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TAXING DISCRIMINATION RECOVERIES: BUCKING BURKE.

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In this article, Wood explores the limited nature of the holding in Burke, arguing that damages under the post-1991 version of Title VII, as well as ADEA and wrongful termination recoveries, will probably continue to be excludable. For claims brought under the pre- 1991 version of Title VII, he notes they are often brought in conjunction with other claims, thus affording allocation possibilities.

On May 26, 1992, the U.S. Supreme Court decided United States v. Burke, [1] concluding that Therese Burke and several other women who received proceeds from a suit for sex discrimination were taxable on their recoveries. Whether one believes the case is correctly decided or not (I believe it is not), [2] the decision ended a conflict among the circuit courts. /3 /On the surface at least, it should put the tax treatment of sex discrimination recoveries into a one-sentence black letter category that every plaintiff's lawyer and every discrimination victim will understand. Because cases involving racial discrimination are generally brought under precisely the same statute (Title VII of the Civil Rights Act of 1964), the result in Burke should control those cases as well.

Yet, while this certainty by itself might seem laudable, a closer examination of the case reveals that the Supreme Court has not addressed the tax treatment of many discrimination and similar recoveries. And even as to the claims considered by the Court, there are already established techniques for minimizing the taxable element of the recovery.

The first part of this article reviews the limited nature of the holding in Burke, resting as it does on the pre-1991 version of Title VII of the Civil Rights Act of 1964. The second part examines what result this holding should, and will, have on recoveries that do not come within its specific ambit (including other Title VII recoveries, recoveries for age discrimination under the Age Discrimination in Employment Act, and wrongful termination awards under various state laws).

Finally, even in a case to which the Supreme Court's taxable holding applies, the third part of this article examines the techniques that are available -- and that have been in use for some time -- to reduce its impact.

I. THE BURKE HOLDING

A. Facts

Burke and a number of other plaintiffs recovered a settlement from their employer, the Tennessee Valley Authority. The underlying action was brought under Title VII of the Civil Rights Act of 1964, alleging discrimination based on gender. When amounts were withheld from the settlement proceeds paid to Burke, she filed a refund claim. On denial of that claim, she sued in district court. The district court reviewed the underlying lawsuit and concluded that only back wages had been sought, and that therefore the recoveries did not fall within the definition of a tort recovery excludable from income under section 104.

The Sixth Circuit Court of Appeals reversed, concluding that whether an amount is excludable under section 104(a)(2) turns on whether the injury and the claim are personal and tort-like in nature. Because a claim for discrimination constitutes a personal and tort-like injury, the Sixth Circuit determined that Burke's award of back pay under Title VII was excludable [P. 364] under section 104(a)(2). Granting certiorari to resolve a conflict among the circuits, the Supreme Court agreed to hear the case.

B. No Tort Remedy

The Supreme Court's majority opinion (written by Justice Blackmun, in which Justices Rehnquist, White, Stevens, and Kennedy joined) begins with an analysis of section 104(a)(2) and the case law dealing with the interpretation of the tort-like recovery concept. Quickly, though, the Court reverts to an analysis of the types of compensation Title VII is supposed to provide. Quite beyond the personal nature of any discrimination, which the Court acknowledged but never entirely addressed, the Court correctly noted that Title VII was designed to remedy discrimination by ordering:

> such affirmative action as may be appropriate, which may include, but is not limited to, reinstatement or hiring of employees, with or without back pay . . . or any other equitable relief as the court deems appropriate. [4]

While there is no prohibition of an award of compensatory damages in this language, the Court noted judicial interpretations of it that lead to that result. According to the Court, Title VII has its focus on economic damages such as back pay and lost benefits, and not on pain and suffering. Remedies for the latter would be consistent with a more traditional tort context.

