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The Excludability of Employment Discrimination Awards under Code Section 104(a)(2) after Burke v. United States and Commissioner v. Schleier

Leandra Lederman

Indiana University Maurer School of Law, llederma@indiana.edu

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The Excludability of Employment Discrimination Awards under Code Section 104(a)(2) after *Burke v. United States* and *Commissioner v. Schleier*

Leandra Lederman Gassenheimer*

I. INTRODUCTION

Section 104(a)(2) of the Internal Revenue Code carves out an exception from the broad income inclusion of section 61 for “the amount of any damages received (whether by suit or by agreement and whether as lump sums or periodic payments) on account of personal injuries or sickness.” The exclusion of damages under this section is particularly important in framing claims and structuring settlements. Until the Supreme Court’s decision in *Commissioner v. Schleier* this past June, courts had become increasingly generous in allowing exclusion under section 104(a)(2) of recoveries for a multitude of harms, including employment discrimination on the basis of age, race, or gender. In *Schleier*, the Court denied the taxpayer exclusion of all damages recovered for a claim under the Age Discrimination in Employment Act ("ADEA") because they were not recovered “on account of personal injuries or sickness.” The *Schleier* decision was particularly surprising in that it gives short shrift to a test the Court

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*Assistant Professor of Law, Walter F. George School of Law of Mercer University. The author gratefully acknowledges the helpful comments and suggestions of Mark Wright Cochran, Gregg Grauer, Mark Jones, Hal Lewis, Filiz Serbes, and Lawrence Zelenak. The author also appreciates the excellent research assistance of Suzanne Causey and Jeanne Strickland.


established only three years earlier in *United States v. Burke.* As a result, *Schleier* has caused confusion regarding the tax treatment of awards under employment discrimination statutes other than ADEA.

This article analyzes the law on the tax treatment of employment discrimination damages. It attempts to reconcile *Burke* and *Schleier* and thereby provide guidance for the future. In Part II, the article discusses the historical development of the exclusion for damages received on account of nonphysical, business-related injuries. In Part III, the article discusses the development of the law with respect to the exclusion of employment discrimination damages under section 104(a)(2). Part III criticizes the Supreme Court’s decision in *Burke* for deciding the excludability of awards recovered under the pre-1991 version of Title VII on overly narrow grounds, and then looks at the effects of *Burke* on the application of section 104(a)(2) to other employment discrimination statutes. Part III also criticizes the approach taken in *Schleier.* Part IV looks at the implications for the future. In Part V, the article concludes that, despite the two Supreme Court decisions, Congressional action may be needed to clarify the area.

II. PERSONAL INJURIES: DEVELOPMENT OF THE LAW

The employment discrimination cases under section 104(a)(2) developed out of a historical exclusion of damages received on account of personal injuries. For employment discrimination damages to be excludable, nonphysical, business-related injuries must be considered “personal injuries.” In order to understand the current tax treatment of employment discrimination damages, it is helpful to understand the history and rationale of the personal injury exclusion and its application to nonphysical, professional injuries.

The first codification of the law on personal injury damages occurred in 1918. The statute provided that gross income did not include:

> 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 . . . .

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This was a codification of the law at the time, rather than a change in the law. At that time, the rationale for the exclusion of personal injury damages rested on a theory of conversion of capital, with the human body considered a form of capital. That is, damages were considered to “make whole” the injured taxpayer. Accordingly, in 1920, the Internal Revenue Service ("IRS") opined that the exclusion applied only to damages for physical injuries.

The Supreme Court’s decision in *Eisner v. Macomber* changed the development of the law with respect to damages. In *Macomber*, in the context of a stock dividend, the Court defined income as “the gain derived from capital, from labor, or from both combined.” At the time, *Macomber* was thought to represent the constitutional boundary on the definition of income. Based in part on *Macomber*, the IRS determined that damages for "slander or libel of personal character" were excludable.

In 1955, the Supreme Court held in *Commissioner v. Glenshaw Glass* that *Macomber* “was not meant to provide a touchstone to all future gross income questions.” Instead, the Court focused on “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion,” and found that punitive damages awarded in an antitrust suit were gross income. This approach includes most receipts not specifically exempted by statute. It should also bring into question administrative opinions that exclude damages...
from income on the theory that they do not meet the *Macomber* definition of income. However, the courts did not question the reasoning of the pre-*Glenshaw Glass* authorities.\(^\text{17}\) For example, in 1972, the Tax Court relied in part on the 1922 IRS ruling on damages for defamation of personal character to decide that the injuries encompassed by section 104(a)(2) need not be physical.\(^\text{18}\)

The physical versus nonphysical injury distinction did not address a possible contrast between “personal” injuries and “business” injuries. Even under a conversion of capital theory, an exclusion of lost business income seems to make the taxpayer more than whole (unlike imputed income from use of one’s body)\(^\text{19}\) because the income would have been taxed absent the injury. The 1922 IRS opinion, which allowed exclusion of damages for defamation of personal character, expressly did not consider or decide whether damages to professional reputation were excludable.\(^\text{20}\) The opinion even stated that an earlier memorandum holding that damages recovered for libel were includable may have been correct with respect to damages received for libel of professional reputation.\(^\text{21}\)

