CHAPTER 20 Tax Treatment of Employment-Related Damages, Settlement Agreements, and Early Retirement Incentive Payments

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This article discusses the extent to which income taxes, employment (FICA) taxes, and wage withholding may be applicable to payments that arise in the employment context in connection with voluntary and involuntary terminations of employment and in connection with the litigation or settlement of employer/employee disputes. To a large extent, the enactment of the Small Business Job Protection Act of 1996 will moot the discussion of income taxation (specifically, the applicability of I.R.C. § 104(a)(2)) with respect to payments made after August 20, 1996, the date of enactment, since the Act will render I.R.C. § 104(a)(2) inapplicable to virtually all of the payments discussed in this article. The discussion of FICA taxes and wage withholding, however, will continue to be relevant to payments to which the Act applies.
Chapter 20: Tax Treatment of Employment-Related Damages, Settlement Agreements, and Early Retirement Incentive Payments

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§ 20.02 BACKGROUND: INCOME TAX RULES BEFORE THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

[1] Section 104(a)(2)
I.R.C. § 104(a)(2) provides: “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 I.R.C. § 104(a) modifies I.R.C. § 104(a)(2) (effective for amounts received after July 10, 1989) as follows: “Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.”

[2] Reg. § 1.104-1(c)
Reg. § 1.104-1(c), which is the only regulation elaborating on I.R.C. § 104(a)(2), provides:

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 regulation addresses only the first question. That is, it provides that, for purposes of I.R.C. § 104(a)(2), “damages” are amounts received in connection with legal actions or settlements, and it cryptically narrows 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 also raises two additional questions, namely: (4) What is a “settlement agreement?” and (5) What are “tort or tort type rights?”

It has become axiomatic in the I.R.C. § 104(a)(2) jurisprudence that, when a payment is made pursuant to a settlement agreement, the payor’s “purpose” or “reason” for making the payment determines whether the payment is made on account of personal injury claims. See, e.g., Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965), aff’d T.C. Memo. 1964-33 (“The most important fact … in the absence of an express personal injury settlement agreement, is the intent of the payor as to the purpose in making the payment”); Agar v.
Commissioner, 290 F.2d 283, 284 (2d Cir. 1961), aff’g 19 T.C.M. 116 (1960) ("the ultimate inquiry is into the 'basic reason' for the company's payment").

The payor's purpose for making a payment is most frequently examined and held to be controlling when a payment is made to settle multiple claims that include both personal injury claims and other claims. For example, if in a multiple-claim situation it is demonstrated that the payor's only reason for making a payment was to avoid contract claims, no part of the payment will be excluded under I.R.C. §104(a)(2), even if the taxpayer sincerely believed his or her personal injury claim had merit. On the other hand, if it is demonstrated that the payor made all or part of a payment to avoid personal injury claims, I.R.C. §104(a)(2) will apply to the amount paid for that purpose.

Naturally, the payor's own testimony is an important factor in determining the payor's intent. Other evidence, however, is taken into account as well, even if it contradicts the payor's testimony. For example, in Stocks v. Commissioner, 98 T.C. 1 (1992), the Tax Court allocated 20 percent of a settlement payment to personal injury claims (specifically, race discrimination claims) based on the entire record before the court, despite the testimony of the payor's representative that he could not remember discrimination claims having been an issue. A provision in a settlement agreement expressly allocating all or a portion of a settlement payment to personal injury claims also is an important factor in determining the payor's intent. See McKay v. Commissioner, 102 T.C. 465 (1994), vacated and remanded on other grounds, No. 94-41189 (5th Cir. April 10, 1996). Since the parties to a settlement both may benefit from the application of I.R.C. §104(a)(2), however, a favorable allocation in the settlement agreement may be given less weight than a factual record that supports the allocation. See Robinson v. Commissioner, 102 T.C. 116 (1994).
§ 20.03 IMPACT OF THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

Section 1605(a) of the Small Business Job Protection Act of 1996 amended I.R.C. § 104(a)(2) to read as follows (with the new language italicized):

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

Section 1605(b) of the Act struck the last sentence of I.R.C. § 104(a) (relating to punitive damages in non-physical injury cases) and inserted in its place the following two sentences:

“For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.”

