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Are Back Pay and Damages in Age Discrimination Cases Subject to Federal Income Tax?

by Matthew J. Barrett

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The federal income tax generally applies to "all income from whatever source derived." 26 U.S.C. § 61(a) (1988). However, Section 104(a)(2) of the Internal Revenue Code of 1986 provides that income does not include "the amount of any damages received (whether by suit or agreement . . .) on account of personal injuries or sickness." 26 U.S.C. § 104(a)(2) (1988 & Supp. V 1993).

The applicable Treasury Regulation provides: "The term 'damages received (whether by suit or agreement)' means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." 26 C.F.R. § 1.104-1(c) (1994). A tort is a private or civil wrong, other than breach of contract, for which courts award damages. This case will determine whether or not claims under the Age Discrimination in Employment Act of 1967 (the "ADEA" or the "Act"), 29 U.S.C. §§ 621-34 (1988 & Supp. V 1993), vindicate tort or tort-type rights for purposes of federal income taxation.

The ADEA prohibits employers from "discharg[ing] any individual . . . because of such individual's age."

29 U.S.C. § 623(a)(1) (1988). The remedies for an unlawful discharge under the ADEA include reinstatement, back pay, injunctive and declaratory relief, and attorneys' fees. 29 U.S.C. §§ 626(b), 216(b) & 217 (1988). In the case of a willful violation of the ADEA, the Act also authorizes an additional award of liquidated damages in an amount equal to the back pay award. 29 U.S.C. § 626(b) (1988).

ISSUE

Are monies received as back pay and liquidated damages in settlement of an ADEA claim excluded from federal income taxation because they qualify as damages received on account of personal injuries or sickness?

FACTS

This case concerns the 1986 federal income tax liability of Erich E. and Helen B. Schleier. Until 1979, Erich Schleier spent 20 years as a pilot for United Airlines, Inc. ("United"). During an earlier 20-year military career, the retired Air Force colonel

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COMMISSIONER OF
INTERNAL REVENUE V. ERICH E.
AND HELEN B. SCHLEIER
DOCKET NO. 94-500

ARGUMENT DATE:
MARCH 27, 1995
FROM: THE FIFTH CIRCUIT

Case at a Glance

The Internal Revenue Code excludes damages received "on account of personal injuries" from federal income taxation. In this case, the Supreme Court decides if back pay and damages received under the Age Discrimination in Employment Act qualify for this exclusion. The Court's decision could affect thousands of workers who have brought, or may bring, federal age discrimination claims after losing their jobs in downsizings. It may also resolve the tax status of punitive damages.





flew bombers in World War II and served as a member of the special unit that flew President Dwight D. Eisenhower.

Pursuant to company policy, United forced Schleier to retire when he turned 60 years of age. Schleier and others affected by the policy filed lawsuits alleging that their firings violated the ADEA. In 1986, after several years of litigation, United agreed to settle claims of intentional age discrimination. United paid Schleier \$72,814.50 in back pay and an equal amount in liquidated damages.

The Schleiers reported the back pay as income on their 1986 federal income tax return, but they did not report the liquidated damages. Upon audit, the Commissioner of Internal Revenue (the "Commissioner") issued a statutory notice of deficiency for failure to pay taxes on the liquidated damages and asked for payment of \$35,918.50 in additional federal income taxes.

The Schleiers filed a petition in the Tax Court contesting the notice of deficiency. They also sought a determination that they overpaid their federal income taxes for 1986, claiming that the back pay portion of their settlement with United was not subject to tax under Section 104(a)(2).

In an unreported order, the Tax Court ruled that both the back pay and the liquidated damages qualified for exclusion under Section 104(a)(2). Pursuant to the order, the Tax Court issued a decision determining that the Schleiers had overpaid their income taxes for 1986 by \$31,495. 1993 U.S. Tax Ct. LEXIS 93.