Similarly, in 1982, when the Tax Court first considered a libel suit that resulted in lost income and business opportunities, it drew a distinction between such “business injuries” and “personal injuries” and concluded that the full amount of the compensatory damages received by the taxpayer was includable in his gross income.\(^\text{22}\) However, on appeal, the Court of Appeals for the Ninth Circuit reversed, holding that a distinction between injuries to personal and professional reputation was not justified under section 104(a)(2).\(^\text{23}\) The court found that the amount of damages recovered for lost income was excludable.\(^\text{24}\)

In 1986, the Tax Court reconsidered its holding on damages to professional reputation. In *Threlkeld v. Commissioner*, the Tax Court followed the Ninth Circuit’s approach, allowing exclusion of the settlement

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18. *Seay v. Commissioner*, 58 T.C. 32, 40 (1972) (holding damages received for embarrassment, mental strain, and injury to personal reputation excludable under § 104(a)(2)).
19. *See supra* note 10 and accompanying text.
21. *Id.* at 93.
24. *Id.* at 696.
amount allocated to damages to professional reputation.\textsuperscript{25} The Tax Court expressly found no distinction between physical and emotional injuries or between injury to personal reputation and injury to professional reputation.

In deciding \textit{Threlkeld}, the Tax Court held that the proper inquiry is the “origin and character of the claim,” not “the consequences of the injury.”\textsuperscript{26} According to the court, even if lost income is the best measure of damages, that does not change the character of the claim. To characterize the claim in that case, the court focused on the taxpayer’s complaint and found that the cause of action was malicious prosecution, which would be classified as a personal injury cause of action under applicable state law. On appeal, the Sixth Circuit affirmed the Tax Court, adopting the reasoning of the Ninth Circuit.\textsuperscript{27}

\section*{III. Employment Discrimination: Character of the Claim}

The \textit{Threlkeld} decision paved the way for employment discrimination damages cases. First, \textit{Threlkeld} characterized lost income as a mere “measure” of damages, undercutting the argument that the damages replaced otherwise includable income. Second, \textit{Threlkeld} made no distinction between physical and nonphysical injuries, or between professional and nonprofessional injuries. Third, \textit{Threlkeld} focused on the “character” of the claim, an amorphous test. This enabled courts to decide employment discrimination cases in favor of taxpayers, despite the fact that a large component of an employment discrimination award may be back pay.\textsuperscript{28}

Courts were nonetheless concerned about the exclusion of back pay awards. In some cases where taxpayers had recovered back wages and other damages under a single anti-discrimination statute, courts bifurcated the damages into a taxable “contractual” component (back pay) and a nontaxable

\textsuperscript{25} 87 T.C. 1294, 1298 (1986). \textit{Threlkeld} was appealable to the Sixth Circuit under I.R.C. § 7482(b). The Tax Court follows a Court of Appeals decision that is squarely on point, when appeal lies to that court alone. \textit{See} Golsen v. Commissioner 54 T.C. 742, 757 (1970), \textit{aff'd}, 445 F.2d 985 (10th Cir. 1971), \textit{cert. denied}, 404 U.S. 940 (1971). When that appellate court has not yet expressed a view, the Tax Court applies its own view. \textit{See id.}

\textsuperscript{26} \textit{Threlkeld}, 87 T.C. at 1299.

\textsuperscript{27} \textit{Threlkeld} v. Commissioner, 848 F.2d 81 (6th Cir. 1988).

\textsuperscript{28} \textit{See, e.g.}, Redfield v. Insurance Co. of N. Am., 940 F.2d 542 (9th Cir. 1991) (addressing a claim based on ADEA); Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990) (similarly addressing an ADEA claim); Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990) (also addressing an ADEA claim); Metzger v. Commissioner, 88 T.C. 834 (1987) (addressing a § 1983 claim), \textit{aff'd without published op.}, 845 F.2d 1013 (3d Cir. 1988).
“tortious” component (often the portion the underlying statute termed “liquidated damages”).

ADEA is an example of a statute offering both back pay and liquidated damages; under ADEA, a victim of willful discrimination is entitled to “liquidated damages” in an amount equal to the back pay awarded. In 1989, the Tax Court decided its first ADEA damages case, *Rickel v. Commissioner.* Following earlier cases involving other anti-discrimination statutes, the Tax Court distinguished between the two types of damages awarded and held only the wage-related damages taxable. The court found that liquidated damages were excludable from income under section 104(a)(2) as damages received for personal injuries. On appeal, the Court of Appeals for the Third Circuit reversed, allowing exclusion of all of the damages on the theory that the nature of an age discrimination claim is personal injury.

**A. Burke v. United States: Tort-Like Personal Injuries**

Like ADEA claims, Title VII claims proved difficult to characterize. Before the Civil Rights Act of 1991 amended Title VII, back pay was the only monetary remedy provided. The Courts of Appeals divided on the issue of whether such back pay awards were excludable under section 104(a)(2). In *Burke v. United States,* the Sixth Circuit held that prohibited discrimination was a form of personal injury, so any damages received were excludable under the statute. Other courts held that back pay, which would have been taxed if received when earned, was includable because it was not “compensation for loss due to a tort.”