Indeed, the Court noted that the 1991 amendments to Title VII [5] enlarged the scope of Title VII's remedial provisions in a way that made it clear that -- before these amendments at least -- Title VII must not have been tort-like in scope. Under the 1991 amendments, a victim of intentional discrimination is entitled to a jury trial, at which he or she may recover compensatory damages for future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses. Punitive damages may also be recovered.

Finding this to support its position that the pre-amendment version of Title VII did not call for tort-like recoveries, the Court concluded that the pre-1991 amendment version of Title VII did not provide tort remedies. Predictably, the taxpayer (as well as amicus curiae) argued that the enlargement of available remedies by the 1991 amendments to Title VII made it clear that Congress intended Title VII to entail broad redress of discrimination injuries. The Court, however, took the contrary view, which seems consistent with the notion that fixing something is evidence that it was broken.

The Court left open the question whether recoveries under the revised statute would be treated differently. The strong implication, though, is that recoveries under the statute amended in 1991 would qualify for the tort exclusion.

C. Scalia and Common Sense

Justices Scalia and Souter each filed separate concurring opinions. Justice Scalia liked the result reached by the majority, but went back to basics, with dictionary definitions and proclaimed common sense about what is and what is not a "personal injury." Scalia even disagreed with long-standing Treasury regulations that in interpreting section 104(a)(2), "tort-like" recoveries -- those based upon tort-like causes of action -- will qualify for exclusion too.

Indeed, had he been able, Scalia would no doubt have struck down the regulation as invalid! Concluding that Burke's recovery for gender discrimination was not received on account of personal injuries within his own more colloquial definition, Justice Scalia seems also to conclude -- although it is not germane to the case -- that defamation and other nonphysical torts also should not lead to excludable awards.

Although Scalia disagreed heartily with the Treasury regulations and their tort-like analysis, he was forced to admit that his basis for reversing the Sixth Circuit was argued neither in the Supreme Court nor below. All but wiping away the rule that points not argued cannot form the basis of decision, Scalia nevertheless concluded that:

> there must be enough play in the joints that the Supreme Court need not render judgment on the basis of a rule of law whose nonexistence is apparent on the face of things, simply because the parties agree upon it -- particularly when the judgment will reinforce error already prevalent in the system.

In a separate concurring opinion, Justice Souter projects considerable ambivalence, acknowledging that good reasons tug toward a determination of either excludability or of includability. He concludes only that since exclusions from income should be strictly construed, and since section 104(a)(2) is not plain that Title VII recoveries are excludable, they should be taxable.

D. Dissent Gets It Right

Justice O'Connor penned a dissent, in which Justice Thomas joined. The dissent notes the personal nature of any discrimination - - a notion even the majority opinion seems to adopt. Referring to the tort-like inquiry that is required under the government's own regulations, the dissent turned to the nature of the rights protected -- such rights being purely personal in the case of Title VII -- rather than the nature of the remedy provided.

The latter, asserted the dissent, cannot possibly be controlling of the appropriate tax character of the recovery, given that the IRS' own regulations require an examination of the type of rights protected.

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II. RAMIFICATIONS OF THE BURKE DECISION

What then has this opinion, its two concurring opinions, and its dissenting one decided? Are all Title VII recoveries now taxable?And what about other similar types of recoveries, such as those for discrimination based on age under the Age Discrimination in Employment Act, and those for wrongful termination?

A. Other Title VII Cases

To begin with, the Supreme Court has itself acknowledged that the 1991 amendments to the Civil Rights Act of 1964 open up the remedial side of Title VII actions. The Court all but says that recoveries under this amended statute would have to fall into the excludable category.

This, it would seem, is the inescapable logic of the Court's arguments about the availability of remedies. Employment lawyers are already reading the decision as saying that recoveries under the amended statute will be tax-free. [6] Since the Court does not hold that recoveries under the amended statute should be so treated, however, the Service can be expected to disagree when recoveries involving such cases come before it. Unless another level of analysis is applied in the future (such as Scalia's supposed common sense analysis, under which even defamation recoveries might be taxable!), these recoveries will likely be held to be tax-free. Unfortunately, this conclusion will probably not emerge until there have been many litigated cases and many dollars spent in the process of reaching this result.

