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Taxation of ADEA Settlements and the Lack of Personal Injury in Age Discrimination Claims, The

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The Taxation of ADEA Settlements and the Lack of Personal Injury in Age Discrimination Claims

Commissioner v. Schleier[1]

I. INTRODUCTION

Age discrimination is one of the hottest areas of employment litigation.[2] With corporate downsizing becoming the norm in American business, the use of the Age Discrimination in Employment Act (ADEA) has flooded courts with claims of age discrimination.[3] The twenty-five largest job cuts since 1991 have cost 600,000 workers their jobs.[4] The volume of discrimination suits in general increased seventy-seven percent from 1979 to 1988.[5] Age discrimination suits are no exception. Awards for discrimination are generally large compared to most plaintiffs' average income. A question arises whether awards from a successful discrimination claim should be subject to federal income tax. How much income tax does one have to pay when receiving a jury award or settling a case? The answer to that question has important implications.[6]

Section 61(a) of the Internal Revenue Code (the "Code") defines gross income as "all income from whatever source derived."[7] Section 104(a)(2) of the Code, however, specifically excludes from gross income "the amount of any damages received . . . on account of personal injuries or sickness."[8] The

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1. 115 S. Ct. 2159 (1995).

2. Julie M. Buchanan, *Age Discrimination Complaints Rising Steadily*, MILWAUKEE SENTINEL, May 4, 1992, at 10B.

3. *More Than Half a Million Job Cuts in 1994: Year-end Research Indicates Layoffs Are Way of Life for Corporations*, PR NEWSWIRE, Jan. 5, 1995.

4. *The Pain of Downsizing*, BUS. WK., May 9, 1994, at 1.

5. Timothy Noah and Albert R. Karr, *What New Civil Rights Law Will Mean*, WALL ST. J., Nov. 4, 1991, at B1.

6. For example, in 1992, a jury awarded $27 million in damages to a 65 year old man for an age discrimination case. The taxes due on such an award could be very large indeed. *See* Jamie Beckett, *Attorneys Expect Increase in Job-Bias Suits*, L. A. DAILY NEWS, Aug. 10, 1992, at N3.

7. I.R.C. § 61(a) (1994).

8. I.R.C. § 104(a)(2) (1994). Congress amended § 104 in 1989 by providing that any punitive damages received in a case not involving physical injuries or sickness are not to be excluded from gross income. *Schleier*, and most ADEA cases discussed in this note arose before the 1989 amendment and are not subject to

importance of this exclusion cannot be overstated, especially when dealing with extremely large judgment or settlement amounts. The United States Supreme Court, in *Commissioner v. Schleier*,[9] addressed the question of what types of damage awards or settlements are excluded from gross income by section 104(a)(2).

This Note will proceed in five parts. Part II will discuss the factual background of the *Schleier* case and the holding of the Supreme Court.[10] Part III will briefly outline the legal background behind ADEA awards and their potential section 104(a)(2) treatment.[11] Next, part IV examines the decision and analysis of the Supreme Court in *Schleier*.[12] Finally, part V comments on the Court's holding and discusses the policy implications of the decision.[13] This Note then concludes that Congress needs to act to provide for exclusion from gross income amounts received from a settlement or jury award of a discrimination claim.

II. FACTS AND HOLDING

Erich Schleier filed suit against the Commissioner of the Internal Revenue Service in the Tax Court after the Commissioner issued a deficiency notice on Mr. Schleier's 1986 federal income tax return.[14] The deficiency related to a settlement agreement between Mr. Schleier and United Airlines, Inc.[15] United Airlines, Inc. (United) employed Mr. Schleier as an airplane captain. Under an established policy, United fired Mr. Schleier from his position when he reached sixty.[16] Mr. Schleier sued under the ADEA in federal district court.[17] The court consolidated his claim with a class action suit brought by other former United employees with similar claims.[18] The jury in the consolidated case found that United Airlines had engaged in willful misconduct in violation of the ADEA.[19] The Fifth Circuit overturned the jury

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its changes.

9. 115 S. Ct. 2159 (1995).

10. *See infra* notes 14 to 40 and accompanying text.

11. *See infra* notes 41 to 72 and accompanying text.

12. *See infra* notes 73 to 98 and accompanying text.

