Chapter 35 Recent Developments in the Income Tax Treatment of Employment-Related Damages

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This article discusses recent developments in the law concerning the income tax treatment of employment-related damages. For this purpose, “recent” refers to the period from October 1993 through October 1995. “Income tax treatment of employment-related damages” encompasses a variety of issues relating to the income taxation of damages with a focus on damages arising out of the employer/employee relationship.
§ 35.02 BACKGROUND

During the 24 months between October 1993 and October 1995, at least 46 cases and nine IRS pronouncements were issued in connection with the income tax treatment of employment-related damages! Because of the sometimes conflicting analyses in these authorities, and their varying levels of precedential significance, it is important to take careful note of their precise dates of issuance.

IRC § 104(a)(2) states:

“Gross income does not include the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.”

The last sentence of IRC § 104(a) modified IRC § 104(a)(2), as follows:

“Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.”

The latter provision is effective only for amounts received after July 10, 1989.

Reg. § 1.104-1(c), which is the only regulation elaborating on IRC § 104(a)(2), states:

“Damages received on account of personal injuries or sickness.— Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term ‘damages received’ (whether by suit or agreement) means an amount received (other than workmen’s compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.”

The statute (leaving aside the 1989 modification regarding punitive damages) raises three analytical questions, namely, (1) what are “damages?”; (2) what constitutes a “personal injury?”; and (3) when should damages be treated as “received on account of” a personal injury? The regulations address only the first question. That is, they clarify that, for purposes of IRC § 104(a)(2), “damages” are amounts received in connection with legal actions or settlements, and they narrow the field of potentially excludable damages to include only damages that are based on tort or tort type rights. Thus, although the regulation partially answers the first question, it raises (but does not answer) two additional questions, namely, (4) what is a “settlement agreement?” and (5) what are “tort or tort type rights?”

The term “personal injuries” has been held to include both physical and nonphysical injuries. United States v. Burke, 112 S.Ct. 1867, 1871-72 (1992). In Burke, the Supreme Court wrote:
The courts and the IRS long since have recognized that § 104(a)(2)’s reference to “personal injuries” encompasses, in accord with common judicial parlance and conceptions ... nonphysical injuries to the individual, such as those affecting emotions, reputation, or character, as well [as physical injuries].

112 S.Ct. at 1871 n.6.

In addition, since 1986, the courts have uniformly held that, in determining whether a claim is a claim for personal injuries, it is the “nature” of the claim, rather than the “consequences” of the claim, that is determinative. See Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986), cited with approval by the Supreme Court in Burke, 112 S.Ct. at 1872. This means that, if a cause of action is based on a personal injury, the fact that the consequences to the injured person are primarily economic is irrelevant. See, e.g., Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983), holding that, because a defamation action is an action for personal injuries, a recovery in a defamation action compensating the taxpayer for damage to his business reputation is excludable.

In Threlkeld, the Tax Court explained the concept of “personal injury” in broad and eloquent terms, stating that the term “personal injury” refers to “any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law.” 87 T.C. at 1308.

In United States v. Burke, 504 U.S. 229, 112 S.Ct. 1867 (1992), the Supreme Court made ambiguous statements that many courts and commentators have interpreted as suggesting that whether an invasion of rights is a “personal injury” depends on whether the remedies available to the victim are as comprehensive as the remedies traditionally available to tort victims. See Section 35.03, below.

In Commissioner v. Schleier, 115 S.Ct. 2159 (1995), the Supreme Court made ambiguous statements that some commentators have interpreted as suggesting that the mere invasion of an individual’s personal rights does not constitute a “personal injury.” Under this restrictive interpretation, Schleier may be viewed as holding that only the physical, psychological, or emotional damage resulting from an invasion of personal rights should be considered a “personal injury” for purposes of IRC § 104(a)(2). See Section 35.03, below.

Several courts have observed that the phrase “on account of” may have at least two meanings. See, e.g., Reese v. United States, 24 F.3d 228, 230-31 (Fed. Cir. 1994).

On the one hand, damages could be treated as received “on account of” a personal injury as long as the damages would not have been received but for the injury. Under this view, any damages received by the taxpayer as a result of a personal injury claim should be excludable under IRC § 104(a)(2).

On the other hand, damages could be treated as received “on account of” a personal injury only if the injury in and of itself justifies the damages. Under this view, damages should be taxable if they would not have been received but for, e.g., a jury’s decision to punish the defendant or a jury’s determination that a defendant’s conduct was particularly egregious.

Interpretation of the phrase received “on account of” has been central in cases considering whether punitive damages and prejudgment interest may be excludable under IRC § 104(a)(2). See Sections 35.04 and 35.06, below.

In 1992, the Supreme Court held in Burke that, in order to determine if a claim is based on “tort or tort type rights,” within the meaning of Reg. § 1.104-1(c), it is necessary to determine whether the body of law giving rise to the claim has certain characteristics traditionally associated with tort claims, including the availability of (1) a jury trial, (2) a broad range of compensatory damages, and (3) punitive damages. 112 S.Ct. at 1872-74. Burke held that Title VII of the Civil Rights Act of 1964, as in effect before the 1991 amendments thereto, did not have those characteristics, and, therefore, claims under pre-1991 Title VII were not based on “tort or tort type rights.” The holding in Burke was recently refined by the Supreme Court in Commissioner v. Schleier, 115 S.Ct. 2159 (1995). See Section 35.05, below.
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§ 35.03 RECENT DEVELOPMENTS REGARDING THE MEANING OF “PERSONAL INJURY”

In *Burke*, a 1992 case involving damages received in settlement of a sex discrimination case under Title VII of the Civil Rights Act of 1964 as in effect before the 1991 amendments thereto, the Supreme Court wrote, “It is beyond question that discrimination in employment on the basis of sex, race, or any of the other classifications protected by Title VII is … an invidious practice that causes grave harm to its victims,” *112 S.Ct. at 1872*, and, “No doubt discrimination could constitute a “personal injury” for purposes of §104(a)(2) if the relevant cause of action evidenced a tort-like conception of injury and remedy.” *112 S.Ct. at 1873*. Thus, *Burke* leaves little doubt that, as long as the cause of action underlying an employment discrimination claim is “tort-like,” the discrimination itself constitutes a “personal injury.”

NOTE:

Still, much confusion has been caused by the sentence, “No doubt discrimination could constitute a ‘personal injury’ for purposes of § 104(a)(2) if the relevant cause of action evidenced a tort-like conception of injury and remedy.” That sentence can be read to imply that, if the cause of action underlying a discrimination suit does not provide a tort-like remedial scheme, the discrimination victim is not viewed as having suffered a “personal injury.” However, since the “tort” concept is introduced by Reg. §1.104-1(c) only for purposes of amplifying the phrase “damages received,” it does not seem sensible for the Court to have examined the remedial scheme to determine whether the taxpayer’s injury is “personal.” In fact, when the *Burke* opinion is read as a whole, it appears that the Court did *not* intend to define the simple term “personal injury” by reference to the applicable statutory remedial scheme. Throughout the analytical section of the *Burke* opinion, the phrase “personal injury” is generally used as part of the larger phrase “tort-like personal injury.” See *112 S.Ct. at 1872-74*. It appears that what the *Burke* court held to be dependent on the breadth of the remedial scheme was the existence of a *tort-like* personal injury, not the existence of any personal injury.

