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Avoidable Unfairness in Tax Law and *United States v. Burke*

I. INTRODUCTION

Tax laws are reputed to be unduly complicated. This complication is, of course, partly due to case law that is both confusing and excessive. However, as the recent Supreme Court decision *United States v. Burke*¹ points out, the legislature has greatly contributed to the general lack of understanding. The following case note discusses this case and the issue of whether back pay received for employment discrimination should be taxed. Section II examines the background cases and statutes which led up to *Burke*. Section III summarizes *Burke*. Section IV points out *Burke*'s shortcomings and offers a legislative solution to consistent and fair treatment of victims of non-physical personal injury.

II. BACKGROUND

On February 13, 1913, the Sixteenth Amendment was ratified, giving the federal government the power to lay and collect taxes on income.² Income is defined as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."³ Section 61 of the Internal Revenue Code requires the taxation of income "from whatever source derived" unless the item is specifically excluded.⁴ It is from these rules of law that taxable income is initially determined.

Section 213(b)(6) of the Revenue Act of 1918, the predecessor to section 104(a)(2) of the Revenue Act of 1989, excluded from taxable income amounts received "on account of personal injury."⁵ This exclusion has changed little since 1918.⁶ In fact, the personal injury exclusion received very scant attention in

1. 112 S. Ct. 1867 (1992).

2. Douglas K. Chapman, *No Pain, No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?* 9 U. ARK. LITTLE ROCK L.J. 407, 413 (1986-87).

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

4. 26 U.S.C. § 61 (1988).

5. 26 U.S.C. § 104(a)(2) (1988).

6. *Id.*

early years because individual tax rates were low and taxpayers were few before the 1940's, thus dismissing a need for definitive legislation until taxes became significant.⁷

Section 104(a)(2) was probably initially adopted to cover only physical injury.⁸ However, the courts throughout the years have applied section 104(a)(2) to non-physical as well as physical injuries.⁹ This court-created extension, followed by Congress' failure to amend section 104(a)(2), arguably constituted legislative endorsement of applying the personal injury exclusion to physical and non-physical injuries. Consequently, in 1970, the Treasury described personal injuries for section 104(a)(2) purposes to be those damages received from a case "based upon tort or tort-type rights."¹⁰ Thus it was established that "personal injury" can apply to both physical and non-physical injuries. The issue has now arisen of whether back pay awards for non-physical torts qualify for the section 104(a)(2) exclusion. The section 104(a)(2) test for this issue is two-prong: (1) is back pay from employment discrimination awards based upon tort or tort-type rights¹¹ and (2) if the injury is non-physical, is back pay punitive or compensatory.¹²

The Tax Court has not had much opportunity to decide the tax consequences of back pay damages received for employment discrimination. However, the few cases have been decided with confusion and inconsistency.

The first resolution of the issue held that damages received from Title VII of the Civil Rights Act of 1964 were to be included in gross income.¹³ The 1972 ruling found the damages to be taxable because they were a substitute for taxable compensation.¹⁴ This analysis will be referred to as the "in lieu of what"

7. Robert J. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 212 (1958) as cited in Lorraine S. Boss, Note, *Taxation and Personal Injury Awards: The Search for Workable Guidelines*, 62 ST. JOHN'S L. REV. 628, 631-32 (1988).

8. Mark W. Cochran, *1989 Tax Act Compounds Confusion over Tax Status of Personal Injury Damages* TAX NOTES, December 31, 1990, at 1565, 1568.

9. *Id.*

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

11. *Id.*

12. 26 U.S.C. § 104 (1988 & Supp. I 1989).

13. Rev. Rul. 72-341, 1972-2 C.B. 32. The I.R.S. held that because the payments to the employees were made by the corporation based on compensation that they otherwise would have received, the amount of the payments are includable in gross income under 26 U.S.C. § 61. *Id.*

14. *Id.*

test. It is often challenged by a test which examines the definition of "personal injury." This second test we will call the "nature of claim" standard.