The foregoing amendments apply to all payments received after August 20, 1996, the date of enactment of the amendments, except for payments made under written binding agreements, court decrees, or mediation awards in effect on or issued before September 13, 1995. (Act section 1605(d).)

The following passages in the Joint Explanatory Statement of the Committee of conference, August 5, 1996, at 143, make it clear that the amendments are intended to render I.R.C. § 104(a)(2) inapplicable to certain damages received in the employment context:

“The House bill also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses …) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.”

1 It is intended that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.

The balance of this article will discuss I.R.C. § 104(a)(2) as in effect prior to the enactment of the Small Business Job Protection Act of 1996.
§ 20.04 MEANING OF “RECEIVED ON ACCOUNT OF PERSONAL INJURIES” UNDER I.R.C. § 104(a)(2)

[1] Pre-Schleier Rules

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:

“[T]he 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, courts have uniformly held that, in determining whether a claim is a claim for personal injuries, it is the “nature” of the claim that is determinative, not the “consequences” of the claim. See Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986), cited with approval by the Supreme Court in Burke, supra, at 1872. This means that, if a cause of action is based on a personal injury, the fact that the redressed 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 Burke, a 1992 decision 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 (emphasis added). On its face, 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.”

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 I.R.C. § 104(a)(2). By way of explanation, the Ruling simply 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 the factual section of 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 decided before the Supreme Court decided Commissioner v. Schleier, 115 S.Ct. 2159 (1995), generally were consistent with this view.

In Banks v. United States, 94-2 U.S.T.C. ¶ 50,630 (W.D. Wash. 1994), aff’d, 96-1 U.S.T.C. ¶ 50,212 (9th Cir. 1996), 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, “The 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 redressed injuries caused by the union’s breach of its duty were 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), 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.”

[2] Impact of Schleier

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 I.R.C. § 104(a)(2).

The Court articulated 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 interpreted to imply that the taxpayer’s unlawful termination in violation of the ADEA was not itself a “personal injury” for purposes of I.R.C. § 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.2

2 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,
The foregoing interpretation of the quoted passage also seems to contradict \textit{Threlkeld v. Commissioner, 87 T.C. 1294 (1986)}, and \textit{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 business reputation (evidenced by lost business profits) is excludable under \textit{I.R.C. § 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 \textit{Schleier} that the Court intended to overrule \textit{Threlkeld} and \textit{Roemer}. (In fact, in \textit{Dotson v. United States, 87 F.3d 682 (5th Cir. 1996)}, the Fifth Circuit noted that \textit{Threlkeld} was “cited with approval by the Supreme Court in \textit{Schleier}.”)

The quoted passage from \textit{Schleier} may be reconciled with \textit{Burke, Threlkeld, and Roemer} by assuming that the \textit{Schleier} Court interpreted its prior holding in \textit{Burke} as narrowing the definition of “personal injury” to include a violation of a statutory personal right only if the violation is “tort-like” (\textit{i.e.}, if intangible personal harms are compensable), a characteristic that the \textit{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, simply because ADEA does not evince a tort-like conception of age discrimination.

On balance, a good argument can be made that the \textit{Schleier} Court did not modify the definition of “personal injuries” adopted in \textit{Burke, Threlkeld, Roemer}, and other cases. As evidenced by the cases discussed in the following section, however, ultimate resolution of the issue may require additional Supreme Court guidance.

\textbf{[3] Post-Schleier Decisions}

In \textit{Lane v. United States}, 95-2 U.S.T.C. ¶ 50,455 (W.D. Okla, August 2, 1995), the district court stated that, under Oklahoma law, a \textit{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. The government apparently did not argue to the contrary: it agreed that the compensatory damages (as opposed to the punitive damages) received by the taxpayer in the bad faith action were excludable under \textit{I.R.C. § 104(a)(2)}. Although the district court relied on the Supreme Court’s decision in \textit{Schleier} in reaching the conclusion that noncompensatory punitive damages are taxable, the court did not refer to \textit{Schleier} in connection with the “personal injury” issue. Since there is no mention of personal suffering in the \textit{Lane} decision, it may 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. Lane is thus consistent with the view that \textit{Schleier} did not modify the \textit{Burke/Threlkeld} definition of “personal injuries”.