B. Age Discrimination Recoveries

The situation with age discrimination recoveries is less clear. Regardless of how clear one chooses to view the majority opinion in the Burke case, it technically does not control the result with recoveries under the Age Discrimination in Employment Act (ADEA). At most, it establishes a framework for future analysis by other courts. To date, all of the circuit courts that have considered such awards have held that they are tax-free. [7] There is no conflict within the circuits as was present with Title VII recoveries. Of course, the Supreme Court's analysis suggests that we should look to the types of remedies available under the ADEA in assessing whether or not recoveries under that statute are taxable.

If a plaintiff prevails in an ADEA claim, the statute provides for a number of remedies. These include reinstatement, back pay, and even front pay where immediate reinstatement or promotion is not feasible. More important, where the employer's conduct is willful or deliberate, liquidated damages are available. This would suggest that under the Supreme Court's analysis in Burke, recoveries under the ADEA would be excludable, since they are received under a remedial system that is tort-like in scope.

What one does to plan for the tax treatment of ADEA recoveries in the interim is debatable. There certainly appears to be nothing wrong with relying on the strength of the various circuit court decisions that have held ADEA recoveries to be tax-free. [8]

Moreover, as in the case of other discrimination-type claims, ADEA claims will likely be made in connection with other claims, including wrongful termination, intentional infliction of emotional distress, and so on. In this light, there may be some flexibility in focusing on more traditional torts even if a particular litigant is circumspect about the continued viability of excluding ADEA recoveries. On balance though, it would appear that ADEA recoveries stand an excellent chance of continuing to be excludable until such time (if ever) as Justice Scalia's views about the scope of section 104 become law.

C. Wrongful Termination Awards

A claim of "wrongful termination" is generally viewed as a more fearsome battle cry in many states today than a claim based on Title VII. Likewise, a wrongful termination claim may also be more frightening than an ADEA claim. As a practical matter, of course, these claims are often brought together, a topic to be addressed in III, below.

In Redfield v. Insurance Company of North America, [9] Redfield sued his employer under the ADEA, under the California Fair Employment and Housing Act, and under several other theories. The complaint also sought recovery for wrongful discharge, breach of the implied duty of good faith and fair dealing, and intentional infliction of emotional distress. The court determined that the employer had violated the ADEA and the California

Fair Employment and Housing Act, had breached its employment contract, and had violated the implied covenant of good faith and fair dealing. [P. 366] Redfield was awarded $189,500 in economic damages, $25,000 in emotional distress damages, and $75,000 in punitive damages.

In addition to concluding that the ADEA recovery was excludable (Redfield is generally cited as an ADEA case), the Ninth Circuit found that a recovery for violations of the California Fair Employment and Housing Act was a tort recovery. Even more significantly, the court found that Redfield's claim for wrongful discharge and for breach of the implied covenant of good faith and fair dealing were alleged as tort causes of action, and that any damages awarded on these causes of action were also excludable.

The Ninth Circuit, in Redfield, acknowledged the decision in Foley v. Interactive Data Corp.,10 in which the California Supreme Court held that a termination in violation of the covenant of good faith and fair dealing does not give rise to tort damages. Since Foley was decided after the entry of judgment in Redfield's suit, however, the Ninth Circuit declined to apply the notion expressed in Foley that tort damages for the breach of an implied covenant were not available.

It remains to be seen how cases will fare in California -- for tax purposes -- once the courts apply the result in Foley. An example of the application of Foley appears in Lanouette v. Ciba-Geigy Corporation.11 In this case, a plaintiff received $1.6 million in tort damages, $100,000 for pain and suffering for breach of the implied covenant of good faith and fair dealing, $100,000 for intentional infliction of emotional distress, and $1 million in punitive damages. The Court of Appeals modified the judgment to delete the award of damages for pain and suffering for breach of the implied covenant of good faith and fair dealing, since, under Foley, tort remedies are not available for breach of the implied covenant in an employment contract.