The only other important decision on this issue prior to 1986 also adopted the "in lieu of what" standard.¹⁵ *Watkins v. United States* involved the taxation of a racial discrimination employment award.¹⁶ The Claims Court judged the back pay award includable in gross income, ignoring the "nature of claim" argument that racial discrimination constitutes a personal injury.¹⁷

In the 1987 case *Bent v. Commissioner*, the Tax Court decided, contrary to previous cases, that the taxability of the award depends on the nature of the claim brought under the violated statute.¹⁸ Because the claim generally involved personal injury, the Tax Court held that the damages received were excludable from gross income under 104(a)(2).¹⁹ This decision directly opposed *Watkins*. On review, the Third Circuit agreed with the Tax Court.²⁰ Since *Bent* had been compensated for a personal injury, even though the settlement included lost wage compensation, the entire award was excluded under section 104(a)(2).²¹ Thus the "nature of claim" test was affirmed.

In 1988 *Metzger v. Commissioner* examined an employment discrimination award to determine its taxation.²² The Tax Court, as in *Watkins*, agreed that the "nature of claim" test determined back pay taxability.²³ The court reasoned that if taxpayers' complained injuries are similar, the back pay should be equally taxed despite different statutory remedies.²⁴ Since *Metzger's* injury, employment discrimination, was similar to other injuries where back pay was not taxed, the court held that *Metzger's* back pay should be untaxed.²⁵

15. Timothy R. Palmer, Note, *Internal Revenue Code Section 104(a)(2) and the Exclusion of Personal Injury Damages: A Model of Inconsistency*, 15 J. CORP. L. 83, 106 (1989).

16. 223 Ct. Cl. 731 (1980).

17. *Id.* at 732-33.

18. 87 T.C. 236 (1986).

19. *Id.* at 249.

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

21. *Id.* at 70.

22. 88 T.C. 834 (1987).

23. *Id.* at 852.

24. *Id.* at 855-59.

25. *Id.* at 858.

In spite of *Bent* and *Metzger's* "nature of claim" endorsement, the Tax Court in the 1989 case *Thompson v. Commissioner*,²⁶ chose the "in lieu of what" standard.²⁷ This case also involved sex employment discrimination under Title VII.²⁸ The Fourth Circuit affirmed the "in lieu of what" test as the appropriate touchstone.²⁹

Burke, the 1992 Supreme Court case, addressed the split in the circuits and chose a "nature of claim" standard for determining personal damage taxation.³⁰ *Burke* was unique in that it narrowed this test by closely examining the available damages of the cause of action.

III. SUMMARY OF *UNITED STATES V. BURKE*

A. *Facts*

Therese A. Burke, along with fellow union employees, sued Tennessee Valley Authority (T.V.A.) claiming sexual discrimination.³¹ Burke claimed that T.V.A. had increased employee salaries in certain male-dominated pay schedules, but had not similarly treated certain female-dominated pay schedules.³² T.V.A. filed a counterclaim against the Union alleging, among other things, fraud, misrepresentation, and breach of contract.³³

In settlement, T.V.A. agreed to pay over \$5,000,000 to be distributed among affected employees.³⁴ T.V.A. withheld federal income taxes on Burke's allocated amount on the basis of the "in lieu of what" standard.³⁵

Burke claimed entitlement to the withheld taxes arguing that the back pay award was "received on account of personal injuries or sickness," and so should not be taxed.³⁶ The Internal Revenue Service disallowed the claim, and Burke appealed to the federal courts.³⁷

26. 89 T.C. 632 (1987).

27. *Id.* at 646.

28. *Id.* at 632-33.

29. *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989).

30. 112 S. Ct. at 1867.

31. *Id.* at 1868-69.

32. *Id.* at 1869.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

B. District Court Ruling

The District Court ruled in favor of the government on the “in lieu of what” theory since Burke sought and received only back wages rather than compensatory or other damages.³⁸ Thus the settlement proceeds were not excludable from gross income as “damages received . . . on account of personal injuries.”³⁹

C. Court of Appeals Ruling

The Sixth Circuit reversed, concluding that the test for section 104(a)(2) exclusion turns on the “nature of claim” touchstone.⁴⁰ Finding that T.V.A.’s discrimination constituted a personal tort-like injury to Burke, the court found the back pay not taxable.⁴¹

D. Supreme Court Ruling

The United States Supreme Court reversed the Sixth Circuit.⁴² Ironically, the Supreme Court also applied a “nature of claim” test.⁴³

