Tax Notes

Viewpoint

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NAVIGATING THE TAX MAZE OF WORKPLACE WINNINGS.

by Robert W. Wood

Robert W. Wood practices law with Robert W. Wood P.C., in San Francisco. He is the author of the book Taxation and Damage Awards and Settlement Payments (copyright 1991 with 1996 Supplement), published by Tax Institute (800-852-5515).

It is not surprising that there continues to be a great deal of confusion over the tax treatment of employment recoveries, despite the several recent "clarifications" made by both Congress and the courts. What is perhaps most frustrating to employment and tax practitioners alike is that the rules have changed so radically and over such a short period of time. Under these circumstances, some kind of timeline seems necessary. Advisors must inform clients whether a recovery they received at a particular time is subject to the old rules, the new rules, or even more recent rules.

Let me begin with a few illustrations of how the date upon which a settlement is binding or payment is made can be critical. Then I'll turn to a flowchart for determining whether a recovery may or may not be excludable.

TITLE VII

We begin with the tax treatment of Title VII claims. After a split in the circuit courts that largely seemed to favor the excludability of Title VII awards for gender and race discrimination, the Supreme Court in its 1992 Burke decision held that recoveries under the pre-1991 version of Title VII were taxable. That decision was retroactive in effect, meaning that Title VII recoveries in prior years (at least ones that were still open by the statute of limitations governing tax returns) were taxable. The Supreme Court, though, implied that a different result might apply to recoveries under Title VII after the 1991 amendments. Following the Burke case, most tax advisors and settling litigants felt there was a good basis for excluding post-November 21, 1991, Title VII recoveries from income (November 21, 1991, was the effective date of the 1991 amendments).

The next big development was Revenue Ruling 93-88, confirming that the IRS drew the line between pre-November 21, 1991, Title VII claims and post-November 21, 1991, Title VII claims. The IRS ruled that the latter variety were not taxable in Revenue Ruling 93-88. With a published ruling, people during this time frame could rely on tax-free treatment for their Title VII recoveries.

Unfortunately, only two years later the IRS suspended Revenue Ruling 93-88 as a result of the Schleier case (which viewed narrowly dealt only with ADEA recoveries). Notice 95-45, which effected this suspension, and the Schleier case are discussed below. However, on December 30, 1996, the IRS finally released Revenue Ruling 96-65, 1996-53 IRB 1, ruling that Title VII recoveries are taxable. The general effective date for the ruling, curiously enough, is June 14, 1995, the date the Supreme Court decided Schleier.

ADEA

There was another split in the circuit courts over an ostensibly different statute, the ADEA. After years of controversy, in 1995 the Supreme Court in Schleier ruled that ADEA recoveries are taxable. Again, this decision was retroactive in effect, being considered an interpretation of prior case law. Thus, even someone who settled an ADEA case before Schleier could expect to face tax on their ADEA recovery (again, if the statute of limitations for that tax year was still open).

As significant as the Schleier holding was that age discrimination recoveries under the ADEA are now taxable, the ancillary effects of the Schleier case were arguably even more important. Promptly after Schleier, the IRS issued Notice 95-45, suspending Revenue Ruling 93-88. Cases that were settled in reliance on Revenue Ruling 93-88 (which had said post-November 21, 1991, Title VII recoveries were nontaxable), were thus thrust into a quagmire of uncertainty. Cases settled after the release of Notice 95-45 were also uncertain, since Notice 95-45 did not say Title VII recoveries were now taxable, but only that Revenue Ruling 93-88's holding of nontaxability no longer applied and that the IRS was studying the matter. During this hiatus, it was clear that reliance on Revenue Ruling 93-88 was no longer appropriate.

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STATE LAW RECOVERIES

Amidst all the hoopla about the tax treatment of Title VII and ADEA claims, there has been at least as much focus by practitioners about state law discrimination and harassment actions. There has been a paucity of guidance from the IRS. After Notice 95-45 suspended Revenue Ruling 93-88, most people were assuming that all Title VII recoveries would ultimately be held taxable, even though at that point the IRS had not yet said so. However, there were still good arguments in many states that state recoveries for discrimination or harassment should be treated differently.

Thus, one must analyze whether there is a state law recovery, even though federal tax treatment of the federal-based claim might be not advantageous. There are still a number of cases involving the tax treatment of state discrimination and state harassment claims working their way through the courts. However, some courts have applied an analysis since the Supreme Court's Schleier decision that focuses on the physical nature of the harm. In any event, this state law area has been dramatically affected by the Small Business Job Protection Act, discussed below.

SMALL BUSINESS JOB PROTECTION ACT

On August 20, 1996, Congress took over this confused playing field and modified section 104 to provide that emotional distress damages are not excludable unless accompanied by a physical injury. The change came in the Small Business Job Protection Act of 1996 (H.R. 3448), a euphemistic name that certainly has nothing to do with this particular change in the law. The wording of the amendment is somewhat ambiguous, as is its scope.

At its core, however, the change is designed to tax most employment-related recoveries and to require that there be a physical injury for any exclusion in this context. At least the effective dates of this change are clear, being generally effective for recoveries received after August 20, 1996.

However, certain settlements are grandfathered. Basically, 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 early 1995 under a binding, written agreement calling for three or four annual settlement payments, the September 13, 1995, date would prevent the subsequent payments from being taxed under the new version of section 104, even though those subsequent payments are received after August 20, 1996.

Quite apart from the physical injury requirement, it should also be noted that even after these effective dates, amounts paid for medical expenses can be excluded from the recipient's income. This is so even if there was no physical injury. Thus, reimbursed psychiatric and counseling costs seem well within the ambit of this medical expense provision under the new law. One question now arising with some frequency is whether the medical expenses must already have been incurred, or might represent an allowance for the costs of future medical treatment.

CLAIMS AFTER AUGUST 20, 1996

For cases that are currently settling (or even that proceed to trial and judgment), the recent learning of the Small Business Job Protection Act takes primary importance compared to the body of case law. Apart from the grandfather provisions mentioned above, most recoveries received after August 20, 1996 will be taxable unless one can legitimately argue physical injury. I have written before about the effect of the new version of section 104 and how I expect there to be litigated cases concerning the line between physical and nonphysical injuries. See "New Law Radically Changes Tax Rules in Employment Litigation," Tax Notes, Aug. 19, 1996, p. 1045.

The Conference Committee Report to the enacting statute (H.R. 3448) does state that "[i]t 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 will clearly give the Internal Revenue Service fuel to argue that the physical injury requirement must be for a serious injury. At the same time, there would still seem to be great latitude to focus on physical consequences to the injured party that go beyond these three items.

There also remains considerable confusion about whether a physical touching must have occurred. The statute does not clearly so state, and there may be demonstrable physical consequences of an action that is not at all physical. For example, if someone is defamed and promptly suffers serious physical injuries, the question may be whether the origin of the harm was sufficient to result in excludable personal injury damages. While the new law appears to elevate the underlying and initial harm to extreme importance, it would seem arguable that whatever the initial harm, if the consequences are serious and physical, the tort exclusion should apply.

If an act of defamation causes serious physical consequences (how about a heart attack?) and accompanying emotional distress (nervous disorders, hives, etc.), shouldn't exclusion for the recovery be appropriate? The IRS has not yet given guidance whether it will require that there have been a physical touching (such as a battery). However, one can expect these issues to arise.

FLOWCHART

Against all this background and admitted confusion, the following chart attempts to show the broad approach that can be taken with some of the more common types of employment claims, covering likely tax results for the specified period of time.

[The flowchart is unsuitable for online reproduction and has been omitted]

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