This raises the question, of course, whether one should evaluate the tax status of a claim under state or federal law. The Third Circuit, in Byrne v. Commissioner,12 expressly noted that whether a claim is one for personal injuries is to be decided according to federal law rather than state law. The Third Circuit stated, for example, that a federal court might conclude that a state contract claim alleges the violation of tort or tort-type rights for tax purposes.

Despite the New Jersey statute involved in Byrne, the Third Circuit concluded that the action involved damages of a personal nature rather than mere economic loss. Such authority suggests that there may still be room for courts to determine tort causes of action based upon federal rather than state law interpretations. Indeed, even the Supreme Court's decision in Burke seems to rest on the notion that the taxability of a recovery is strictly a federal question, whether one bases the determination on: (a) the types of remedies available under the statute, as called for by the Burke majority opinion: (b) the common sense gut analysis proffered by Justice Scalia; or (c) the "tort or tort-type rights" analysis called for by the regulations.

In any event, it is safe to conclude that there are sufficient uncertainties surrounding the treatment of wrongful termination recoveries that many plaintiffs will continue to exclude them.

As an aside, apart from its other lessons, the Redfield decision is instructive in its implicit admonition that litigants should think about these matters. Redfield refused to acknowledge satisfaction of the judgment in the underlying litigation because the defendant/ employer withheld on it. The employer sued in district court to force the question. The district court held that withholding was proper and that Redfield should have acknowledged the judgment. The Ninth Circuit felt differently. One assumes the employer (Insurance Company of North America) was nonplussed about all its lawyers' fees, since the withholding question should have been discussed in advance.

III. THE PRACTICAL CONSEQUENCES OF BURKE

As a practical matter, the consequences of Burke, even for the classes of Title VII recoveries it addresses (that is, recoveries under Title VII as it existed prior to the effective date of the Civil Rights Act of 1991), may be somewhat less dramatic than might appear at first blush. Quite often, claims of this nature are not made solely under one statute, but are paired with a whole host of claims. This was the case, for example, in Redfield v. Insurance Company of North America13 (discussed above in II.C. of this article). The fact that there may (and typically will be) other claims alleged will give the plaintiff much more flexibility in allocating a recovery.

In most cases, the conclusion of the litigation will be -- as it was in Burke -- a settlement rather than the final adjudication of a court. The presence of multiple claims and the process of settlement will generally give the plaintiff considerable latitude to allocate the settlement -- on a presumptive basis at least -- in a manner that is tax favored.

Failing to allocate a settlement payment in the settlement documents (in cases where it is not clear that the entire recovery is excludable) may raise factual questions about the reason for the payment, at least where the complaint (as it often will) alleges multiple claims.

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A perfect example of this is Madson v. Commissioner. There, a taxpayer sued his city employer for forcing him to retire early, alleging breach of contract as well as a denial of equal protection of the laws. The settlement payment was not allocated between the two claims. The taxpayer claimed that the entire amount was excludable as tort damages.

The Tax Court denied his motion for summary judgment, ruling that there was a genuine issue of material fact whether the settlement payment was intended as a payment for the breach of contract or as tort damages.

The difficulties encountered by a plaintiff who signs a general release in order to receive a settlement award are also illustrated by William H. Evans v. Commissioner. [15] In that case, a tenured professor received a lump-sum settlement for release of all claims against his former employer. The university had dismissed a number of employees and, to avoid liability, brought a declaratory judgment action against them with respect to claims it anticipated they would make. The settlement was, however, individually negotiated with the taxpayer. He signed a release containing language concerning any disputed claim arising out of the termination of the taxpayer's employment and, specifically stating that it included, but was not limited to, "such things as due process, professional defamation, and damage to professional reputation." [16]

The language concerning loss of professional reputation was specifically requested by the taxpayer. Noting this fact, the court concluded that the entire award was taxable to the professor. The court stated that the entire $25,000 was a lump sum with no proration, and that in the absence of an allocation of the settlement among the various claims, all of the payment was includable in the taxpayer's income. [17] Other cases may be cited for the same unfortunate proposition. [18] Conversely, in my experience at least, allocations in this area are more likely than not going to be respected.