The Supreme Court found that the back pay was an accession to wealth and thus “income.”⁴⁴ The question then became whether the back pay was excludable as “damages received . . . on account of personal injuries or sickness.”⁴⁵ The Court pointed out that since 1960, I.R.S. regulations have formally linked section 104(a)(2) personal injuries to the existence of tort or tort-type rights involved in the claim.⁴⁶ Thus, in agreement with the Court of Appeals, the Supreme Court decided that if the nature of the claim underlying *Burke’s* damage award was tort-like, then the back pay was excludable from income.⁴⁷

38. *Id.*

39. 26 U.S.C. § 104(a)(2) (1988).

40. *Burke v. United States*, 929 F.2d 1119, 1121, 1124 (6th Cir. 1991).

41. *Id.* at 1121-23.

42. 112 S. Ct. at 1874.

43. *Id.* at 1870-72.

44. *Id.* at 1870.

45. *Id.*

46. *Id.*

47. *Id.* at 1870-71.

The Court accepted the definition of a "tort" as a "civil wrong . . . for which the court will provide a remedy in the form of an action for damages."⁴⁸ The Court placed great emphasis on the remedies available in the involved statute.⁴⁹

The Court pointed out that harming individuals does not necessarily establish a tort-like personal injury with respect to tax treatment.⁵⁰ Instead, the crucial factor is that the claim was brought under a statute which didn't allow "compensatory or punitive" damages, but only "back pay, injunctions, and other equitable relief."⁵¹ The Court found that when damages were excludable from income the claims were brought under statutes that included recompense for: pain and suffering, emotional distress, harm to reputation, etc.⁵² These were found to be traditional harms associated with personal injury.⁵³ Since Title VII did not include these traditional harms, the Court found its remedies in marked contrast with those remedies available under traditional tort and federal anti-discrimination statutes.⁵⁴ The Court thus held that a statute with only back pay, injunction, and other equitable relief as available remedies was not within the traditional tort-like category for tax purposes, and so Burke's back pay was not excludable from income.⁵⁵

IV. DISCUSSION OF *BURKE*

Two problems with the section 104(a)(2) personal damage exclusion are exemplified in *Burke*. First, Congress' failure to define "personal injury." Second, Congress' categorization of tort damages as "punitive or compensatory." As the background section indicated, courts have wavered between various forms of the "nature of injury" test and the "in lieu of what" standard. This inconsistency was caused greatly by Congress' imprecise statute. The obstacles which the statute created, however, can be avoided if the legislature amends section 104 to include both the "nature of claim" and "in lieu of what" rationals.

48. *Id.*

49. *Id.* at 1870-72.

50. *Id.* at 1872-73.

51. *Id.* at 1873.

52. *Id.*

53. *Id.*

54. *Id.* at 1874.

55. *Id.* at 1873-74.

A. *The Result of Not Carefully Defining "Personal Injury"*

The "nature of claim" test as applied in *Burke*, when used as the only touchstone, has two undesirable outcomes: (1) extreme dependence on state law and counsel's advice and (2) unjustified unequal treatment of plaintiffs who have suffered similar injuries. A broader version of *Burke's* "nature of claim" test would overcome these problems.

1. *Two instances of unfairness*

The initial problem with *Burke's* "nature of claim" test is its reliance on state and federal statutes.⁵⁶ This reliance produces unequal treatment of equally injured taxpayers. Rather than the merits of the victims claims being the touchstone, a *Burke-like* "nature of claim" test turns on where or in which state the plaintiffs reside or were hurt, as well as how well-advised the plaintiffs are in making their initial claims, drawing up their settlement agreement, and choosing to sue in a particular state.⁵⁷ If two identically hurt victims recover, different tax treatment of their recoveries is unjust and should be avoided.

Burke's heavy reliance on statutory listings of remedies increases tax unfairness.⁵⁸ As a concurring opinion in *Burke* stated, "there are definite parallels between . . . a defamation action, which vindicates the plaintiff's interest in [a] good name [which is not taxed], and a Title VII suit, which . . . vindicates an interest in dignity as a human being entitled to be judged on individual merit [which under *Burke* is taxed]."⁵⁹ To tax one victim, and not the other, when the injury is inherently similar, is unjust.

