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# IRS RULES DISCRIMINATION AWARDS ARE NONTAXABLE.

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This article arises out of Wood's representation of clients involved in settling employment claims and as a consultant to other attorneys. In this article, Wood briefly reviews some of the discrimination authorities and analyzes the Service's conclusion in Revenue Ruling 93-88 that most racial and gender discrimination recoveries are now excludable. Wood suggests, however, that there now may be more impetus in consensual employment terminations to consider allocating payments to nontaxable recoveries, and that this may generate further scrutiny in the area.

Furthermore, Wood points out the nettlesome treatment of age discrimination recoveries, which the IRS still asserts are taxable, a conclusion with which most courts disagree. Wood advocates harmony in this area, but suggests that the current situation can be ameliorated by proper drafting of settlement agreements.

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The taxation of discrimination recoveries has long been muddled. In the 1970s, it seemed clear that recoveries for racial discrimination under Title VII of the Civil Rights Act of 1964 were taxable as wages. [1] In the 1980s and early 1990s, recoveries for gender discrimination under Title VII generally were held nontaxable under section 104 of the Internal Revenue Code, while most courts still tended to hold racial discrimination recoveries taxable. [2] Then, in 1992, the Supreme Court decided Burke, [3] holding that gender discrimination recoveries under Title VII as it existed prior to the Title VII Amendments Act of 1991 [4] were taxable, but strongly implying that recoveries under the amended version of the statute after 1991 would not be taxable.

Given the Service's track record on this and similar issues, it seemed a foregone conclusion that there would be continued litigation on the proper treatment of recoveries throughout (and perhaps beyond) the 1990s. Moreover, during the past few years, there has been an increasing line of decisions concerning age discrimination recoveries under the Age Discrimination in Employment Act (ADEA). These decisions have generally held for excludability. [5]

## I. A New Day?

Happily, on December 20, 1993, the IRS released Revenue Ruling 93-88, [6] in which it determined that damages for intentional discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, are nontaxable. The ruling concludes that recoveries under the Americans With Disabilities Act are similarly excludable. The ruling is significant in that it represents the first determination by the IRS that such amounts [P. 1318] are nontaxable since the IRS's 1992 Supreme Court victory in the Burke case. Indeed, in the wake of

Burke, there had been widespread speculation that the IRS would continue to fight taxpayer assertions of excludability despite the fact that the Supreme Court, in holding a pre-1991 sex discrimination recovery to constitute taxable income, strongly implied that recoveries under the post-1991 version of Title VII would be excludable.

Revenue Ruling 93-88 considers two factual situations, the first involving gender discrimination, and the second involving racial discrimination. In each case, suit was brought under Title VII of the Civil Rights Act of 1964, as amended in 1991. Each plaintiff claimed back pay and compensatory damages for emotional pain and suffering, inconvenience, mental anguish, and other nonpecuniary losses. After a jury trial, each plaintiff was awarded back pay as well as compensatory damages.

The ruling reviews the provisions of the substantive law of Title VII, focusing on the remedial provisions of that law, under which a plaintiff may receive back pay as well as compensatory and punitive damages. Noting that the Supreme Court in Burke focused on the lack of tort-like remedies in Title VII prior to its 1991 amendments, and that in 1991 that law had been amended to provide the full panoply of tort-like remedies, the IRS concluded that amounts recovered as damages under the amended version of Title VII are excludable.

II. Racial Discrimination vs. Gender Discrimination

Curiously, Revenue Ruling 93-88 makes one critical distinction over which practitioners are likely to stumble for some time, that between so-called "disparate treatment" gender discrimination and "disparate impact" gender discrimination. Title VII's prohibition on "disparate treatment" discrimination makes it unlawful for an employer "to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment because of such individual's race, color, religion, sex, or national origin." [7]

The prohibition on "disparate impact" discrimination provides that it is an unlawful employment practice for an employer to classify employees or applicants for employment in any way that would tend to deprive them of employment opportunities or otherwise adversely affect their employment status if the classification (1) is not necessary for business purposes, and (2) tends to discriminate on the basis of race, color, religion, sex, or national origin. [8]

Distinguishing between these two types of prohibited discrimination, the ruling concludes that compensatory damages, including back pay, received in satisfaction of a claim of disparate treatment gender discrimination (under post-1991 Title VII) are excludable -- even if the only damages that are received explicitly constitute back pay. Back pay received by a victim of disparate impact gender discrimination is not excludable, says the ruling.

