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Tax Notes

Viewpoint

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NEW LAW RADICALLY CHANGES TAX RULES IN EMPLOYMENT LITIGATION.

Most employment lawyers are aware that a controversy has raged over the last few years regarding the tax treatment of various employment-related claims. In 1992, the Supreme Court decided Commissioner v. Burke, 112 S.Ct. 1867, 92 TNT 110-1 (U.S. 1992), holding that Title VII gender and race recoveries were taxable. However, the Supreme Court strongly implied that under the post-1991 version of Title VII, the result would be different. Following that implication, the IRS issued Revenue Ruling 93-88, 93 TNT 257-12, ruling that gender and race recoveries under the post-1991 version of Title VII are tax-free. The IRS applied the same result to recoveries under the Americans With Disabilities Act.

Only three years later, in 1995, the Supreme Court again addressed the scope of section 104. This time it ruled that recoveries for age discrimination under the Age Discrimination in Employment Act (ADEA) were taxable. With this major victory, the IRS then suspended Revenue Ruling 93-88. The IRS has not yet released revised guidance. That means no one is quite sure whether Title VII gender and race recoveries are taxable now or not, as the IRS has simply not spoken since it suspended its previously favorable Revenue Ruling 93-88.

STATE LAW CLAIMS

Since a majority of employment claims seem to be brought under state rather than federal law, the tax treatment of state law claims is arguably of much greater significance to most attorneys and their clients than the tax treatment of federal claims. To some extent, the question of how age, race, gender, and wrongful termination claims fare under state law has been a function of the particular state law provisions themselves. Historically, the Supreme Court and the lower courts have advocated an approach that emphasizes whether a cause of action is based on "tort or tort-type rights" in determining whether a recovery is excludable from the recipient's income under section 104.

After the Supreme Court's decision in Commissioner v. Schleier, 115 S.Ct. 2159, 95 TNT 116-8 (June 14, 1995), the rules of the game may have changed. In ruling that ADEA recoveries under federal law are taxable, the Schleier Court determined that for an amount to be excludable under section 104, two requirements must be met. The first requirement is that a personal tort or tort-like cause of action must exist. This requirement would seem to be easily met in the case of many state law wrongful termination or discrimination claims. For example, claims under the California Fair Employment and Housing Practices Act can carry extensive remedies, so can arguably be treated as tort claims for this purpose.

The second requirement that must be met for a recovery to be excludable under this Schleier standard is some link or connection between the wrong committed by the defendant and the damages received by the plaintiff. If the recovery is prompted by some physical injury or physical sickness on the part of the injured party, and the injury or sickness has resulted from the bad conduct of the defendant, then the requirements of section 104 would seem to be easily met. The question is what treatment should apply when there is no evidence of physical injury or physical sickness, and the harm is merely emotional. Even if a state law claim qualifies as a tort claim, should the damages (based on pay rates, etc.) all be excludable?

The case law regarding wrongful termination recoveries has been spotty. There were a number of early cases indicating that wrongful termination recoveries were tort-like, and thus excludable from the recipient's income. See Redfield v. Insurance Company of North America, 940 F.2d 542, 91 TNT 172-12 (9th Cir. 1991). Even after Schleier, there has still been some authority supporting the excludability of such recoveries. For example, in Johnny L. Banks, et ux. v. U.S., No. 95-35045, Doc 96-11602 (7 pages) (9th Cir., April 16, 1996), a taxpayer received a settlement arising out of his firing as a mill worker at Bethlehem Steel Corp. He got into a fight with a co-worker. Bethlehem Steel had [P. 1046] a policy against fighting, and therefore suspended the taxpayer. A union representative in a grievance action negotiated a settlement in which the individual received $3,000 from the company and would voluntarily quit. Mr. Banks objected to this settlement, and sued the company and the union.

The court ruled against Banks. The Ninth Circuit Court of Appeals reversed in part, holding that the trial court had improperly granted the union's summary judgment motion on Banks' breach of fair representation claims. The court also reinstated his unjust discharge claim. There was a trial on remand, and the district court ruled that Banks suffered damages of $134,500, for past and future wages. Before judgment was entered, however, the parties settled. Bethlehem Steel made a payment on Banks' wrongful discharge claim, and the union made a payment on the claim for breach of the duty of fair representation.

Mr. Banks and his wife reported the amount received from Bethlehem Steel on their 1990 return, but excluded the amount received from the union. The IRS determined that the settlement payment from the union was taxable. Mr. Banks paid the deficiency but then sued for a refund.

The Ninth Circuit Court of Appeals considered the guidelines established in the Schleier case, but rejected the IRS's contention that Schleier dictated that the payment was taxable. In fact, the court looked to the nature of the injuries compensated, and held that the damages from the union were nontaxable. Interestingly, the Ninth Circuit was able to rely on the fact that unions do not pay wages to their members. This helped the court conclude that the settlement from the union could not be wages.

