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viewpoint

Scope of Personal Injury Tax Exclusion Still Clouded

by Robert W. Wood

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Tax lawyers, tax accountants, employment lawyers, personal injury lawyers, and even members of the general public may be aware that the tax code underwent a rather important change in 1996. On August 20, 1996, President Clinton signed the euphemistically named Small Business Job Protection Act of 1996. Buried among the supposed small business job protections (where did they go anyway?), there were a number of substantive tax changes designed to substantially increase revenues and to bloat the federal kitty. Apparently, that bloating was successful, since we reached the first federal budget surplus in many years.

Tax lawyers, tax accountants, and even labor lawyers and other less specialized litigators, have had to deal with the nitty-gritty of what one minuscule change in this tome did to the tax treatment of damage awards and settlement payments. With a very small change being the addition of the words "physical" to the concept of personal injuries or personal illness, Congress seemingly rewrote the law. How radically that change will be interpreted remains to be seen.

First, let's state what is clear. Apart from some transitional rules that are generally inapplicable, for an exclusion from income to apply to a judgment or settlement payment, there must be physical injuries or physical illness. This means that an automobile accident case is to be treated differently from a Title VII race discrimination case. On the other hand, it is not clear exactly what the word "physical" means. It has been argued by some that if one has an employment-type claim (such as a discrimination or harassment claim or even wrongful termination) and that one experiences physical injuries or physical illness directly linked to the conduct complained of by the employer, this too should give rise to an exclusion from income.

No cases have yet been decided detailing the exact scope of this provision. The only guidance contained in the legislative history to the 1996 act is that headaches, insomnia, and stomach disorders do not constitute physical injury. The drafters of this legislative history apparently intended this list to be nonexclusive, that is to be illustrative only. But the fact remains that we do not yet know what "physical" really means.

Moreover, there is also a question as to the required element of causation between the injury and the physical consequences. The Internal Revenue Service would doubtless like to see a physical battery giving rise to a chain of events producing the physical injury or physical illness. This is not explicit in the statute, but it is generally understood among tax practitioners.

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How does this all shake out in common practice? The answer has recently become even more cloudy, since case law continues to be decided under the pre-1996 version of section 104. Although generally the courts have been adopting stricter standards, cases come along that occasionally suggest that section 104 prior to the 1996 amendments (and implicitly, even afterwards) may still have substantial vitality. Take the recent case of *Greer v. United States*, No. 96-117, 82 AFTR2d par. 98-5443, *Doc 98-31496 (14 pages), 98 TNT 208-7* E.D. Ky. (Sept. 23, 1998). The *Greer* case arose out of Daniel Greer's termination from Ashland Oil, Inc. in 1993. He was a long-time employee of Ashland and had been suddenly terminated.

Apparently Mr. Greer identified various environmental problems that Ashland was allegedly causing and was terminated for that reason. There was, as there often is in circumstances of this type, a dispute between the company and the disgruntled employee about the reason for his termination. Ultimately, however, the taxpayer never actually threatened the company with a wrongful discharge suit. Instead, he appealed his dismissal all the way to the Chairman of the Board without mentioning his wrongful discharge suspicions. In fact, the taxpayer never sued Ashland Oil. They negotiated what was referred to as a "termination settlement" (as denominated by the taxpayer) and what was referred to by the company as a "severance agreement." It is appropriate here to note as an aside that in the tax world, what one calls something can be vitally important to what it turns out to be considered by the taxing authorities!

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Whatever one calls it, the agreement between Mr. Greer and Ashland Oil required the taxpayer to give up all claims against Ashland Oil in return for the payment of $331,968. A normal severance package for the taxpayer (given his rank and years of service) would have been only $51,000. The taxpayer predictably argued that he was given this extra payment specifically in exchange for his agreement to release all claims against Ashland Oil.

The IRS, on the other hand, predictably argued that this extra payment was both for the release of all potential claims, and as consideration for past services. The agreement did not segregate the amounts paid between different categories. Upon accepting this settlement payment, the taxpayer was required to turn over his volumes of environmental reports and agreed to confidentiality obligations with respect to his conduct and the settlement.

Wages or Not?

When paying the amount out to the taxpayer, Ashland Oil treated the amount as wages and withheld taxes in the amount of $108,873 from the settlement payment. The taxpayer, thinking withholding was improper, sued for a refund of the taxes paid.

The district court in the case, sitting in the Eastern District of Kentucky at Ashland, went through the requirements of section 104 as in effect during the years in question. The court clearly found that tort-type rights were involved, and that the taxpayer had suffered personal injuries to which the settlement could be attributed. Based on what it found to be undisputed evidence, the court found that there was no other logical explanation but that Ashland Oil was "buying peace" from a potential wrongful discharge suit in which its alleged environmental liabilities would surface. The court found no evidence that Ashland Oil intended to compensate any other type of claim.

Turning to the portion of the settlement that the court found was undeniably severance pay, the court found that Ashland Oil's standard severance program would have paid severance to the taxpayer of $51,000. Finding no evidence to suggest anything more than the customary severance, the court concluded only that $51,000 was severance pay includable in gross income (and subject to withholding). The remaining $280,968 was held to constitute an excludable personal injury tort settlement. The court found that any taxes withheld from such proceeds would have to be refunded by the IRS.

