back pay award received in settlement of pre-1991 Title VII racial discrimination claim was not excludable from income), *cert. denied*, 505 U.S. 1211 (1992). For a more complete discussion of these developments, see Burke & Friel, *supra* note 98, at 28-38, and Richard T. Helleloid & Joanne H. Turner, *Tax Status of Employment Discrimination Awards and Settlements*, 15 REV. TAX'N INDIVIDUALS 127, 129, 134-39 (1991).

121. *E.g.*, *Burke*, 929 F.2d at 1122; *Byrne*, 883 F.2d at 214; *Bent*, 835 F.2d at 70. The Sixth Circuit's response in *Burke* was typical: "[T]he government [improperly] focuses its analysis on the consequences of a Title VII violation (the payment of back pay for lost wages) rather than the personal nature of the injury (invidious discrimination)." 929 F.2d at 1122.

without reference to the consequences of the injury, to determine whether the statute in question was analogous to a tort-like cause of action designed to redress personal injuries.[122] If so, then the analysis ceased—all damages resulting from such a claim were excludable from income as damages received on account of personal injuries under § 104(a)(2).[123]

In response to judicial expansion, § 104(a)(2) was amended in 1989[124] to include the following provision: "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."[125] The accompanying legislative history revealed the House's concern over how courts had broadly interpreted § 104(a)(2) to allow exclusion of damages received in cases not involving physical injury (e.g., cases involving employment discrimination and defamation).[126] The House bill therefore proposed to restrict the scope of the statute to cover only damages that relate to a physical injury or physical sickness.[127] However, as reflected by the final amendment, only punitive damages received in cases not involving physical injury were ultimately made

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122. In examining the "nature of the claim" to determine whether a particular statute constituted a tort type cause of action, these courts relied on, *inter alia*, the fact that a personal injury statute of limitations was applicable to the claim, *see Metzger*, 88 T.C. at 850-56, a belief that the particular employment discrimination claim was more analogous to a tort than a breach of contract action, *see Byrne*, 883 F.2d at 215, and the reasoning of other judicial opinions characterizing the statute as a tort-like personal injury action and recognizing that invidious discrimination in general causes a personal injury, *see Burke*, 929 F.2d at 1121-22; *Metzger*, 88 T.C. at 850-56. Interestingly, the court in *Metzger* determined that relief under Title VII could recompense a personal injury given that this cause of action seeks to prohibit the same type of conduct as § 1981, notwithstanding the stark differences in the remedial schemes of the two statutes. *Metzger*, 88 T.C. at 856-58 ("[A]lthough the relief sought under one statute may in some cases be different from the relief sought under the other statute, the injuries complained of are often essentially the same.").

123. *See Burke*, 929 F.2d at 1121-23; *Byrne*, 883 F.2d at 214-16; *Metzger*, 88 T.C. at 850-58. Note that excludability of punitive damages was not an issue in any of these cases.

124. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379.

125. § 7641, 103 Stat. at 2379. This amendment generally applies to punitive damages received in taxable years ending after July 10, 1989, or received on account of a lawsuit pending as of such date. *Id.* Therefore, the amendment is not applicable to *Schleier*, *see Schleier*, 115 S. Ct. at 2162-63 & n.3, nor is it applicable to any of the other cases cited in this Note unless otherwise indicated.

126. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1354-55 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2824-25.

127. *Id.* Similar legislation has again been proposed and is currently pending in Congress. *See infra* note 263.

taxable.[128] Hence the exclusion as it pertained to compensatory damages received for nonphysical personal injuries emerged unscathed.

The first major federal appellate decision to address the taxability of damages awarded under the ADEA was *Rickel v. Commissioner*.[129] The taxpayer in *Rickel* settled an ADEA lawsuit with his former employer, receiving as consideration a payment that the Tax Court allocated evenly between back pay and liquidated damages.[130] Reflecting on its prior decisions in *Bent v. Commissioner* and *Byrne v. Commissioner*,[131] the Third Circuit again embraced the *Threlkeld* approach as the proper analysis for § 104(a)(2) issues.[132] In correcting the Tax Court's misapplication of this doctrine to the facts of the instant case, the Third Circuit instructed as follows:

> [O]nce it 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 Tax Court should have ended its analysis and found that all damages flowing therefrom were excludable under § 104(a)(2). . . . By going further and rummaging through the taxpayer's prayers for relief in order to determine the nature of his claim, the Tax Court was simply defining the nature of the taxpayer's injury by reference to its nonpersonal consequences . . . . [T]he nonpersonal, economic effects of the employer's act of discrimination, e.g., loss of wages, does not transform a personal tort type claim into one for nonpersonal injuries.[133]

The court in *Rickel* also had no trouble deciding that the nature of an age discrimination claim was more analogous to a personal

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128. H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 622-23 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3225-26.

129. 900 F.2d 655 (3d Cir. 1990). Several courts of appeals prior to *Rickel* had presumed that ADEA recoveries would be taxable, but their statements were made in the context of reviewing and fashioning judgments for ADEA violations, and the issue of taxability was not directly before them. *See* Gelof v. Papineau, 829 F.2d 452, 455-56 (3d Cir. 1987); Blim v. Western Elec. Co., 731 F.2d 1473, 1480 (10th Cir.), *cert. denied*, 469 U.S. 874 (1984).

130. *Rickel*, 900 F.2d at 656-57, 661. For the rationale behind this allocation, see *supra* note 25. The Tax Court determined that the amount received as liquidated damages represented compensation for a tort-like personal injury, but it held that back wages were in the nature of a breach of contract action and thus were not excludable from income. *Rickel*, 900 F.2d at 661.

131. *See supra* note 120.

132. *Rickel*, 900 F.2d at 658-61.

133. *Id.* at 661-62 (citation omitted).

injury tort than to a breach of contract action.[134] First, it recognized that the antidiscrimination provisions of the ADEA arise by operation of law to remedy wrongful conduct, independent of any obligations incident to an express or implied employment contract.[135] In addition, the court analogized to an abundance of Supreme Court and federal appellate decisions labeling various forms of employment discrimination as personal injuries and characterizing the statutes designed to redress such discrimination as fundamentally actions in tort.[136] Moreover, the court believed that its outcome was buttressed by the legislative history behind the 1989 amendment to § 104(a)(2),[137] arguing that "Congress chose to implicitly endorse the courts' expansive interpretation of § 104(a)(2) to encompass nonphysical injuries and merely circumscribe the scope of the exemption as to only one type of remedy, i.e., punitive damages, and not other types of remedies typically available in employment discrimination cases, such as back pay."[138]

Based on the foregoing analysis, the *Rickel* court held that the taxpayer's age discrimination suit under the ADEA was analogous to the assertion of a tort type right to redress a personal injury such that all damages received, both liquidated damages[139] and back wages,[140] were excludable from income under § 104(a)(2).[141] The

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134. *Id.* at 662.

135. *Id.*

136. *Id.* at 662-63. For a sample of these decisions, see Goodman v. Lukens Steel Co., 482 U.S. 656, 661 (1987) ("[R]acial discrimination . . . is a fundamental injury to the individual rights of a person."); Wilson v. Garcia, 471 U.S. 261, 277 (1985) (analogizing a violation of the Civil Rights Act of 1871 to a violation of the Fourteenth Amendment, which "is an injury to the individual rights of the person"); Curtis v. Loether, 415 U.S. 189, 195-96 n.10 (1974) (dictum) (analogizing an action to redress racial discrimination to an action for defamation or intentional infliction of emotional distress); Dillon v. AFBIC Dev. Corp., 597 F.2d 556, 562 (5th Cir. 1979) ("An action based upon the federal antidiscrimination statutes is essentially an action in tort."); Tillman v. Wheaton-Haven Recreation Ass'n, Inc., 517 F.2d 1141, 1143 (4th Cir. 1975) ("An action brought under statutes forbidding racial discrimination is fundamentally for the redress of a tort."). Following the *Threlkeld* rhetoric closely, the court used decisions such as these to conclude that "[b]y discriminating against the taxpayer on the basis of his age, [the employer] invaded the rights that the taxpayer 'is granted by virtue of being a person in the sight of the law.' " *Rickel*, 900 F.2d at 663 (quoting Threlkeld v. Commissioner, 87 T.C. 1294, 1308 (1986) (en banc), *aff'd*, 848 F.2d 81 (6th Cir. 1988)).