In any event, even if the *Burke* Court *did* intend to incorporate the requirement of a tort-like remedial scheme in the definition of “personal injury,” it remains the case that, under *Burke*, if a discrimination statute is tort-like, discrimination in violation of that statute is itself a personal injury for purposes of IRC § 104(a)(2), without regard to whether any physical, psychological, or emotional harm results from the discrimination.

In *Rev. Rul. 93-88, 93-2 C.B. 61*, the Service applied the holding of *Burke* to sex and race discrimination cases brought under Title VII after the 1991 amendments thereto. Those amendments granted to Title VII claimants the right to a jury trial and, in the case of claimants alleging disparate treatment discrimination, the right to seek compensatory damages for a broad range of intangible harms (e.g., pain, suffering, and mental anguish), as well
the right to seek punitive damages. The Ruling concluded that all compensatory damages (including back pay) awarded to Title VII claimants alleging disparate treatment discrimination (and all compensatory damages awarded to claimants alleging disparate impact race discrimination, who are entitled to a broad range of compensatory remedies under 42 U.S.C. § 1981), are excludable from gross income under IRC § 104(a)(2). The Ruling states:

Title VII and section 1981 currently provide the broad range of traditional tort remedies that the Supreme Court in Burke said would warrant excludability under section 104(a)(2) of the Code.

Since Rev. Rul. 93-88 states that the taxpayers in question were denied promotions on a discriminatory basis, but does not state that they suffered any particular physical, psychological, or emotional harm as a result of the discrimination, it is implicit in the Ruling that, in the Service’s view, discrimination itself constitutes the requisite “personal injury.”

Post-Burke cases generally have been consistent with this view.

In Banks v. United States, 94-2 U.S.T.C. ¶ 50,630 (W.D. Wash. 1994), decided on November 10, 1994, the district court held that an employee’s action against a union for breach of the union’s duty of fair representation is an action relating to a personal injury, reasoning that, under an earlier Supreme Court decision regarding the labor laws, “[t]he fundamental purpose of unfair representation suits is to compensate for injuries caused by violations of employees’ rights … [and] to make the injured employee whole.” 94-2 U.S.T.C. at 86,380. Since the injuries caused by the union’s breach of its duty often are purely economic, Banks implies that the personal injury in question must be the violation of the employee’s right to fair representation, without more.

In Wesson v. United States, 48 F.3d 894, 898 (5th Cir. 1995), decided on March 30, 1995, the Fifth Circuit stated that, under Mississippi law, a bad faith claim against an insurance company “is one sounding in tort and, accordingly, one redressing a personal injury.” 48 F.3d at 898.

In Commissioner v. Schleier, 115 S.Ct. 2159 (1995), decided on June 14, 1995, the Supreme Court held that damages received under the federal Age Discrimination in Employment Act of 1967 (the “ADEA”) are not excludable from gross income under IRC § 104(a)(2).

The Court stated that there were two independent reasons for the decision: first, the Court concluded that, because of the limited remedies available under the ADEA, an ADEA action is not based upon “tort or tort type rights;” second, the Court asserted that the taxpayer in question had failed to “show that the damages were received ‘on account of personal injuries or sickness.’” 115 S.Ct. at 2167.

In reaching the second conclusion, the Court stated (115 S.Ct. at 2164):

[T]hough respondent’s unlawful termination may have caused some psychological or “personal” injury comparable to the tangible pain and suffering caused by an automobile accident, it is clear that no part of respondent’s recovery of back wages is attributable to that injury …. In age discrimination, 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. In short, § 104(a)(2) does not permit the exclusion of respondent’s back wages because the recovery of back wages was not “on account of” any personal injury and because no personal injury affected the amount of the back wages recovered.

The quoted passage may be read to imply that the taxpayer’s unlawful termination in violation of the ADEA was not itself a “personal injury” for purposes of IRC § 104(a)(2), and that the personal injuries suffered by the taxpayer were his resulting psychological harms. This implication, however, directly contradicts Burke, and the Schleier Court gave no indication that it intended to modify the holding in Burke. Regarding Burke, the Court merely stated:

[T]hough Burke relied on Title VII’s failure to qualify as an action based upon tort type rights, we did not intend to eliminate the basic requirement found in both the statute and the regulation that only amounts received “on account of personal injuries or sickness” come within § 104(a)(2)’s exclusion.
115 S.Ct. at 2167. (This statement apparently was intended to rebut the taxpayer’s argument that, under Burke, if a remedial statute is determined to be tort-like, any damages received in an action under that statute must be excluded under IRC § 104(a)(2), without the need for additional analysis.)

The possible implication of the quoted passage also seems to contradict Threlkeld v. Commissioner, 87 T.C. 1294 (1986), and Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983). Those cases hold that an award compensating the taxpayer for damage to his or her reputation (evidenced by lost business profits) is excludable under IRC § 104(a)(2) if the award is received in a defamation action, because a victim of defamation has suffered a personal injury simply by reason of being defamed. Yet there is no indication in Schleier that the Court intended to overrule Threlkeld and Roemer.

The quoted passage may be reconciled with Burke, Threlkeld, and Roemer by assuming that the Schleier Court interpreted its prior holding in Burke as narrowing the definition of “personal injury” to include a violation of a personal right only if the violation was “tort-like,” a characteristic that the Schleier Court held was not present in an ADEA case. Following such an interpretation, age discrimination in violation of ADEA may indeed cause a personal injury without constituting one.

On balance, it does not appear that the Schleier Court intended to modify the definition of “personal injuries” adopted in Burke, Threlkeld, Roemer, and other cases.

In the post-Schleier district court case Lane v. United States, 95-2 U.S.T.C. ¶ 50,455 (W.D. Okla, 1995), decided on August 2, 1995, the court stated that, under Oklahoma law, a bad faith claim against an insurance company is “an action sounding in tort to recover for personal injuries.” 95-2 U.S.T.C. at 89,447 n.4. In Lane, the government apparently did not take issue with this conclusion: it agreed that the compensatory damages (as opposed to the punitive damages) received by the taxpayer in the bad faith action were excludable under IRC § 104(a)(2). Since there is no mention of personal suffering in the Lane decision, it must be inferred that, in the district court’s view, a bad faith claim is a personal injury claim simply because the taxpayer’s personal rights are alleged to have been violated.

