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Recent Developments: Commissioner v. Schleier: Monetary Awards Resulting from Claims of Discrimination under the Age Discrimination in Employment Act of 1967 ("Adea") Are Not Excludable from Gross Income for Purposes of Income Taxation

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*Commissioner
v. Schleier:*

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Recently, the United States Supreme Court held in *Commissioner v. Schleier*, 115 S. Ct. 2159 (1995), that awards resulting from claims of age discrimination under the Age Discrimination in Employment Act of 1967 ("ADEA") may not be excluded from gross income for purposes of income taxation. In so holding, the Court created a two-prong test which must be satisfied before such an award may be excluded from gross income. First, the cause of action asserted by a taxpayer must be sufficiently akin to a traditionally recognized tort and, second, the resultant damages awarded must be attributable to a personal injury or sickness.

Upon reaching the age of sixty, Erich E. Schleier ("Schleier") was terminated from his position with United Airlines ("United") in accordance with existing company policy. Subsequently, Schleier filed a claim in the United States District Court alleging that, in terminating his employment, United violated the ADEA. The parties eventually entered into a settlement agreement in which Schleier received \$145,629. The terms of the settlement agreement attributed one-half of the award to back wages and the other half to liquidated damages.

On his 1986 federal income tax return, Schleier reported the back pay portion of the award as part of his gross income, but excluded the liquidated damages portion of the

award. After the Commissioner of the Internal Revenue Service ("Commissioner") issued a deficiency notice citing Schleier for failure to report the liquidated damages portion of the settlement as gross income, Schleier sought relief in the Tax Court. Schleier asserted that the entire award should be excluded from gross income. Relying on 26 U.S.C. § 104(a)(2), which provides an exclusion from gross income for damages received "on account of personal injury or sickness," the Tax Court held that the entire settlement was excludable from gross income. The Court of Appeals for the Fifth Circuit affirmed the decision of the Tax Court, and the Supreme Court granted certiorari in order to clarify the uncertainty surrounding the issue of taxability of ADEA awards.

The Court began its analysis by examining the purpose of the ADEA, which was enacted to prohibit "arbitrary discrimination in the workplace based on age." *Schleier*, 115 S. Ct. at 2162 (quoting *Lorillard v. Pons*, 434 U.S. 575, 577 (1978); *Trans World Airlines, Inc. v. Thurston*, 469 U.S. 111, 120 (1985)). Specifically, certain defenses notwithstanding, the ADEA condemns the termination of any employee between the ages of forty and seventy "because of such individual's age." *Id.* (quoting 29 U.S.C. §§ 623(a)(1) and 631(a)). A claimant succeeding in an ADEA action may receive a variety of awards, including reinstatement.

ment, promotion and back wages. *Id.* (citing 29 U.S.C. §§ 626(b), 216(b)). Additionally, a claimant may recover liquidated damages, but “only in cases of willful violations” of the ADEA by the offending employer. *Id.* (quoting 29 U.S.C. § 626(b)). Significantly, the majority noted, unlike claims based upon tort law, the ADEA “does not permit a separate recovery of compensatory damages for pain and suffering or emotional distress.” *Id.* (citations omitted).

In reversing the court of appeals, the Supreme Court then examined the statutory definition of “gross income,” as well as the permissible exclusions therefrom. *Id.* at 2163. The Court emphasized that in 26 U.S.C. § 61(a), “gross income” is broadly defined as including “all income from whatever source derived.” *Id.* Section 104(a)(2) of the Internal Revenue Code, under which Schleier argued his award was excludable, provides several exclusions from gross income, including an exclusion for “damages received . . . on account of personal injuries or sickness.” *Id.* Based upon the plain language of the statute, however, the Court rejected Schleier’s position, holding instead that neither the back wage portion of Schleier’s award, nor the liquidated damages portion fell within the purview of the Section 104(a)(2) exclusion. *Id.* at 2163-64.

The Court first reasoned that Schleier’s alleged injury,

the termination of his employment due to his age, did not constitute a “personal injury” or “sickness” within the meaning of the Section 104(a)(2) exclusion. *Id.* at 2164. As to the portion of Schleier’s award attributed to back wages, the Court held that Section 104(a)(2) “does not permit the exclusion of [Schleier’s] back wages because the recovery of back wages was not ‘on account of’ any personal injury and because no personal injury affected the amount of back wages recovered.” *Id.* Furthermore, the Court rejected Schleier’s contention that, his back wages notwithstanding, the liquidated damages portion of his award fell within the Section 104(a)(2) exclusion as compensation for personal injuries. *Id.* Relying on its decision in *Trans World Airlines v. Thurston*, the Court held that “Congress intended for liquidated damages to be punitive in nature.” *Schleier*, 115 S. Ct. at 2165 (citing *Trans World Airlines v. Thurston*, 469 U.S. 111, 125 (1985)).

