

Tax Notes

Viewpoint

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IRS REVISITS TREATMENT OF GENDER AND RACE
DISCRIMINATION RECOVERIES.

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After a controversy that raged in the courts for many years, the IRS finally issued a public ruling in late 1993 that recoveries for gender and racial discrimination were excludable from income as personal injury damages. Revenue Ruling 93-88, 1993-2 C.B. 61. Revenue Ruling 93-88 dealt only with gender and racial discrimination, and recoveries under the Americans with Disabilities Act (ADA). The IRS chose to fight on in its campaign that recoveries for age discrimination under the Age Discrimination in Employment Act (ADEA) were taxable.

The Supreme Court in *Schleier v. Commissioner*, Docket No. 94-500 (June 14, 1995), ruled that a recovery under the ADEA constitutes taxable income. Perhaps more ominously, the Supreme Court seemed to cut back dramatically on its 1992 opinion in *Burke*. In *Schleier*, the Court agreed with the IRS that section 104 could operate to exclude a recovery from income only where it is both: (1) received through prosecution or settlement of an action based on tort or tort-type rights; and (2) received on account of personal injuries or sickness. The Court concluded that neither of these two requirements was satisfied in the case of an ADEA recovery.

Setting the stage for the IRS to revisit its conclusion in Revenue Ruling 93-88 that recoveries for gender and racial discrimination are tax-free, the Supreme Court in *Schleier* commented in a footnote that Revenue Ruling 93-88 was premised on the same reading of the *Burke* case that the taxpayer in *Schleier* urged on the Court. The Court then stated that while Revenue Ruling 93-88 was not before it, IRS interpretive rulings cannot be used to overturn the plain language of a statute. This seemingly gratuitous footnote certainly played a large part in what happened next in the drama -- the IRS's release of Notice 95-45.

IRS Suspends Revenue Ruling 93-88

Given the Supreme Court's conclusion in the *Schleier* case, it is hardly surprising that the IRS decided that maybe it had given up too soon on the tax status of age and gender recoveries. Revenue Ruling 93-88 was a published ruling on which taxpayers could rely, stating simply that gender and race recoveries are excludable from income. In Notice 95-45, 1995-34 I.R.B. (August 21, 1995), however, the IRS announced that it has suspended the application of Revenue Ruling 93-88, so you no longer can rely on that published ruling.

What does this mean for plaintiffs in Title VII actions? What does it mean for those in the process of settling a case of this type? What does it mean for those who already settled such a case in reliance on Revenue Ruling 93-88? What does it mean for employers who in reliance on Revenue Ruling 93-88 did not withhold (and agreed not to issue a Form 1099) as a result of a race or gender settlement?

To most of these questions, neither I nor the IRS have complete answers.

The IRS's suspension of Revenue Ruling 93-88 is clear enough. You cannot rely on that ruling anymore. But that does not mean such recoveries are taxable. Notice 95-45 explicitly requests comments regarding *Schleier*'s impact on the following:

1. the treatment of recoveries, including those arising under Title VII for gender and race discrimination, and recoveries under the ADA;
2. the allocation of the excludable and nonexcludable

portions of lump sum awards and settlements; and

3. the extent to which section 7805(b) relief should be granted in the event that guidance previously issued by the IRS is modified.

As to the third item, the Service seeks comments on whether it will be appropriate for the IRS to change the rules (perhaps specifying that Title VII gender and race recoveries are now fully taxable) retroactively. Most people are likely to scream loud and clear that after the publication of Revenue Ruling 93-88, which was at least foreshadowed by the Supreme Court in its Burke decision, it would be wholly inappropriate for the IRS to apply this result retroactively. Cynical readers might [p. 1650] assume that any mention of retroactivity would make it a foregone conclusion that the IRS will come out saying Title VII (and potentially ADA) recoveries are taxable. However, the author of Notice 95-45 states that it is not yet clear.