Such favorable case law has prompted many lawyers and their clients, and many tax advisors, to engage in tax planning at settlement time. However, the case law has now been interrupted with the passage of new legislation.

NEW LAW TAXES MOST RECOVERIES

It has long bothered the IRS that courts have found such recoveries to be excludable. The damages received in these cases generally consist at least to some extent of back pay and other awards intended to compensate the claimant for lost wages or lost profits. Although there has been a huge cutback in such favorable cases in light of the Supreme Court decision in Schleier, the Internal Revenue Service was still concerned that a bigger change was needed.

Consequently, the Small Business Job Protection Act (H.R. 3448) just passed by Congress tightens up two areas. The act provides that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Current law (before the act) was confused, and a U.S. Supreme Court case to clarify it is still pending. The new act does contain an interface with that law, stating that current law continues to apply to punitive damages received in a wrongful death action if the applicable state law (as in effect on September 13, 1995, without regard to subsequent modification) provides (or has been construed to provide in a court decision issued on or before such date), that only punitive damages may be awarded in a wrongful death action.

EMOTIONAL DISTRESS RECOVERIES

A far broader change in the act restricts the scope of section 104 to physical (as opposed to merely personal) injuries. Now, the exclusion from income applies only to damages received on account of a personal physical injury or physical sickness. The operative word here is physical. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) flowing from the injury are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party.

For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of the individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.

Of particular relevance to employment lawyers is the fact that the new law singles out emotional distress damages. The act provides that emotional distress is not considered a physical injury or physical sickness. Furthermore, a footnote in the Conference Committee Report states that the term "emotional distress" includes physical symptoms (e.g., insomnia, headaches, stomach disorders) that may result from such emotional distress. Thus, says the Conference Report, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Conversely, emotional distress damages arising out of a physical injury can still be excluded. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to physical injury or physical sickness.

The provisions generally are effective with respect to amounts received after the date this new law was enacted. The provisions do not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995. More about this effective date below.

WHAT NOW?

It will be a vastly different world for litigants after the effective date of this law. There was a collective sigh of relief among many employment law practitioners, and many recovering litigants, about effective dates. The House bill had proposed a general effective date of June 30, 1996. Consequently, many persons settling lawsuits in July and the first few days of August did so not knowing whether or not their recoveries would be within the ambit of section 104. Fortunately, the Conference Agreement adopted a prospective effective date.

[P. 1047]

At this writing, Congress has passed the bill, but it has not been signed by the president. The presidential signature is "enactment" for purposes of this rule. Furthermore, a grandfather provision is also of some significance. If an amount is received pursuant to a written binding agreement, court decree, or mediation award that was in effect on (or issued on or before) September 13, 1995, the new law will not apply. Thus, if a plaintiff and defendant settled their case in the early part of 1995 under an agreement calling for three or four annual installments of settlement payments, assuming that settlement agreement is in writing and is binding, the September 13, 1995, date would protect the subsequent payments from being taxed under the new version of section 104, even though those subsequent payments are received after the date of enactment of H.R. 3448.

GETTING PHYSICAL

The larger question, of course, is what all of the focus on the physical (as opposed to merely "personal") injury requirement will really mean. The Conference Committee Report attempts to draw a clear line, reciting the House bill provision and indicating that now an action must have its origin in a physical injury or physical sickness. If it does, then all damages (other than punitive damages) that flow from that physical injury or physical sickness will be treated as excludable -- whether or not the recipient of the damages is the injured party.

The examples used in the Conference Committee Report include damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of that person's spouse. Such damages for loss of consortium will still be excludable. Furthermore, damages (again, excepting punitive damages) received on account of a claim of wrongful death will continue to be excludable, even though the party collecting those damages is obviously not the one who died.

The situation with emotional distress causes of action is less clear. According to the Conference Report, section 104 no longer applies to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation that is accompanied by a claim of emotional distress. On the other hand, the Conference Committee Report recognizes that all damages received on account of physical injury or physical sickness are excludable. Thus, say the conferees, exclusion under section 104 is still appropriate for any damages received that are based on a claim of emotional distress attributable to physical injury or physical sickness.

This would seem to elevate the underlying and initial harm to extreme importance. If there is a personal physical injury, such as a battery, and that battery produces various physical harms as well as emotional distress, exclusion for the entire recovery (except punitives, of course) would seem to be self-evident. There would not only be a physical injury, but also emotional distress being produced by a physical injury.

