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SCHLEIER STRIKES TAXPAYERS THREE TIMES.

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In this article, Wood reviews the background of the tax treatment of recoveries under the Age Discrimination in Employment Act, and then focuses on the meaning of the Supreme Court's decision in Schleier. He notes that, far from affecting only ADEA recoveries, the Supreme Court may influence the tax treatment of other types of recoveries beyond the ADEA. According to Wood, the Supreme Court particularly tips its hand with respect to the likely taxability of all punitive damages. Wood concludes that the IRS can be expected to attempt to exploit its victory in Schleier, thus further unsettling the scope of section 104.

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Many employment lawyers, tax lawyers, and accountants have been waiting with bated breath for the Supreme Court to resolve the split in the Circuit Courts concerning the tax treatment of recoveries under the Age Discrimination in Employment Act (ADEA). In mid-June, the High Court handed down its ruling determining that ADEA recoveries are taxable. Many people -- including me -- had predicted that the Supreme Court would go the other way. After all, the majority of Circuit Courts had concluded that ADEA recoveries were nontaxable (only the Seventh Circuit had held to the contrary). Decisions and rulings of the last few years had suggested that a goodly number of statutory claims like those under the ADEA would fit within the personal injury exclusion established by section 104 of the Internal Revenue Code.

Indeed, the Supreme Court itself had suggested in United States v. Burke, 504 U.S. 229, 92 TNT 110-1 (1992), that Title VII recoveries (for gender and race) would probably be excludable. (Technically, the Burke holding was that Title VII recoveries were taxable, based on the version of Title VII in effect prior to significant amendments in 1991, which the Court implied would change the result.) Then the IRS, a short time later in Revenue Ruling 93- 88, 1993-2 C.B. 61, 93 TNT 257-13, seemingly threw in the towel on Title VII claims. The IRS ruled explicitly that recoveries for gender and racial discrimination under Title VII after amendments made in 1991 would not constitute income to recipients. Revenue Ruling 93-88 even indicated that recoveries under the Americans With Disabilities Act are nontaxable. For discussion, see Wood, "IRS Rules Discrimination Awards Are Nontaxable," Tax Notes, Mar. 7, 1994, p. 1317.

Now the Supreme Court has again interpreted section 104, this very brief but awfully important provision of the Internal Revenue Code. This time the [P. 476] Supreme Court did so with dire results for many settling employees and former employees (the bare holding that ADEA recoveries are taxable I'll call Strike One). Plus, the Court's interpretation of section 104 suggests that the case may have adverse implications beyond the ADEA and similar employment claims (Strike Two). In particular, it seems evident that taxpayers who receive punitive damages (even in physical injury cases) may be unlikely to move the Supreme Court that any portion of those punitive damages should be tax-free. This contrasts strikingly with the decisions the U.S. Tax Court has been rendering concerning punitive damages (Strike Three).

I. Strike One

The background of the controversy in Commissioner of Internal Revenue v. Schleier, Docket No. 94-500, 95 TNT 116-8 (U.S. Sup. Ct. June 14, 1995), is fairly straightforward. Back in 1988, Schleier, who was a United Airlines pilot, received a settlement payment because he had been discharged upon reaching age 60 pursuant to United Airlines' policy. Pilot Schleier included one-half, of the settlement award (which had been designated as back pay) but did not report as income the other half which had been designated as liquidated damages. The IRS issued a deficiency notice and the matter wound up in Tax Court. The Tax Court determined that not only was the liquidated damages half of the settlement excludable from Schleier's income, but the other half (denominated as back pay) was also excludable. The Court of Appeals for the Fifth Circuit affirmed (see Schleier v. Commissioner, No. 93-5555, 94 TNT 135-14 (5th Cir. June 21, 1994)).