Also consistent with this view are the Ninth Circuit decisions in \textit{Banks v. Commissioner}, 96-1 U.S.T.C. ¶ 50,212 (9th Cir. 1996), decided on April 16, 1996, \textit{aff’g} 94-2 U.S.T.C. ¶ 50,630 (W.D. Wash. 1994), and \textit{Strong v. Commissioner}, No. 94-70818, decided on March 19, 1996, \textit{aff’g} 68 T.C.M. 203 (1994).

In \textit{Banks}, the Ninth Circuit upheld a pre-\textit{Schleier} district court holding that damages received by an employee from a union for breach of the union’s duty of fair representation were received on account of personal injuries and were excludable under \textit{I.R.C. § 104(a)(2)}. On appeal, the government argued that \textit{Schleier} required reversal of the district court decision, since the damages received from the union were calculated by reference to the employee’s past and future wage loss. The Ninth Circuit rejected this argument, stating: “Unions do not pay wages to their members, and what the Union paid in settlement here to Banks did not constitute wages. It paid damages to compensate for its unfair and arbitrary treatment of Banks, conduct that the court had found to be in bad faith and in violation of the Union’s duty to fairly represent Banks.” The Ninth Circuit also held: “Banks’ injuries were, as the district court found, personal injuries.” Since Banks’ injuries, as described in the district court and Ninth Circuit opinions, were limited to the loss of his job, the Ninth Circuit’s decision must be viewed as holding that a union’s infringement of an employee’s right to fair representation establishes a per se personal injury, even if the consequences of the infringement are purely economic.

In \textit{Strong}, an unreported decision, the taxpayer received an unallocated lump-sum settlement payment in connection with an action for breach of contract and violation of the taxpayer’s civil rights under federal anti-discrimination laws. The Tax Court and the Ninth Circuit held that no part of the settlement was excludable

\textit{any} damages received in an action under that statute \textit{must} be excluded under \textit{I.R.C. § 104(a)(2)}, without the need for additional analysis.
because there was no evidence that the payor intended any part of the settlement payment to be in satisfaction of the discrimination claim. In dictum, the Ninth Circuit stated that the “racial discrimination claims under 42 U.S.C. §§ 1981, 1983, 1985(3), 1986, and 1988 are … ‘personal injury’ claims,” citing the Supreme Court’s opinion in Burke. Since the Strong opinions described no psychic injuries allegedly sustained by the taxpayer, this post-Schleier dictum suggests that racial discrimination in violation of a statute that provide tort-like remedies establishes a per se personal injury, even if the consequences of the discrimination are purely economic.

On the other hand, in another unreported post-Schleier decision, the Ninth Circuit stated that, under Schleier, economic damages received by taxpayers in a wrongful discharge action are not “received on account of personal injuries.” See Burns v. United States, 77 AFTR2d 96-480, No. 94-16639 (9th Cir. January 24, 1996).

The Fifth Circuit has applied Schleier on two occasions, holding each time that certain economic damages at issue were not received on account of personal injuries. In Dotson v. United States, 87 F.3d 682 (5th Cir. 1996), decided on June 27, 1996, the Fifth Circuit held that, where the taxpayer received tort-like damages from an employer in settlement of ERISA claims, the lost-earnings component of the settlement was not excludable under I.R.C. § 104(a)(2) because “the personal injuries, as the Supreme Court has distinguished them, did not give rise to the loss of wages.” Apparently, the Fifth Circuit read Schleier to mean that where a taxpayer whose ERISA rights were infringed was compensated for both dignitary injuries and lost earnings, only the damages attributable to dignitary injuries were received on account of personal injuries. This implies that the violation of the employee’s ERISA rights did not establish a per se personal injury even though the rights were personal and the claims (at least under the facts of Dotson) were “tort-like.”