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32. *See, e.g., Thompson,* 89 T.C. 632.


34. *Rickel,* 900 F.2d at 663-64.


37. *Burke,* 929 F.2d at 1126 (Wellford, J., dissenting); *see also Sparrow v. Commissioner,* 949 F.2d 434, 438 (D.C. Cir. 1991); *Thompson v. Commissioner,* 866 F.2d 709, 712 (4th Cir. 1989).
The United States Supreme Court granted certiorari in Burke and reversed. Writing for the majority, Justice Blackmun focused on what constitutes a "personal injury" for purposes of section 104(a)(2). The phrase is not defined in the statute, but a regulation defines the term "damages received (whether by suit or by agreement)" as "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." The meaning of the regulation is far from clear. Although the regulation purports to define only "damages received," it echoes much of the language of section 104(a)(2). In fact, the phrase "tort or tort type rights" seems to parallel the statutory phrase "personal injuries or sickness," in effect defining it. The IRS had interpreted the regulation that way for many years, and the Burke majority did the same.

Thus, Justice Blackmun formulated the "personal injury" question as whether a Title VII action is a prosecution of "tort or tort type rights," similar to Threlkeld's focus on the origin and character of the claim. Having done so, Justice Blackmun stated that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages . . . ." According to the Court, a claim under a law, such as 42 U.S.C. § 1981, that provides a broad range of damages including emotional distress, pain and suffering, and punitive damages, is sufficiently tort-like for its violation to constitute a personal injury. The Court concluded that before the 1991 amendments, Title VII claims failed to qualify as sufficiently tort-like to justify exclusion of back pay because Title VII did not provide a broad range of damages.

The concurring and dissenting opinions in Burke reflect the split in views on the meaning of section 104(a)(2) in general, and how to characterize employment discrimination statutes in particular. Justice O'Connor's dissent focused on her view that discrimination in the workplace causes personal injury. She argued that Title VII rights are tort-type rights; echoing Threlkeld, she argued that "the remedies available to Title VII plaintiffs do not fix the character of the right they seek to enforce." Although the

39. Id. at 234.
41. See Burke, 504 U.S. at 242 n. 1 (Scalia, J., concurring).
42. Id. at 234.
43. Id. at 235.
44. Id. at 240.
45. Id. at 238, 241. The damages available under the pre-1991 version of Title VII were back pay and equitable relief. 42 U.S.C. § 2000e-5(g) (1990).
46. Burke, 504 U.S. at 249 (O'Connor, J., dissenting).
47. Id.
majority noted that the amounts awarded as back pay would have been taxed had they been received as wages, Justice O’Connor pointed out that other victims of personal injuries can receive damages measured by lost income and still exclude those damages under section 104(a)(2).\(^{48}\)

Justice Scalia wrote a compelling concurrence, arguing that section 104(a)(2) should be interpreted narrowly to apply only to injuries to physical and mental health.\(^{49}\) He argued that the IRS’s formulation of “tort-type rights” was “not within the range of reasonable interpretation of the statutory text” and need not be accepted.\(^{50}\) In his interpretation, the close association of the phrase “personal injuries” with the word “sickness,” and the context of the use of the phrase “personal injuries or sickness” elsewhere in section 104(a) show an intent to limit the exclusion to injuries to physical or mental health.\(^{51}\) Justice Scalia also argued that the damages received by the taxpayer were not received “on account of” injuries to her physical or mental health since Title VII did not require her to make a showing of psychological harm in order to recover back pay.\(^{52}\) Justice Souter also concurred in the judgment, reasoning that the limitation in Title VII of back pay as the sole money damages reflected an action that was more contractual than tort-like.\(^{53}\)

\textbf{B. The Effects of Burke on Other Employment Discrimination Statutes}

\textit{Burke} was a problematic decision. Characterizing the claim as a whole based on the realm of theoretically available damages could lead to absurd results in that a taxpayer who recovered exclusively back pay under a suitably “tort-like” statute could exclude the recovery, whereas a recovery under a less tort-like statute would be includable.\(^{54}\) In addition, despite the arguable similarity of Title VII to other federal anti-discrimination in employment statutes, \textit{Burke}'s holding of taxability was not generalizable outside of pre-1991 Title VII, so it required judicial decisions on every employment discrimination statute. As a result, the IRS and courts considered awards under various statutes on an ad hoc basis. In Revenue

\begin{itemize}
  \item \(^{48}\) \textit{Id.} at 252.
  \item \(^{49}\) \textit{Id.} at 243-44 (Scalia, J., concurring).
  \item \(^{50}\) \textit{Id.} at 242.
  \item \(^{51}\) \textit{Id.} at 244.
  \item \(^{52}\) \textit{Id.} at 245.
  \item \(^{53}\) \textit{Id.} at 247-48 (Souter, J., concurring).
\end{itemize}
Ruling 93-88, the IRS opined that recoveries under the Americans with Disabilities Act ("ADA") were excludable and that both the back pay and the compensatory damages portions of awards for or settlements of disparate treatment claims were excludable under the post-1991 version of Title VII. This version provides for compensatory damages for future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses, punitive damages, and jury trials in disparate treatment cases.