2. *A better interpretation of "personal injury"*

Burke's dissent analysis offers a better "nature of claim" application. It suggests that a critical factor in deciding if an injury is tort or tort-like is whether the tort is closer to a con-

56. *Id.* at 1872.

57. Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 762 (1988).

58. 112 S. Ct. at 1873.

59. *Id.* at 1877.

tractual right interference or a personal right interference.⁶⁰ This interpretation of "personal injury" and "tort-like action" doesn't rely on inflexible statutes and looks instead at the reality of the victim's harm. Thus, this wider construction avoids the inequitable results of *Burke's* analysis.

B. *The New Definition Applied*

Although the above suggestion produces fairer results than *Burke's* test, its direct application results in excluding back pay from taxable income. For non-physical injuries, this outcome is inconsistent with legislative intent.

1. *Logical result of the new definition*

Once the claim is found to be a personal injury with the suggested "nature of claim" test, the harm must then be classified as physical or non-physical. This distinction is extremely significant since the legislature probably meant for physical injuries to receive preferential treatment.

In sexual discrimination cases, such as *Burke*, non-physical injury is involved. Congress, with the 1989 amendment, eliminated the exclusion of "punitive damages in connection with a case not involving physical injury or sickness."⁶¹ The logical inference of the 1989 amendment is that only non-punitive damages are excludable from income for sexual discrimination cases. The question then becomes: Is back pay punitive or non-punitive?

Popular definitions of compensatory damages and punitive damages do not clearly dictate the tax treatment of back pay. Compensatory damages are those damages which make the taxpayer whole from a previous loss of personal rights.⁶² Punitive damages are defined as either (1) those damages that are to punish the defendant⁶³ or (2) those damages over and above the amount necessary to restore the taxpayer's loss.⁶⁴

Back pay, when strictly applied to the above definitions, can cause strange conclusions. For example, assume the tax-

60. *Id.* at 1880.

61. 26 U.S.C. § 104(a)(2) (1988 & Supp. I 1989).

62. *Commissioner v. Miller*, 914 F. 2d 586, 590 (4th Cir. 1990).

63. *Chapman*, *supra* note 2, at 428.

64. Mary J. Morrison, *Getting a Rule Right and Writing a Wrong Rule: The I.R.S. Demands a Return on All Punitive Damages*, 17 CONN. L. REV. 39, 94 (1984).

payer received \$1500 in a back pay damage award, which represents \$1000 take home pay and \$500 tax (assume for simplicity taxpayer is in a 33% tax bracket). This is how the \$1500 would have been distributed if she had not been discriminated against but normally paid without a lawsuit. Applying the above definitions, \$1000 represents compensatory damages because this amount makes the taxpayer whole. If the first definition of punitive damages is applied, then none of the award represents punitive damages, since back pay does not punish the defendant. Defendant simply has to reimburse the plaintiff. He has lost nothing in the "gamble" of discrimination. Thus the taxpayer would not be taxed on the \$500, although it is not compensatory.

If the second punitive damage definition is applied, however, since \$1000 fully compensates the victim, then \$500 represents damages over and above the amount necessary to restore the plaintiff's loss. Thus, if the victim of a non-physical personal injury is to be taxed on punitive, but not compensatory damages, the victim could arguably be taxed only on the \$500 (instead of the entire \$1500). This would be approximately \$165. However, if the plaintiff had never been discriminated against, she would have been taxed \$500. Thus, even under the most inclusive punitive damage definition, the plaintiff could gain \$335. Thus the section 104(a)(2) exclusion, when logically followed, can result in a tax advantage to non-physical personal injury victims.

2. *Not taxing back pay from non-physical injury is inconsistent with legislative intent*

Tax equity requires that persons with the same income should pay the same amount of tax regardless of the source of the income.⁶⁵ It follows that a person who receives pay from uncontested work, and one who receives pay from contested work should both pay the same amount of tax, unless the legislature decides otherwise.⁶⁶ Thus section 104(a)(2) must be examined to determine if Congress intended to give the above preferential tax treatment to non-physical injury back pay awards.