If all this seems odd, a brief history of ADEA recoveries is in order. For many years now, most courts have held that ADEA recoveries are excludable from income. In 1989, the Third Circuit Court of Appeals concluded that ADEA recoveries were excludable. See Byrne v. Commissioner, 883 F.2d 211, 89 TNT 179-5 (3d Cir. 1989). After a string of lower court decisions, in 1990, the Third and Sixth Circuit Courts of Appeal held ADEA recoveries were excludable. See Rickel v. Commissioner, 900 F.2d 655, 90 TNT 80-36 (3d Cir. 1990); and Pistillo v. Commissioner, 912 F.2d 145, 90 TNT 179-7 (6th Cir. 1990). Then the Ninth Circuit agreed in 1991. See Redfield v. Insurance Company of North America, 940 F.2d 542, 91 TNT 172-12 (9th Cir. 1991).

This string of federal appeals court decisions is all the more striking because virtually all of the lower courts confronting the issue (even in other circuits) were holding that ADEA recoveries were excludable. There were a few exceptions, but they were generally viewed as aberrations.

Finally, a conflict in the circuits developed when, on the same day -- August 30, 1994 -- the Seventh and Ninth Circuits reached opposite conclusions. The Seventh Circuit in Downey v. Commissioner, 33 F.3d 836, 94 TNT 176-8 (7th Cir. 1994), concluded that ADEA recoveries were taxable. The Ninth Circuit in Schmitz v. Commissioner, 34 F.2d 790, 94 TNT 178-17 (9th Cir. 1994), reconfirmed its earlier view in Redfield that ADEA recoveries were excludable. Indeed, Downey and Schmitz both involved settlement awards made to United Airlines pilots. With the conflict between the circuits, the Supreme Court granted certiorari in the Schleier case.

A. Strict View

In the Schleier case, the Supreme Court predictably went through the sweeping definition of income contained in the Internal Revenue Code. The Court acknowledged that damages for medical expenses, lost wages, and pain and suffering received on account of an automobile accident were excludable. The Court noted that each element of damages from an auto accident recovery would be received not merely as a tort settlement, but because it was "on account of personal injuries or sickness."

An ADEA recovery, on the other hand, was a different thing in the Court's view. Recovery of back wages could at first glance be considered comparable to the auto accident victim's recovery of lost wages. However, the Court said that this did not satisfy the critical statutory requirement of being "on account of personal injury or sickness." Said the Court, "[w]hether one treats respondent's attaining the age of 60 or his being laid off on account of his age as the proximate cause of respondent's loss of income, neither the birthdate nor the discharge can fairly be described as a 'personal injury' or 'sickness.'" Schleier, Opinion at page 7.

In the automobile case, said the Supreme Court, an accident causes a personal injury, which in turn causes a loss of wages. With age discrimination, though, the discrimination causes both personal injury and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury.

B. Liquidated Damages, Too

With this first critical conclusion reached in the Court's opinion, it is certainly no surprise that the Supreme Court looked with a jaundiced eye on pilot Schleier's claim that the liquidated portion of his settlement was excludable under section 104. While the taxpayer had eminent authority suggesting that liquidated damages are compensation rather than intended as a penalty, the Court found support for the notion that Congress had not intended the "liquidated damages" portion of ADEA recoveries to be compensatory. Indeed, in earlier (nontax) decisions, the Supreme Court effectively ruled that the liquidated damages portion of ADEA recoveries was punitive. See **[P. 477]** Trans World Airlines, Inc. v. Thurston, 469 U.S. 111 (1985); and Lorillard v. Pollard, 434 U.S. 575 (1978). The Court makes this conclusion more explicit in Schleier.

Ultimately, the Supreme 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. Strictly interpreting these requirements, the Court found that neither requirement was satisfied in this case.