The Commissioner appealed to the Fifth Circuit and filed a suggestion that the court of appeals hear the case *en banc* (i.e., that all active judges in the circuit would hear the appeal). The Commissioner's

en banc request was denied and, in an unpublished opinion, the Fifth Circuit affirmed the decision of the Tax Court. In so holding, the court followed the Circuit's earlier decision in *Purcell v. Seguin State Bank & Trust Co.*, 999 F.2d 950 (5th Cir. 1993), which concluded that Section 104(a)(2) excluded amounts recovered under the ADEA from the federal income tax. On November 14, 1994, the Supreme Court granted the Commissioner's petition for a writ of certiorari to review the Fifth Circuit's decision. 115 S. Ct. 507 (1994).

CASE ANALYSIS

Congress enacted the exclusion for damages received on account of personal injuries or sickness as part of the Revenue Act of 1918, 40 Stat. 1057, 1065-66 (1919). For more than 75 years, Congress has retained the exclusion in every codification of the tax law with essentially no change in the relevant statutory language. Interestingly, however, Congress has never defined the term *personal injuries*, and the provision's legislative history does not define or explain the term. As mentioned above, since 1960, a Treasury Regulation has interpreted the provision to apply to monies received in settlement of lawsuits involving tort or tort-type rights. Treas. Reg. § 1.104-1(c). Beginning in the 1980s, courts started accepting arguments that Section 104(a)(2) could apply to monies received by complainants in employment discrimination cases.

About three years ago, in *United States v. Burke*, 112 S. Ct. 1867 (1992), the Supreme Court considered a case involving the exclusion of Section 104(a)(2). The Court held that the back pay awards received in settlement of sex discrimination claims brought under the pre-1991 version of Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e-2000e-17 (1988 & Supp. V

1993), did not qualify for the exclusion from income under Section 104(a)(2). The Court, however, did not discuss the applicability of its ruling to ADEA cases since *Burke* involved sex discrimination under the pre-1991 version of Title VII, rather than age discrimination.

After the *Burke* decision, various federal courts have reached conflicting conclusions regarding the taxation of ADEA awards. The Fifth and Ninth Circuits, as well as the Tax Court, the Court of Federal Claims, and several federal district courts have concluded that ADEA damages do not give rise to taxable income under Section 104(a)(2). *See, e.g., Purcell*, 999 F.2d at 950; *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994), *petition for cert. filed*, No. 94-944; *Downey v. Commissioner*, 97 T.C. 150 (1991), *supp. op.*, 100 T.C. 634 (1993) (but note subsequent case history set forth below); *Bennett v. United States*, 30 Fed. Cl. 396 (1994), *appeal filed*, No. 94-5107 (Fed. Cir.); *Rice v. United States*, 834 F. Supp. 1241 (E.D. Cal. 1993), *aff'd*, 35 F.3d 571 (9th Cir. 1994), *petition for cert. filed*, No. 94-944; *Klein v. Secretary of Transportation*, 807 F. Supp. 1517 (E.D. Wash. 1992). In addition, before *Burke* was decided, the Third and Sixth Circuits concluded that taxpayers could exclude ADEA damages under Section 104(a)(2). *Rickel v. Commissioner*, 900 F.2d 655 (3d Cir. 1990); *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990).

The Seventh Circuit and several other district courts, however, have reached contrary conclusions after *Burke*. *Downey v. Commissioner*, 33 F.3d 836 (7th Cir. 1994), *petition for cert. filed*, No. 94-999; *Maleszewski v. United States*, 827 F. Supp. 1553 (N.D. Fla. 1993); *Shaw v. United States*, 853 F. Supp. 1378 (M.D. Ala. 1994); *Drase v. United States*, 866 F. Supp. 1077 (N.D. Ill. 1994). This



case is expected to resolve the conflict.

The Commissioner contests the lower courts' rulings which refused to tax either back pay or liquidated damages. The Commissioner argues that the interpretation of Section 104(a)(2) which the Supreme Court adopted in *Burke* applies to ADEA awards or settlements.