13. *See infra* notes 99 to 124 and accompanying text.

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

15. *Id.* at 2161.

16. *Id.*

17. *See* Monroe v. United Airlines, Inc., 736 F.2d 394 (7th Cir. 1984), *cert. denied*, 470 U.S. 1004 (1985).

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

19. *See Monroe*, 736 F.2d at 398.

verdict in favor of the former employees.[20] Prior to the second trial, the parties settled, and Mr. Schleier received $145,629 in damages.[21] The settlement agreement allocated fifty percent to back pay and fifty percent to liquidated damages.[22] Mr. Schleier's income tax return for 1986 included the amount attributed to the back pay portion of the settlement but excluded the portion attributed to liquidated damages.[23]

Mr. Schleier argued that section 104(a)(2) of the Code excluded from gross income the damages he received from the settlement agreement.[24] Because he originally excluded only the amount attributed to liquidated damages, he then sought a refund on the amounts attributed to back pay.[25] Mr. Schleier argued that his award of liquidated damages and back pay constituted "damages received on account of personal injuries or sickness."[26]

The Commissioner argued that the liquidated damages portion of the settlement should have been included in Mr. Schleier's gross income for two reasons.[27] First, the Commissioner argued that liquidated damages under the ADEA do not provide compensation to the victim of age discrimination. Liquidated damages deter "willful violations" of the statute.[28] Second, the Commissioner argued that liquidated damages arise "on account of" the employer's willful misconduct, not personal injury.[29]

The Tax Court postponed ruling on Schleier's case pending its ruling in *Downey v. Commissioner.*[30] In *Downey*, the Tax Court held that section 104(a)(2) and its accompanying regulations only excluded amounts recovered from a tort or tort-like claim.[31] The Tax Court held that the back pay portion of an ADEA settlement award arose from a tort like cause of action and excluded those awards from gross income.[32]

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

21. *Id.*

22. *Id.*

23. *Id.* at 2162. United did not withhold any payroll or income taxes from the portion of the settlement allocated to liquidated damages.

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

25. *Id.*

26. *Id.*

27. Petitioner's Brief at 9, Commissioner v. Schleier (No. 94-500) 1994 WL 7212151.

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

29. *Id.*

30. 97 T.C. 150 (1991), *supp. op.*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995). This was the lead case in the United Airlines settlement.

31. *Downey*, 97 T.C. at 160.

32. *Id.* at 169-70. The Tax Court further held that liquidated damages, while

Following its determination in *Downey*, the Tax Court found in favor of Mr. Schleier and allowed him to exclude from gross income the entire settlement, including both the back pay and liquidated damages.[33] The Tax Court held that the settlement constituted "damages received . . . on account of personal injuries or sickness" under section 104(a)(2) of the Code.[34] The Fifth Circuit affirmed the judgment in an unpublished opinion.[35]

The Supreme Court granted certiorari and reversed the Fifth Circuit.[36] The Court held that a taxpayer seeking to exclude judgment proceeds from gross income must meet two tests.[37] First, a taxpayer must demonstrate that the underlying cause of action is based upon "tort or tort-type rights."[38] Second, the taxpayer must show that the damages were received "on account of personal injuries or sickness."[39] The Court found that neither of these two tests were met by a claim arising from an ADEA settlement.[40]

III. LEGAL BACKGROUND

A. The Age Discrimination in Employment Act of 1967

Congress enacted The Age Discrimination in Employment Act of 1967 (the ADEA) to combat age discrimination in the work-place.[41] Congress intended to promote employment of older people and find solutions to problems of aging in general.[42] To that end, Congress prohibited "arbitrary age discrimination" in the work-place.[43]

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punitive in nature, served a compensatory purpose and also were properly excluded. *Id.* at 171-72.

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

34. *Id.*

35. *Id.* at 2161. *See* Schleier v. Commissioner, 26 F.3d 1119 (5th Cir. 1994).

36. *Schleier*, 115 S. Ct. at 2163.

37. *Id.* at 2167. The Supreme Court stated that the two tests were created by § 104(a)(2), the applicable regulations, and United States v. Burke, 540 U.S. 229 (1992); *see also infra* notes 55 through 59 and accompanying text.