137. *See supra* notes 124-28 and accompanying text.

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

139. With regard to ADEA liquidated damages, the court proceeded under the assumption that such damages were not punitive since the IRS did not appeal that issue from the Tax Court. *Id.* at 661 n.8.

140. Once again, the Third Circuit patently rejected the Service's argument that back pay awarded in the employment discrimination context does not represent compensation

reasoning of *Rickel* was uniformly adopted by subsequent courts charged with determining the tax status of ADEA recoveries.[142]

The Tax Court was first to explore in depth the issue of whether, for tax purposes, ADEA liquidated damages were intended solely to serve a punitive and deterrent purpose, or whether they concurrently operated to compensate victims of age discrimination for certain intangible, nonpecuniary losses.[143] Such an exercise became useful in light of the Service's argument that ADEA liquidated damages were entirely punitive in nature and therefore were designed to punish the defendant, rather than to compensate the plaintiff for any personal injury.[144]

While the Tax Court conceded that the Supreme Court's declaration in *Trans World Airlines, Inc. v. Thurston*,[145] that Congress intended for ADEA liquidated damages to be punitive in nature,[146] supported the IRS position, it urged that this statement must be taken in context.[147] From the *employer's* perspective, which

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for personal injuries. *Id.* at 662 n.9 (" '[W]e find this argument to have been rejected in *Bent* [and *Byrne*] and we reject it again here' for the *third* time.") (alteration in original) (quoting Byrne v. Commissioner, 883 F.2d 211, 214 (3d Cir. 1989)).

141. *Id.* at 667.

142. Redfield v. Insurance Co. of N. Am., 940 F.2d 542, 544-46 (9th Cir. 1991); Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990); Downey v. Commissioner, 97 T.C. 150, 156-58 (1991), *aff'd on reh'g*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995).

143. *See Downey*, 97 T.C. at 171-73; Rickel v. Commissioner, 92 T.C. 510, 521-22 (1989), *rev'd on other grounds*, 900 F.2d 655 (3d Cir. 1990). To this point, the federal appellate courts never had occasion to consider this issue in depth, either because the tax status of back wages was the only issue before the court, *see Redfield*, 940 F.2d at 544; *Pistillo*, 912 F.2d at 146-47, or because the lower court's disposition of the issue was not challenged on appeal, *see Rickel*, 900 F.2d at 661 n.8.

144. *Downey*, 97 T.C. at 170; *Rickel*, 92 T.C. at 521. A finding that ADEA liquidated damages were wholly or partially compensatory provided a simple avenue to dismiss the Service's argument. However, even if such damages were found to be entirely punitive, the court would still have needed to decide whether punitive damages received in a personal injury action were excludable under the appropriate version of § 104(a)(2). *Downey*, 97 T.C. at 170. This latter issue, like many others derived from § 104(a)(2), developed into a subject of much debate among the courts. *Compare* Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994) (concluding that punitive damages received in personal injury action were excludable from income under § 104(a)(2)), *aff'g* 100 T.C. 93 (1993) *with* Hawkins v. United States, 30 F.3d 1077, 1084 (9th Cir. 1994) (finding that punitive damages received in personal injury action were taxable) *and* Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990) (same).

145. 469 U.S. 111 (1985).

146. *Id.* at 125; *see also supra* notes 51-52 and accompanying text.

147. *See Downey*, 97 T.C. at 171.

was at issue in *Thurston*,[148] the punitive objectives of ADEA liquidated damages are manifest—these damages represent an effective deterrent to willful violations of the Act.[149] However, when viewed from the *victim's* perspective, the Tax Court did not believe that *Thurston* foreclosed the possibility that ADEA liquidated damages could also serve a compensatory purpose to remunerate various nonpecuniary losses that are difficult to prove and calculate.[150] To support this argument, the court cited numerous appellate decisions concluding that ADEA liquidated damages serve *both* a compensatory and a punitive function,[151] analogized to the compensatory purpose ascribed by the Supreme Court to FLSA liquidated damages (which are incorporated into the ADEA by express reference),[152] and cited text from the ADEA legislative history[153] ostensibly adopting the FLSA analogy.[154] Upon finding that ADEA liquidated damages did serve a compensatory purpose, the Tax Court readily allowed exclusion under § 104(a)(2).[155]

After years of fairly consistent, albeit expansive, application of the *Threlkeld* standard,[156] the tide abruptly changed and the scope of § 104(a)(2) was moderately narrowed. In *United States v. Burke*,[157] the Supreme Court considered whether back pay received in settlement of a gender discrimination claim brought under the pre-1991 version of Title VII of the Civil Rights Act of 1964[158] qualified for exclusion under § 104(a)(2).[159] The Sixth Circuit applied the *Threlkeld* "nature of the claim" analysis in traditional fashion and

148. The *Thurston* Court briefly considered the purpose of ADEA liquidated damages in connection with defining the standard for willfulness under the Act. *Thurston*, 469 U.S. at 125-26; *see also supra* note 52.

149. *Thurston*, 469 U.S. at 125; *Downey*, 97 T.C. at 171.

150. *Downey*, 97 T.C. at 171.

151. *See, e.g.*, Powers v. Grinnell Corp., 915 F.2d 34, 41-42 (1st Cir. 1990) (ADEA liquidated damages serve dual punitive and compensatory purposes); Graefenhain v. Pabst Brewing Co., 870 F.2d 1198, 1205 (7th Cir. 1989) (same); Blum v. Witco Chem. Corp., 829 F.2d 367, 382 (3d Cir. 1987) (same). *Contra* Reichman v. Bonsignore, Brignati & Mazzotta, P.C., 818 F.2d 278, 281-82 (2d Cir. 1987) (ADEA liquidated damages are punitive only); Lindsey v. American Cast Iron Pipe Co., 810 F.2d 1094, 1102 & n.7 (11th Cir. 1987) (same).

152. *See supra* note 53 and accompanying text.

153. *See supra* note 54.

154. *Downey*, 97 T.C. at 172-73.

155. *Id.* at 173.

156. *See* cases cited *supra* notes 120, 129, 142.

157. 504 U.S. 229 (1992).

158. 42 U.S.C. §§ 2000e to 2000e-17 (1988), *amended by* Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071 (codified in scattered sections of 42 U.S.C.).

159. *Burke*, 504 U.S. at 230.

found that sex discrimination in general caused a tort-like personal injury sufficient to permit the taxpayer to exclude her back pay from income.[160] Although the Supreme Court purportedly agreed that it was appropriate to examine the nature of the claim underlying the damages award for this purpose, citing *Threlkeld* with approval,[161] its vision of what constituted an action based upon tort or tort type rights was markedly different in that great emphasis was placed on the remedies available to the victim.[162] Indeed, the Court remarked that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff 'fairly for injuries caused by the violation of his legal rights,' " often including indemnity in excess of pecuniary losses.[163]

The Court then examined the remedial scheme of the pre-1991 version of Title VII to determine whether the statute possessed these

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160. *See* Burke v. United States, 929 F.2d 1119, 1121-23 (6th Cir. 1991), *rev'd*, 504 U.S. 229 (1992); *see also supra* notes 120-23 and accompanying text.

161. *Burke*, 504 U.S. at 237.

162. *Id.* at 233-37.