Similarly, in McKay v. Commissioner, No. 94-41189 (5th Cir. April 10, 1996), vacating and remanding 102 T.C. 465 (1994), an unreported decision, the Fifth Circuit held that economic damages received in settlement of a wrongful discharge action were not received on account of personal injuries. Interestingly, the taxpayer in McKay never filed a brief in the court of appeals, and the court stated that it would “proceed to decide this case on the briefs as presented by the Commissioner.” Thus, the precedential importance of this decision is questionable.

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3 Dotson’s treatment of ERISA claims is explained in some detail in the text in § 20.05 infra.
§ 20.05 MEANING OF “TORT OR TORT TYPE RIGHTS” UNDER REG. § 1.104-1(c)

In its 1992 *Burke* decision, the Supreme Court held 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.”

In *Schleier,* the taxpayer argued that the Age Discrimination in Employment Act of 1967 is tort-like because of the availability under that Act of a jury trial and liquidated damages (which potentially double the compensatory damages where the defendant is shown to have acted willfully and therefore are similar to punitive damages). The *Schleier* Court rejected the argument, however, stating 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 that is a “sufficient” condition.

It should be noted that both *Burke* and *Schleier* involved the tax treatment of amounts received in settlement of claims brought under well-defined statutory schemes—although the characterization of damages under those statutes was unsettled, there was no doubt as to what damages were available under each statute. In each case, therefore, the Court had only to examine the nature of the remedial statute to determine the tax treatment of the damages.

A different problem arises where the claims being settled have not been identified with specificity by the claimant or where the availability of tort-like compensatory damages is unclear. In such a case, a good faith belief by the payor that it is settling claims that may entitle the claimant to tort-like damages may be sufficient grounds for excludability. In *Dotson v. United States,* the taxpayer had received a payment in settlement of a class-action lawsuit. In the first phase of the lawsuit, the Third Circuit Court of Appeals determined that Dotson’s employer had violated ERISA. In the second phase of the lawsuit, the district court assigned the case to a Special Master to help the court fashion an appropriate remedy. In this phase, the Special Master determined that tort-like remedies were available under ERISA, and, on the basis of that determination, the parties reached a settlement, which included payments of tort-like damages. Subsequent to the settlement, the Supreme Court held in an unrelated case that tort-like remedies are not available under ERISA. The government therefore argued in the *Dotson* case that ERISA claims are not tort-like and no damages received pursuant to an ERISA action may be excluded under *I.R.C.* § 104(a)(2). The Fifth Circuit rejected this argument, holding that the taxability of the damages at issue in *Dotson* was controlled
exclusively by the payor’s bona fide intention, at the time the settlement was agreed to, to settle the taxpayer’s compensatory damage claims.

The Fifth Circuit’s holding in Dotson suggests that if an employer makes a settlement payment with a bona fide intention to settle tort or tort-claim claims, the payment may be nontaxable even if it is later demonstrated that, under the facts, damages to compensate for nonpecuniary losses could not have been obtained by the taxpayer through litigation.

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ISSUES RAISED BY PREEMPTIVE RELEASES

[1] Background
Since the early 1990s, it has become common for employees leaving employment under a variety of circumstances to be offered a sum of money in exchange for releasing potential employment-related claims against the employer, regardless of whether the employee has actually prosecuted or threatened a claim prior to receiving the offer. The releases typically cover a broad range of potential claims, including tort claims, contract claims, and statutory claims under federal and state human rights laws. Also, the releases universally include boilerplate language designed to satisfy the requirements of the Older Workers' Benefits Protection Act of 1990, which provides that a release of claims under the Age Discrimination in Employment Act of 1967 is ineffective unless the release contains certain notice provisions.

In litigation regarding the application of I.R.C. § 104(a)(2) to payments received by departing employees in exchange for signing general releases, the IRS has argued that I.R.C. § 104(a)(2) cannot apply to such payments as a matter of law because (1) a claim must be “asserted” before it can be “settled” and (2) I.R.C. § 104(a)(2) cannot apply to an unallocated lump-sum payment made in exchange for an all-encompassing release that is not limited to tort-like personal injury claims.