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

39. *Id.*

40. *Id.*

41. 29 U.S.C. §§ 621-634 (1994); *see also* Andrew M. Wright, Note, Commissioner v. Schleier: *An Approach for Interpreting the Exclusion Under I.R.C. Section 104(a)(2) of Awards of Settlements in Federal Employment Discrimination Claims*, 70 NOTRE DAME L. REV. 991, 1002 (1995).

42. 29 U.S.C. §§ 621-634 (1994).

43. 29 U.S.C. § 621(b) (1994).

The ADEA grants a private cause of action for age discrimination and provides for both legal and equitable remedies.[44] A plaintiff under the ADEA may sue for back pay and for liquidated damages.[45] A plaintiff cannot, however, collect compensatory damages for pain and suffering or punitive damages.[46] An ADEA plaintiff also has equitable remedies available, including injunctive relief, reinstatement, and awards of attorney's fees.[47] The ADEA additionally provides for a jury trial.[48]

B. Statutory History of Taxation of Damage Awards

The Internal Revenue Code broadly defines gross income.[49] Clarifying the broad scope of this statute, the Supreme Court found income to be an "undeniable accession to wealth."[50] However, section 104(a)(2) allows for an exclusion from gross income those amounts received as damages for a personal injury case.[51]

The Service promulgated regulations equating "personal injury" under section 104(a)(2) with elements of tort law in 1960 and amended them in

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44. 29 U.S.C. § 626(b), (d) (1994).

45. 29 U.S.C. § 626(b), (d) (1994). The ADEA provides for liquidated damages only for a "willful" violation of the statue.

46. *See* Wright, *supra* note 41, at 1003-04.

47. 29 U.S.C. § 626(c) (1994).

48. 29 U.S.C. § 626(c)(2) (1994).

49. Gross income includes all income from whatever source derived. I.R.C. § 61(a) (1995); *see also* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

50. *Glenshaw Glass*, 348 U.S. at 431.

51. § 104. Compensation for injuries or sickness.

(a) In General. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) 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.

I.R.C. § 104 (1994).

In 1989, Congress amended § 104 by, among other changes, adding the following sentence: Paragraph (2) shall not apply to any punitive damages in connection with a case involving physical injury or physical sickness. Omnibus Budget Reconciliation Act of 1989 (amendment), Pub. L. No. 101-239, § 7641 (1989). This change, while possibly altering the holding in cases after 1989, has no direct impact on cases arising before 1989, such as *Schleier*.

1964.[52] The regulations defined the term "damages received (whether by suit or agreement)" as an amount received from the settlement of a claim or through prosecution of a lawsuit or action based upon tort or tort-type rights.[53] Only damages from a personal injury case that involved a tort-like cause of action would be excludable.[54]

C. *Case History of Taxation of Damage Awards*

The Supreme Court's previous pronouncement regarding the taxability of back pay awards received as a result of a discrimination claim under section 104(a)(2) came in *United States v. Burke.*[55] In *Burke,* the plaintiffs settled a Title VII sexual discrimination case.[56] Title VII at the time of the Burke decision awarded only back pay and did not allow for a jury trial.[57] Because of these limitations, the Court found that Title VII did not provide for the "full panoply" of remedies traditionally available in a tort claim.[58] The Court held that because Title VII allows only back pay awards and no jury trial, the settlement award was not based on tort or tort-type rights.[59]

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52. 25 Fed. Reg. 11402, Nov. 26, 1960, as amended by 29 Fed. Reg. 5070, April 14, 1964.

53. 75 Fed.Reg. 11,490 (1960); Treas. Reg. § 1.104-1(c) (1991).

54. Wright, *supra* note 41, at 996.

55. 504 U.S. 229 (1992).

56. Three female Tennessee Valley Authority (TVA) employees settled a Title VII discrimination suit before trial. The plaintiffs alleged that female dominated positions were not given pay raises whereas male dominated positions were. The settlement called for $5 million in damages for all affected employees. The TVA withheld federal income taxes and FICA taxes from the awards before payment to the employees. *Burke,* 112 S. Ct. at 1868-69.

57. 42 U.S.C. § 2000e-5(g) (1994) (limiting awards to back pay or reinstatement); *see also* Curtis v. Loether, 415 U.S. 189, 192-7 (1974) (describing availability of jury trials for common-law forms of action and citing Title VII cases).