163. *Id.* at 235 (quoting Carey v. Piphus, 435 U.S. 247, 257 (1978)). The substance of the Court's analysis here marked a dramatic change in the procedure for identifying whether a claim seeks to redress a tort-like personal injury. Although the Court alleged that it was proper to look at the nature of the claim for this purpose, the emphasis it placed on available remedies was a far cry from the traditional *Threlkeld* analysis that flourished prior to this decision. *See supra* notes 122, 134-36 and accompanying text. While the Court acknowledged that invidious discrimination does inflict harm on its victims, it maintained that this of itself was not sufficient to invoke § 104(a)(2): "The fact that employment discrimination causes harm to individuals does not automatically imply, however, that there exists a tort-like 'personal injury' for purposes of federal income tax law." *Burke*, 504 U.S. at 238. Rather, the focus must be directed at the remedies available to redress such discrimination. *Id.* Consistent with this approach, the Court rejected any general analogy of Title VII claims to other antidiscrimination statutes judicially characterized as tort-like personal injury actions, labeling such an argument as "unpersuasive in light of those statutes' differing remedial schemes." *Id.* at 240-41 n.11. Furthermore, in response to the dissent's criticism that "[f]ocusing on remedies . . . misapprehends the nature of the inquiry required by § 104(a)(2)," *id.* at 249-50 (O'Connor, J., dissenting), the majority reasoned that "the concept of a 'tort' is inextricably bound up with remedies" such that "consideration of the remedies available . . . is critical in determining the 'nature of the statute' and the 'type of claim' brought," *id.* at 237 n.7.

In sum, *Burke* effectively supplanted *Threlkeld* insofar as the nature of the claim analysis was now directed at the plaintiff's remedies (i.e., at the consequences of the injury). Yet while the new procedure for identifying a tort-like personal injury claim was remarkably different than before, commentators at the time believed the reasoning of *Burke* would still permit exclusion of damages received under most federal employment discrimination statutes. *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, 82-85 (1992); *see also* Rev. Rul. 93-88, 1993-2 C.B. 61, *suspended*, I.R.S. Notice 95-45, 1995-34 I.R.B. 20 (applying *Burke* to allow exclusion of damages received from various types of discrimination claims).

characteristics.[164] In holding for the Service on this issue, Justice Blackmun emphasized that the sole remedial focus of Title VII was back wages,[165] and he pointed specifically to the absence of the right to a jury trial and the lack of a provision for punitive damages as factors cutting against the classification of Title VII as a personal injury action based upon tort or tort type rights.[166] In the end, the Court simply found that "[n]othing in this remedial scheme purports to recompense a Title VII plaintiff for any of the other traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages."[167] Accordingly, the taxpayer was ordered to include the back wages she received under the pre-1991 Title VII provisions in her gross income.[168]

Subsequent application of the Supreme Court's decision in *Burke* to damages recovered under the ADEA proved difficult, and the federal courts became substantially divided over the issue of taxability of such amounts.[169] Following *Burke*, courts generally agreed that for purposes of determining whether an ADEA claim seeks to redress a tort-like personal injury, the focus must be directed at the remedial structure of the Act.[170] At this point, however, the agreement ended. One line of cases evaluated the remedies available under the ADEA and concluded that the existence of back pay, liquidated damages (whether compensatory or punitive), and the right to a jury trial were sufficient to bring the ADEA within *Burke*'s conception of a tort-like claim.[171] In stark contrast, another line of cases held that

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164. *Burke*, 504 U.S. at 237-42.

165. *See* 42 U.S.C. § 2000e-5(g) (1988), *amended by* 42 U.S.C. § 2000e-5(g) (1994).

166. *Burke*, 504 U.S. 237-42.

167. *Id.* at 239. The Court contrasted the "circumscribed" remedies available under Title VII to the broader selection of remedies available under other federal antidiscrimination statutes such as 42 U.S.C. § 1981 (1994), and the fair housing provisions of Title VIII of the Civil Rights Act of 1968, implying that damages awarded under these actions would satisfy § 104(a)(2). *See id.* at 239-42.

168. *Burke*, 504 U.S. at 242.

169. *See* cases cited *infra* notes 171-72.

170. *See, e.g.*, Schmitz v. Commissioner, 34 F.3d 790, 792 (9th Cir. 1994), *vacated*, 115 S. Ct. 2573 (1995) (mem.); Maleszewski v. United States, 827 F. Supp. 1553, 1557 (N.D. Fla. 1993).

171. *See Schmitz*, 34 F.3d at 792-94; Rice v. United States, 834 F. Supp. 1241, 1243-45 (E.D. Cal. 1993), *aff'd without published opinion*, 35 F.3d 571 (9th Cir. 1994), *vacated*, 115 S. Ct. 2573 (1995) (mem.); Bennett v. United States, 30 Cl. Ct. 396, 399-400 (1994), *rev'd per curiam*, 60 F.3d 843 (Fed. Cir. 1995); Downey v. Commissioner, 100 T.C. 634, 637 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); *see also* Purcell v. Seguin State Bank & Trust Co., 999 F.2d 950, 960-61 (5th Cir. 1993) (relying on Tax Court's decision in *Downey* and holding that ADEA award is nontaxable in context

the ADEA did not provide for the broad range of compensatory remedies required under a more narrow interpretation of *Burke*.[172] Moreover, the debate over the proper function of ADEA liquidated damages continued to rage,[173] with both sides advancing the various arguments highlighted previously.[174] At this point, it was clear that the issue of whether § 104(a)(2) should allow exclusion of ADEA recoveries from gross income was ripe for review by the Supreme Court.

A profitable way to analyze the *Schleier* decision will be to first examine the genesis of the two requirements found to exist under § 104(a)(2),[175] and then to explore the Court's application of these requirements along with the implications flowing therefrom. The starting point for this discussion must involve a review of the language of § 104(a)(2),[176] which reveals two things about the criteria for exclusion of damages under the statute. First, there must be an underlying "personal injury;" and second, the damages must be received "on account of" that personal injury.

Neither the text nor the legislative history of § 104(a)(2) offers an explanation of what constitutes a "personal injury" for purposes of

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of reviewing amount of judgment for ADEA violation); Burns v. Commissioner, 67 T.C.M. (CCH) 3116 (1994) (Tax Court memorandum decision following *Downey*). These cases are basically consistent with the second argument in Justice O'Connor's dissent in *Schleier*. *See supra* notes 78-83 and accompanying text.

Of these cases, *Schmitz* was the first to utilize a formal two-part test for determining whether ADEA damages were excludable under § 104(a)(2). *See Schmitz*, 34 F.3d at 792. In the Ninth Circuit, the taxpayer had to show both that (1) the underlying cause of action was a tort-like claim within the meaning of *Burke*; and (2) the damages were received "on account of" personal injuries. *Id.* As stated in the accompanying text, the court answered the tort-like claim issue in the affirmative. After determining that ADEA liquidated damages compensated for intangible losses, the Court held that such damages also satisfied the second requirement. *Id.* at 794-96. Although not challenged by the IRS, the court stated in dictum that back wages would also be considered as received on account of personal injuries. *Id.* at 794 n.4.

172. Downey v. Commissioner, 33 F.3d 836, 838-40 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Drase v. United States, 866 F. Supp. 1077, 1079-80 (N.D. Ill. 1994); Shaw v. United States, 853 F. Supp. 1378, 1380-82 (M.D. Ala. 1994); *Maleszewski*, 827 F. Supp. at 1555-57.

173. *Compare Schmitz*, 34 F.3d at 794-96 (ADEA liquidated damages are punitive and compensatory) *and Rice*, 834 F. Supp. at 1244-45 (same) *with Drase*, 866 F. Supp. at 1080 (ADEA liquidated damages are punitive only) *and Maleszewski*, 827 F. Supp. at 1556-57 (same).

174. *See supra* notes 51-54, 145-54 and accompanying text.

175. *See supra* text accompanying note 35.

176. See *supra* note 3 for the relevant text of the statute.

the statute.[177] The courts, therefore, have been forced to improvise. Their solution attempts not to define precisely what constitutes a personal injury per se, but rather to identify the type of claim designed to redress such an injury. By reference to the Treasury's regulations,[178] courts have long associated claims for personal injury under § 104(a)(2) with legal actions based upon tort or tort type rights.[179] Following *Burke*, the *Schleier* Court properly concluded that exclusion of damages under § 104(a)(2) is only appropriate when the "underlying cause of action giving rise to the recovery is 'based upon tort or tort type rights.' "[180] However, this "definition" still fails to define what constitutes an action based upon tort or tort type rights.