IV. CONCLUSION

Given the typical pattern of multiple claims, and the various recoveries that Burke does not address, the decision is unlikely to be a boon to the government. Precisely what will transpire with age discrimination recoveries, wrongful termination and similar claims, and indeed, even with Title VII claims governed by the new version of Title VII, is likely to be the subject of further litigation.

FOOTNOTES

[1] 112 S. Ct. 1867.

[2] See "More on the Taxation of Tort Damages," Tax Notes, Apr. 6, 1992, p. 131.

[3] Thomson v. Commissioner, 89 T.C. 632 (1987), aff'd, 866 F.2d 709, 89-1 U.S.T.C. 9164, 63 AFTR 2d 89-677 (4th Cir. 1989) (award under Equal Pay Act excludable); Byrne v. Commissioner, 90 T.C. 1000 (1988), rev'd and remanded, 883 F.2d 211, 89-2 U.S.T.C. 9500, 64 AFTR 2d 89-5430 (3d Cir. 1989) (employee sex discrimination recovery obtained without filing of lawsuit, but after related EEOC suit, excludable); and Sparrow 949 F.2d 434 (D.C. Cir. 1991) cert. denied (June 22, 1992) (Title VII sex discrimination recovery taxable).

[4] 42 U.S.C. section 2000e-5(g).

[5] The Civil Rights Act of 1991, Pub. L. 102-166, 105 Stat. 1071.

[6] See, e.g., Gomez and Oncidi, "High Court Rules Title VII Damages Taxable," San Francisco Daily Journal, June 8, 1992, p. 5.

[7] See Redfield v. Insurance Company of North America, 940 F.2d 542 (9th Cir. 1991) (excludable); Rickel v. Commissioner, 900 F.2d 655, 90-1 U.S.T.C. 50,200, 65 AFTR 2d 90-800 (3d Cir. 1990) (excludable); and Pistillo v. Commissioner, 90-2 U.S.T.C. 50,469 (6th Cir. 1990).

[8] See Byrne v. Commissioner, 90 T.C. 1000 (1988), rev'd and remanded, 883 F.2d 211, 89-2 U.S.T.C. 9500, 64 AFTR 2d 89-5430 (3rd Cir. 1989); and Redfield v. Insurance Company of North America, 940 F.2d 542 (9th Cir. 1991).

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

[10] 47 Cal.3d 654, 254 Cal. Rptr. 211 (1988).

[11] 230 Cal. App. 3d 889 (1990), modified, 275 Cal. Rptr. 420,800 P.2d 898 (1990) pending before the California Supreme Court.

[12] 883 F.2d 211, 89-2 U.S.T.C. 9500, 64 AFTR.2d 89-5430 (3d Cir. 1989).

[13] 940 F.2d 542 (9th Cir. 1991).

[14] 55 T.C.M. 1351, P-H T.C. Memo 88,325 (1988).

[15] 40 T.C.M. 260, P-H T.C. Memo 80,142 (1980).

[16] 40 T.C.M. at 262.

[17] See also Whitehead v. Commissioner, 41 T.C.M. 365, P-H T.C. Memo 80,508 (1980) affirmed per court order (10th Cir. 1981), involving similar facts.

[18] See, e.g., Coats v. Commissioner, 36 T.C.M. 1650, P-H T.C. Memo 77,407 (1977) (settlement of discrimination suit held all income because taxpayer could not establish what portion was for damages); and Leo Dalbo, 28 T.C.M. 1171, P-H T.C. Memo 69,220 (1969) (settlement of employment contract dispute held all income).