58. *Burke,* 112 S. Ct. at 1874-75.

59. *Id.* at 1873-74. Justice Scalia in a concurring opinion found the Service's interpretation of § 104(a)(2), in particular the "tort or tort-type rights" test, troublesome. *Id.* at 1875. Justice Scalia found that "personal injury" in the statute included only physical injuries and injuries to mental health. *Id.* Justice Scalia rejected the definition of "personal injury" would include any non-contractual injury. *Id.* Justice Scalia was the only Justice to take this position.

Justices O'Connor and Thomas argued that discrimination causes personal injury in a dissenting opinion. *Id.* at 1878. Justices O'Connor and Thomas also disputed that the remedial nature of the statute controlled the "tort or tort-type rights" analysis, preferring to focus on the nature of the claim, i.e. discrimination. *Id.* at 1879. They would have allowed the exclusion of the Title VII damage award under § 104(a)(2).

The appellate courts have found ADEA settlement awards more troublesome to categorize for section 104(a)(2) purposes. In *Rickel v. Commissioner*,[60] the Third Circuit allowed the exclusion from gross income of both back pay and liquidated damages under the ADEA.[61] The Third Circuit found that the claim was both a personal injury and involved tort-type rights.[62] The *Rickel* court relied on a long string of civil rights and discrimination cases to find that an ADEA claim was similar to a personal injury claim.[63]

In *Schmitz v. Commissioner*,[64] the Ninth Circuit also held that an ADEA settlement amounted to a personal injury claim based on tort-type rights.[65] The Ninth Circuit found that "liquidated" damages were traditionally compensatory, not punitive.[66] Assuming that the Supreme Court limited its *Burke* holding to pre-1991 Title VII claims, the *Schmitz* court found that ADEA claims allowed for more tort-like remedies than pre-1991 Title VII claims[67] and, therefore, the Ninth Circuit found that the ADEA settlement award qualified for section 104(a)(2) exclusion from gross income.[68]

Conversely, the Seventh Circuit, in *Downey v. Commissioner*,[69] held that section 104(a)(2) does not exclude ADEA damages from gross income because those damages are not "on account of personal injury."[70] Relying on the *Burke* decision, the court found that the ADEA's compensatory scheme did not create a tort-type cause of action. The damages allowed were not the "broad range of compensatory damages . . . that characterize tort-type personal injury."[71] The *Downey* court held that without those remedies traditionally

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Justice Souter concurred in the majority opinion. His concurring opinion reasoned that the Service regulation required the claim to be based in tort, not contract. *Id.* at 1877. Because Title VII at the time allowed only back pay awards, the claim to Justice Souter was essentially a contract claim. *Id.* at 1878. In as much as Title VII focused on contract remedies, the damage award failed to qualify for § 104(a)(2) exclusion. *Id.*

60. 900 F.2d 655 (3d Cir. 1990).

61. *Id.* at 663.

62. *Id.* at 661.

63. *Id.* at 662-63.

64. 34 F.3d 790 (9th Cir. 1994).

65. *Id.* at 796.

66. *Id.* at 795-96. The court found support in the fact that liquidated damages had to be in relation to the back pay award.

67. *Id.* at 793-94.

68. *Id.* at 796.

69. 33 F.3d 836 (7th Cir. 1994).

70. *Id.* at 840.

71. *Id.* at 839.

available to tort claims, ADEA settlements could not qualify for section 104(a)(2) treatment.[72]

IV. INSTANT DECISION

A. Majority Opinion[73]

In *Commissioner v. Schleier*,[74] the Supreme Court held that damages received on account of a settlement of a claim under the ADEA failed to meet the two-pronged test of *Burke*.[75] The Court stated that to qualify for the section 104(a)(2) exclusion, the award must arise "on account of personal injuries."[76] The Court offered a hypothetical car accident to demonstrate what exactly the "on account of" language in section 104(a)(2) really means.[77]

The Court also found that under the plain language of section 104(a)(2) a taxpayer may not exclude any part of an ADEA settlement because the ADEA award for back pay was not "on account of" personal injury.[78] The Court reasoned that the back pay award was wholly independent of any personal injury and therefore failed to qualify as "on account of personal injury."[79]