The development of the law on the taxability of ADEA awards was more complicated. After the Third Circuit reversed the Tax Court in Rickel in 1990, allowing exclusion of both back pay and liquidated damages, the Tax Court considered a number of cases arising out of United Airlines' ("United") settlement of an ADEA class action. United's company policy required pilots to retire when they reached age 60. In 1979, three former United pilots filed a class action suit under ADEA. The suit was consolidated with another ADEA suit, brought by former United flight engineers. A jury returned a verdict awarding the former United employees back pay and liquidated damages. United appealed, and in 1984 the Seventh Circuit reversed and remanded the consolidated cases on the basis of erroneous jury instructions. The parties settled during the course of the second trial; United agreed to pay each plaintiff a specific amount designated as both back pay and liquidated damages in equal proportions.

In Downey v. Commissioner, the lead case in the settlement with United Airlines, the Tax Court held that bifurcation of an ADEA award was not required. However, after the Supreme Court reversed the Sixth Circuit in Burke, the Tax Court granted the IRS's motion to reconsider its decision in

58. See, e.g., Commissioner v. Schleier, 115 S. Ct. 2159 (1995); Gates v. Commissioner, 61 F.3d 915 (10th Cir. 1995); Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994), vacated and remanded, 115 S. Ct. 2573 (1995); Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994), cert. denied, 115 S. Ct. 2576 (1995); see also Bennett v. United States, 60 F.3d 843 (Fed. Cir. 1995).
60. Id.
61. Id.
62. Id.
63. Id.
64. Id.
Downey in light of Burke. The court entered a second opinion confirming its initial holding. A majority of the Tax Court concluded that ADEA claims are distinguishable from Title VII claims because, in contrast to the limited remedies available under pre-1991 Title VII, ADEA damages can include liquidated damages. According to the Tax Court, liquidated damages may compensate nonpecuniary losses or serve as a deterrent or punishment. Following the Burke direction to characterize the claim as a whole according to the nature of relief afforded, the majority refused to treat the liquidated and nonliquidated damages differently.

In a separate opinion, Judge Laro, joined by Judge Jacobs, argued that the majority misconstrued Burke. According to Judge Laro, Burke reaffirms prior law that the nature of the claim underlying the taxpayer's damage award determines whether the award was received "on account of personal injuries." Thus, as stated by the Supreme Court, the statute must redress a "tort-like personal injury" for damages awarded under it to be excludable under section 104(a)(2). Applying Treasury regulation 1.104-1(c), Judge Laro developed a two-pronged test for the exclusion of damages received from a suit or settlement: "(1) Damages were received on account of personal injuries, and (2) suit or action was based upon tort or tort type rights." Judge Laro concluded that ADEA is both contractual and tort-like. He argued for bifurcation of the "tort" and "contract" components of the plaintiff's recovery, alleging that nonliquidated damages redressed contractual wrongs, for which back pay was awarded, and liquidated damages redressed "tort-like" personal injuries. Thus, Judge Laro agreed with the majority that liquidated damages were excludable but argued that the nonliquidated damages were taxable.

Following Downey, the Tax Court decided several cases reconfirming its holding in that case. At that time, the Tax Court followed Burke with respect to pre-1991 Title VII cases, requiring inclusion of back pay awards. In contrast, with respect to ADEA cases, the court allowed exclusion of the

67. Id. at 637.
68. Id.
69. Id. at 643 (Laro, J., concurring in part and dissenting in part).
70. Id. at 645.
71. Burke, 504 U.S. at 237.
72. See supra note 40 and accompanying text.
73. Downey, 100 T.C. at 645 (Laro, J., concurring in part and dissenting in part).
entire award under section 104(a)(2). However, the Seventh Circuit reversed the Tax Court in Downey, holding that ADEA awards are not received on account of personal injury or sickness. The Seventh Circuit said that Burke stands for the proposition that a federal anti-discrimination statute must provide compensatory damages for intangible elements of personal injury for it to be "tort-like" and allow its damages to be excluded.

Two of the cases following Downey, Schmitz v. Commissioner and Commissioner v. Schleier, also involved parties to the United Airlines settlement. In Schmitz, Mr. Schmitz had received a settlement of $115,050, characterized in the agreement as consisting half of back pay and half of liquidated damages. The Schmitzes initially had reported only the back pay portion of the settlement as income, bifurcating the award into includable and excludable portions as the Tax Court had done in Rickel. The IRS mailed them a notice of deficiency and they petitioned the Tax Court. After the Third Circuit decided Rickel, they amended their petition to assert that both portions of the award were excludable. The Tax Court granted summary judgment in favor of the Schmitzes, holding the entire award excludable.