Substantive Comments

The IRS asks for views on two other issues. As to the first comment topic, the Service seems genuinely to be looking for guidance as to whether, in light of Schleier, gender, race, and ADA recoveries ought still to be excludable. Certainly the IRS may be predisposed to view these elements as taxable now. Indeed, the rather brief text of Notice 95-45 does not fail to note specifically that the Supreme Court in Schleier set up a two-tiered test for what must occur for a recovery to be excludable. It is worth mentioning that two-tiered requirement: (1) the recovery must be based on tort or tort-type rights; and (2) it must be received on account of personal injuries or sickness.

Only a couple of years ago when Burke was decided, and even more recently when Revenue Ruling 93-88 was released, many IRS personnel were saying that they perceived distinct differences between the language of Title VII and the language of the ADEA. That accounts for the Service ruling in Revenue Ruling 93-88 that Title VII recoveries were excludable, but still arguing that ADEA recoveries are taxable. Now that the IRS has won on the ADEA issue, it seems a relatively safe bet that some IRS personnel will no longer see such dramatic differences between Title VII and ADEA recoveries. At least the IRS is soliciting views, and comments should certainly be submitted by tax professionals and taxpayers who are affected by these rules. However, the 1991 amendments to Title VII still provide the grounds for distinguishing Title VII and ADEA claims, with the former including more compensatory elements that the IRS would at least have to recognize.

The second item on which comments are solicited by the Service, "Schleier's impact on the allocation of the excludable and nonexcludable portions of lump-sum awards and settlements," is a bit puzzling. Taxpayers have considerable incentive when settling a case to determine what portion of a recovery can properly be allocated to taxable claims and what portion to nontaxable. If the IRS is asking for which portions of a Title VII or ADA claim should be taxable or nontaxable (presumably based on some notion of liquidated vs. actual damages), that would seem to be unhelpful. If the IRS is asking for some discussion of how one allocates between ADEA, Title VII, ADA, and other claims (wrongful termination, defamation, intentional infliction of emotional distress, etc.), then that would seem to go far beyond the scope of Revenue Ruling 93-88 or the decision in Schleier.

Yet at least from my discussions with the IRS, this is indeed what the Service wants to explore. The IRS is understandably concerned that the courts have gone various ways in determining what portion of an award should be attributed to such items as emotional distress. One IRS source specifically mentioned the McKay case to me. *Bill E. McKay, Jr. et ux. v. Commissioner*, 102 T.C. 16, 94 TNT 60-9 (1994), appeal docketed No. 94-41189 (5th Cir., Nov. 14, 1994). McKay had objected to his employer's illegal activities, and was terminated. In a suit for wrongful termination, breach of contract, RICO violations, and punitive damages, he was awarded \$1.6 million for lost compensation and \$12.8 million for future damages. The RICO statute resulted in trebling of damages to more than \$43 million.

However, after this jury award, McKay settled for \$16,744,300. The settlement agreement allocated \$12.25 million to the tort claim for wrongful discharge, \$2.04 million to the breach of contract claim, and \$2.45 million was allocated as a reimbursement of previously deducted legal expenses. The settlement agreement expressly stated that no amount was allocable to the RICO claim.

In the Tax Court, McKay argued that only the \$2.04 million allocated to the breach of contract claim and the \$2.45 million received as reimbursement of previously deducted legal fees constituted income. The Tax Court agreed, noting that the most important factor in determining whether a payment was made as a result of tortious personal injury was the express language of a settlement agreement. The court noted that express allocations in such agreements must be negotiated at arm's length between adverse parties to be respected by the courts. The IRS has appealed the McKay decision.

There are many other cases, of course, in which allocations and settlement agreements have been scrutinized. Exactly what kind of comment the IRS is soliciting here is not clear.

Conclusion

Ultimately, as comments trickle into the IRS regarding Notice 95-45 and the suspension of Revenue Ruling 93-88, most are probably going to focus on retroactivity (the IRS's third request). The comment period ends September 30, 1995. Written comments should be sent to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (IA-Branch 2), Room 5228, Washington, DC 20044.

In the meantime, practitioners and taxpayers should probably start getting used to the notion that gender and race recoveries (and potentially recoveries under the ADA, too) may now (again) be viewed as taxable by the IRS. This may invite yet further litigation between taxpayers and the IRS, since at least some taxpayers will probably not agree. If I am right that this course now seems set, I would not at all be surprised to find yet another Supreme Court case some years down the road in this continually developing field.

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