The Court also refused to exclude the liquidated damages portion of the settlement from Mr. Schleier's gross income on the basis that they served to compensate him for injuries difficult to quantify. Citing *Trans World Airlines, Inc. v. Thurston*,[80] the Court dismissed this claim as already decided.[81] In *Thurston*, the Court held that Congress intended liquidated damages under the ADEA to be punitive in nature, unlike the Fair Labor Standards Act (the

72. *Id.*

73. Justice Stevens wrote the opinion for the majority, which Chief Justice Rehnquist and Justices Kennedy, Ginsburg, and Breyer joined.

74. 115 S. Ct. 2159 (1995).

75. *Id.* at 2167.

76. *Id.* at 2163.

77. *Id.* at 2163-64. The hypothetical assumes that a taxpayer is injured in a car accident incurring (i.) medical expenses, (ii.) lost wages, and (iii.) pain, suffering and emotional distress. The taxpayer settles for $30,000, all of which would qualify for § 104(a)(2) treatment.

78. *Id.* at 2164.

79. *Id.*

80. 469 U.S. 111 (1985).

81. *Schleier*, 115 S. Ct. at 2165.

"FSLA").[82] Accordingly, in *Schleier* the Court held that liquidated damages are not awarded "on account of personal injury."[83]

Next the Court dealt with Mr. Schleier's argument that, because the ADEA is a tort-type cause of action, the settlement award should be excluded.[84] The Court disputed whether the ADEA created a tort-type right.[85] Although the ADEA does allow jury trials and liquidated damages, the Court concluded that, while it was a closer case than *Burke*, the ADEA failed to qualify as a tort-type right.[86] The Court stated that the ADEA limited recovery to back wages, which were clearly economic damages, and liquidated damages, which under *Thurston* had no compensatory function.[87]

Thus, the Court held that because the damages received from the settlement of an ADEA claim are not "on account of personal injury" as required by section 104(a)(2), and because the ADEA does not create a tort or tort-type cause of action, Mr. Schleier could not exclude from gross income either the liquidated or the back pay portion of the award.[88]

B. Dissenting Opinion

The dissent began its analysis on the premise that, "[a]ge discrimination inflicts personal injury."[89] Citing a string of unrelated discrimination cases, the dissent stated that discrimination based on race and sex have long been held to inflict personal injury.[90] Justice O'Connor, who also dissented in *Burke*, disagreed with the Court's reliance on the analysis of available remedies to determine whether a claim was tort-like for purposes of section

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82. *Trans World Airlines*, 469 U.S. at 125. The ADEA, § 626(b), provides that the rights created under the ADEA are to be enforce in accordance with the remedies and powers of the FLSA. *See* Lorillard v. Pons, 434 U.S. 575, 579 (1978). Under the FLSA, liquidated damages are mandatory in all cases, whereas under the ADEA, liquidated damages are awarded only for "willful violations" of the statute. *Compare* 29 U.S.C. § 626(b) (ADEA liquidated damages provision) *with* 29 U.S.C. § 216(b) (FLSA liquidated damages provision).

83. *Schleier*, 115 S. Ct. at 2165.

84. *Id.*

85. *Id.* at 2166.

86. *Id.* at 2168.

87. *Id.*

88. *Id.* at 2167.

89. *Id.*

90. *Id.* at 2168 (citing Goodman v. Lukens Steel Co., 482 U.S. 656 (1987) (racial discrimination); Price Waterhouse v. Hopkins, 490 U.S. 228 (1989) (O'Connor, J., concurring) (race and sex discrimination); EEOC v. Wyoming, 460 U.S. 226 (1983) (age discrimination)).