Not surprisingly, the *Schleier* Court also embraced the analysis in *Burke*, which focused on the remedies available to the plaintiff for purposes of determining whether a claim represents a tort-like cause of action.[181] Following the *Burke* rhetoric closely, the Court concluded that the ADEA does not provide the requisite spread of compensatory remedies associated with a typical personal injury claim.[182] The fundamental problem inherent in this approach is that it leads to discrepant tax results with respect to similarly situated individuals.[183] For example, a claim of intentional gender

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177. *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. 15 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4025, 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; H.R. REP. NO. 767, 65th Cong., 2d Sess 9-10 (1918), *reprinted in* 1939-1 C.B. (Part 2) 86, 92.

178. See *supra* note 36 for the relevant text of the regulation.

179. *See, e.g.*, United States v. Burke, 504 U.S. 229, 233 (1992) ("IRS regulations formally have linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles."); Burke v. United States, 929 F.2d 1119, 1121 (6th Cir. 1991) ("Treasury regulations define a claim for personal injuries under § 104(a)(2) as one which is based upon 'tort or tort-type rights.' "), *rev'd on other grounds*, 504 U.S. 229 (1992); Byrne v. Commissioner, 883 F.2d 211, 214 (3d Cir. 1989) ("As defined by the relevant regulation, personal injury claims assert violations of 'tort or tort type rights.' "); Threlkeld v. Commissioner, 87 T.C. 1294, 1305 (1986) (en banc) ("[C]ommon law tort concepts are helpful in deciding whether a taxpayer is being compensated for a 'personal injury.' "), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

180. *Schleier*, 115 S. Ct. at 2167.

181. *See id.* at 2166-67; *see also supra* notes 157-68 and accompanying text for a review of *Burke*.

182. *Schleier*, 115 S. Ct. at 2166-67. For a detailed discussion of the Court's analysis, see *supra* notes 57-65 and accompanying text.

183. For an extensive criticism of *Burke's* focus on the remedies available to the injured plaintiff, see Scott E. Copple, *How Many Remedies Make a Tort? The Aftermath of* U.S. v. Burke *and its Impact on the Taxability of Discrimination Awards*, 14 VA. TAX REV. 589, 599-603 (1995).

discrimination brought under current, amended Title VII[184] would presumably qualify as tort-like under the principles of *Burke*,[185] whereas the exact same claim brought under the pre-1991 version of the statute clearly would not.[186] In both situations, however, the victim has been subjected to exactly the same discriminatory conduct and has suffered exactly the same harm or personal injury.[187]

This type of disparity is easily avoided under a true application of the *Threlkeld* "nature of the claim" analysis, which does not consider the consequences of the injury.[188] To recapitulate, a court following the *Threlkeld* approach would seek to determine whether the harm suffered by the victim constitutes an "invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."[189] After considering the reasoning of a decision such as *Goodman v. Lukens Steel Co.*,[190] which characterized racial discrimination as a fundamental injury to an individual's personal rights,[191] it logically follows that sex discrimination, an equally

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184. Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 1981a, 2000e to 2000e-17 (1994) (effective as amended Nov. 21, 1991). In addition to back wages, *see* § 2000e-5(g), the amended version of Title VII also provides victims of intentional employment discrimination with a trial by jury and allows recovery of compensatory damages (including amounts for future pecuniary losses, emotional pain and suffering, mental anguish, loss of enjoyment of life, and other nonpecuniary losses) and punitive damages, *see* § 1981a.

185. *See* Rev. Rul. 93-88, 1993-2 C.B. 61, *suspended*, I.R.S. Notice 95-45, 1995-34 I.R.B. 20; Helleloid & Mattson, *supra* note 163, at 83-84; CONGRESSIONAL RESEARCH SERVICE, NO. 95-827, THE TAX-TREATMENT OF DISCRIMINATION AWARDS: COMMISSIONER V. SCHLEIER (1995), *available in* WESTLAW, 1995 WL 582419 (C.R.S.).

186. United States v. Burke, 504 U.S. 229, 242 (1992).

187. Justice O'Connor essentially raises this point in her dissenting opinions in *Burke* and *Schleier* by arguing that "the remedies available to Title VII plaintiffs do not fix the character of the right they seek to enforce." *See Schleier*, 115 S. Ct. at 2169 (O'Connor, J., dissenting); *Burke*, 504 U.S. at 239 (O'Connor, J., dissenting); *see also* Copple, *supra* note 183, at 602 ("The amendment to Title VII has only changed the remedies available to the injured party, not the nature of the injury itself.").

188. Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986) (en banc) ("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 injury.") (citations omitted), *aff'd*, 848 F.2d 81 (6th Cir. 1988); *accord* Roemer v. Commissioner, 716 F.2d 693, 699 (1983) ("The personal nature of an injury should not be defined by its effect.").

189. *Threlkeld*, 87 T.C. at 1308. This standard is consonant with the popular definition of personal injury. *See* BLACK'S LAW DICTIONARY 786 (6th ed. 1990) ("[T]he term [personal injury] is also used (usually in statutes) . . . as including any injury which is an invasion of personal rights."). Defining "personal injury" in this manner for purposes of § 104(a)(2) seems particularly appropriate given that our Supreme Court has indicated that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." Crane v. Commissioner, 331 U.S. 1, 6 (1947).

190. 482 U.S. 656 (1987).

191. *Id.* at 661; *see also* cases cited *supra* note 136.

reprehensible form of invidious discrimination, should likewise be placed in the same category regardless of any differences in the types of remedies available to redress the respective claims.[192] Remedies are simply a tool to measure the extent of damages sustained from an injury—they do not define the type of injury that has occurred.[193]

Courts prior to *Burke* overwhelmingly applied the *Threlkeld* analysis to find that most kinds of employment discrimination caused a personal injury for purposes of § 104(a)(2).[194] But today, for example, victims of age discrimination will have to pay income tax on damages they recover,[195] while victims of intentional sex discrimination presumably will not.[196] There does not appear to be any rational policy justification for treating these types of discrimination differently for federal income tax purposes. The parity that would again exist if the *Threlkeld* approach were followed, in terms of the taxability of damages recovered by victims of invidious employment discrimination, is apparent.

Nevertheless, *Schleier* reaffirmed that for purposes of determining whether a particular cause of action is "based upon tort or tort type rights," *Burke*'s emphasis on the remedies available to the plaintiff is the appropriate mode of analysis.[197] Upon satisfaction of this threshold inquiry, the *Schleier* majority also declared that § 104(a)(2) contains an additional requirement that taxpayers must demonstrate

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192. *See* Metzger v. Commissioner, 88 T.C. 834, 856 (1987) ("[A]lthough the relief sought under one statute may in some cases be different from the relief sought under the other statute, the injuries complained of are often essentially the same."), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988); Nina Krauthamer, *The Taxability of Title VII "Back Pay" Awards*, 54 TAXES 332, 337 (1976) (arguing the proper question for determining excludability of damages from pre-1991 Title VII action is whether the act of discrimination causes personal injury, not whether the recovery represents back wages).

193. *Cf.* Roemer v. Commissioner, 716 F.2d 693, 699 (9th Cir. 1983) ("The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered."). Defining an injury by reference to its consequences, as opposed to the nature of the claim, exemplifies a classic situation of the "tail wagging the dog."

194. *See, e.g.*, Burke v. United States, 929 F.2d 1119, 1121-22 (6th Cir. 1991) (sex discrimination), *rev'd*, 504 U.S. 229 (1992); Rickel v. Commissioner, 900 F.2d 655, 661-64 (3d Cir. 1990) (age discrimination); *Metzger*, 88 T.C. at 857-58 (discrimination based on sex and national origin); *cf. Goodman*, 482 U.S. at 661 (racial discrimination).

195. *Schleier*, 115 S. Ct. at 2167.

196. *See supra* notes 184-85 and accompanying text. Although Title VII claimants should be able to exclude compensatory damages they receive from income, back wages will most likely be taxable after *Schleier*. *See infra* notes 240-43 and accompanying text.