Next, the Court examined Schleier’s argument that the Commissioner’s regulation, codified at 26 C.F.R. § 1.104-1(c) (1994), interpreting 26 U.S.C. § 104(a)(2), provided an additional basis upon which his award was excludable. *Id.* at 2165-66. In part, the regulation expands upon exclusions expressly set forth in Section 104(a)(2) by interpreting the statute as providing an exclusion based broadly upon “tort

or tort type rights.” *Id.* at 2165-66. In rejecting Schleier’s argument, the Court held that the language of the regulation constituted an additional requirement which must be met in order for a recovery to be excludable. Not only must a settlement be “on account of personal injury or sickness,” but it must be based upon the assertion of “tort or tort type rights.” *Id.* at 2166.

Finally, the Court considered Schleier’s contention that the Court’s decision in *United States v. Burke*, 504 U.S. 229 (1992), supported the argument that ADEA awards are excludable from gross income. *Schleier*, 115 S. Ct. at 2166. In *Burke*, the Court held that awards resulting from claims of discrimination under Title VII of the Civil Rights Act of 1964 were not excludable from income. *Schleier*, 115 S. Ct. at 2166. The *Burke* Court noted that its decision was based, in part, upon the conclusion that the claim asserted therein did not rest upon the “tort or tort type rights” referenced in the Commissioner’s regulation interpreting 26 U.S.C. § 104(a). *Schleier*, 115 S. Ct. at 2166. In so holding, the Court indicated that it would, in fact, recognize a claim based upon “tort or tort type rights” as excludable from gross income. *Id.* Accordingly, Schleier argued that the ADEA was sufficiently distinguishable from Title VII in two critical respects: the ADEA, unlike Title VII, allows for jury trials, as well as

the recovery of liquidated damages. *Id.* at 2166. In rejecting Schleier's argument, the Court held that the distinctions advanced by Schleier were not adequate to bring his claim within the scope of the statutory exclusion. *Id.* at 2166-67. Essentially, the Court concluded that an award under the ADEA, which is devoid of the broad range of compensatory damages available to tort claimants, could not be recognized as an "action based upon tort type rights." *Id.* at 2167.

In sum, the Court held that even if Schleier had, in fact, succeeded in convincing the Court that his claim constituted a tort type action, Schleier's claim fell short of satisfying the personal injury prong of the statute. *Id.*

In Part I of her dissent, Justice O'Connor, joined by Justice Thomas, maintained that age discrimination is, in fact, a personal injury, and damages from such an injury are properly excludable within the purview of 26 U.S.C. § 104(a)(2). *Id.* at 2167-68. Justice

O'Connor noted that despite the view of the majority that Section 104(a)(2) offers an exclusion for tangible, as well as intangible injuries, the Court nevertheless held that ADEA awards are not excludable, hence, suggesting that Section 104(a)(2) applies only to tangible personal injuries. *Id.* at 2168-69.

In Part II of her dissent, Justice O'Connor, joined by Justices Thomas and Souter, criticized the majority for its departure from precedent and noted the Court's previous ruling in *Burke* that discrimination constituted a "personal injury." *Schleier*, 115 S. Ct. at 2169-70. Additionally, Justice O'Connor maintained that the broad range of remedies available to ADEA claimants "qualify an ADEA suit as a 'tort type' action." *Id.* at 2170. Lastly, Justice O'Connor expressed her concern for the majority's failure to consider with appropriate deference the long-standing IRS regulation interpreting the statute. *Id.* at 2171-72.

In *Commissioner v.*

Schleier, the Supreme Court expressed the view that age discrimination will not be recognized as a personal injury for income taxation purposes. While not immediately apparent, the impact of the Court's decision is far-reaching for all parties involved in the ADEA claims process. For both individuals and employers involved in an attempt to settle discrimination claims under the ADEA, the Court's decision will certainly be a key factor in any settlement negotiations, as no portion of an ADEA settlement is excludable from an individual's gross income. Hence, in the future, it appears that ADEA claimants will seek higher monetary settlements in an effort to secure a fair net settlement after taxation. Thus, it is likely that employers involved in the ADEA claims process will bear the cost of the *Schleier* decision.

-Carole N. Roche'

The Great Seal of Maryland, first sent from England after colonial settlement, was adopted by Joint Resolution in 1876. The reverse shows a shield with the Calvert and Crossland arms supported by a farmer and a fisherman. The scroll contains a motto usually translated "manly deeds, womanly words." Around the border, the Latin legend reads "with favor wilt thou compass us as with a shield." On the bottom, the date, 1632, refers to the year Charles I, King of England, granted the Maryland Charter to Cecilius Calvert, second Lord Baltimore. The obverse of the Seal shows Lord Baltimore in knight's armor riding a stallion.