NOTE:

This post-Schleier decision is consistent with the view that Schleier did not modify the Burke/Threlkeld definition of “personal injuries.”

On August 3, 1995, the IRS issued Notice 95-45. The Notice solicited public comment on the impact of the Schleier decision in a number of areas, including the application of IRC § 104(a)(2) to recoveries under the federal discrimination statutes referred to in Rev. Rul. 93-88, 93-2 C.B. 61, which unquestionably give rise to “tort type” claims. Although Notice 95-45 does not state precisely what concerns gave rise to the request for public comment, it is likely that the request was motivated by the following considerations:

• Schleier suggests that a back pay award made in settlement of a federal age discrimination claim, absent contrary extrinsic evidence, is not received on account of the taxpayer’s personal injuries or sickness.

• If this implies that, in the Supreme Court’s view, all forms of illegal discrimination may not, in and of themselves, constitute personal injuries, the Service may need to reexamine Rev. Rul. 93-88. As noted above, that Revenue Ruling holds that back pay awards resulting from tort-type claims under certain federal discrimination statutes are excludable under IRC § 104(a)(2), reaching that conclusion without explaining the precise causal link between those back pay awards and the personal injuries suffered by the recipients of the awards.

At this time, it is not known whether the Service will reaffirm, modify, or revoke Rev. Rul. 93-88.
Section 11311 of the Revenue Reconciliation Bill of 1995, H.R. 2491, as agreed to by the Conference Committee on November 16, 1995, would amend IRC §104(a)(2) by modifying the phrase “personal injuries or sickness” to read “personal physical injuries or physical sickness,” generally effective for amounts received after 1995.
§ 35.04 RECENT DEVELOPMENTS REGARDING THE MEANING OF “ON ACCOUNT OF”

[1] Prejudgment interest

A number of cases have considered whether prejudgment interest included in a personal injury award is excludable under IRC §104(a)(2). The issue has been framed in a number of ways, including: (1) whether prejudgment interest constitutes “damages” under the applicable state law, (2) whether prejudgment interest constitutes “damages” as that term is specially defined for purposes of IRC §104(a)(2), (3) whether prejudgment interest is simply a form of “interest,” which, by definition, is not “damages” and therefore is includable in income, and (4) whether prejudgment interest compensates the taxpayer for the time value of money rather than the personal injury. However the issue is articulated, a central question is whether prejudgment interest is considered to be received “on account of” the taxpayer’s personal injuries in such a manner as to fall within the ambit of IRC §104(a)(2).

An important backdrop to the analysis of this issue is the principle, adopted by the Tax Court in Threlkeld v. Commissioner, 87 T.C. 1294 (1986), and affirmed by the Supreme Court in United States v. Burke, 504 U.S. 229, 112 S.Ct. 1867 (1992), that the applicability of IRC §104(a)(2) to damages received on account of an injury is determined by reference to the nature of the injury, not by reference to the consequences of the injury, even though those consequences may be important factors in determining the amount of damages. As a consequence of this principle, the fact that the taxpayer’s loss of the time value of money is an economic loss is of no more relevance in determining the applicability of IRC §104(a)(2) than the fact that the taxpayer’s loss of wages or business profits is an economic loss. There is no question that damages for lost wages or profits resulting from a personal injury are excludable under IRC §104(a)(2). See Commissioner v. Schleier, 115 S.Ct. 2159, 2164 (1995).

In Brabson v. United States, 859 F. Supp. 1360 (D. Col. 1994), decided on August 15, 1994, the district court held that, because prejudgment interest that is included in a personal injury award resulting from a tort action is part of the “amount received’ by the [taxpayer] through prosecution of [the tort] action,” it is excludable from income under IRC §104(a)(2). 859 F. Supp. at 1363. In response to the government’s arguments, the court emphasized (1) that prejudgment interest constitutes “damages” under Colorado law and (2) that prejudgment interest is not uniformly treated as interest for federal income tax purposes.

In contrast to the district court in Brabson, the Tax Court has consistently held that “[s]tatutory interest imposed on tort judgments … must be included in gross income under section 61(a)(4) even under circumstances in which the underlying damages are excludable under section 104(a)(2).” Delaney v. Commissioner, T.C. Memo 1995-378 (August 8, 1995), citing Kovacs v. Commissioner, 100 T.C. 124, 128-30 (1993). The Tax Court’s position is based principally on the theory that prejudgment interest is a form of “interest” and therefore cannot be considered “damages.” The Tax Court stresses that prejudgment interest is paid on account of the delay in the receipt of a “principal amount.” Judge Halpern, who dissented in Kovacs on the ground that the 1982 amendment of IRC §104(a)(2) (which codified the exclusion from gross income of personal injury awards paid
as “periodic payments,” including the time value component of deferred payments) should be viewed as compelling the exclusion from gross income of prejudgment interest as a necessary corollary, made this point cogently in his dissenting opinion:

[T]he purposes of the Michigan statutory interest provision in question … have been stated by the Michigan Supreme Court to be compensating for delay in payment of money damages, covering the costs of litigation, and encouraging prompt settlement …. From the description alone, I would not conclude that the interest in question was received “on account of personal injuries or sickness.” 100 T.C. at 139 (emphasis added). Accordingly, Judge Halpern stated that, but for the 1982 amendment to IRC § 104(a)(2) regarding periodic payments, he would have joined the majority in holding that prejudgment interest is not excludable under that provision.

[2] Punitive damages

Several recent cases have considered whether punitive damages awarded in a personal injury action are “received on account of” personal injuries. Those cases are discussed in Section 35.06 below.

[3]—Impact of Commissioner v. Schleier

It should be noted that, although much of the majority opinion in Schleier is devoted to a denial that the taxpayer’s age discrimination damages under the ADEA were received “on account of personal injuries,” the analysis in that portion of the opinion relates more to the meaning of “personal injuries” than to the meaning of “on account of.” Nonetheless, the Court made the following three comments, which appear to relate specifically to the meaning of the latter phrase:

• “[T]hough [the taxpayer’s] unlawful termination may have caused some psychological or ‘personal’ injury comparable to the pain and suffering caused by an automobile accident, it is clear that no part of [the taxpayer’s] recovery of back wages is attributable to that injury,” 115 S.Ct. at 2164 (emphasis added).

• “We agree with [the taxpayer] that if Congress had intended the ADEA’s liquidated damages to compensate plaintiffs for personal injuries, those damages might well come within § 104(a)(2)’s exclusion.” 115 S.Ct. at 2165.

• “[W]e explicitly held in Thurston: ‘Congress intended for liquidated damages to be punitive in nature.’ [citations omitted] Our holding in Thurston disposes of [the taxpayer’s] argument and requires the conclusion that liquidated damages under the ADEA, like back wages under the ADEA are not received ‘on account of personal injury or sickness.’” 115 S.Ct. at 2165.