When the Second Circuit decided Taggi v. United States, 35 F.3d 93 (2d Cir. 1994), aff’g 835 F. Supp. 744 (S.D.N.Y. 1993) (holding that I.R.C. Section 104(a)(2) did not apply to a lump-sum payment received by a departing AT&T employee in exchange for signing a general release), the IRS’ arguments appeared to be succeeding. Notably, however, Taggi and the cases it relied on all involved factual records that were devoid of any evidence showing that the employer made the payment for the purpose of avoiding litigation of personal injury claims. Thus, the cases trumpeted by the IRS as establishing dispositive rules of law (see Taggi, supra; Whitehead, 41 T.C.M. 365 (1980); and Galligan v. Commissioner, 66 T.C.M. 1669 (1993)) actually were decided in favor of the government on the more prosaic ground that the taxpayer had failed to meet the burden of proof. In each of those cases, the absence of (1) a prior asserted claim and (2) an express allocation of all or part of the payment to potential personal injury claims was simply part of that failure. The subsequently decided case Webb v. Commissioner, T.C. Memo. 1996-50 (February 13, 1996), is similar.

The Tax Court emphasized the factual nature of the issues in two cases decided on June 13, 1996. In Sodoma v. Commissioner, T.C. Memo. 1996-275, and Foster, et al. v. Commissioner, T.C. Memo. 1996-276, in dicta responding to arguments made in amicus curiae briefs, the Tax Court rejected the IRS’ arguments that (1) a prior asserted claim and (2) an express allocation of all or a part of a payment to personal injury claims are legal prerequisites to the application of I.R.C. § 104(a)(2). The court granted the IRS’ summary judgment motions in both cases due to the lack of evidence that the payor made the payment at issue for the purpose of settling personal injury claims—the court made it clear, however, that a prior asserted claim and an express

4 The amicus curiae briefs were filed by the author of this article.
allocation are simply facts tending to prove that the payor made the payment for the purpose of settling potential personal injury claims and that the absence of such facts is not dispositive if there is other evidence of the payor’s intent.

In a September 27, 1996 ruling in Abbott, et al. v. United States, Civil Action No. 3:96-CV-510 (N.D.N.Y., Binghamton Division), a federal District Court flatly rejected the government’s argument that both a prior asserted claim and an express allocation are legal prerequisites to I.R.C. § 104(a)(2). In Abbott, a refund action on behalf of 737 ex-IBM employees who received payments in exchange for releasing claims against IBM when they left the company, the government filed a motion asking the court to dismiss the case on the basis of that argument. The court denied the motion, holding that the plaintiffs were entitled to discover evidence of IBM’s purpose for making the payments.⁵


The IRS argued in Sodoma that, because Schleier holds that “the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is ‘based upon tort or tort type rights,’” 115 S.Ct. at 2167, there is an implicit requirement under I.R.C. § 104(a)(2) that the taxpayer must have asserted a claim (through suit or threat of suit) before entering into a settlement agreement. In a brief filed in the Sodoma case, the IRS insisted: “A taxpayer cannot prove that an underlying cause of action is tort or tort-like in nature if the underlying cause of action is nonexistent.” The amicus curiae briefs filed in Sodoma pointed out, however, that (1) the quoted language from Schleier merely holds that where the payor’s purpose is to settle a particular cause of action I.R.C. § 104(a)(2) does not apply unless the cause of action is tort-like; and (2) quoted language does not address the kinds of facts that are essential to establish that the payor’s purpose is to settle a particular cause of action.

The Tax Court’s dicta in Sodoma rejected the IRS’ argument. The court stated:

“Essential to petitioner’s ability to satisfy the first requirement [of the two I.R.C. § 104(a)(2) requirements described in Schleier] is the existence of a claim “based upon tort or tort type rights.” The parties and the amicus curiae have advanced extensive arguments as to whether such a claim must have been a valid claim that was asserted prior to the settlement. We are satisfied that the only requirement is that there be a claim which is bona fide, not necessarily valid, i.e., sustainable …. Moreover, while it need not have been previously asserted, the absence of any knowledge of the claim on the part of the employer-payor obviously has a negative impact in determining the requisite intent of the payment.” (Emphasis added.)