197. *See supra* notes 58-60 and accompanying text.

that their damages were received "on account of" personal injuries.[198]

The Court principally relied on the "plain language" of § 104(a)(2) as the basis for adopting this second requirement.[199] Justice Stevens then defined the requirement using a rather convoluted analysis involving illustrations and hypotheticals,[200] again relying on "plain language" to conclude that ADEA back wages and liquidated damages were not received on account of personal injuries.[201] While the statute undoubtedly speaks of "damages received . . . on account of personal injuries,"[202] this language is "anything but plain" and alone is not supportive of the Court's restrictive reading of § 104(a)(2).[203] Rather, the text of the statute is ambiguous with respect to when damages are received "on account of" personal injuries.[204] The Ninth Circuit in *Hawkins v. United States*[205] captured the essence of the problem, recognizing that " '[d]amages received on account of personal injury' could mean *all* damages recovered in a personal injury lawsuit, or, it could mean only those damages which purport to *compensate* the taxpayer for her personal injuries."[206]

To employ the former interpretation literally would effectively mean that the only requirement for exclusion under § 104(a)(2) would be that the taxpayer must establish the existence of a tort-like personal injury; the "on account of" language would have no independent significance, because once a personal injury is found to

198. *Schleier*, 115 S. Ct. at 2167.

199. *Id.* at 2163, 2167; *see also supra* notes 36-37 and accompanying text. It is fair to say that this second requirement was "adopted" by the Court for the first time in *Schleier* because *Burke*, the only other Supreme Court decision interpreting § 104(a)(2), did not explicitly mention, or even allude to, the existence of such a requirement. *See Schleier*, 115 S. Ct. at 2171 (O'Connor, J., dissenting) ("Every member of the [*Burke*] Court so understood the opinion—that the scope of § 104(a)(2) is defined in terms of traditional tort principles.").

200. *See Schleier*, 115 S. Ct. at 2163-64; *see also supra* notes 44-48 and accompanying text.

201. *See Schleier*, 115 S. Ct. at 2164-65.

202. I.R.C. § 104(a)(2) (1994).

203. *See Schleier*, 115 S. Ct. at 2172 (O'Connor, J., dissenting). Indeed, the trouble encountered by Justice Stevens in clearly articulating his reasoning in this part of the opinion exemplifies this point.

204. Wesson v. United States, 48 F.3d 894, 897 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077, 1080 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Reese v. United States, 24 F.3d 228, 230-31 (Fed. Cir. 1994); Commissioner v. Miller, 914 F.2d 586, 589-90 (4th Cir. 1990).

205. 30 F.3d 1077 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995).

206. *Id.* at 1080 (emphasis added).

exist, any and all types of damages received, including punitive damages, would be ipso facto treated as received on account of personal injuries.[207] Such an approach does not, however, ignore the "on account of" language in the statute.[208] Rather, it interprets the phrase as requiring merely a "but for" causal relationship between the damages received and the personal injury.[209] The arguments in support of this interpretation are compelling.

The language used by Congress in drafting § 104(a)(2) manifestly invites a broad interpretation of the statute. Section 104(a)(2) speaks of "*any* damages received . . . on account of personal injuries,"[210] as opposed to only compensatory damages. Several courts have recognized that "any damages" suggests "all damages."[211] Moreover, the phrase "on account of" should likewise be interpreted broadly. The Tax Court referred to Webster's Dictionary, which defines "on account of" as "for the sake of," "by reason of," or "because of," noting that these phrases suggest causation.[212] Congress would presumably have used more restrictive language, like "as compensation for," if it intended more than the basic "but for" causal nexus implied by these popular definitions.[213]

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207. The Sixth Circuit, *see* Horton v. Commissioner, 33 F.3d 625, 630-31 (6th Cir. 1994), and the Tax Court, *see* Horton v. Commissioner, 100 T.C. 93, 96 (1993), *aff'd*, 33 F.3d 625 (6th Cir. 1994); Miller v. Commissioner, 93 T.C. 330, 338-40 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990), adopted this interpretation. Judge Trott also advocated this position in a poignant dissenting opinion. *See Hawkins*, 30 F.3d at 1085 (Trott, J., dissenting). Although *Schleier* did not involve punitive damages, Justice O'Connor's dissent seems to embrace this view as well. *See Schleier*, 115 S. Ct. at 2170-72 (O'Connor, J., dissenting). In fact, even the IRS formally accepted this position at one time. *See* Rev. Rul. 75-45, 1975-1 C.B. 47, 47-48, *revoked*, Rev. Rul. 84-108, 1984-2 C.B. 32, 34.

208. Justice Stevens dubbed this argument an attempt to "circumvent the plain language of § 104(a)(2)." *See Schleier*, 115 S. Ct. at 2165.

209. *See Horton*, 33 F.3d at 631; *Hawkins*, 30 F.3d at 1085-86 (Trott, J., dissenting); *Miller*, 93 T.C. at 339-40. Applying this reasoning, punitive damages, for example, would be excludable since they would not otherwise be available "but for" the existence of the basic personal injury claim. *See Hawkins*, 30 F.3d at 1085 (Trott, J., dissenting) ("[P]unitive damages are received on account of personal injury because punitive damages are not available unless a personal injury has occurred."); *accord Horton*, 33 F.3d at 630; *Miller*, 93 T.C. at 339-40.

210. I.R.C. § 104(a)(2) (1994) (emphasis added).

211. *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting) (citing *Miller*, 93 T.C. at 338); *accord Horton*, 33 F.3d at 631.

212. *Miller*, 93 T.C. at 339.

213. *Id.* at 338 ("Congress . . . could have excluded only 'compensatory damages' or provided that only damages received 'as compensation for' personal injuries be excluded. It did neither.") (citation omitted); *accord Horton*, 33 F.3d at 631; *Hawkins*, 30 F.3d at 1084 (Trott, J., dissenting).

This broad interpretation of § 104(a)(2) is also consistent with a logical reading of the statute and underlying regulation together. Although § 1.104-1(c) purports to define only the phrase "damages received (whether by suit or agreement),"[214] the overall context of the regulation suggests otherwise. The term "damages" is a broad judicial concept used to describe all kinds of indemnity, be it "inflicted on property or person, based on contract or tort, [or] received by suit or agreement."[215] The language of the statute itself, not the regulation, performs the function of narrowing and defining the scope of this expression by injecting the phrase "on account of personal injuries." This modifier is the elusive phrase in need of regulative interpretation.

Thus, it seems more sensible to read the second sentence of the regulation as follows: The phrase "damages received on account of personal injuries" means an amount received through prosecution of a legal action based upon tort or tort type rights.[216] Such a construction would permit exclusion of *any* amount received as damages through this type of legal action. Moreover, the fact that the full text of § 104(a)(2) is repeated in the first sentence of the regulation does not, as Justice Stevens suggests, militate against this interpretation.[217] On the contrary, it seems perfectly reasonable for the regulation to first lay out the language that it seeks to define. As the *Schleier* dissent persuasively argued, "[i]t is surely more reasonable to read the regulation as defining an ambiguous statutory phrase, rather than as imposing a superfluous precondition without any statutory basis."[218]

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214. See *supra* note 36 for the complete text of the regulation.

215. *Schleier*, 115 S. Ct. at 2171-72 (O'Connor, J., dissenting). The term "damages" has been defined to mean "[a] pecuniary compensation or indemnity, which may be recovered in the courts by any person who has suffered loss, detriment, or injury, whether to his person, property, or rights, through the unlawful act or omission or negligence of another." BLACK'S LAW DICTIONARY 389 (6th ed. 1990).

216. *See Schleier*, 115 S. Ct. at 2172 (O'Connor, J., dissenting) ("In light of . . . the futility of any attempt to define only 'damages received,' the regulation is more sensibly read as defining the entire scope of § 104(a)(2)."); United States v. Burke, 504 U.S. 229, 242 n.1 (1992) (Scalia, J., concurring in the judgment) ("Though this regulation purports expressly to define only the term 'damages received,' and not the succeeding term . . . ('personal injuries'), the IRS has long treated the regulation as descriptive of the ambit of § 104(a)(2) as a whole.") (citation omitted).

217. As additional support for his conclusion that the second sentence of the regulation supplements § 104(a)(2) with a conjunctive requirement, Justice Stevens argued that "the statutory requirement is repeated in the [first sentence of the] regulation." *Schleier*, 115 S. Ct. at 2166.

218. *Id.* at 2172 (O'Connor, J., dissenting).