On appeal, the Ninth Circuit held that under its decision in United States v. Hawkins, Mr. Schmitz had to show both that the underlying cause of action was "tort-like" within the meaning of Burke and that the damages were received "on account of" the taxpayer's personal injuries. The Ninth Circuit agreed with the Tax Court's conclusion that an ADEA claim represents a "tort-like" cause of action because of the availability of liquidated damages and jury trials. The court disagreed with the IRS's argument that the liquidated damages were not received "on account of" a

75. See, e.g., Fogle v. Commissioner, T.C. Memo. 1992-412. At that point, the ADEA cases were fairly uniform, with the exception of one district court case. Maleszewski v. United States, 827 F. Supp. 1553 (N.D. Fla. 1993).
76. Downey, 33 F.3d at 836 (7th Cir. 1994).
77. Id. at 839.
78. 34 F.3d at 790.
80. Schmitz, 34 F.3d at 791.
81. Id.
82. Id.
83. 30 F.3d 1077 (9th Cir. 1994).
84. Schmitz, 34 F.3d at 792.
85. Id. On June 19, 1995, the Supreme Court granted certiorari in Schmitz and vacated and remanded the Ninth Circuit's opinion for further consideration in light of Schleier. 115 S. Ct. 2573 (1995).
The court found that the liquidated damages were not solely punitive and that the damages did bear a relation to the underlying personal injury in that they must equal the plaintiff’s total pecuniary loss. Thus, in contrast to the Seventh Circuit in Downey, the Ninth Circuit affirmed the Tax Court’s decision.

In Schleier, the taxpayer's ADEA case had been consolidated with the class action against United Airlines. Like Mr. Schmitz, Mr. Schleier had received back pay and liquidated damages. He too had reported the back pay as income but did not report the liquidated damages. The IRS asserted that the liquidated damages were improperly excluded from Mr. Schleier’s income and assessed a deficiency. He contested the deficiency, and claimed an overpayment for the amount he had paid with respect to the back pay portion of the award. The Tax Court deferred Schleier pending its disposition of Downey. Following Downey, the court entered an order that the taxpayer was entitled to a refund, but did not publish the opinion. The Court of Appeals for the Fifth Circuit affirmed the Tax Court’s decision in Schleier in a brief, unpublished, per curiam opinion. In that opinion, the Fifth Circuit relied entirely on its decision in Purcell v. Seguin State Bank and Trust Co., which allowed exclusion of ADEA damage awards under the reasoning of the Tax Court’s post-Burke decision in Downey.


Responding to the split in the circuits, the United States Supreme Court granted certiorari in Schleier. The Court ruled in favor of the IRS, reversing the Court of Appeals. The Burke test of “tort or tort-type rights” was not the focus of the opinion, although Justice O'Connor argued convincingly in her dissent in Schleier that Burke was intended to be the

86. The court noted that the IRS did not argue that the back pay was not received “on account of” a personal injury. Schmitz, 34 F.3d at 794 n.4.
87. Id. at 795.
88. Id. at 791.
90. Id.
91. Id.
92. 97 T.C. 150 (1991), opinion supplemented by, 100 T.C. 634 (1993), rev’ed, 33 F.3d 836 (7th Cir. 1994).
93. 26 F.3d 1119 (5th Cir. 1994) (per curiam) (unpublished).
94. 999 F.2d 950, 961 (5th Cir. 1993).
95. Id. at 961.
97. Id. at 2162.
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definitive interpretation of the requisite elements for exclusion under section 104(a)(2). She quoted the majority opinion in Burk as illustrating the understanding the majority shared with the entire Court, that "the scope of § 104(a)(2) is defined in terms of traditional tort principles." However, Justice Stevens, writing for a five-Justice majority, created a new hurdle in the statute, focusing on the phrase "on account of," similar to the Ninth Circuit’s approach in Schmitz. Justice Stevens found that the damages considered in Schleier for United’s violation of ADEA were not received "on account of" personal injuries.

In ruling for the IRS, the majority purported to agree with the dissent that the “intangible harms of discrimination” constitute “personal injuries.” However, the Court stated that neither Schleier's sixtieth birthday nor his discharge from United Airlines were “personal injuries or sickness.” The Court held that back pay awarded under ADEA does not actually compensate plaintiffs for the intangible harms of discrimination, but presumably for the discharge, so Mr. Schleier’s damages were not received on account of a personal injury. The Court noted that the amount of back pay is “completely independent of the existence or extent of any personal injury.”

The Court did not hold that back pay is always gross income. Instead, the majority contrasted awards of back pay paid “on account of personal injuries or sickness,” with back pay paid on account of something else, even where the recipient of that back pay suffered personal injuries caused by the payor. The majority’s example was that of an automobile accident involving various injuries to the taxpayer. If the taxpayer settles a resulting lawsuit for $30,000, the entire amount would be excludable under Section 104(a)(2), assuming the taxpayer has not previously deducted the medical expenses. According to the Court, “[t]he medical expenses for injuries arising out of the accident clearly constitute damages received 'on account of personal injuries.'” The portion compensating pain and suffering also constitutes such damages. Finally, the portion paid for back

98. Id. at 2167 (O'Connor, J., dissenting).
99. Id. at 2171.
100. See supra text accompanying note 84.
101. Schleier, 115 S. Ct. at 2162.
102. Id. at 2165 n.6.
103. Id. at 2164.
104. Id. at 2165 n.6.
105. Id. at 2164.
106. Id. at 2163.
107. Id. at 2164.
108. Id.
wages is also "on account of personal injuries" if the taxpayer was out of work as a result of his injuries.\textsuperscript{109} The Court cited a hypothetical in \textit{Threlkeld} where a surgeon, who loses his finger as a result of the tortfeasor's actions, is allowed to exclude any recovery for lost wages because these are special damages paid on account of the injury.\textsuperscript{110} The majority opinion thus seemed to state that damages are awarded "on account of" personal injury only where the damages are awarded for consequences of the personal injury itself. Accordingly, the Supreme Court's two-part test would seem to require looking first at the nature of the claim under \textit{Burke} and then at its consequences under \textit{Schleier}.