C. What About Burke?

The Schleier decision could probably not have been decided by the Supreme Court without at least some discussion of its prior decision in United States v. Burke. The taxpayer in Schleier had argued that Burke compelled the conclusion that the settlement from United Airlines was fully excludable from his income. Although Burke concluded that the gender recovery involved in that case was taxable under the pre-1991 version of Title VII, the decision strongly implied that post-1991 recoveries under that statute would be excludable. Indeed, the IRS shortly thereafter so ruled in Revenue Ruling 93-88. Burke is certainly important for the proposition that "tort or tort-type rights" can include statutory claims. To most eyes other than those possessed by Supreme Court Justices, Title VII recoveries for gender or racial discrimination look quite similar to recoveries for violations of the ADEA.

Nonetheless, the Court distinguished the provisions of the ADEA from the kind of broad remedial scheme it alluded to in the Burke decision. In essence, the Supreme Court said that, like the pre-1991 version of Title VII, the ADEA provides no compensation for any of the other traditional harms associated with personal injury. Monetary remedies under the ADEA are limited to back wages, and liquidated damages -- at least in the ADEA -- are not viewed as compensatory by the Supreme Court.

Perhaps more ominously, the Supreme Court stated in Schleier that the Burke analysis for what constitutes "tort or tort-type rights" is not singular. Recounting the fact that one must first ask whether a recovery involved an action for tort or tort-type rights, the Supreme Court said that this was only the first step, and not a conclusory one. First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is based on tort or tort-type rights. Second, said the Court, the taxpayer must show that the damages were received "on account of personal injuries or sickness." In short, the tort or tort-type rights analysis suggested by Burke may get you only halfway to a finding of excludability.

Where does this leave the Burke decision? Muddled, at least. The Supreme Court in Schleier states that Burke relied on the pre-1991 version of Title VII's failure to qualify as an action based on tort- type rights analysis, concluding that the ADEA provides no compensation for any of the other traditional harms associated with personal injury. The Court thus concludes that even this initial condition to excludability is not met.

In an ominous footnote, the Supreme Court refers to the IRS position announced in Revenue Ruling 93-88. The footnote acknowledges that Revenue Ruling 93-88 is premised on the same reading of Burke that was urged by the taxpayer in Schleier. The Supreme Court noted that Revenue Ruling 93-88 was not before it, but that the Service's interpretive rulings do not have the force and effect of regulations, and may not be used to overturn the plain language of a statute. Does this gratuitous footnote mean that the Court views Revenue Ruling 93- 88 as at odds with the plain language of section 104? In any event, the IRS could hardly ask for a more helpful shove in the direction of revisiting Revenue Ruling 93-88.

II. Strike Two

Particularly given the adverse effect that the Schleier opinion will have on many taxpayers, it may be at least halfway comforting that three Justices dissented. Justice O'Conner wrote a dissenting opinion, and Justices Thomas and Souter joined. The dissenting opinion runs 11 pages (to the majority opinion's 14 pages), but it can be quickly summarized.

The dissent essentially says: Age discrimination inflicts a personal injury. Personal injury damages are excludable from income under section 104(a)(2). The inescapable conclusion from the ADEA statute itself, from the Supreme Court's Burke decision, and from the IRS's own authorities interpreting section 104, is that ADEA recoveries are excludable. The majority of the Court, in effect, is now saying that only tangible harms (like a smack on the face) can be tort recoveries. This, said the three dissenting Justices, is wrong.

As should be apparent from the above discussion, the Schleier case has import well beyond the area of ADEA recoveries. Indeed, after the Burke decision, and the IRS's release of Revenue Ruling 93- 88, one may wonder precisely what the IRS is thinking about doing next. Will it change its position about Title VII recoveries? (I hope this question is rhetorical.) The IRS had been saying that it recognized a clear and demonstrable difference between Title VII recoveries and ADEA recoveries.

Yet the IRS is now armed with a 1995 Supreme Court decision in Schleier that might be seen as substantially undercutting the IRS's admission of nontaxability for Title VII recoveries in Revenue Ruling 93-88. Thus, maybe something will break loose there, too. It has long galled the IRS that any employment-related dispute should result in excludable amounts. After all, if the employee really remained working (instead of suffering the prohibited discrimination of whatever variety), then all of the wages produced by that worker would be taxable (and subject to employment taxes to boot).