The notion that § 104(a)(2) embraces only one functional requirement for exclusion is further supported by an examination of the results that follow from the decisions employing a formal two-part analysis similar to that set forth in *Schleier*.[219] These courts, concerned about allowing exclusion of punitive damages under § 104(a)(2), adopted a more restrictive interpretation of the phrase "on account of" personal injuries.[220] They accomplished their goal of denying an exclusion for punitive damages by distinguishing damages designed to *compensate the plaintiff* from damages designed to *punish the tortfeasor*.[221] As the *Hawkins* court explained, "[p]unitive damages . . . which do not purport to compensate the taxpayer for personal injuries and which bear no relation to the severity of the taxpayer's injuries, are not necessarily awarded 'on account of' personal injuries; rather, they are awarded 'on account of' the tortfeasor's egregious conduct."[222] This reasoning would apply equally to punitive damages received in cases involving physical or nonphysical injuries.

An interpretation of § 104(a)(2), restricted as such, gives the "on account of" language status as an independent requirement that serves

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219. Prior to *Schleier*, several circuits had already formally adopted a two-part test for exclusion under § 104(a)(2). Wesson v. United States, 48 F.3d 894, 901-02 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077, 1083-84 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Reese v. United States, 24 F.3d 228, 235 (Fed. Cir. 1994).

220. *See Wesson*, 48 F.3d at 898-902; *Hawkins*, 30 F.3d at 1080-83; *Reese*, 24 F.3d at 230-35; Commissioner v. Miller, 914 F.2d 586, 589-91 (4th Cir. 1990). The Fourth Circuit in *Miller* provided the impetus for this movement by construing the statute to require a standard of what it labeled "sufficient causation" that is satisfied only when the taxpayer's personal injury *in and of itself* justifies recovery of the particular damages at issue. 914 F.2d at 589-91.

221. *See Wesson*, 48 F.3d at 899-901; *Hawkins*, 30 F.3d at 1083; *Reese*, 24 F.3d at 231; *Miller*, 914 F.2d at 589.

222. *Hawkins*, 30 F.3d at 1080; *accord Wesson*, 48 F.3d at 900; *Reese*, 24 F.3d at 231; *Miller*, 914 F.2d at 590. Advocates of this position generally relied on three principal arguments. First, § 104 is entitled "*Compensation* for injuries or sickness." *E.g.*, *Reese*, 24 F.3d at 231. Second, the established rules for interpreting federal income tax statutes require that the definition of gross income is to be interpreted broadly while exclusions therefrom must be narrowly construed. *E.g.*, *Wesson*, 48 F.3d at 899; *see also supra* note 92 and accompanying text. Finally, the historic underpinnings of § 104(a)(2) have focused on allowing exclusion of damages intended to restore a loss of capital; punitive damages, however, represent a windfall to the victim and do not fit this mold. *E.g.*, *Miller*, 914 F.2d at 590-91; *see also* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 432 n.8 (1955) ("Punitive damages . . . cannot be considered a restoration of capital for taxation purposes."). Relying on these arguments, courts have concluded that "Congress did not intend section 104(a)(2) to exclude from gross income noncompensatory damages such as punitive damages." *Reese*, 24 F.3d at 231, *quoted in Wesson*, 48 F.3d at 899, *and cited in Hawkins*, 30 F.3d at 1084 & n.8.

to deny exclusion of certain types of damages, such as punitive damages,[223] that would otherwise qualify under the statute if the only requirement were the existence of a tort-like personal injury.[224] Accordingly, courts adopting this type of analysis began to formally recognize that § 104(a)(2) has two separate and distinct requirements that must be satisfied before exclusion is permitted.[225]

The fact that a two-prong § 104(a)(2) analysis serves to deny exclusion of punitive damages received in all cases, involving both physical and nonphysical injuries alike, helps bring to the forefront the critical shortfall of this approach. The flush language of § 104(a)(2) as amended expressly provides that "[p]aragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury."[226] By negative implication, it seems clear that Congress must have therefore intended for punitive damages received in cases involving physical injury to be excludable from income.[227] Consequently, use of a two-part analysis under

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223. Interestingly, all indicators at this point led to the conclusion that, assuming the underlying claim fell within *Burke's* conception of an action based upon tort or tort type rights, back wages received in the employment discrimination context would satisfy the "on account of" personal injuries requirement. In Schmitz v. Commissioner, 34 F.3d 790, 794 n.4 (9th Cir. 1994), *vacated*, 115 S. Ct. 2573 (1995) (mem.), the Ninth Circuit, which authored the *Hawkins* opinion, suggested such a result in dictum. The IRS apparently shared this perspective. Although the Service held in Rev. Rul. 84-108, 1984-2 C.B. 32, 34, that punitive damages are not excludable from income since they are not awarded on account of personal injury, it also held in Rev. Rul. 93-88, 1993-2 C.B. 61, 62-63, that back wages received under several federal antidiscrimination statutes (found to represent tort-like causes of action under *Burke*) would be excludable. To the extent the holding in Rev. Rul. 84-108 represents the IRS's attempt to invoke a separate "on account of" personal injuries requirement, the unavoidable implication of the holding in Rev. Rul. 93-88 is that back wages received from discrimination claims must necessarily satisfy this test. Rev. Rul. 93-88 was subsequently suspended in light of the *Schleier* decision. I.R.S. Notice 95-45, 1995-34 I.R.B. 20.

224. *See* Horton v. Commissioner, 33 F.3d 625, 630-31 (6th Cir. 1994) (finding that punitive damages are excludable from income once the existence of a tort-like personal injury is established).

225. *Wesson*, 48 F.3d at 898; *Hawkins*, 30 F.3d at 1082; *see Reese*, 24 F.3d at 235.

226. I.R.C. § 104(a)(2) (1994); *see also supra* notes 125-28 and accompanying text.

227. Justice Blackmun offered such an interpretation of the statutory amendment in *Burke*. United States v. Burke, 504 U.S. 229, 236 n.6 (1992) (dictum) ("Congress amended § 104(a) to allow the exclusion of *punitive* damages only in cases involving 'physical injury or physical sickness.' "); *accord Hawkins*, 30 F.3d at 1086 (Trott, J., dissenting) ("After Congress's narrowing of the exclusion in 1989, only punitive damages received in personal injury cases involving physical injury or sickness were excludable."). Several commentators also share this view. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 42 (7th ed. 1994); WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAXATION 228 (10th ed. 1994); Mark Wright Cochran, *1989 Tax Act Compounds Confusion over Tax Status of Personal Injury Damages*, 49 TAX NOTES 1565, 1567 (1990); Margaret Henning, *Recent*

§ 104(a)(2) will lead to the inevitable result that punitive damages received in cases involving physical injury are not excludable from income, a result that flies in the face of the statute itself.

Despite these shortfalls, the *Schleier* decision made perfectly clear that § 104(a)(2) does contain two separate and distinct requirements that must be satisfied before damages can be excluded from gross income.[228] Accordingly, the focus will now be shifted to an examination of the Court's application of these requirements in

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Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries, 45 TAX LAW. 783, 800-01 (1992); David G. Jaeger, *Taxation of Punitive Damage Awards: The Continuing Controversy*, 57 TAX NOTES 109, 114 (1992); James Serven, *The Taxation of Punitive Damages:* Horton *Lays an Egg?*, 72 DENV. U. L. REV. 215, 261, 291 (1995).

This reading of the 1989 amendment has intuitive appeal. There are several plausible ways to interpret congressional intent behind the amendment. *See generally Hawkins*, 30 F.3d at 1086-87 (Trott, J., dissenting) (analyzing the possible explanations for the 1989 amendment to § 104(a)(2)); Cochran, *supra*, at 1567 (same); Serven, *supra*, at 260-66 (same).

First, Congress may have believed that punitive damages received in all personal injury cases were excludable from income prior to 1989, and it enacted the amendment to narrow the scope of § 104(a)(2) by making post-1989 punitive damages received in cases involving nonphysical injuries taxable, while allowing those received with respect to physical injuries to remain excludable under the statute. This interpretation seems most consistent with the tenor of the legislative history, in which Congress manifestly expressed an intent to narrow the scope of § 104(a)(2). *See supra* notes 126-28 and accompanying text.