65. Michael J. Graetz, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLITICS* 17 (2d ed. 1988).

66. *Burford v. United States*, 642 F. Supp. 635, 636 (N. D. Ala. 1986).

a. *Legislative intent of section 104.* As previously discussed, in 1989 Congress implied that for physical injuries, all damage awards, including otherwise taxable items such as back pay, were tax-free.⁶⁷ This special treatment did not extend to non-physical injury damages, since punitive damages are not excludable when in connection with a case not involving physical injury or sickness.⁶⁸ Since the legislature seems to classify all damages as either compensatory or punitive, and since punitive damages are taxable, it follows that the legislature meant for only compensatory damages to be tax free when a non-physical injury is involved.⁶⁹ Compensatory damages are those damages that make the taxpayer whole from a previous loss of personal rights.⁷⁰ The law for non-physical torts, then, was meant to fully compensate the victim for her injury, i.e., to make her "whole."⁷¹ There was no desire to put her in a better position than she was before the injury.⁷²

b. *Is the taxpayer made whole?* The correct inquiry then is whether, if the taxpayer is taxed on the damage award, he will still be made whole.⁷³ This question follows the reasoning of the "in lieu of what" test, which looks at individual damages and asks if the money replaces a taxable or non-taxable status? As long as the taxpayer is merely made whole, the money replaces a non-taxable status.

To illustrate the concept of a tort victim being made "whole" the example of a plaintiff who loses his leg is often given.⁷⁴ For simplicity, we will assume that the injury did not result in lost wages or loss of earning capacity. If the plaintiff receives \$500,000 for a leg, he has been restored, if only by a monetary payment, to the position he held before the accident.⁷⁵ The money recovered has theoretically compensated the victim for the value of being physically whole - the value of

67. 26 U.S.C. § 104(a)(2) (1988 & Supp. I 1989).

68. *Id.*

69. *Id.*

70. *Commissioner v. Miller*, 914 F. 2d 586, 590 (4th Cir. 1990).

71. Malcolm L. Morris, *Taxing Economic Loss Recovered in Personal Injury Actions: Towards a Capital Ideal*, 38 U. FLA. L. REV. 738, 745 (1986).

72. *Id.*

73. Chapman, *supra*, note 2, at 428.

74. Brooks, *supra* note 56, at 770.

75. *Id.*

having a leg.⁷⁶

A similar analysis applies for one who, in a discrimination case, has lost her dignity as a human being entitled to be judged on individual merit. The money designated to compensate the victim for the loss of this dignity theoretically restores her to the position she would have occupied without the injury, i.e., the money makes her whole. The use of money to replace what is lost does not justify imposing tax on a person who has simply been restored to a status others enjoy tax-free.⁷⁷ Thus damages for pain and suffering, emotional harm, etc., should not be taxed. If the victim is taxed on these damage awards, she will be made less than whole.

Lost earnings, however, are different. Back pay compensates the plaintiff for taxable earnings he should have received. "If the earnings had been received, they would have been taxable as ordinary income. Thus the past earnings portion of the settlement appears to be an includable substitute for ordinary income."⁷⁸ If taxpayer is taxed on the back pay award, he will still be made whole. This "in lieu of what" or "wholeness" test should become a part of section 104(a)(2) in order to avoid the present confusion that compensatory and punitive definitions cause.

3. *The solution*

As pointed out earlier, Congress seemed to intend the result, although not the analysis of *Burke*. The problem in *Burke* of interpreting tax codes is an inherent problem of unspecific law.

The "nature of claim" and "in lieu of what" touchstones both illustrate important concepts of tax equity. These standards together should form a congressionally mandated two-prong test for the 104(a)(2) exclusion.

The "nature of claim" standard initially should screen the cases. The non-physical injury cases that pass this first test should then be scrutinized by the "in lieu of what" test to determine whether, if taxed on the non-physical damage award, the plaintiff will still be made whole.

76. *Id.*

77. *Id.* at 780.

78. *Id.* at 775.

V. CONCLUSION

Burke and its historical background illustrate the inconsistency and unfairness of the personal injury exclusion. To avoid continuing these problems, the legislature should amend and clarify section 104(a)(2). Both the "nature of claim" and "in lieu of what" touchstones should be adopted in the modified exclusion so that the legislative intent of section 104(a)(2) can at last be realized.

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