But what if the defendants' conduct did not involve a physical touching, but did produce physical injury, particularly physical injury caused by intentional infliction of emotional distress? Suppose an act of defamation caused serious physical consequences to the injured party and accompanying emotional distress. Will weight gain, weight loss, bulimia, ulcers, nervous disorders, hives, etc., be considered physical injuries or physical sickness? The precise line between physical and nonphysical is not yet clear. However, a

footnote to the Conference Committee Report does state that "It is intended that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." While this list does not seem exhaustive, it at least will give the Internal Revenue Service fuel concerning the seriousness of the new physical injury or physical sickness requirement. Given the importance of this footnote, it may give new meaning to the old adage about the important law always being in the footnotes.

We should expect these physical vs. nonphysical issues to arise. The IRS, reading the new law, would probably answer that if there has been no physical touching, then despite the admitted physical consequences of an action, there will be no exclusion. This seems to place an undue emphasis on the original harm. Indeed, it can be argued that in a suit for defamation, if the resulting injuries include physical consequences (such as some of those mentioned above), then is the origin of the harm the physical consequences that result or is it the defamatory act?

MEDICAL EXPENSES

One of the intended mitigating impacts of the new legislation concerns the reimbursement of medical expenses. The change to section 104 includes an exception to the taxability of emotional distress damages. The taxability of emotional distress damages would not apply to damages which do not exceed the amount paid for medical care (as defined in section 213(d)) that is attributable to the emotional distress. Thus, the exclusion of section 104 would still apply to medical expenses that the plaintiff receives on account of emotional distress, even if there were no physical injuries.

CAUTION

Even if one assumes that the "origin of the claim" notion about physical consequences being required will be an easy standard to apply, I think there will be confusion over this new provision. For example, sexual harassment cases are becoming more and more common today. They are not brought as federal employment discrimination suits, but generally as state law cases focused upon harassment and, indeed, battery. Budding plaintiffs' lawyers will doubtless be even more aggressive in alleging battery, which, in common parlance, is a nonconsensual physical touching. Many sexual harassment cases involve exactly that. True, the big dollar judgments (and often even bigger dollar punitive damages) do not generally come solely from some physical act of touching, but rather from the emotional and psychiatric impact that these touchings may have. There will probably be disputes between litigants and the IRS over these issues.

In contrast, there is now a bright line drawn between actual (or compensatory) damages and punitive damages, ending the long history of litigation over the
[P. 1048]
tax treatment of punitives. The bill now puts to rest this long-litigated line. Punitive damages, even those arising out of a catastrophic injury of a minor in a defective automobile, will now always be taxable. (An exception to this rule would apply to wrongful death actions where only punitives are available under state law as in effect on September 13, 1995). As we all know, punitive damages are by definition designed not to compensate the plaintiff, but to punish the defendant. Thus, this probably is an equitable rule, and it certainly will stop the unfortunate tide of litigation about the tax treatment of punitives.

However, some readjustment by lawyers will probably begin occurring. In my experience -- long before there was clarity over the tax treatment of punitives -- companies saddled with punitive damage awards wished to settle cases (for example, settling on appeal) rather than agree to pay a punitive damage award. In the settlement process, even settling after a jury verdict, the parties might agree that each felt the award was incorrect. A plaintiff who receives $1 million in actual damages and $5 million in punitives, for example, might choose to settle for $2 million rather than fight through the appellate courts. The plaintiff might well argue that the $1 million in actual damages was inadequate.

Likewise, the defendant would almost certainly state that the punitive damages were all wholly inappropriate and unjustified. How should such a $2 million settlement be treated for tax purposes? Without any prompting at all from the plaintiff (motivated by tax considerations or otherwise), the defendant will surely say that it is not paying any punitive damages. How should such a situation be handled? The case law has not been wholly effective in such circumstances.

On the topic of punitive damages, incidentally, it should be remembered that the current change to section 104 (drawing an ostensibly bright line between physical injuries or physical sickness on the one hand and merely personal injuries or sickness on the other) has a close parallel in the law of punitive damages. Way back in 1989, section 104 was amended supposedly to clarify the treatment of punitive damages. In the 1989 amendment, punitives were to be taxable in cases where there was no physical injury. There has been no real attempt to define what this 1989 change meant when it comes to what constitutes a physical injury and what does not. The brief but important footnote in the Conference Report now says insomnia, headaches, and stomach disorders produced by emotional distress aren't physical. But more clarity will be needed.

CONCLUSION

The tax treatment of settlements and judgments has become increasingly important and the stakes increasingly high. From what I see, many employment lawyers and plaintiffs' lawyers of all sorts attempt to know something about these rules and to practice a brand of quasi-tax law. While this has been dangerous in the past, I think it has just become even more dangerous. Handling cases now involves considerable dexterity, particularly at the settlement stage. And the matter for defense counsel is not all that much easier.

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