The first bulleted quotation is interesting in that it strongly suggests that the relevant “on account of” relationship is not the relationship between the personal injuries and the loss of wages; rather, it is the relationship between the personal injuries and the recovery of lost wages.¹ This being so, if the determination that the defendant has legally wronged the taxpayer is based, in whole or in part, on the fact that the taxpayer suffered personal injuries, then the “on account of” requirement should be satisfied, even with respect to a category of damages the amount of which is determined independently of the kind or extent of the taxpayer’s personal injuries. It should be noted, however, that the Schleier Court, discussing the treatment of damages recovered in a lawsuit arising out of an automobile accident, made the following inconsistent statement: “[T]he recovery for lost wages is also excludable as being ‘on account of personal injuries,’ as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries.” 115 S.Ct. at 2164. Since it is difficult to imagine a

¹ This is consistent with the “plain language” of IRC § 104(a)(2), which refers to “damages received … on account of personal injuries or sickness,” not “amounts received to compensate the taxpayer for damages sustained on account of personal injuries or sickness.”
lost wages recovery in a physical injury case where the lost wages did not result from personal injuries, it is difficult to tell what the Court meant by the italicized portion of this statement.\(^2\)

The second and third bulleted quotations suggest that, in the Court’s view, a category of damages should be treated as “received on account of” personal injuries if and only if the purpose of that category of damages is to compensate the taxpayer for personal injuries. This analysis is consistent with Judge Halpern’s dissenting opinion in *Kovacs v. Commissioner*, 100 T.C. 124, 139 (1993), with the result in *Kovacs* (i.e., taxation of prejudgment interest because it compensates for the delay in payment), and, to a large extent, with the analysis that has been applied by other courts in cases regarding punitive damages (see Section 35.06, below). Interestingly, the Court’s “compensatory purpose” analysis implies a rejection of both the “but for” analysis and the “sufficient cause” analysis, which many courts have examined in analyzing punitive damages. That is, the “compensatory purpose” analysis entails the following two conclusions: (1) even if the taxpayer’s personal injury, without more, is sufficient to justify an award of a particular category of damages, the damages arguably are taxable if they are intended to serve a noncompensatory purpose, and (2) even if a category of damages would not be awarded but for the presence of some factor other than the taxpayer’s personal injuries (e.g., bad intent on the part of the wrongdoer), the damages arguably are excludable if they are intended to serve a compensatory purpose.\(^3\)

\(^2\) It also is difficult to square this statement with the second and third passages from *Schleier* quoted in the text above, which strongly imply that the required “on account of” relationship between a recovery and an injury is conclusively established where the “purpose” of the recovery is to compensate for the injury.

\(^3\) This appears to be the gravamen of the Court’s comment in *Schleier* that, “if Congress had intended the ADEA’s liquidated damages to compensate plaintiffs for personal injuries, those damages might well come within § 104(a)(2)’s exclusion.” 115 *S.Ct. at 2165.*
As noted above, the Supreme Court held in *Burke* that the important characteristics of a tort-type cause of action are the availability of (1) a jury trial, (2) a broad range of compensatory damages, and (3) punitive damages. In *Schleier*, the taxpayer argued that the ADEA is tort-like because of the availability under the ADEA of a jury trial and liquidated damages (which the Court held to be punitive in nature). The *Schleier* Court rejected the argument, however, on the ground that the “primary characteristic” of a tort-like action is the availability of a broad range of compensatory remedies. *115 S.Ct. at 2166-67.* On the basis of *Schleier*, it is reasonably certain that a broad range of compensatory remedies is a necessary condition of a “tort-type” cause of action; it cannot be said, however, whether it is a “sufficient” condition.
§ 35.06 TREATMENT OF PUNITIVE DAMAGES

For all amounts received after July 10, 1989, the last sentence of IRC § 104(a) provides that IRC § 104(a)(2) does not apply to punitive damages unless they are received in connection with a case involving “physical injury or physical sickness.” Accordingly, the following cases, which discuss the application of IRC § 104(a)(2) to punitive damages, generally are not relevant to punitive damages received after July 10, 1989 in employment-related actions.

In Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990), rev’g 93 T.C. 330 (1989), the Fourth Circuit reversed the Tax Court and held that punitive damages received in a Maryland defamation action were not excludable under IRC § 104(a)(2). In the lower-court proceedings, the Tax Court had held that the punitive damages were received “on account of” personal injuries because, but for the personal injuries, those damages would not have been received. 93 T.C. at 339. The Fourth Circuit reasoned that the phrase “damages received on account of personal injuries” is ambiguous because it may be interpreted to refer to either (1) damages that would not have been received “but for” personal injuries, or, more restrictively, (2) damages for which personal injuries are a sufficient condition. 914 F.2d at 589-90. To interpret the statute in light of this ambiguity, the Fourth Circuit looked to the “underlying purpose” of IRC § 104(a)(2), which, in the court’s view, is to “make the taxpayer whole from a previous loss of personal rights—because, in effect, [the damages] restore a loss of capital.” 914 F.2d at 590, quoting Starrels v. Commissioner, 304 F.2d 574, 576 (9th Cir. 1962). The court determined that, under Maryland law, punitive damages are a “windfall … over and above any award of compensatory damages,” 914 F.2d at 591, and, therefore, Maryland punitive damages are taxable.

The holding in Miller was followed by the Federal Circuit and the Ninth Circuit in Reese v. United States, 24 F.3d 228 (Fed. Cir. 1994) (decided on May 16, 1994), and Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994) (decided on July 19, 1994), respectively. In Reese, the Federal Circuit, after noting the ambiguity of the phrase “on account of,” stressed that the several subdivisions of IRC § 104(a) encompass “only the replacement of losses resulting from injury or sickness,” and concluded that “Congress did not intend section 104(a)(2) to exclude from gross income noncompensatory damages such as punitive damages.” 24 F.3d at 231. The court also emphasized that, in the underlying personal injury action, the following instruction had been given to the jury: “Punitive damages are awarded to punish the defendant and to deter others from engaging in similar conduct in the future.” 24 F.3d at 232. In Hawkins, the Ninth Circuit followed similar reasoning.

However, in Horton v. Commissioner, 33 F.3d 625 (6th Cir. 1994), decided on August 29, 1994, the Sixth Circuit rejected the reasoning of the Fourth, Federal, and Ninth Circuits, and held that punitive damages received in an action for personal injuries are excludable under IRC § 104(a)(2). The Sixth Circuit, following its own analysis in Burke v. United States, 929 F.2d 1119 (6th Cir. 1991), rev’d on other grounds, 112 S.Ct. 1867 (1992), reasoned that (1) since an examination into the nature of the claim underlying the damages award is “the beginning and end of the inquiry,” the entire recovery (including both compensatory and punitive damages) resulting from a personal injury action is excludable under IRC § 104(a)(2), (2) the “plain meaning” of IRC § 104(a)(2) does not permit a
distinction between compensatory and punitive damages, 33 F.3d at 631, and (3) punitive damages are “damages” within the meaning of Reg. § 1.104-1(c), since they are received through prosecution of a legal suit or action based upon tort or tort type rights. 33 F.3d at 631. The court also stated that, under Kentucky law (which governed the underlying tort action), punitive damages serve a compensatory function as well as a punitive one. Id.