The court granted the IRS’ summary judgment motion in Sodoma due to the lack of evidence that the payor made the payment at issue for the purpose of settling personal injury claims.


Thus, according to Sodoma, a prior asserted claim is not a prerequisite to the application of I.R.C. § 104(a)(2). The assertion or nonassertion of a claim is simply a fact to be taken into account in determining the payor’s purpose for making the payment.

The Sodoma court’s conclusion is consistent with the holding of Rev. Rul. 84-108, 1984-2 C.B. 32, in which the IRS held that I.R.C. § 104(a)(2) applies to a preemptive payment to a decedent’s estate in exchange for a release of wrongful death claims even though no claim had been asserted by the estate or by surviving family members. See also the unreported district court ruling in Abbott, et al. v. United States, Civil Action No. 3:96-CV-510 (N.D.N.Y., Binghamton Division, September 27, 1996), in which the court rejected the government’s argument that a prior asserted claim is a legal requirement under I.R.C. § 104(a)(2).

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⁴ The author of this article represents the plaintiffs in Abbott. The district court’s decision in Abbott is not available in print as this article goes to press.

⁵ The court granted the IRS’ summary judgment motion in Sodoma due to the lack of evidence that the payor made the payment at issue for the purpose of settling personal injury claims.
The IRS also argued in *Sodoma* that the absence of an express allocation of a portion of the departing employee’s settlement payment to personal injury claims was an independent and sufficient basis for finding the payment to be fully taxable. The IRS’ summary judgment motion asserted: “Where a settlement agreement is silent as to what portion, if any, of a settlement payment should be allocated towards damages excludable under I.R.C. § 104(a)(2), a court should not apportion a lump sum payment among various possible tort and contract claims.” The amicus curiae pointed out, however, that (1) in the only authority cited by the IRS (*Taggi v. United States, supra*), and in the authorities referred to by the Second Circuit in *Taggi,* there was a complete absence of any evidence upon which the court could base an allocation, and (2) courts frequently allocate payments based on the record as a whole where the settlement agreement is silent.8

The Tax Court’s dicta in *Sodoma*9 declined the IRS’ invitation to rule that an express allocation to personal injury claims is a legal prerequisite under I.R.C. § 104(a)(2). Instead, the court ruled that the need for evidence regarding allocation is simply a component of the taxpayer’s burden of proving the excludable amount of the payment. Regarding the record in *Sodoma,* the court emphasized, “The release makes no allocation, and petitioners have set forth no facts upon which they would rely to prove an allocation.” (Emphasis added.) See also the unreported district court ruling in *Abbott, et al. v. United States,* Civil Action No. 3:96-CV-510 (N.D.N.Y., Binghamton Division, September 27, 1996), in which the court rejected the government’s argument that an express allocation to personal injury claims is a legal requirement under I.R.C. § 104(a)(2).

[4] Pedagogical Examples

The importance of the issues discussed in this section may be illustrated by considering a simple pair of hypothetical situations in which (1) some or all of the members of an identifiable group may have suffered personal injuries for which the payor may be liable, and (2) the payor makes a standardized preemptive settlement offer to all members of the group. Although no existing case examines the applicability of I.R.C. § 104(a)(2) to this precise situation, it is difficult to escape the conclusion that the payments made to the members of the group should be excludable. From this conclusion, it follows that, if a number of employees leaving their employment (voluntarily or involuntarily) are paid by an employer in exchange for releases of claims, the payments should be excludable under I.R.C. § 104(a)(2) to the extent it can be proven that the employer made the payments to preempt potential personal injury claims.

Example (1):

Twenty shoppers are riding in a department store elevator when the main elevator brake fails, and the elevator falls 40 feet before it is brought to a jarring halt by an emergency braking mechanism. When store personnel open the elevator doors, they find 20 frightened individuals, some in tears, some in shock, some comforting others. A personal injury lawyer on the scene interviews the 20 elevator riders and writes down their names and addresses. A week later, the lawyer contacts the store’s counsel and threatens to file tort actions on behalf of all 20 individuals. Without investigating the nature or extent of the injuries suffered by any of the individuals, the store offers to settle all potential claims by making an identical payment to each in exchange for an identical general release of potential claims against the store. Each of the 20 individuals accepts the offer.