Justice O'Connor responded to the majority's hypothetical by arguing that a distinction between wages lost due to a car crash and wages lost due to illegal discrimination is significant only if personal injuries are read to include only tangible injuries, as Justice Scalia did in \textit{Burke}.\textsuperscript{111} In Footnote six, the majority answered the dissent's charge that the Court "assume[d] that the intangible harms of discrimination do not constitute personal injuries,"\textsuperscript{112} stating, "[w]e of course have no doubt that compensation for such harms may be excludable under § 104(a)(2). However, to acknowledge that discrimination may cause intangible harms is not to say that the ADEA compensates for such harms or that any of the damages received were on account of those harms."\textsuperscript{113} It is hard to reconcile these two sentences. Perhaps the majority has left open the door for lower courts to hold that Title VII recoveries are excludable under section 104(a)(2), even though ADEA recoveries are not.

In deciding \textit{Schleier}, Justice Stevens also had to confront Treasury regulation 1.104-1(c), the focus of \textit{Burke}, which seems to allow the exclusion of any damages received through the prosecution of a suit based on tort or tort-type rights.\textsuperscript{114} Justice Stevens argued that the IRS's interpretation of the Treasury regulation had not been consistent, and that the IRS correctly argued in its brief that the regulation was not intended to eliminate the "on account of" requirement of section 104(a)(2).\textsuperscript{115} However, Justice O'Connor countered that for thirty-five years, including in its briefs in \textit{Burke} and in its opening brief in \textit{Schleier}, the IRS consistently interpreted the Treasury

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{109} \textit{Id}.
\item \textsuperscript{110} \textit{Id} (citing \textit{Threlkeld} v. Commissioner, 87 T.C. 1294, 1300 (1986), \textit{aff'd}, 848 F.2d 81 (6th Cir. 1988)).
\item \textsuperscript{111} \textit{Id} at 2167 (O'Connor, J., dissenting).
\item \textsuperscript{112} \textit{Id} at 2165 n.6.
\item \textsuperscript{113} \textit{Id}.
\item \textsuperscript{114} \textit{See supra} text accompanying note 40.
\item \textsuperscript{115} \textit{Schleier}, 115 S. Ct. at 2166 n.7.
\end{itemize}
\end{footnotesize}
regulation as conclusively establishing the requirements under section 104(a)(2). According to Justice O'Connor, only one sentence in the IRS's reply brief expressed the view adopted by the Supreme Court as the basis of its holding. Justice Stevens also chose not to follow Revenue Ruling 93-88, which supported the taxpayer, stating that "interpretive rulings do not have the force and effect of regulations." Instead, Justice Stevens adopted a two-part test from the IRS's brief, similar to that devised by Judge Laro in his dissent in Downey. The claim must be for a "tort-like" personal injury and the damages must be awarded "on account of" that injury.

Perhaps in response to Justice O'Connor's arguments that Burke was meant to be the sole test of excludability under section 104(a)(2), Justice Stevens addressed the Burke issue. The Court held that ADEA fails the Burke test of "tort or tort-type rights" because it provides only back wages, which are economic in nature, and liquidated damages. The Court accepted the IRS's argument that liquidated damages are essentially punitive. The majority found that ADEA does not compensate "any of the other traditional harms associated with personal injury." Presumably the Court was referring to compensatory damages such as medical expenses and damages for pain and suffering. Although in Burke the Court focused on the availability of a broad spectrum of damages, including punitive and compensatory damages, in Schleier, the Court's alternative holding was apparently that punitive-type damages are not sufficient to make a statute "tort-like." Justice O'Connor's position was that "age discrimination inflicts a personal injury." She argued that even after Burke, the damages received under ADEA are "on account of" that injury. In her dissent, Justice O'Connor argued convincingly that ADEA meets the Burke test of

116. Id. at 2171 (O'Connor, J., dissenting).
117. Id.
118. Id. at 2167 n.8 (quoting Davis v. United States, 495 U.S. 472, 484 (1990)).
119. See supra text accompanying notes 69-73.
120. Schleier, 115 S. Ct. at 2167.
121. Id. at 2162. This is perhaps the most troubling aspect of Schleier. If Burke did not consider the "on account of" language because pre-1991 Title VII recoveries failed the "personal injury" prong of § 104(a)(2), why does Schleier need to consider "on account of" if ADEA recoveries also fail the "personal injury" prong? More likely, the shift in focus from "personal injury" to "on account of" reflects the 1995 Court's dissatisfaction with the prior test, which made more employment discrimination awards potentially excludable.
122. Id. at 2161 (citing Trans World Airlines v. Thurston, 469 U.S. 111, 125 (1985)).
123. Id. at 2166.
125. Schleier, 115 S. Ct. at 2167 (O'Connor, J., dissenting).
126. Id.
“tort-like” remedies in that it authorizes a range of damages. She further argued that liquidated damages, if characterized as punitive, support the tort-like characterization because punitive damages can be awarded only in tort. In addition, ADEA authorizes “such legal or equitable relief as will effectuate the purposes” of the Act. Furthermore, ADEA affords a jury trial, something the majority in Burke suggested might affect the analysis.