Cases decided subsequent to Horton by other circuits have followed the Miller line of cases, distinguishing or rejecting Horton. In Wesson v. United States, 48 F.3d 894 (5th Cir. 1995), decided on March 30, 1995, the Fifth Circuit followed the reasoning in Miller and Reese, relying on the “object and policy” of IRC § 104(a)(2) in light of the ambiguity of the phrase “on account of.” 48 F.3d at 898. The court determined that, under Mississippi law (which governed the underlying personal injury action), the purpose of punitive damages is to punish the tortfeasor, and therefore held that Mississippi punitive damages “are not awarded to compensate the plaintiff, and are therefore not awarded on account of personal injuries.” 48 F.3d at 900. The court expressly stated that it disagreed with the Sixth Circuit’s conclusion in Horton that the “nature of the claim” principle compelled a different conclusion, but it also distinguished Horton on the ground that Kentucky punitive damages (which were at issue in Horton) served, in part, a compensatory purpose. The Fifth Circuit reaffirmed its Wesson holding in Estate of Moore v. Commissioner, 53 F.3d 712 (5th Cir. 1995), decided on June 2, 1995, reasoning that Texas punitive damages (which were at issue in Moore) do not serve a compensatory purpose.

As noted above (see Section 35.04), on June 14, 1995, the Supreme Court held in Commissioner v. Schleier, 115 S.Ct. 2159 (1995), that liquidated damages under the ADEA are not intended to serve a compensatory purpose and therefore are not excludable under IRC § 104(a)(2), reasoning that damages that are not intended to serve a compensatory purpose are not received “on account of personal injury or sickness.” 115. S.Ct. at 2165.

On September 19, 1995, the Tenth Circuit also held that punitive damages are taxable. O’Gilvie v. United States, No. 94-3004 (10th Cir. 1995). The Tenth Circuit, however, explicitly rejected the reasoning of the Fourth, Federal, Fifth, and Ninth Circuits. Instead, concluding that “it is not clear whether Congress intended to exclude punitive damages from income under § 104(a)(2),” the Tenth Circuit followed “the default rule that exclusions from income are narrowly construed.” (It should be noted that, in O’Gilvie, the Tenth Circuit apparently assumed that the punitive damages at issue were noncompensatory because the taxpayer did not argue otherwise. See O’Gilvie, at note 11.)

Interestingly, although the Tenth Circuit’s opinion in O’Gilvie was issued on September 19, 1995, three months after Supreme Court rendered its decision in Commissioner v. Schleier, 115 S.Ct. 2159 (1995), the Tenth Circuit did not refer to Schleier’s assertion that ADEA liquidated damages are taxable because they are punitive rather than compensatory. The Tenth Circuit cited Schleier only for the proposition that the “nature of the claim” analysis adopted by Burke is used only to determine whether a claim involves a personal injury, but not to determine whether damages are received “on account of” personal injuries. It is possible that the Tenth Circuit considered Schleier’s assertions regarding ADEA liquidated damages to be dictum, since Schleier clearly disposed of all of the damages at issue therein by concluding that rights redressed by the ADEA are not “tort or tort type” rights.

Nonetheless, in Lane v. United States, 95-2 U.S.T.C. ¶50,455 (W.D. Okla. 1995), decided on August 2, 1995, a district court considering the application of IRC § 104(a)(2) to punitive damages received in a bad faith action found Schleier to be dispositive. The court stated (at p.89,448):

The Court is constrained by a recent pronouncement by the United States Supreme Court in [Schleier] to conclude that punitive damages are not received on account of personal injury or sickness and are therefore not excludable from gross income under Section 104(a)(2) …

As noted above, proposed tax provisions in Section 11311 of the Revenue Reconciliation Bill of 1995, H.R. 2491, as agreed to by the Conference Committee on November 16, 1995, would amend IRC § 104(a)(2) by modifying the phrase “personal injuries” to read “personal physical injuries,” generally effective for amounts received after 1995. The amendments also would modify the beginning of IRC § 104(a)(2) to read: “the amount of any damages (other than punitive damages) received …” (This change also would be effective for amounts received after 1995.) The term “punitive damages” is not defined in the bill. The identical explanations issued by the Ways and Means and Finance Committees, however, state the following under the heading “Reasons for Change:”
Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income.

On the basis of this explanation, it could be argued that if, under the applicable state law, damages labeled “punitive” are intended to serve a compensatory purpose, they may be excludable even under the proposed amendments to IRC § 104(a)(2). By the same token, it is likely that the term “punitive damages,” as used in the proposed amendments, would be interpreted to include all damages that are intended to punish the wrongdoer and not to compensate the claimant, regardless of their label.

The Committee explanations contain a standard admonition to the effect that the proposed amendment is not intended to create an inference as to the application of IRC § 104(a)(2) to punitive damages received prior to the effective date of the amendment.
§ 35.07 TREATMENT OF AMOUNTS RECEIVED UNDER SETTLEMENT AGREEMENTS THAT CONTAIN SPECIFIC ALLOCATIONS

It is well-settled that, when a lump-sum settlement resolves several claims, only some of which are for personal injuries, the courts will look to various factors, including provisions in the parties’ written settlement agreement, to assist the court in allocating the settlement proceeds between tort-like personal injury damages and other damages. See, e.g., Threlkeld v. Commissioner, 87 T.C. 1294, 1306 (1986). Two recent cases demonstrate that incorporating self-serving allocations in a settlement agreement is less critical than having a factual record that supports the allocations contended for by the taxpayer.

In Robinson v. Commissioner, 102 T.C. 116 (1994), the taxpayer initiated an action against a bank for failure to release a lien on the taxpayer’s property. After the jury returned a verdict in the taxpayer’s favor for approximately $6 million in lost profits, $1.5 million for mental anguish, and $50 million in punitive damages, the parties settled all claims for $10 million. The taxpayer was given carte blanche by the bank to allocate the settlement proceeds in the manner that was most favorable for tax purposes. Accordingly, the final settlement (which became the basis for a judgment entered by the court) allocated 95 percent of the $10 million to mental anguish and five percent to lost profits. The Tax Court refused to respect the settlement agreement because it was nonadversarial, entirely tax motivated, and did not accurately reflect the underlying claims. Instead, the Tax Court allocated the settlement to lost profits and mental anguish, to the extent of the jury award for those items, and the balance to punitive damages, reasoning that both the taxpayer and the bank expected the punitive damages awarded by the jury to be reduced on appeal. 102 T.C. at 134-35.