In the Commissioner's view, Section 104(a)(2) applies only when the underlying cause of action which led to the taxpayer's recovery provides compensation for the *personal*, not just the *economic*, components of the taxpayer's injury. Based on *Burke*, the Commissioner contends that a cause of action that does not compensate for the traditional harms associated with personal injury, e.g., pain and suffering, emotional distress, or harm to reputation, does not produce damages on account of personal injuries within the language of Section 104(a)(2).

The Commissioner agrees that age discrimination can cause personal injury but argues that the ADEA's remedial scheme, like the remedial scheme of the pre-1991 Title VII, focuses on the employee's economic loss, rather than the employee's personal injury. The Commissioner reasons that because neither back pay nor liquidated damages compensate a victim for the traditional personal harms associated with personal injury, the recovery of these monies does not fall within the tax exclusion of Section 104(a)(2).

The Commissioner also contends that liquidated damages do not qualify for the exclusion from income for two reasons. First, the Commissioner observes that the ADEA awards liquidated damages for willful discrimination only when the employee has suffered economic loss. If an employee obtains only declaratory or equitable relief and does not recover back pay

or if the employer did not willfully violate the ADEA, the Act does not authorize liquidated damages even though the employee has suffered a personal injury, broadly construed. Furthermore, when liquidated damages are paid, those damages bear no relationship to the personal injury that the victim has endured. In the Commissioner's view, therefore, liquidated damages do not provide compensation for the personal elements of the employee's injury; rather, liquidated damages serve as an enforcement mechanism to deter willful violations of the ADEA.

Second, the Commissioner maintains that liquidated damages do not qualify for the exclusion because the ADEA awards such amounts "on account of" the employer's willful misconduct, not "on account of personal injuries." The Commissioner argues, therefore, that liquidated damages punish employers for illegal conduct and deter similar conduct; they do not compensate employees for personal injuries. Under the Commissioner's interpretation, the plain language of the statute simply does not encompass liquidated damages.

In response, the Schleiers also rely on the literal language in Section 104(a)(2). They begin by arguing that the statute excludes "*any* damages received . . . on account of personal injuries" from income. (Emphasis added.) The Schleiers argue that Mr. Schleier suffered a personal injury when he became the victim of age discrimination.

The Schleiers assert that the *Burke* Court cited with approval *Rickel*, 900 F.2d at 655, the first decision to hold that Section 104(a)(2) authorizes the exclusion of back pay awards under the ADEA from income for purposes of the federal income tax. Based on *Burke*, the Schleiers contend that broad reme-

dial schemes such as the ADEA that provide for jury trials and damages beyond lost wages give rise to excludable personal injury damages. The Schleiers observe that the ADEA incorporates both of these elements, whose absence led the *Burke* Court to conclude that damages paid to victims of sex discrimination under the pre-1991 version of Title VII were taxable. In their view, liquidated damages under the ADEA compensate for injuries that flow from the discrimination but that are difficult to prove and measure, thereby offering the range of damages that *Burke* requires. In addition, they reason that the Commissioner's argument that ADEA liquidated damages punish wrongdoers highlights an additional tort-type right that the ADEA provides.

The Schleiers contend that the policy underlying Section 104(a)(2) justifies excluding ADEA damages from income. They emphasize the role of compassion as the justification for the exclusion. In the Schleiers' view, excluding ADEA damages from a victim's income comports with Section 104(a)(2)'s policy to extend legislative compassion to victims of tort-type injuries and realizes the ADEA's humanitarian objectives. The Schleiers argue that no rational policy justifies denying victims who seek relief for age discrimination under the ADEA the same compassionate treatment which Section 104(a)(2) accords victims proceeding under other federal anti-discrimination statutes or under tort law generally.