Yet, the ruling draws no such distinction with respect to racial discrimination. According to Revenue Ruling 93-88, compensatory damages, including back pay, received in satisfaction of a claim of racial discrimination under 42 U.S.C. section 1981 and Title VII of the Civil Rights Act of 1964 are excludable from gross income, even if the only damages received are back pay.

III. Technical Differences

The technical basis for this distinction (perhaps of interest only to real aficionados of the area) is that, based on the number of employees employed by the employer, Title VII limits the sum of compensatory and punitive damages that may be awarded for disparate treatment discrimination. In contrast, no compensatory or punitive damages may be awarded against an employer who engaged only in disparate impact discrimination. (The Burke case, in fact, involved disparate impact gender discrimination, as to which only back pay was awarded.)

The reason racial discrimination is different is also technical. Successful claimants of racial discrimination are eligible to recover damages under section 1981 (42 U.S.C. section 1981), which provides a federal remedy for racial discrimination, including a full range of compensatory and punitive damages. The availability of a full range of tort-like remedies was what the Supreme Court in Burke said was needed for a recovery to be excludable under section 104.

IV. What Now?

Many practitioners (employment lawyers, tax lawyers, and accountants) are justifiably breathing a sigh of relief. After all, the IRS has evidently determined not to litigate the cases many assumed would be litigated after the Burke decision (in fact, cases the IRS has been litigating). For the vast majority of recovering litigants in gender and racial discrimination cases, the IRS position has switched abruptly from one of hostility to one of tacit resignation. Indeed, now even strictly back pay recoveries for racial discrimination, and even strictly back pay recoveries for disparate treatment gender discrimination, will be nontaxable [P. 1319] without a fight with the IRS. That is a startling development.

It also raises several important questions. Since there has always been considerably more flexibility in characterizing the tax nature of recoveries in settlements than in cases that proceed to judgment, it would seem that would be the case here too. Interestingly, in Revenue Ruling 93-88, both the recoveries (for gender and for racial discrimination) proceeded to judgment. If the cases had been resolved by settlement, the same result

would surely apply, but the precise nature of the recovery, particularly for gender discrimination, may not be so clear in a settlement.

Furthermore, one wonders whether the IRS will choose to litigate cases involving the characterization of amounts as compensation for alleged racial or gender discrimination even when no lawsuit has been filed. In the context of many negotiated employment terminations, there may be allegations of gender or racial discrimination. The newly clarified nontaxable status of amounts paid for such claims may cause many practitioners to be more likely to include allocations to such claims in settlement agreements. This seems all the more important in light of the scrutiny to which settlement agreements may be subject.

V. More Scrutiny, Especially of Refund Claims

As a recent example, in Taggi v. United States, [9] the court determined that a release for age discrimination did not produce nontaxable tort damages. The principal reason for this conclusion was the manner of settlement and lack of specificity of claims. Taggi was terminated as part of a reduction in force, and was offered two termination payment plans. One plan called for a larger lump sum payment, but was conditioned on him signing a release for all claims he might have, including age, sex, or racial discrimination.

Taggi took this option and reported the entire $49,500 as income. Nonetheless, he and other employees later sued for age discrimination, but the suit was dismissed on the strength of the release. Taggi then sued for a refund of the taxes paid, arguing that the monies received were for his ADEA claim and therefore were nontaxable.

In upholding the IRS's denial of the refund claims, the court noted the general nature of the release. While it referred to various claims, it was in consideration for Taggi waiving his statutory right to seek compensation for any potential injury. It was not paid for a specific claim. One suspects that the fact Taggi originally reported the income also may have been influential.