In McKay v. Commissioner, 102 T.C. 465 (1994), on the other hand, the taxpayer’s settlement was respected. In McKay, the taxpayer, who was fired for objecting to improper practices by his employer, filed a lawsuit against the employer for wrongful discharge, breach of employment contract, RICO violations, and punitive damages. The jury awarded the taxpayer $1.6 million for lost pre-trial compensation and $12.8 million for lost future earnings. All of the damages were trebled due to the RICO violation. In addition punitive damages were awarded in the amount of $1.2 million. Following hostile settlement negotiations, the parties settled for $16.7 million. Of that amount, the settlement agreement allocated $12.2 million to the wrongful discharge claim (which the settlement agreement characterized as "payable on account of an alleged tort-type invasion of the rights that McKay is granted by virtue of being a person in the sight of the law"), $2 million to the breach of contract claim, and nothing to the RICO claim or to punitive damages. In explaining why the settlement agreement should be respected, the Tax Court stressed that (1) the parties were adverse as to the allocations because it was very important to the defendant not to allocate anything to RICO violations or punitive damages, (2) the settlement agreement recited that the allocation was based on the defendant’s refusal to pay anything for RICO violations or punitive damages, (3) the taxpayer recognized that he would face risks on appeal with respect to the RICO damages and punitive damages, (4) the defendant threatened the taxpayer with 15 to 20 years of litigation if he would not agree to allocate nothing to RICO damages and punitive damages, and (5) the allocation between wrongful discharge and breach of contract was
based on “appellate counsels’ estimates of probability of success on the merits, recognition of the jury verdict, and mutual assessment of the total and relative values of the claims.” 102 T.C. at 472. The court stressed that the parties could be considered to be adverse with respect to the allocation even though the deductibility of the payment by the payor was not at issue. 102 T.C. at 485.

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The preceding section of this article discussed the impact of written settlement agreements on the division of a lump-sum settlement into a component that is excludable under IRC § 104(a)(2) and a component that is not. The current section discusses the allocation of a lump-sum settlement payment under an agreement that does not specifically allocate the payment between personal injury claims and other claims. Although some decisions state in dicta that the absence of an allocation in the agreement precludes the taxpayer from arguing for an allocation before the court, those decisions are actually based on a complete lack of proof, and the courts uniformly make allocations based on all the facts in the record as long as there is a sufficient factual basis for an allocation.

Two pre-1993 cases are frequently cited by the government for the proposition that, where a settlement agreement is silent as to the portion of the settlement payment that is intended to be allocated to personal injury claims, the courts will not make the allocation. The cases are Whitehead v. Commissioner, 41 T.C.M. 365 (1980), and Villaume v. United States, 616 F. Supp. 185 (D. Minn. 1985).

In Whitehead, 41 T.C.M. 365 (1980), the taxpayer was a university professor whose employment, along with the employment of 103 other faculty members, was terminated by the university. The taxpayer filed for a grievance hearing with the president of the university. The request was denied pending a decision in a declaratory judgment action to clarify the rights of the parties. Before any judgment was rendered in the action, the university proposed to settle all potential claims with the faculty members for payments equal to one year’s salary plus other amounts determined on an individual basis. The taxpayer agreed to the settlement, received a payment equal to one year’s salary, and signed a general release.

The taxpayer, who represented himself before the Tax Court, argued that he had potential tort-type rights against the university, but it appears that he presented the Tax Court with no evidence regarding the university’s intent. The court concluded that the taxpayer “did not establish that the university intended the lump-sum payment as compensation for tort or tort-type damages suffered by petitioner.” 41 T.C.M. at 368. Having disposed of the case on the basis of a lack of any evidence regarding the university’s intent, the court stated in dictum: “Even if petitioner had established, which he has not, that the university regarded a portion of the settlement as payment for tort or tort-type damages suffered by petitioner, we would be compelled to reach the same result because no allocation of the lump-sum payment was made.” 41 T.C.M. at 369. It is quite likely, however, that the court would not have made this statement if the taxpayer’s evidence had established the amount that the university regarded as a payment for tort-type damages or had established that the university intended the payment to be exclusively or primarily for tort-type damages.

In Villaume, 616 F. Supp. 185 (D. Minn. 1985), a real estate salesman received only $20,000 of a $40,000 commission and sued to recover the $20,000 unpaid commission plus $100,000 in punitive damages for the
defendant’s wrongful acts in withholding the money. Prior to trial, the action settled for $20,000. The settlement agreement made no allocation between contract and punitive damages, and the parties did not explicitly agree that any portion of the settlement was attributable to personal injury damages.

In the tax refund action, the taxpayer argued that the damages were actually attributable to libel and slander claims against the defendant and introduced an affidavit from his attorney alleging that the state court complaint would have been amended to include libel and slander claims and that all parties in the action understood that a settlement would include substantial amounts for libel and slander. The district court determined that the attorney’s affidavit was not admissible in evidence and concluded: “There is simply no competent evidence before the Court … that plaintiffs’ suit in state court was a personal injury action.” 616 F. Supp. at 189. Having disposed of the case on the basis of a lack of any evidence regarding the payor’s intent, the court stated in dictum that, “even if” it were to consider the attorney’s affidavit, it would deny the refund claim on the basis of the dictum in Whitehead, which, according to the court, described a rule that “the entire settlement would be considered income since no allocation had been made between lost compensation and tort damages at the time of the settlement.” This dictum is not surprising since, even if the district court had considered the attorney’s affidavit, there still would have been no meaningful evidence that the payor did not simply intend to pay the full commission originally agreed to.

Where there is evidence supporting the allocation of a portion of a lump-sum settlement to excludable personal injury damages, the courts uniformly make an allocation despite the lack of any express allocation in the settlement agreement. Commissioner v. Miller, 914 F.2d 586 (4th Cir. 1990), provides a typical example. In that case, a taxpayer filed two separate personal injury actions, received a jury verdict for $500,000 in compensatory damages and $450,000 in punitive damages in one of the actions, and subsequently settled both actions for a single lump sum of $900,000. The settlement agreement did not allocate the amount between the two actions or between the claims for compensatory and punitive damages. After the court of appeals held that the portion of the settlement allocable to punitive damage claims was taxable, it remanded the case to the Tax Court for an allocation, stating: “The question of allocation could be approached on remand by the Tax Court in a myriad of ways ….” 914 F.2d at 592. On remand, the Tax Court stated:

[T]he intent of the defendants in making the settlement payment to petitioner is a critical factor to be considered. [citation omitted] The record, however, is devoid of any direct evidence of the defendants’ intent. Accordingly, we must rely on indirect evidence to establish how much the defendants intended to pay to petitioner in consideration of her release of punitive damage claims.