Congress may have thought likewise that all punitive damages were excludable prior to 1989, but it enacted the amendment to deny exclusion in all cases. If this was its purpose, however, it seems that the amending language would have affirmatively referred to *all* punitive damages instead of just those received in cases "not involving physical injury."

Alternatively, Congress may have thought that all punitive damages were taxable under pre-1989 law, and it enacted the amendment to reflect clearly this position by statute. This would mean, however, that the amendment had no substantive effect because the law did not change, and it can scarcely be argued that Congress intended its enactment to be mere surplusage. Even assuming for the moment that the amendment was a provision designed simply to clarify existing law and to legislatively overrule all cases holding to the contrary, it can again be said that Congress presumably would have referred to *all* punitive damages in the amending language if that was its intention.

Finally, regardless of whether it had any understanding of the taxation of punitive damages under pre-1989 law, Congress may have enacted the amendment to speak only to punitive damages received for nonphysical injuries and therefore left the issue of taxation of punitive damages awarded for physical injuries to the courts. Such a result, however, seems awkward since it deliberately leaves the law in a state of confusion in the latter context. Moreover, assuming some consensus regarding the tax status of punitive damages received for physical injuries did emerge, Congress would be required to take action a second time if it did not agree with the prevailing judicial result. In the end, the first justification offered above provides the most coherent rationale for the 1989 amendment.

228. *Schleier*, 115 S. Ct. at 2167.

Schleier in order to understand the implications for damages received outside the ADEA context.

Recall that the first requirement of *Schleier*'s two-prong test requires the taxpayer to demonstrate that the underlying cause of action giving rise to his damages recovery is "based upon tort or tort type rights."[229] The principles of *Burke* indicate that the remedies available from the claim at issue are of paramount importance in making this determination.[230] The *Schleier* decision has narrowed the scope of what types of remedies meet the *Burke* requirements. The Court went beyond *Burke*'s holding that back wages alone do not qualify[231] and announced that provisions for a jury trial and punitive damages complementing relief in the form of back wages are still insufficient.[232] The *Schleier* majority apparently interpreted *Burke* to mean that a tort-like claim must, at a minimum, provide compensatory relief for what it termed " 'any of the *other* traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages.' "[233]

Even after considering these slight refinements, significant questions remain regarding application of this test to discrimination awards, since *Schleier* did not leave us with an affirmative example of what constitutes an action "based upon tort or tort type rights" in this context. For instance, *Schleier* did not disclose how many different types of these "other" compensatory remedies are required.[234] Also, assuming a given claim does provide for one or more "other" compensatory remedies, it remains to be seen whether that alone is sufficient, or whether a jury trial and/or punitive damages are

229. *See supra* text accompanying note 35.

230. *See supra* notes 161-63 and accompanying text.

231. *See* United States v. Burke, 504 U.S. 229, 241 (1992).

232. *See supra* notes 61-65 and accompanying text.

233. *See Schleier*, 115 S. Ct. at 2167 (emphasis added) (quoting *Burke*, 504 U.S. at 239).

234. On the one hand, *Schleier* suggests that a variety of different types of compensatory remedies are required. *Schleier*, 115 S. Ct. at 2166-67 ("[O]ne of the hallmarks of traditional tort liability is the availability of a *broad range of damages* to compensate the plaintiff.") (emphasis added) (quoting *Burke*, 504 U.S. at 235). The examples cited by Justice Blackmun in *Burke* as indicative of typical tort claims, namely cases involving physical injury and defamation, all possess this characteristic. *See Burke*, 504 U.S. at 235-37. On the other hand, however, the precise language of *Burke* and *Schleier* stated that the discrimination statutes at issue did not contain "*any* of the other traditional harms associated with personal injury," thereby permitting an inference that only one of these "other" compensatory remedies is required. *See* Bennett v. United States, 30 Cl. Ct. 396, 400 (1994), *rev'd per curiam*, 60 F.3d 843 (Fed. Cir. 1995).

necessary attributes in addition.[235] Consequently, litigation on this issue will likely continue on a case-by-case basis as different types of claims are tested or until more definitive standards are pronounced.

The second prong of *Schleier*'s test for exclusion under § 104(a)(2) requires the taxpayer to show that his damages were received "on account of" personal injuries.[236] Under the majority's formulation, this means that the taxpayer must suffer a personal injury, which in turn must "cause" the damages sought to be excluded (i.e., there must be some intermediate causal nexus between the personal injury and the damages suffered).[237] The substance of Justice Stevens's analysis here implies that something more than a mere "but for" standard of causation is required. According to *Schleier*, the extent of the personal injury must actually affect the amount of damages recovered for those damages to be regarded as received "on account of" personal injuries.[238] Each element of the taxpayer's damages recovery will need to be examined separately to determine whether this type of direct causal relationship exists. Although the Court's analysis in this part of the opinion is less than a model of clarity, several generalizations can be made.

First, *Schleier* made clear that all compensatory damages received for physical injuries, including lost wages, are received on account of personal injuries.[239] Likewise, where a federal antidiscrimination statute or similar claim involving nonphysical injury expressly provides a compensatory remedy for intangible mental harms, such as emotional distress, pain and suffering, etc., the related damages should also qualify.[240] However, the substance of the Court's application of its on account of personal injuries test to ADEA back wages[241] would be the same regardless of the type of discrimination claim involved, since the requisite causal nexus between the personal injury

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235. The Court in *Burke* cited 42 U.S.C. § 1981 (1988 & Supp. V 1993) and the fair housing provisions of Title VIII of the Civil Rights Act of 1968 as examples of federal antidiscrimination statutes that presumably possess a tort-like remedial scheme. *See Burke*, 504 U.S. at 240. Both of these claims, like the physical injury and defamation claims referred to previously, provide for a jury trial, punitive damages, *and* compensatory relief. *Id.*

236. *See supra* text accompanying note 35.

237. *See supra* notes 44-50 and accompanying text.

238. *See Schleier*, 115 S. Ct. at 2164. For example, as the severity of physical injuries sustained by a victim of an automobile accident increases, the amount of damages recoverable for pain and suffering should likewise increase.

239. *See id.*, 115 S. Ct. at 2163-64.

240. *See id.* at 2165 n.6.

241. *See supra* text accompanying notes 47-50.

and loss of wages, implicit in Justice Stevens's analysis, will always be lacking.[242] Therefore, *Schleier* almost certainly marks the end of the exclusion for back wages recovered from employment discrimination claims involving a wrongful discharge.[243]

Consistent with the line of cases leading up to *Schleier*, which held that true punitive damages were not excludable from gross income,[244] the Court's on account of personal injuries requirement will effect the same result.[245] In *Schleier*, Justice Stevens found that ADEA liquidated damages were entirely punitive, and therefore such damages were adjudged not to have been received on account of personal injuries.[246] Although not explicitly stated, the rationale for this conclusion almost certainly follows that of the majority of appellate courts[247]—punitive damages are received on account of the tortfeasor's egregious conduct, not on account of any personal injury sustained by the taxpayer.[248] That is, punitive damages do not bear

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242. A rare exception to this rule would be a situation where a mental injury, such as emotional distress, is the cause of the victim's inability to work, as opposed to the employer's wrongful discharge (e.g., a discrimination case to recover for an unjustified salary differential where the plaintiff's employment was not wrongfully terminated).

243. *See* Burns v. United States, No. 94-16639, 1996 WL 26936, at *4 (9th Cir. Jan. 24, 1996) ("In the context of a wrongful discharge suit, economic damages are not received on account of personal injury.") (citing *Schleier*, 115 S. Ct. at 2164); BITTKER & MCMAHON, *supra* note 93, ¶ 7.3[2], at S7-2 to S7-3 (Supp. 1996) ("[W]hile a wrongful discharge may cause a personal injury, back-pay damages are not received on account of that personal injury; the back-pay damages are received on account of the economic injury caused by the discharge."). What this essentially means is that although an antidiscrimination statute like Title VII may qualify as a tort-like cause of action under the principles of *Burke*, *see supra* notes 184-85 and accompanying text, to say that the claim involves a personal injury does not necessarily mean that the claim is fully about personal injury. This realization follows from the different income tax consequences applicable to compensatory damages (excludable) and back wages (taxable) recovered under the same statute.