Even more obvious is another recent case, John E. Galligan v. Commissioner. [10] Mr. Galligan was a long-term employee of Grumman Corp. Galligan and Grumman executed an agreement regarding termination of his employment in 1986 that called for him to receive salary plus benefits for one year in exchange for a release of claims. Under the agreement, Galligan was then to receive $30,000 per year for five years. During this period, Galligan was not obligated to perform services for Grumman, but was required to provide information concerning his prior services.

Galligan received and reported as income the one-year severance, and received the first two $30,000 payments in 1987 and 1988, including these in his income. Then, in 1988, Galligan and Grumman agreed to accelerate the three remaining $30,000 payments into a single, discounted lump sum of $76,500. Galligan did not report this as income and the matter wound up in Tax Court. Galligan originally argued that the lump sum was the tax-free proceeds of a loan(!), but eventually found himself arguing that the amount was in settlement of personal injury claims.

Predictably, the Tax Court concluded that Galligan had failed to prove that the company settled his claim for damages on account of personal injury. The court found that Grumman intended to reward Galligan for his years of service rather than to settle a personal injury claim. To be sure, the Galligan case is predictable, given that the personal injury claim was evidently an afterthought, and clearly was inconsistent with the prior conduct of the taxpayer in reporting the earlier installment amounts. This case should be contrasted with one in which there is real evidence of personal injury claims, whether they be for alleged racial, gender, or age discrimination, wrongful termination, defamation, emotional distress, or what have you.

If a settlement agreement acknowledges that there is alleged racial and/or gender discrimination, even though (as settlement agreements always do) the document denies any wrongdoing on the part of the payor, will the IRS accept this characterization? Obviously, there needs to be an underlying claim, but it is axiomatic that one looks to the underlying nature of the claim whether or not a lawsuit has been filed. [11] Nevertheless, it seems conceivable that a greater level of scrutiny will now apply in this area precisely because of the increased clarity of the treatment of such amounts, at least if more taxpayers now find themselves claiming all or a portion of a recovery as excludable.

VI. What About Age Discrimination Claims?

Even more poignant is the question of what treatment age discrimination recoveries will receive in the future. The IRS has continued to litigate the tax treatment of recoveries under the federal ADEA. In Redfield [P. 1320] v. Insurance Company of North America, [12] Rickel v. Commissioner, [13] and Pistillo v. Commissioner, [14] the courts concluded that ADEA recoveries were tort-like and therefore nontaxable. Even after Burke, the Tax Court recently confirmed the nontaxable treatment of ADEA recoveries in Downey v. Commissioner. [15]

However, the IRS has continued to litigate these claims. Indeed, the IRS recently won a case in a district court in Florida. [16] The fact that the IRS persuaded a district court to reach a conclusion contrary to all these other

cases suggests that the IRS will continue its litigating position. The Taggi case, discussed above, suggests likewise. In fact, it is curious that Revenue Ruling 93-88 makes no statement at all about the age discrimination law, but does note at the end of the ruling -- with no explanation -- that "[s]imilar results will apply to amounts received under the Americans With Disabilities Act."

Confirming the implications of Revenue Ruling 93-88's silence on ADEA recoveries, the ruling's author, Patrick Kirwin of the Office of Assistant Chief Counsel (Income Tax and Accounting) has confirmed that the Service intends to keep fighting the tax treatment of ADEA recoveries. The asserted reason is the Service's view, in the terminology of Burke, that there really is a difference between the remedial provisions of the ADEA and post-1991 Title VII.

This perceived distinction may depend on the eyes of the beholder. Indeed, most courts have not found the distinction advocated by the Service. The Florida District Court in Maleszewski v. United States [17] found it, but that hardly seems persuasive authority compared with the many courts, including the Tax Court in a post-Burke reviewed decision, [18] that have flatly held ADEA recoveries excludable.

Moreover, the General Counsel of the EEOC issued guidance earlier in 1993 on ADEA recoveries, opining that they were tort-like and should not be taxable. After some apparent prodding from the IRS, the EEOC indicated that such recoveries should be taxable. [19] This is unfortunate and seems misguided.