104(a)(2).[91] In *Burke*, Justice O'Connor noted, and seven other justices agreed, that discrimination inflicts a personal injury.[92] Justice O'Connor argued that the majority opinion reversed that position, if not explicitly, then accidentally.[93]

The Service's interpretation of section 104(a)(2) also drew attention from the dissent. In *Burke*, the Court deferred to a Service regulation which stated that discrimination could be a personal injury if the cause of action was tort-like.[94] The Service in *Schleier*, however, argued that the tort-like standard in *Burke* was not a conclusive test.[95] The dissent found the ADEA to have the appropriate "panoply" of remedies to make this a "tort-type" cause of action as required by section 104(a)(2) and the applicable regulations.[96] Citing to *Burke*, the dissent claims that the Service and the Court in *Burke* linked personal injury to these tort principles alone.[97] Because the dissent would characterize ADEA suits as arising from tort or tort-type rights, the damage award should fall under section 104(a)(2).[98]

V. COMMENT

A. Philosophy of Section 104(a)(2)

Scholars have debated the reason for enacting section 104(a)(2) in differing contexts.[99] One common argument for excluding from gross

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91. *Id.* at 2169.

92. *Id.* Only Justice Scalia, who concurred with the majority in *Burke*, argued that personal injuries for § 104(a)(2) purposes were limited to physical and mental health.

93. *Schleier*, 115 S. Ct. at 2169-170.

94. *Id.* at 2170-71. Justice O'Connor also looked at 35 years of Service interpretations, which state that a "tort-type right" conclusively established § 104(a)(2) qualification. Because this interpretation has been considered reasonable for so long, Justice O'Connor would hold the Service to this position.

95. Justice O'Connor notes that the Commissioner only argued the point that the tort-like standard was not the exclusive requirement in one sentence of her reply Brief. *Schleier*, 115 S. Ct. at 2171.

96. *Schleier*, 115 S. Ct. at 2170.

97. *Id.* at 2171.

98. *Id.*

99. *See* J. Martin Burke and Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13 (1989); Wright, *supra* note 41, at 1019-25 (discussing possible motive of Congress for adopting § 104(a)(2)); *see also* 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 (1995) (discussing court treatment of § 104(a)(2)).

income amounts received on account of a personal injury involves the "human capital" theory.[100] The human capital theory resembles the concept of basis in tax law.[101] In tort law, the return of capital is not "income" to a person, but rather "makes a person whole."[102] In fact, early applications of this principle found payments to a person on account of personal injury merely reimbursed a victim for "a conversion of capital lost through . . . injury."[103] In a sense, there is no "gain" to the taxpayer.[104] The taxpayer only "breaks even."[105]

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100. Some scholars have suggested that Congress adopted the "human capital" theory when it enacted § 104(a)(2)'s statutory predecessor. *See, e.g.*, Wright, *supra* note 41, at 995; Burke & Friel, *supra* note 99, at 14.

The legislative history of § 104(a)(2) begins with the Internal Revenue Act of 1918, § 213(b)(6). This provision excluded from gross income:

> Amounts 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.

Pub. L. 65-254, ch. 18, § 213(b)(6), 40 Stat. 1057, 1065-66 (1919).

A House Report accompanying § 213(b)(6) stated:

> Under present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts not be included in gross income.

H.R. Rep. No. 767, 65th Congress., 2d Sess. 9-10 (1918), *reprinted in* 1939-1 C.B. 86, 92.

101. *See* Wright, *supra* note 41, at nn.258-265 and accompanying text; *see also* Hawkins v. United States, 30 F.3d 1077, 1087 (9th Cir. 1994) (Trott, J., dissenting). In *Hawkins*, the dissent questioned how the human capital theory can be at all useful in deciding whether punitive damages are return of capital or a windfall. More specifically, how do value an arm, leg, or 30% use of a hand?

This difficulty in calculating an economic value for such a loss highlights the limitations of this theory. In addition, the human capital theory fails to adequately explain why back pay and punitive damages should be excluded from gross income. *See* Wright, *supra* note 41, at 1022-23.

102. This presumes that a taxpayer would never realize gain because his basis in his body or reputation would always exceed any amount realized from an ADEA settlement. *See* Wright, *supra* note 41, at n.259.

103. 31 Op. Att'y Gen. 304, 308 (1918).

104. For example, there is no "accession to wealth." *See* the discussion of *Commissioner v. Glenshaw Glass*, *see supra* notes 49-51 and accompanying text.

105. *See* Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 766-68 (1988).