Miller v. Commissioner, 65 T.C.M. 1884, 1886 (1993). After discussing various approaches to deducing the defendants’ intent, the Tax Court allocated the settlement payment on the basis of the ratio of punitive to compensatory damages in the jury verdict.

On November 4, 1993, the District Court for the Southern District of New York decided Taggi v. United States, 835 F. Supp. 744 (S.D.N.Y. 1993), aff’d, 35 F.3d 93 (2d Cir. 1994), a case strikingly similar to Whitehead. In Taggi, the taxpayer’s employment with AT&T was terminated as part of a workforce reduction. Each employee was given the opportunity to receive a lump-sum payment in exchange for a general release of “all claims … and causes of action’ relating to [his] employment or termination,” and the taxpayer signed the release in exchange for the payment. 835 F. Supp. at 745. The taxpayer argued that all or a portion of the payment was received in exchange for his rights to sue AT&T in connection with employment discrimination claims and other unspecified tort-like claims. However, he introduced no evidence regarding injuries, possible claims against AT&T, the company’s awareness of such possible claims, or any other evidence from which the court could infer the company’s intent in making the payment. Accordingly, citing Villaume and Whitehead, the court concluded: “[P]laintiffs may not simply pick and choose between various potential claims included in a general release for the purpose of excluding the payment made for that release from gross income.” 835 F. Supp. at 746. On appeal, the Second Circuit agreed that, in the absence of any evidence, “the [district] court was not in a position to apportion the payment among the various possible claims.” 35 F.3d at 96-97.

In several cases subsequent to Taggi, courts have allocated lump-sum settlement payments between excludable personal injury damages and other amounts despite the lack of an express allocation in the settlement agreement.
In *Fitts v. Commissioner*, 67 T.C.M. 2136 (1994), decided on February 9, 1994, the taxpayer, who had been fraudulently induced to sell his business, asserted claims based on breach of contract, misrepresentation, and emotional distress. The claims were settled for a lump-sum payment pursuant to a general release that covered all potential claims arising out of the parties’ business relationship. The Tax Court stated:

If settlement results from claims based on both personal injury and claims not based on personal injury, we may allocate amounts to each claim. [citations omitted] Petitioners have provided little to guide us in making the allocation, perhaps because of the broadly inclusive nature of the statement of the claims in communications between their counsel and [the defendant].

Notwithstanding the general release and the lack of extrinsic evidence supporting an allocation, the court allocated one fourth of the settlement payment to personal injury claims.

In *Lane v. United States*, 95-2 U.S.T.C. ¶ 50,455 (W.D. Okla. 1995), decided on August 2, 1995, the taxpayer filed a bad faith action against an insurance company. The trial court awarded the plaintiff contract damages, compensatory tort damages, and punitive damages. While the punitive damage award was on appeal, the parties settled for a lump sum. The settlement agreement did not allocate the amount among the various claims that were asserted or among the elements of damages awarded by the trial court. Citing *Taggi*, *Whitehead*, and *Villaume*, the government argued that the absence of an allocation in the settlement agreement rendered the entire amount taxable. The district court, however, rejected that argument and made an allocation based on the amounts of damages in the trial court decision, emphasizing the following passage from *Glatthorn v. United States*, 818 F. Supp. 1548, 1551 (1993):

When a lump sum settlement encompasses both tort and contract claims, an allocation must be made between and among the various claims. If the parties themselves do not make the allocation in a settlement agreement, the court must do so.


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§ 35.09 TREATMENT OF AMOUNTS RECEIVED FOR A RELEASE OF POTENTIAL CLAIMS

As noted in Section 35.08 above, Taggi v. United States, 35 F.3d 93 (2d Cir. 1994), aff'g 835 F. Supp. 744 (S.D.N.Y. 1993), involved a taxpayer whose employment with AT&T was terminated as part of a workforce reduction. The taxpayer received a lump-sum payment in exchange for signing a general release of “all claims … and causes of action” relating to [his] employment or termination.” 835 F. Supp. at 745. The taxpayer argued that all or a portion of the payment was received in exchange for his rights to sue AT&T in connection with employment discrimination claims and other unspecified tort-like claims. However, not only had the taxpayer neither filed nor threatened any claim against AT&T prior to the time the release was signed, 35 F.2d at 96, in the tax refund action the taxpayer introduced no evidence whatsoever regarding (1) injuries or possible injuries suffered by him or other AT&T employees, (2) potential claims against AT&T by him or other employees as a result of such injuries, (3) the company’s awareness of or concerns regarding such potential claims, or (4) any other evidence from which the court could infer that the company’s purpose for making the payment was to forestall a potential claim. In fact, the only evidence in the case was the general release itself. In this light, even though the Second Circuit acknowledged that “a settlement is an agreement to terminate or forestall all or part of a lawsuit,” 35 F.3d at 96 (emphasis added), the court concluded that the release was not a “settlement agreement” within the meaning of the regulations under IRC § 104(a)(2).
§ 35.10 CASES INVOLVING TAXPayers WHO HAVE INSUFFICIENT PROOF THAT THE PAYOR INTENDED TO MAKE THE PAYMENT ON ACCOUNT OF PERSONAL INJURIES

Not surprisingly, taxpayers settling disputes with employers and business associates have attempted to exclude their recoveries on the basis of IRC § 104(a)(2) even when there is scant justification for the argument or, perhaps, ample justification but scant evidence. The following cases are illustrative.

In *Beckey v. Commissioner, 68 T.C.M. 945 (1994)*, the taxpayer became involved in a dispute with her employer (a federal agency), filed a labor grievance, contacted the agency’s Equal Employment Opportunity office, and unsuccessfully attempted to file a “Jane Doe” tort suit against the employer in state court. Eventually, with the assistance of an attorney, the taxpayer negotiated a settlement with the employer. Under the settlement agreement, the taxpayer resigned her position, was immediately rehired as a temporary employee for a six-month period with the same salary and benefits as in her previous permanent position, and agreed to produce for the employer during that six-month period a substantial written report on a subject that apparently was relevant to the employer’s affairs. The employer agreed to provide salary and benefits during the period of temporary employment and to modify the taxpayer’s personnel file so as to enable her to find subsequent employment. In the Tax Court, the taxpayer took the position that the salary she received during the period of temporary employment was excludable from income under IRC § 104(a)(2), arguing that her status as a temporary employee was fictitious. The court rejected the taxpayer’s position, stressing that the settlement agreement resembled an employment contract and that the taxpayer performed meaningful work in exchange for the salary payments. The court also pointed out that the taxpayer introduced no evidence to establish either that she suffered any physical or mental injury or that her obligations to perform work under the settlement agreement were not real.