IV. IMPLICATIONS FOR THE FUTURE

Schleier is troubling in that it holds ADEA awards includable despite Burke. It is difficult to counter Judge Stevens’ argument that the Treasury regulation cannot eliminate a statutory requirement. Much less clear is whether the regulation was meant to establish all of the requirements of section 104(a)(2), and if so, what deference the Court owes the regulation. The question of deference to administrative interpretation, though never easy, is complicated where the agency disavows its prior interpretation. Had the Court been writing on a clean slate, Schleier might make more sense, but instead the Court has added a “consequences” layer to an “origin and character” test.

Schleier incorporates another level of inquiry into any analysis of excludability of employment discrimination damages. Under Burke, the underlying cause of action must be sufficiently “tort-like” to qualify under the Treasury regulation. According to the Court, pre-1991 Title VII recoveries as well as ADEA recoveries fail on that basis. Under Schleier, the focus is on whether the damages were received “on account of . . . personal injuries or sickness.” The majority breathed separate life into the phrase “on account of.” Thus, after Schleier, only where a statute compensates for the specific intangible harms caused by the illegal activity,
not just a wrongful discharge, for example, will recoveries for discharge on the basis of age, race, religion, or gender be excludable.\textsuperscript{135}

_Schleier_, which denied excludability, did not take the next step and specify how excludability would be determined where a plaintiff receives an award under a statute allowing compensatory damages for the intangible harms of employment discrimination. For example, after the 1991 amendments, Title VII offers a wide range of possible damages to victims of intentional discrimination, including compensatory damages for “future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses.”\textsuperscript{136} Even though the post-1991 Title VII apparently meets the _Burke_ test,\textsuperscript{137} a plaintiff who recovers only back pay after prosecuting a Title VII claim presumably cannot exclude it because back pay would fail the _Schleier_ test. That is, under _Schleier_, back pay probably is not awarded “on account of” the intangible personal injury caused by prohibited discrimination.\textsuperscript{138}

However, after _Burke_ and _Schleier_, if a post-1991 Title VII plaintiff receives both back pay and compensatory damages for emotional pain and mental anguish, the exclusion question is less clear. Under the _Burke_ characterization of the claim as a whole,\textsuperscript{139} post-1991 Title VII claims should be sufficiently “tort-like.” Under _Schleier_, the damages received on account of economic injuries probably are not “tort-like” because those damages are not received “on account of” a personal injury. The more difficult question is whether the damages received as compensation for the emotional pain and mental anguish of discrimination would be excludable. Under _Schleier_, they seem to be received “on account of” intangible personal injuries.\textsuperscript{140} Although _Burke_ requires characterizing the claim as a whole, it does not seem to prohibit separating damages into excludable and includable portions according to whether or not they meet the _Schleier_ test. Thus, the best answer under the case law may be to allow exclusion of only the personal

\textsuperscript{135} Since _Schleier_, two circuits have reversed lower court decisions in cases involving former United Airlines pilots and held ADEA damages taxable. Bennett v. United States, 76 A.F.T.R.2d ¶ 95-5070 (Fed. Cir. 1995); Estate of Hillelson v. Commissioner, 76 A.F.T.R.2d ¶ 95-5205 (11th Cir. 1995).


\textsuperscript{137} See _Burke_, 504 U.S. at 241 n.12.

\textsuperscript{138} See _Schleier_, 115 S. Ct. at 2166-67.

\textsuperscript{139} See _Burke_, 504 U.S. at 237 n.7 (noting that appropriate inquiry involves the nature of the claim underlying the award, not solely the availability of various types of awards).

\textsuperscript{140} Perhaps this is the meaning of Footnote 6 in _Schleier_. See text accompanying notes 112-13.
injury portion of the recovery received under a statute that passes the *Burke* test.

Another interesting implication of *Schleier* is that it may have indirectly resolved an issue regarding the excludability of punitive damages. A 1989 amendment to section 104(a) provides that paragraph (2) is inapplicable to punitive damages received after July 10, 1989 "in connection with a case not involving physical injury or physical sickness." It is unclear whether this means that punitive damages are excludable in cases that do involve physical injury or sickness. In *Schleier*, the Court analogized liquidated damages to punitive damages and held that they were not paid "on account of" the intangible personal injury to Mr. Schleier. If that is the case, it would seem that even in a physical injury case, punitive damages are not paid "on account of" that injury. The Court may not have intended this conclusion but it seems implicit in the Court’s reasoning.