Another theory justifying exclusion from gross income under section 104(a)(2) posits that the exclusion for damages in a personal injury case prevents a taxpayer from having large amounts of income in one year.[106] In the case of back pay, the progressive tax rate structure subjects a taxpayer settling a claim to a larger tax bracket.[107] The result from such a settlement would force the taxpayer into a higher tax bracket and requires the taxpayer to pay a higher tax bill.[108]

Some commentators have also suggested that humanitarian motives encouraged Congress to enact section 104(a)(2).[109] This theory proposes that victims have suffered enough at the hands of others and should not now be a victim of an Internal Revenue Service audit.[110] In *Schleier*, the taxpayers argued compassion for the victim advanced the objectives of the ADEA and other anti-discriminatory laws.[111]

B. Section 104(a)(2) Should Exclude From Gross Income Amounts Received From Discrimination Suits.

When Congress enacted section 104(a)(2), it failed to include a solid policy or logical justification of its purpose. Without such a justification, the courts and the Service are left to interpret the statute without any reliable Congressional guidance. This statute has existed since the early 20th century

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106. Wright, *supra* note 41, at 1021-22.

107. Wright, *supra* note 41, at 1021-22.

108. Wright gives a good example of this problem. Assume an employee is fired from his or her job and sues under the ADEA. The parties settle for $200,000 of back pay for the 4 years he or she was unemployed. Since the taxpayer must realize all $200,000 in the year of payment, the taxpayer would have a 39% tax bracket. If the taxpayer received $50,000 over 4 years while working, he or she would have a much lower bracket and subsequently lower tax liability. Wright, *supra* note 41, 1021-22.

It would be possible to spread income from a settlement award over a period of years, allowing for potential recognition over time. This problem, however, is beyond the scope of this case note.

109. *See* Burke and Friel, *supra* note 99, at 43; Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 TAX LAW. 783, 797 (1992) (arguing that Congress probably did not intend for non-physical injuries or punitive damages to be treated as a "humanitarian" recovery.)

110. In *Roemer v. Commissioner*, the Ninth Circuit wrote that he humanitarian theory posits that an injured party should not be burdened with the responsibility of sorting out taxable and non-taxable portions of a judgment or settlement award. 716 F.2d 693, 696 (9th Cir. 1983).

111. Brief for Respondent at 24, Commissioner v. Schleier (No. 94-500) 1994 WL 721251.

but still causes far too much confusion and debate. Congress needs to step forward and explain exactly how awards for discrimination suits should be handled.

Justice O'Connor, in her dissent in *Schleier*, appropriately points to the fundamental problem in the majority decision.[112] That problem lies in the Court's failure to recognize that discrimination causes personal injury.[113] Justice O'Connor notes that the analysis of the majority equates personal injury with only tangible injuries, as Justice Scalia argued in his opinion in *Burke*.[114] This contradicted, perhaps even overturned, many of the Supreme Court's prior rulings which held that discrimination caused personal injuries.[115]

The *Schleier* decision creates more confusion than necessary. An ADEA claim, before *Schleier*, appeared to fit the requirements for section 104(a)(2) exclusion.[116] The Court finds that in addition to failing the tort type rights test, an ADEA claim also fails to pass the "on account of" language of section 104(a)(2) itself. Justice O'Connor again points out that creating the second aspect, the "on account of" language, departs from the Service's own interpretation of section 104(a)(2) as found in Treasury Regulation 1.104-1(c).[117] With this holding, the Court undercut thirty-five years of Service interpretations and Rulings.[118]

The ambiguity of section 104(a)(2) creates a need for consistent interpretation. No such consistency has been forthcoming from the courts or the service. Now Congress needs to act. Over the last thirty-five years, the

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112. *Schleier*, 115 S. Ct. at 2167-72.

113. In the majority opinion, the court writes, "§ 104(a)(2) does not permit the exclusion of . . . back wages because the recovery of back wages was not 'on account of' *any* personal injury." *Id.* at 2164 (emphasis added).

114. *Id.* at 2169.

115. *Id.* at 2170.

116. Under *Burke*, the court stated that a pre-1991 Title VII claim failed to qualify for § 104(a)(2) exclusion because it did not entitle the plaintiff to the "full panoply" of remedies that created a tort-type right. An ADEA claim appears to fit the requirements of a "full panoply" of remedies, including:

a. a jury trial—ADEA § 626(c)(2);
b. legal or equitable relief—ADEA § 626(c)(1); and
c. liquidated damages, which under *Thurston* are considered punitive damages; traditionally available under tort law—ADEA § 626(b).