In *Britell v. Commissioner, T.C. Memo. 1995-264 (June 15, 1995)*, the taxpayer, a bank officer reporting to the bank’s executive V.P. for retail banking, was asked by the executive V.P. to resign because he was dissatisfied with her management style. The taxpayer’s attorney contacted the bank’s attorney and threatened to file a sex discrimination lawsuit. After four months of negotiations, the taxpayer and the bank entered into a settlement and release agreement similar to the agreements entered into by the bank and other officers who were asked to resign. The agreement included a severance package, which was similar to the bank’s previous severance packages and had been recommended by the executive V.P. because he wanted the bank to sever its relationship with the taxpayer on good terms. The bank’s V.P. for human resources, who signed the settlement agreement on behalf of the bank, did not think he was settling a discrimination claim. The agreement did not refer to any claim the taxpayer might have against the bank. In fact, the agreement recited, in part, “WHEREAS, during the course of her employment, it became apparent that [the taxpayer’s] management style, though effective to accomplish the business goals, varied from the management style of the Bank giving rise to disagreements between the parties ….” The agreement provided that the taxpayer would relinquish certain responsibilities immediately but would continue to be employed as a senior V.P. for nine and one half months after the date the agreement was signed.
unless she resigned sooner. Under the agreement, she would continue to receive her normal bi-weekly salary during that nine and one-half month period unless she resigned before the end of the period, in which case she would received the balance of the salary in a lump sum.

The taxpayer argued that the amounts paid pursuant to the agreement were paid to settle her discrimination claim, but the Tax Court rejected the argument, finding that: “[T]he record indicates that the Banks made the payment to compensate petitioner for her employment with them and for her severance of employment with them …. The record shows that the Banks made the payment to petitioner in order to reward her for her past services to them and to make her severance from them as amicable as possible.”

In Osborne v. Commissioner, T.C. Memo. 1995-354 (August 1, 1995), the taxpayer, in the course of selling a closely held business, entered into an employment and consulting agreement with the purchaser. Subsequent to the sale, the taxpayer filed a lawsuit alleging that the purchaser had breached the agreement. Prior to the trial date, the lawsuit was settled. The taxpayer took the position that the settlement payment was excludable from gross income under IRC §104(a)(2), on the ground that the underlying cause of action was “tortlike personal injury in the nature of damage to his personal health and reputation, mental distress, fraud, and misrepresentation.” The IRS argued, and the Tax Court agreed, that the underlying cause of action was breach of contract. The court emphasized that the taxpayer’s letters to the purchaser prior to filing the complaint referred repeatedly to the circumstances of the offer, acceptance, and termination of the taxpayer’s employment, and the taxpayer’s complaint referred repeatedly to the purchaser’s breach of contract. The court also emphasized that the fact that the general release executed by the taxpayer referred once to “alleged fraud” was insufficient to establish that the settlement payment was received on account of personal injuries.

In Taylor v. Commissioner, T.C. Memo. 1995-442 (September 19, 1995), the taxpayer was discharged from her employment by AT&T on February 13, 1990, and, on February 21, 1990, she filed a Title VII discrimination charge with the Equal Employment Opportunity Commission (“EEOC”). On June 14, 1991, the EEOC dismissed the discrimination charge on the ground that there was insufficient evidence that AT&T had violated Title VII. Prior to the dismissal of the EEOC charge, on November 28, 1990, the taxpayer filed a complaint in court against AT&T and the Communication Workers union alleging breach of contract and breach of duty of fair representation. In October 1991, the taxpayer signed a settlement agreement with AT&T and the union, under which she received from AT&T a payment specified as “back wages,” and she released AT&T and the union from any claim she might have relating to her employment or the termination of her employment. Neither the taxpayer's complaint nor the settlement agreement contained any reference to physical or emotional injuries. Nonetheless, the taxpayer, who represented herself in the Tax Court, took the position that the payment was excludable under IRC §104(a)(2), on the ground that it was made to “settle the defamation of character, the stress, the aggravation, the pain that they've caused me and my family over a period of time.” The Tax Court, citing Schleier and Burke, rejected the taxpayer’s argument. Importantly, the court first pointed out that the taxpayer’s Title VII claim arose prior to the 1991 amendments to Title VII and therefore, under Burke, was not “tort-like.” The court then rejected the taxpayer’s factual arguments as follows (with emphasis in original):

[We note that petitioner presented no evidence about AT&T's intent in making the payment in question. Instead, she asserted in her testimony that she intended the AT&T Payment to settle, inter alia, her claim for “the defamation of character, the stress, the aggravation, the pain” that AT&T had caused her to suffer.

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4 Note that, although it still appears to be the law that a Title VII violation is itself a personal injury (see Section 35.03, above), it was important for the taxpayer to take the position that she received damages for her physical or emotional injuries because her Title VII claim arose prior to 1991 and therefore, under Burke, damages for settling her discrimination claim alone would not have been excludable.
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In Dotson v. United States, 95-1 U.S.T.C. ¶ 50,258 (S.D. Tex. 1995), decided on February 15, 1995, the taxpayer had received a payment as part of a settlement of a class action suit against an employer for terminating employees in order to reduce pension liabilities. The settlement was reached after the courts trying the class action determined that the defendant had violated §510 of the Employee Retirement and Income Security Act of 1974, 29 U.S.C. §1140 et seq. (“ERISA”). The taxpayer argued that the settlement payment qualified for a “tort-like exclusion from income for tax purposes.” The district court rejected the claim. Citing Robinson v. Commissioner, 102 T.C. 116 (1994), for the proposition that “damages received through settlement of a lawsuit are excludable from gross income only if the damages were received on account of a tort-like personal injury,” the court held that, because compensatory and punitive damages are not allowable in an ERISA action, the taxpayer’s ERISA claim was not tort-like.
§ 35.12 TREATMENT OF CASH PAYMENTS RECEIVED TO SETTLE CLAIMS FOR NONTAXABLE FRINGE BENEFITS

In McKean v. United States, 95-2 USTC ¶50,382 (Fed. Cl. 1995), decided on June 23, 1995, the taxpayers were flight attendants who had brought a successful Title VII sex discrimination suit against United Airlines. A portion of their payments reflected the value of lost health insurance benefits and travel passes the taxpayers would have received had they not been wrongfully discharged by the airline. Since the Title VII violations occurred prior to the 1991 amendments to Title VII, the taxpayers’ Title VII claims were not tort-like, under the Supreme Court’s decision in Burke. Presumably for this reason, the taxpayers did not argue that the payments in question were excludable from gross income under IRC § 104(a)(2). Instead they apparently argued that, under the “origin of the claim” doctrine, as enunciated in United States v. Gilmore, 372 U.S. 39 (1963), the value of the lost benefits were nontaxable because the health insurance benefits and travel passes would have been nontaxable under IRC §§ 106 and 132, respectively, had they been received in the course of employment. The court rejected the taxpayers’ claims. Although the court’s reasoning is not entirely clear, it appears to be based on the principle that cash in lieu of fringe benefits is necessarily taxable.