Finally, the Schleiers argue that ADEA liquidated damages serve a partially compensatory role, reflecting their origins in the compensatory liquidated damages of the Fair Labor Standards Act. 29 U.S.C. §§ 201-219 (1988 & Supp. V 1993). They, therefore, dis-

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tinguish ADEA liquidated damages from those damages that merely punish a wrongdoer. The Schleiers contend that because ADEA liquidated damages compensate victims for consequential damages flowing from discrimination, those liquidated damages are received and qualify as on account of personal injuries within the meaning of Section 104(a)(2). They observe that the ADEA does not authorize liquidated damages unless the victim can show an entitlement to back pay. In addition, the amount of back pay determines the amount of liquidated damages.

SIGNIFICANCE

The Court's decision may affect thousands of employees who have lost their jobs, or who will lose their jobs, in corporate downsizings and restructurings. Employees who lose their jobs after reaching the age of 40 often bring ADEA claims or accept early retirement buy outs or severance payments that may qualify as settlements of potential ADEA claims.

The nation's aging work force and the continuing trends in corporate downsizing and restructuring suggest that these claims likely will increase in the future. The Court's decision should resolve the federal tax status of damage awards or settlements under the ADEA for these workers.

If the Court characterizes ADEA liquidated damages as exclusively punitive, the Court may also resolve a question regarding the federal tax status of punitive damages, particularly those received before July 11, 1989 with respect to nonphysical injuries. (As a result of the Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, Tit. VII, § 7641(a), 103 Stat. 2301, 2379, the tax exclusion of Section 104(a)(2) does not apply to punitive damages received in cases "not involving physical injury or physical sickness.")

The Commissioner, however, takes the position that taxpayers must treat all punitive damages as income. Again, the lower federal courts disagree. *Compare Hawkins v. United States*, 30 F.3d 1077 (9th Cir. 1994) (holding that punitive damages do not qualify for tax exclusion under Section 104(a)(2)), *petition for cert. filed*, No. 94-1041; *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994) (same holding); and *Commissioner v. Miller*, 914 F.2d 586 (4th Cir. 1990) (same holding), *with Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994) (excluding punitive damages from income).

ARGUMENTS

For the Commissioner of Internal Revenue (Counsel of Record: Drew S. Days, III, Solicitor General; Department of Justice, Washington, DC 20530; (202) 514-2217):

1. Section 104(a)(2) authorizes an exclusion from income only for damages received on account of personal injury or sickness.
2. Back pay and liquidated damages awarded under the Age Discrimination in Employment Act do not represent damages received on account of personal injury.
3. Liquidated damages under the Age Discrimination in Employment Act do not qualify for the exclusion under Section 104(a)(2) for the additional reason that these amounts represent awards "on account of" the defendant's willful misconduct rather than "on account of" the taxpayer's personal injury.

For Erich E. and Helen B. Schleier (Counsel of Record: Thomas F. Joyce; Bell, Boyd & Lloyd; 70 West Madison Street, Suite 3200, Chicago, IL 60602; (312) 372-1121):

1. The Schleiers can exclude the age discrimination damages from their gross income because they received the damages on account of personal injury in a suit involving tort or tort-type rights.

2. The Commissioner's litigating posture is wrong as a matter of law and fails as policy.
3. Liquidated damages under the Age Discrimination in Employment Act are not includable in income as punitive damages under Section 104(a)(2).

AMICUS BRIEFS

In support of Erich E. and Helen B. Schleier

Joint brief of the American Association of Retired Persons and the National Employment Lawyers Association (Counsel of Record: Cathy Ventrell-Monsees; American Association of Retired Persons; 601 E Street, NW, Washington, DC 20049; (202) 434-2060);

The Equal Employment Advisory Council (Counsel of Record: Kimberly L. Japinga; McGuinness & Williams; 1015 15th Street, NW, Suite 1200, Washington, DC 20005; (202) 789-8600);

The Migrant Legal Action Program, Inc. (Counsel of Record: Collette C. Goodman; Shea & Gardner; 1800 Massachusetts Avenue, NW, Washington, DC 20036; (202) 828-2000);

The Pan Am Pilots Tax Group (Counsel of Record: Sanford Jay Rosen; Rosen, Bien & Asaro; 155 Montgomery Street, 8th Floor, San Francisco, CA 94104; (415) 433-6830).