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In the wake of Schleier, employees, employment lawyers, and tax professionals will have to get used to a changing landscape that is increasingly hostile to excludability. The apparent two-level requirement to now satisfy section 104 may well be applied to types of injuries well beyond the ADEA context, and indeed well beyond the employment context. Conceivably, in any case in which a taxpayer asserts excludability under section 104(a)(2), the IRS will now assert that two threshold tests must be met: (1) the underlying cause of action giving rise to the recovery must be based on tort or tort- type rights; and (2) the damages must have been received on account of personal injuries or sickness. Whether this standard makes sense to anyone or not, it may not be easy to meet.

III. Strike Three

One of the more insidious effects of the Schleier opinion would appear to be in the context of punitive damages. Although Schleier is not explicitly a punitive damages case, it certainly suggests that the Supreme Court will view favorably the IRS claims that all punitive damages should be taxable. The Supreme Court virtually says as much, because it treats the liquidated portion of ADEA damages as punitive, and then concludes that as punitive damages, such liquidated amounts must be taxable. While Schleier was not a physical injury case (as to which punitives would presumably be evaluated more favorably), the Court seems to lean toward the IRS.

There has been increasing controversy over the past few years concerning the tax treatment of punitive damages. Although the controversy has raged since then, back in 1989 there had already been heated debate culminating in a statutory amendment to section 104 on the topic of punitives. Under a change adopted in the 1989 Omnibus Budget Reconciliation Act, generally effective for punitive damages received after July 10, 1989, the exclusion for personal injury damages does not apply to any punitive damages in connection with a case not involving physical injury or physical sickness. Although this statutory change would seem to draw a line in the sand so that punitive damages in cases involving nonphysical injuries would be taxable, and punitive damages involving physical injuries would be excludable, a controversy about the meaning of this statutory change has raged.

In Jack R. Hawkins, et ux. v. United States, No. 93-15828, 94 TNT 147-8 (9th Cir., July 19, 1994), the Ninth Circuit held that punitive damages received in a personal injury suit were not excludable from the plaintiff's income. Although the District Court had held that the punitive damages were excludable, the Ninth Circuit reversed based on the theory that punitive damages were not intended to compensate for personal injuries but rather merely to punish the defendant. The Ninth Circuit specifically rejected the taxpayer's claim that the 1989 amendment to section 104 should be interpreted as a change in the law. Since the award in question had been made in 1988, thus predating the 1989 statutory change, the court agreed with the IRS that the taxpayer had not shown that the damages were recovered in a tort-like suit and received on account of personal injury. For additional discussion of punitive damages, see Nath, "Damage Awards -- Included or Excluded?" Tax Notes, Sept. 26, 1994, p. 1739; and Ericsson, "The Burke Legacy: Circuits Split Over Taxation of ADEA Liquidated Damages and Personal Injury Punitive Damages," California Tax Lawyer Fall 1994, p. 16.

In Elizabeth A. Reese v. U.S., No. 92-93T, 93 TNT 167-10 (Fed. Cl. July 29, 1993), aff'd 73 AFTR2d par. 94-935, 94 TNT 96-15 (Fed. Cir. 1994), the U.S. Court of Federal Claims and the Federal Circuit also held that a punitive damages award received in the context of a suit for sex discrimination, sexual harassment, intentional infliction of emotional distress, and breach of contract was not excludable. The court found such an exclusion to be at odds with the purpose of section 104, and granted the government's motion for summary judgment. The case also considers the law applicable to the plaintiff's 1987 tax year, before section 104 was amended.