Another recent example of authority for the conclusion that ADEA recoveries are exludable is Walker B. Fite, et ux. v. Commissioner, [20] in which a taxpayer received $270,000 for age discrimination under the ADEA after a jury trial. The taxpayer was separately awarded $114,000 for attorneys' fees and costs (after the employer's unsuccessful appeal). The taxpayer reported one-half the $270,000 award as gross income and excluded the remainder as a section 104 recovery. The taxpayer included in income the entire attorneys' fee award, but claimed a miscellaneous itemized deduction for $87,000.

Later, the taxpayer filed an amended return seeking a refund of all taxes paid, on the theory that the entire award should be excluded under section 104. The IRS determined that the entire damage award (not merely one-half) and the entire amount of attorneys' fees and costs constituted taxable income. The Tax Court granted the taxpayer's motion for summary judgment, treating it as a settled question of law that damages received for violations under the ADEA are excludable under section 104.

Even more recently, in Bennet v. United States, [21] payments for back pay and liquidated damages in settlement of ADEA claims were held excludable in the U.S. Court of Federal Claims. Former United Airlines pilots who were required to retire at age 60 had filed a class action against United in 1979. The complaint requested back pay, liquidated damages, reinstatement, an injunction preventing the airline from enforcing its mandatory retirement policy, and costs and fees. The jury awarded back pay and liquidated damages, but the judgment was reversed and a settlement was reached during the second trial.

Under the settlement, United paid each plaintiff back pay and liquidated damages in equal amounts. The plaintiffs paid tax on their entire awards and later filed refund claims. The Service refunded the taxes paid on the liquidated damages, but denied the claims with respect to the back pay.

In the subsequent refund suit, the court granted summary judgment in favor of the plaintiffs, ruling that the back pay portion of the award was also excludable. Echoing the Tax Court, the Court of Federal Claims found the ADEA to provide a panoply of tort-like remedies.

In the face of these authorities concerning ADEA recoveries, practitioners may well wonder what the Service's next move will be. Capitulation would be nice, but I am told this is not in the offing.

VII. Conclusion

Notwithstanding these nagging issues, Revenue Ruling 93-88 is a most welcome development. Apart from laying to rest the tax treatment of several types of cases, it suggests new planning avenues in at least some nonlitigated employment terminations where there are underlying vestiges of discrimination and the settlement document is appropriately drafted.

FOOTNOTES:

[1] See Willie B. Hodge, 64 T.C. 616 (1975).

[2] See Burke v. Commissioner, 929 F2d. 1119 (6th Cir. 1991), rev'd 112 S. Ct. 1867 (1992). Compare Sparrow v. Commissioner, 949 F.2d 434 (D.C. Cir. 1991).

[3] See 112 S. Ct. 1867 (1992).

[4] And presumably racial discrimination recoveries as well.

[5] See Redfield v. Insurance Company of North America, 940 F.2d 542 (9th Cir. 1991); Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990); and Pistillo v. Commissioner, 90-2 U.S.T.C. para. 50,469 (6th Cir. 1990).

[6] 1993-41 I.R.B 4.

[7] 42 U.S.C. section 2000e-2(a)(1).

[8] 42 U.S.C. section 2000e-2(a)(2).

[9] 63 FEP Cases 431 (S.D.N.Y. November 4, 1993).

[10] T.C. Memo 1993-605 (1993).

[11] See, e.g., Maxwell v. Commissioner, 95 T.C. No. 9 (1990).

[12] 940 F.2d 542 (9th Cir. 1991)

[13] 900 F.2d 655 (3d Cir. 1990).

[14] 90-2 U.S.T.C. para. 50,469 (6th Cir. 1990).

[15] 100 T.C. No. 40 (1993).

[16] Maleszewski v. United States, Dkt. No. 92-30309-RV (N.D. Fla. 1993).

[17] Id.

[18] See Downey v. Commissioner, 100 T.C. No. 40(1993).

[19] See "Damages Under Age Bias Act Are Taxable EEOC Counsel Says in Revised Memorandum," DTR (March 4, 1993), p. 11.

[20] T.C. Memo 1993-594 (1993).

[21] No. 92-216T (Ct. Fed. Cl. Jan. 15, 1994).

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