244. *See* cases cited *supra* note 222.

245. *See* Lane v. United States, 902 F. Supp. 1439, 1443 (W.D. Okla. 1995) ("The Court is constrained by a recent pronouncement by the United States Supreme Court in [*Schleier*] to conclude that punitive damages are not 'received on account of personal injury or sickness' and are therefore not excludable from gross income under Section 104(a)(2) . . . .").

246. *See supra* notes 51-56 and accompanying text.

247. *See supra* note 222 and accompanying text.

248. *See Lane*, 902 F.Supp. at 1443-44. Following *Schleier*, courts have employed a similar type of analysis to deny exclusion of prejudgment interest under § 104(a)(2), holding that such amounts are not received "on account of" personal injury because they are intended to compensate plaintiffs for the lost time value of money, not for their injuries. *See* Brabson v. United States, 73 F.3d 1040, 1046-47 (10th Cir. 1996) ("[C]ompensation for the lost time value of money is caused by the delay in attaining judgment. Time becomes the relevant factor, not the injury itself—the longer the procedural delay, the higher the amount.").

the direct causal link with the victim's personal injury required by *Schleier*, since the amount of punitive damages awarded generally covaries positively with the degree of the tortfeasor's conduct, not with the extent of the injury sustained. This analysis would apply the same regardless of whether the case involves physical or nonphysical injuries. Henceforth, courts will only need to examine applicable state law, or background materials related to federal statutes, to determine whether amounts labeled as punitive damages are wholly penal in nature and therefore not excludable, or whether they embrace some compensatory purpose such that exclusion is possible.[249]

Application of *Schleier's* on account of personal injuries requirement to damages received from a common law dignitary tort, such as defamation, presents an interesting issue. To the extent the language of Justice O'Connor's dissenting opinion suggests that such damages will no longer be excludable,[250] her conclusion is debatable. Defamation inflicts a personal injury[251]—it results in an injury to the victim's good name, which in turn may cause both personal losses, such as humiliation, personal embarrassment, or loss of standing in the community, and professional losses, such as loss of future business revenue. Regardless of the type of loss incurred, the important point to recognize is that such losses all derive from the same source[252] and the extent of these losses is causally connected to the extent of the victim's personal injury as required by *Schleier*.[253] Therefore, the result in cases such as *Roemer* and *Threlkeld* should still be correct.

In conclusion, the most immediate consequence of *Schleier* is obviously that ADEA damages can no longer be excluded from gross

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249. *See, e.g.*, Estate of Moore v. Commissioner, 53 F.3d 712 (5th Cir. 1995). The Tax Court has apparently accepted this interpretation of *Schleier* also, and thus it begrudgingly indicated that it would not longer follow its *Horton* decision. *See* Bagley v. Commissioner, No. 531-93, 1995 WL 730447 (T.C. Dec. 11, 1995) ("The Supreme Court has made it clear in the *Schleier* case that damages which are not compensatory but puntive in nature are not excludable from gross income under section 104(a)(2).").

250. *See Schleier*, 115 S. Ct. at 2169 (O'Connor, J., dissenting).

251. It seems clear that defamation satisfies *Burke*'s definition of an action based upon tort or tort type rights, given that it was expressly used as a point of positive reference in formulating the definition itself. *United States v. Burke*, 504 U.S. 229, 235-36 (1992). In addition, harm to reputation was expressly cited by the Court in both *Schleier* and *Burke* as an example of one of the "traditional harms associated with personal injury." *Schleier*, 115 S. Ct. at 2167; *Burke*, 504 U.S. at 239.

252. *See supra* text accompanying notes 106-07.

253. For instance, the more flagrant and infamous the defamatory statement made about the victim, the larger the amount of damages, both personal and professional, that would be expected to result.

income under § 104(a)(2).[254] However, the foregoing analysis illustrates the profound effect this decision will have on the overall scope of the statute. *Schleier* affirmed that the threshold inquiry under § 104(a)(2) requires taxpayers to demonstrate that the claims underlying their damages recoveries are "based upon tort or tort type rights" within the meaning of *Burke*.[255] While the Court persists in defining an action based upon tort or tort type rights according to the types and breadth of remedies available, this Note suggests that such an approach leads to discrepant federal income tax treatment of similarly situated victims of invidious employment discrimination.[256] Nevertheless, *Schleier* acted to narrow the types of remedies that are sufficient to meet *Burke*'s requirements, although the exact definition of a tort-like cause of action remains somewhat questionable.[257]

In addition, *Schleier* announced that § 104(a)(2) contains a second requirement that taxpayers must establish that their damages were received "on account of" personal injuries.[258] While the restrictive interpretation ascribed to this language by the Court seems inconsistent with a contextual reading of the statute and its underlying Treasury regulation,[259] the ramifications of this requirement will nonetheless be dramatic. Most significantly, the reasoning of *Schleier* strongly suggests that back wages recovered in the employment discrimination context[260] and punitive damages (whether received in connection with physical or nonphysical injuries)[261] will no longer be excludable from income.

Schleier's constriction of § 104(a)(2) encourages litigants in the employment discrimination context now to allocate more of their private settlements to excludable compensatory damages versus taxable back wages. Moreover, the disparate tax treatment of recoveries under various federal and state antidiscrimination statutes encourages victims of discrimination to bring multiple claims with an eye toward allocating at least part of the subsequent damages award to those claims found to satisfy § 104(a)(2)'s requirements.[262]

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254. *Schleier*, 115 S. Ct. at 2167.
255. *See supra* notes 177-81 and accompanying text.
256. *See supra* notes 182-97 and accompanying text.
257. *See supra* notes 229-35 and accompanying text.
258. *See supra* notes 198-201 and accompanying text.
259. *See supra* notes 202-28 and accompanying text.
260. *See supra* notes 241-43 and accompanying text.
261. *See supra* notes 244-49 and accompanying text.
262. Perhaps some future employment discrimination cases will be similar to Metzger v. Commissioner, 88 T.C. 834 (1987) (taxpayer brought multiple claims for employment

However, these creative efforts may themselves become obsolete in the near term as legislation has once again surfaced that would limit the scope of § 104(a)(2) to damages received on account of physical injuries only.[263] In the end, even if the population of excludable types of damages is reduced by Congress and/or *Schleier*, affected taxpayers should nonetheless be made whole since juries are often instructed on the tax status of judgments,[264] which most likely will lead to larger verdicts to compensate for the portion of recovery lost to income taxes.[265]

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discrimination on basis of sex and national origin under §§ 1981, 1982, 1983, 1985(3), 1986, and Title VII), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988).

263. The Balanced Budget Act of 1995 proposes to limit the scope of § 104(a)(2) to damages received on account of physical injuries or physical sickness only. H.R. 2491, 104th Cong., 1st Sess. § 1311 (1995). Under the proposed rules, all damages (other than punitive damages) flowing from actions involving physical injury would be excludable from income. H.R. CONF. REP. NO. 350, 104th Cong., 1st Sess. 1451 (1995). However, exclusion of damages recovered from nonphysical injuries would be denied in toto. *Id.* Thus, damages derived from claims involving employment discrimination, dignitary torts, and emotional distress (not accompanied by physical injury) would be fully taxable. *Id.* Furthermore, the proposed amendments would unequivocally require inclusion of all punitive damages in income, regardless of whether received in connection with a physical or nonphysical injury (a limited exception applies in cases involving certain wrongful death actions). H.R. 2491, *supra*, § 11311; H.R. CONF. REP. NO. 350, *supra*, at 1451-52. If adopted, these provisions would generally become effective with respect to damages received after December 31, 1995, although the amendments would not apply to amounts received under a written binding agreement or court decree in effect on (or issued on or before) September 13, 1995. H.R. 2491, *supra*, § 11311.

264. *See* Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490 (1980).

265. *Cf.* BITTKER & MCMAHON, JR., *supra* note 93, ¶ 7.3[1], at 7-7 ("[A] repeal of §104(a)(2) would create shock waves throughout the personal injury area and might well lead to larger verdicts and higher insurance premiums.").