Hey, What About Me?

Since there has been a steady stream of Tax Court (and district court and circuit court) cases over the past couple of years in which a number of types of employment claims are viewed as not within the section 104 exclusion (even under the *prior* version of section 104), cases such as *Greer* may cause a little consternation among tax practitioners (and even more consternation among successful plaintiffs). After all, how is it that some claims are viewed as taxable and some are not? The district court in *Greer* went through a number of the classic cases involving what constitutes a personal injury, at least under the pre-1996 law, such as *Banks v. United States*, 81 F.3d 874, *Doc 96-11602 (7 pages), 96 TNT 77-7* (9th Cir. 1996) (excluding intangible damages flowing from breach of fiduciary duty claim); *Dotson v. United States*, 87 F.3d 682, *Doc 96-20362 (28 pages), 96 TNT 140-8* (5th Cir. 1996) (recognizing that dignitary losses are compensable as personal injuries); and even the Supreme Court's pronouncement in *Commissioner v. Schleier*, 515 U.S. 323, *95 TNT 116-8* (1995).

The latter case, of course, was a hallmark case in which the High Court held that backpay and liquidated damages recovered under the Age Discrimination in Employment Act (ADEA) are not received on account of personal injuries. Ultimately, it was the Supreme Court's holding in *Schleier* that served as the bellwether for many in the employment and tax fields to reevaluate the scope of the section 104 exclusion, to narrow it and refine it, even before Congress did in the Small Business Job Protection Act of 1996.

Completing its *tour de force* through the caselaw, the district court in *Greer v. United States* then went on to talk about the employment cases in which settlement agreements had been struck between taxable (and subject to withholding) severance arrangements and payments in the nature of tort payments for tort-type rights. The court cited *Taggi v. U.S.*, 835 F.Supp. 744, *94 TNT 57-9* (S.D. N.Y. 1993), *aff'd* 35 F.3d 93, *94 TNT 186-12* (2d Cir. 1994). The *Taggi* case, in which a taxpayer was terminated and forced to sign a release in exchange for an enhanced benefit package is curious in that at the time Taggi signed the release, he apparently did not realize its gravity. In the year following executing his release, he sued his former employer for age discrimination.

The court dismissed his action, finding that the release was effective. Based on this court determination that the release released tort-like rights, Taggi went back and obtained a refund of his taxes paid on the severance benefits, claiming that these were for settlement of age discrimination claims. Despite the persuasiveness of this argument, Taggi lost because the court ultimately found that he had never made any claim prior to signing a release. Where no personal injury claim is ever asserted, said the court, the settlement can only be considered severance pay. See also

McCelary v. Armstrong World Industries, Inc., 913 F.2d 257 (5th Cir. 1990).

The court in *Greer* also referred to several other cases in which claims were not asserted, and yet concluded that in some cases claims cannot be explicitly asserted (and not be the subject of a formal complaint), but the employee can be thinking about anticipated claims. Indeed, Mr. Greer did not explicitly threaten Ashland with a wrongful discharge suit, and no suit was filed. These facts were undisputed. At the same time, Mr. Greer claimed to have sensitive information, and the company clearly was concerned enough to buy him off. Ashland's legal counsel engaged in lengthy negotiations with Mr. Greer's counsel before reaching a settlement.

In the end, Ashland demanded a return of plaintiff's environmental compliance reports, and reaffirmed his confidentiality obligations. Although each side may have been thinking about a possible claim, they never really disputed its viability. Instead, Ashland merely paid Mr. Greer what the court referred to as a "princely sum to buy his silence." As the court stated, the bottom line was whether the vague threats of pursuing any available remedies created a bona fide dispute in this case. The court in *Greer* believed that it did.

How to Apportion

The last step for the court in *Greer* was turning to how to apportion the claims. It had already concluded that $51,000 was appropriate severance pay. But what of the balance? Again referring to many of the seminal cases in this area, the court said that there was no question that plaintiff Greer provided the company with roughly 25 years of satisfactory service. There was also no question that what the company was really worried about was his silence and the continued confidentiality of the environmental data. As for whether Ashland intended to compensate any other type of claim, the court simply found no evidence of any such intent on Ashland's part. It was true, said the court, that the release the plaintiff was expected to sign mentioned contract, Title VII, and ADEA claims. However, it was testified to in court that these were boilerplate provisions that were included in every employment release. Thus, Mr. Greer was able to receive tax-free the bulk of his "princely sum," with only the $51,000 in severance pay being deemed taxable income (and, of course, taxable as wages, too).

Final Word

There will be great debate over the coming months about whether one can put too much store in a district court decision coming out of Kentucky, admittedly applying pre-August 20, 1996 law. At the same time, the decision in this case is extremely important, showing the analysis that trial court-level judges (and particularly non-tax specialist judges) may go through in reaching what seems to me to be a commonsensical and flatly appropriate result. What, after all, *is* a company paying for when it obtains a release? There was no dispute about the amount of the severance pay ($51,000) that could have been paid (and was paid) in this case. The question was, what were the other payments for? The court systematically went through that analysis and, I think, reached the right result.

For all those litigants who received settlement payments or judgment payments prior to August 20, 1996, this *Greer* case stands as a renewed ray of hope in a sea of what is somewhat bleak authority. Hurrah for the Kentuckians!