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9 The court granted the IRS’ summary judgment motion in *Sodoma* due to the lack of evidence that the payor made the payment at issue for the purpose of settling personal injury claims.
Example (2):
The facts are the same as in Example (1), except that there is no personal injury lawyer on the scene. Instead, the interview with the 20 elevator riders is conducted by the store’s own personnel. A week after the incident, an identical settlement offer is made to each of the 20 individuals, and each accepts the offer.

In each of these examples, the facts of the elevator incident give rise to a reasonable concern on the part of the store that it may be subject to tort-like personal injury claims, and the store makes payments to the potential claimants to forestall the claims. In cases analogous to Example (1), I.R.C. § 104(a)(2) has been held to apply without evidence regarding the nature or extent of the injuries suffered by the taxpayer. (See, e.g., Stocks v. Commissioner, 98 T.C. 1 (1992) (I.R.C. § 104(a)(2) applied to portion of lump sum settlement payment allocated by court to “potential racial discrimination claims” even though there was no evidence of discrimination or other injury and the State Civil Rights Commission had issued “no probable cause” letters). Furthermore, as recognized by the IRS in Rev. Rul. 84-108, 1984-2 C.B. 33 (holding that I.R.C. § 104(a)(2) applies to preemptive settlement of potential wrongful death claims), there is no meaningful distinction between Example (1) and Example (2). Thus, all a recipient of a payment in Examples (1) and (2) should be required to prove in order to establish the applicability of I.R.C. § 104(a)(2) to the payment received is simply that (1) the recipient was on the elevator and (2) the store made the payments to the elevator riders to forestall their potential personal injury claims.

Similarly, if employees leaving employment with a company receive payments from the company in exchange for signing general releases, they should be entitled to exclude their payments from income under I.R.C. § 104(a)(2) if they are able to prove that (1) by virtue of one or more demonstrable conditions of their employment, it was reasonable for the company to be concerned that the employees may have suffered personal injuries, and (2) the company in fact made the payments to departing employees who signed releases in order to forestall their potential personal injury claims.
§ 20.07 FICA AND INCOME-TAX WITHHOLDING

[1] Statutory Rules

[a] Tax Base
FICA taxes (consisting of the 6.2 percent Old-Age, Survivors, and Disability Insurance tax and the 1.45 percent Hospital Insurance tax) are imposed separately on employees and employers by I.R.C. §§ 3101 and 3111, respectively. The taxes are equal to a percentage of the “wages” received by an individual with respect to “employment.”
I.R.C. § 3121(a) defines the term “wages” to mean “all remuneration for employment…” subject to numerous exceptions that are not relevant for purposes of this article. I.R.C. § 3121(b) defines “employment” to mean “any service, of whatever nature, performed … by an employee for the person employing him.” Thus, for FICA taxation purposes, “remuneration for employment” has the same meaning as “remuneration for services performed by an employee for his/her employer.”
I.R.C. § 3121(b) requires employers to deduct and withhold income taxes with respect to “wages”.

[b] Definition of “Wages”
For FICA tax purposes, I.R.C. § 3121(a) defines the term “wages” to mean “all remuneration for employment …” subject to numerous exceptions that are not relevant for purposes of this article. I.R.C. § 3121(b) defines “employment” to mean “any service, of whatever nature, performed … by an employee for the person employing him.” Thus, for FICA taxation purposes, “remuneration for employment” has the same meaning as “remuneration for services performed by an employee for his/her employer.”
For income-tax withholding purposes, I.R.C. § 3401(a) defines the term “wages” to mean “all remuneration … for services performed by an employee for his employer …” again subject to numerous exceptions that are not relevant for purposes of this article.