What other remedies are needed to make a tort-type claim are unclear. The majority simply states, "though this is a closer case than *Burke*, we conclude that a recovery under the ADEA is not one that is "based on tort or tort type rights."" *Schleier*, 115 S. Ct. at 2167.

117. *Schleier*, 115 S. Ct. at 2171.

118. *Id.*

Service and the courts have not built a consensus as to the meaning of section 104(a)(2), and now is the time to settle the issue.

C. *Need for Congressional Action*

The lack of clear policy behind section 104(a)(2) creates a number of problems when planning a tax strategy. Congress should resolve this problem and clarify the policy and application behind section 104(a)(2).

Some commentators have suggested Congress should repeal section 104(a)(2) all together.[119] This path, however, would seriously disadvantage taxpayers who suffer serious injury requiring expensive medical help. While this solution would end any and all debate on the issue, efficiency and ease of administration are not always the best social policy.

Other commentators have suggested amending the section to apply only to cases of physical injury, but not to punitive damages, back pay, or general economic losses.[120] What the courts need most is a uniform standard to apply to these types of cases.

Congress should amend section 104(a)(2) to allow for exclusion from gross income any amounts received from any discrimination suit, whether under the ADEA, American's with Disabilities Act, or the Equal Pay Act. Since these anti-discrimination statutes are based primarily on humanitarian motives, allowing for section 104(a)(2) exclusion would further the objectives of those statutes.[121]

Further justification for amending section 104(a)(2) comes from the disparity that may arise between different anti-discrimination statutes. While the Supreme Court now requires all ADEA awards to be included in gross income, the Court has not ruled on whether awards from other federal anti-discrimination statutes or other similar state statutes should be included in gross income.[122] While all these statutes have the same purpose, eliminating discrimination, they are being afforded different tax treatment by courts on often awkward legal analysis.[123]

After *Schleier*, it would appear that no awards under any anti-discrimination statute would qualify for section 104(a)(2) exclusion from gross

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119. *See* Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed*, 38 CASE W. RES. L. REV. 43, 64-65 (1987-88); Wright, *supra* note 41, at n.271 and accompanying text.

120. Wright, *supra* note 41, at n.272-75 and accompanying text.

121. Congress passed the ADEA, "to promote employment of older persons based on their ability rather than age." 26 U.S.C. § 621(b) (1988).

122. *See* Wright, *supra* note 41, at n.308-09 and accompanying text.

123. Wright, *supra* note 41, at 1029. Wright noted that the 4th Circuit has held that an EPA award was taxable but suggested that an ADEA claim was not taxable.

income. This question, however, has important policy ramifications that Congress should resolve, not the courts. Many policy considerations are properly handled by the courts. Unfortunately the Court has still not created a satisfactory uniform treatment of section 104(a)(2) claims.[124] If Congress amended section 104(a)(2) to apply to all anti-discrimination statutes, the spectrum of employment discrimination could be treated equally and fairly.

VI. CONCLUSION

The *Schleier* decision defined what may be excluded from a taxpayer's gross income when settling an ADEA claim—nothing. This decision took damages received under an ADEA claim out of section 104(a)(2) treatment. More importantly the Supreme Court established a standard by which all future damage awards will be measured for section 104(a)(2) exclusion. A damage award must be "on account of personal injury or sickness" and must arise out of a tort or tort-type cause of action. Failure to meet either of these criteria will result if a denial of the section 104(a)(2) exclusion. While this bright line test is sure to deter many taxpayers from attempting to claim an exclusion, the Court's opinion seems to overturn a long series of precedent and rulings established by the Service and the Supreme Court. By denying the exclusion, the Court made clear its position on back pay and punitive damages—they do not arise on account of personal injuries.

While this holding takes a firm stance on the meaning of an ambiguous statute, the Court missed an opportunity to promote equal employment opportunity. Congress now should act to grant section 104(a)(2) treatment to employment discrimination awards. By doing so, Congress will make clear its intent to treat discrimination as creating a personal injury, something courts acknowledged long before the *Schleier* case.

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124. *See* Henning, *supra* note 109, at 804.