V. CONCLUSION

*Schleier* is a somewhat surprising decision, particularly after the Court’s recent decision in *Burke*, which seemed to limit the test under section 104(a)(2) to the “tort-like” nature of the cause of action, based on its remedies. The *Schleier* majority distinguishes *Burke* on the ground that it only interpreted the phrase “damages received” and applied the Treasury regulation. However, Justice O’Connor points out the broad language in


144. *Cf.* *O’Gilvie*, 66 F.3d at 1557 (noting that *Schleier* made it clear that *Horton*, which found punitive damages excludable, misconstrued *Burke* as holding that § 104(a)(2) requires only a “tort-like” injury).

Burke that appeared to resolve all of the elements necessary for exclusion under section 104(a)(2), not just one of several conditions.\footnote{146} The result in Schleier is understandable, even defensible. If employment discrimination inflicts an injury that is primarily economic, tax policy counsels inclusion of the damages. However, Schleier does not sit well with Burke, and the rationale of Schleier is troubling. Justice Stevens’ majority opinion in Schleier seems to go through contortions in order to reach a conclusion that does not directly overrule Burke. In addition, Schleier reflects the Court’s unwillingness to pay deference to the IRS’s longstanding interpretation of a statute, at least when the IRS argues for a different approach.\footnote{147}

In the post-Glenshaw Glass world,\footnote{148} it is hard to rationalize section 104(a)(2). Congress’ original intent probably was to limit the exclusion to physical or mental health injuries, as Justice Scalia explained in his concurrence in Burke.\footnote{149} However, Congress rejected a bill in 1989 that would have so limited section 104(a)(2).\footnote{150} If the courts extend section 104(a)(2) to nonphysical injuries such as libel, there seems to be no compelling reason to exclude employment discrimination damages from its coverage.\footnote{151}

The application of section 104(a)(2) to employment discrimination damages received with respect to cases under statutes other than ADEA and pre-1991 Title VII remains unclear. Schleier has created doubt regarding the excludability of employment discrimination recoveries under a statute

\footnote{146. Id. at 2171 (O’Connor, J., concurring).}

\footnote{147. Similarly, in Commissioner v. Lundy, the Supreme Court gave no weight to the taxpayer’s argument that the IRS had receded from a generous approach in interpreting a statute. 116 S. Ct 647 (1996); see also Respondent’s Brief in Lundy, LEXIS 95 TNT 190-52, (Sept. 28, 1995); cf. Lawrence Zelenak, Should Courts Require the Internal Revenue Service to Be Consistent?, 40 Tax L. Rev. 411, 417 (1985) (“if the court believed the proper interpretation of the law was that advanced by the Service in the present litigation, and that the Service’s precedents and the position of the taxpayer were wrong, then, the court could enforce a duty of consistency only at the cost of not following its interpretation of the Code”).}

\footnote{148. See supra text accompanying notes 15-17.}

\footnote{149. Burke, 504 U.S. at 243-44 (Scalia, J., concurring). Congress lent some implicit support for the conclusion that § 104(a)(2) applies to nonphysical injuries when it amended § 104 in 1989 to provide that § 104(a)(2) is inapplicable to punitive damages received after July 10, 1989 “in connection with a case not involving physical injury or physical sickness.” I.R.C. § 104(a)(2) (1989). Presumably, Congress would have rendered § 104(a)(2) applicable to all damages for nonphysical injuries, not just punitive damages, had it so desired. However, the bill appears to reflect a compromise between the House bill, which would have limited the scope of § 104(a)(2) to physical injuries, and the Senate bill, which contained no provision. See Cochran, supra note 8, at 53-54.}

\footnote{150. See supra note 149.}

\footnote{151. See supra text accompanying notes 22-24.}
providing a broad range of damages, like post-1991 Title VII. The worst possible situation is confusion because knowledge of the tax treatment of damages may affect settlement negotiations.\(^{152}\)

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152. See *supra* note 2 and accompanying text.

Perhaps in response to this uncertainty, on September 19, 1995, the House Ways and Means Committee approved the Revenue Reconciliation Bill of 1995. See *Revenue Reconciliation Bill of 1995*, 82 *STANDARD FEDERAL TAX REPORTS* 44 (2d extra ed. Oct. 2, 1995). The Revenue Reconciliation Bill included provisions providing that all punitive damages paid as a result of personal injuries would be taxable. See H.R. 2517, 104th Cong., 1st Sess. Title XIII, § 13611 (1995) (The Revenue Reconciliation Bill text was included as Title 13 of the Seven Year Balanced Budget Reconciliation Act of 1995 in House Bill 2517.). Other personal injury damages would be excludable only if received on account of physical injury or physical sickness. *Id.* These changes would have been effective for amounts received after 1995, subject to a transitional rule for agreements, court decrees or awards in effect on September 13, 1995. *Id.* If these changes were enacted, they would resolve the Schleier confusion, but only prospectively. However, the Revenue Reconciliation Bill was included in the Omnibus Budget Reconciliation Act of 1995, which was vetoed by President Clinton on December 6, 1995. See H.R. 2491, 104th Cong., 1st Sess. (1995).