Interestingly, in Talley Industries v. Commissioner, T.C. Memo. 1994-606, 94 TNT 244-9 (1994), the Tax Court suggested that there may be a grey area between damages that are compensatory and those that are punitive. A subsidiary of Talley Industries had been indicted on various counts involving navy contracts, and civil claims were later filed by the government. The civil claims alleged actual losses of approximately $1.6 million, with punitive damages (under a statutory doubling provision) added on top. The company paid $2.5 million pursuant to this asserted liability in exchange for a release of all claims. After the company deducted this $2.5 million payment, the question was whether all of it was compensatory or in effect represented a fine or penalty not deductible under section 162(f).

The IRS treated the amount as nondeductible, but the Tax Court allowed a deduction for the full $2.5 million payment, less only $1,885 that was the navy's actual losses for the 10 incidents with respect to which a guilty plea was entered. Although the court had to admit that the $2.5 million settlement was in excess of the amount originally claimed for "actual compensatory" damages, the court found no evidence in the settlement agreement that any punitive payment or fine was intended. Consequently, the court respected the language of the settlement agreement and implicitly acknowledged that there may be some grey area between a compensatory and punitive (or fine) payment. For discussion, see Manns, "When Does the Payment of Damages Punish the Payor?" Tax Notes, Jan. 9, 1995, p. 276.

At the very least, the Supreme Court has tipped its hand that punitive damages may not be excludable in any circumstance. Still, there are certainly arguments [P. 479] that punitives in true personal injury cases (such as the hypothetical automobile accident case described by the Supreme Court) should be excludable from income. Such a case should eventually reach the Supreme Court.

IV. What To Do in Employment Cases?

Even a cursory review of the holding in Schleier will tell ADEA litigants that they have a problem. No longer will these recoveries be excludable. Whether recoveries for ADEA-like state legislation claims will be excludable remains to be seen. The question may well turn on the type of statute present. The IRS is likely to take a wholesale view of state law, but taxpayers may well have arguments as to the excludability of recoveries for state age discrimination claims notwithstanding the Schleier holding regarding ADEA recoveries. That battle has yet to be fought.

Likewise, uncertainty over other types of claims, such as state law wrongful termination claims, is likely to persist. There has yet been no definitive ruling from either the courts or the IRS on these claims. There continue to be authorities supporting their excludability in certain cases, however. See, e.g., Redfield v. Insurance Company of North America, 940 F.2d 542 (9th Cir. 1991). And, until the IRS suggests otherwise, Title VII gender and sex cases will still produce excludable amounts. Ditto for amounts recovered under the Americans with Disabilities Act. See Revenue Ruling 93-88. Unfortunately, the Supreme Court's footnote in Schleier suggests that the IRS may have reason to revisit Revenue Ruling 93-88.

Another aspect of the Schleier case that should have a significant effect in settlements concerns ancillary claims. A case involving statutory claims, such as for age discrimination, may well also involve common law tort counts, such as for defamation and intentional or negligent infliction of emotional distress. The presence of such other claims will likely become even more important now that age discrimination (at least for federal ADEA claims) is no longer on the plaintiff's preferred tax-free hit list.

What about state law claims for age discrimination (i.e., under the California Fair Employment Practices Act)? The Schleier case does not address such claims, nor has the IRS or court authority adequately addressed the tax treatment of such claims. While most practitioners assumed that the same treatment would apply to such claims as to ADEA recoveries when ADEA recoveries were tax-free, this is unclear now. Of course, Schleier does not bode well for such claims.

Negotiated settlements in the employment termination context (where no lawsuit has ever been filed) will also be profoundly affected by the Schleier case. No longer will the argument exist that the employer's insistence on a departing executive's signature on an ADEA age discrimination release (along with the prominent language now required by the Older Workers Benefit Protection Act that makes it eminently clear that an ADEA claim is being released) constitutes evidence of excludability. This will make all that much more important the presence of other claims that still may be viewed as tort-like. Among other things, it will heighten concern with state law claims and how they will be interpreted.

The Supreme Court has suggested an awfully rigorous standard of excludability under section 104. The IRS can probably be expected to exploit it.

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