[2] Regulations
The regulations interpreting I.R.C. § 3121(a) reiterate that “wages” means “remuneration for employment.” Reg. § 31.3121(a)-1(b). The regulations also emphasize the irrelevance of (1) “the name by which the remuneration for employment is designated” Reg. § 31.3121(a)-1(c), (2) “the basis upon which the remuneration is paid” Reg. § 31.3121(a)-1(d)), (3) “the medium in which the remuneration is paid” Reg. § 31.3121(a)-1(e)), and (4) whether the employment relationship between the employer and employee continues to exist at the time the remuneration is paid. Reg. § 31.3121(a)-1(i)).
The regulations interpreting I.R.C. § 3401(a) contain many of the same provisions as the I.R.C. § 3121(a) regulations and also provide:
“Dismissal payments. Any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments.”
Reg. § 31.3401(a)-1(b)(4). The IRS has ruled that, although there is no comparable regulation under the FICA provisions, the legislative history of the Social Security Act Amendments of 1950 make it clear that dismissal

[3] Interaction with Exclusions from Income
Payments by an employer to an employee that are excluded from income are not included in “wages” for FICA or income-tax withholding purposes. Rowan Companies, Inc. v. United States, 452 U.S. 247, 254 (1981); Anderson v. United States, 929 F.2d 648 (Fed. Cir. 1991); Dotson v. United States, 87 F.3d 682, 689 (5th Cir. 1996) (“Damages not included in the tax code’s definition of ‘income’ are not considered ‘wages’”). Thus, if I.R.C. § 104(a)(2) applies to a payment, the payment is necessarily exempt from FICA taxation and income-tax withholding as well.

On the basis of the foregoing rules, the following scheme emerges:

- If I.R.C. § 104(a)(2) applies to a payment to an employee, the payment is exempt from FICA taxation and income-tax withholding.
- Even if I.R.C. § 104(a)(2) does not apply to a payment to an employee, the payment is exempt from FICA taxation and income-tax withholding unless the payment is made as remuneration for services performed by the employee for the employer.


[a] IRS Position

In support of its position that a back pay award constitutes “remuneration for services performed” even when it relates to periods when the employee was prevented from performing any services, the IRS cites Social Security Board v. Nierotko, 327 U.S. 358 (1946). See Rev. Rul. 57-55 and Rev. Rul. 78-176. Nierotko involved the computation of Social Security benefits, not the imposition of taxes. In Nierotko, a worker whose discharge violated the National Labor Relations Act (“NLRA”) was ordered reinstated with back pay. The Supreme Court held that since the NLRA (1) treated a wrongfully discharged employee as having remained an employee throughout the period between discharge and reinstatement and (2) was designed to make the employee whole, the back pay award should be treated as “remuneration for employment” in calculating the employee’s Social Security benefits. See 327 U.S. at 364–65. As the IRS explained its understanding of Nierotko in Rev. Rul. 78-176, “[I]nasmuch as Congress intended, under the National Labor Relations Act, that back pay could be ordered by the [NLRB] in order to make the victim whole, complete reparation would include the wage credits under the Social Security Act.” Moreover, the IRS asserted: “Congress had a similar intent with respect to the compensatory payments provided under Title VII of the Civil Rights Act of 1964.” The IRS’ reasoning in support of the latter conclusion is explained in G.C.M. 36732 (May 19, 1976).

Interestingly, prior to the Supreme Court’s decision in Nierotko, the IRS took the position that back pay awarded to discharged employees under the NLRA was not wages. In S.S.T. 359, 1939-1 C.B. (Part 1) 305, the IRS explained:
For purposes of the [NLRA], the term ‘employee’ includes ‘any individual whose work has ceased as a consequence of, or in connection with, any current labor dispute or because of any unfair labor practice, and who has not obtained any other regular and substantially equivalent employment.’ However, it does not follow that the sum of money paid to that individual upon reinstatement pursuant to an order of the [NLRB] constitutes remuneration for services performed by an employee for his employer for the purpose of the taxing provisions of the Social Security Act. Such employee has actually performed no services for which such payments are made. …

This position was criticized as “unsound” by the Supreme Court in Nierotko, see 327 U.S. at 367, and, in Rev. Rul. 78-176, the IRS publicly announced the it would treat as FICA wages back pay awards received by job applicants who were wrongfully refused employment.

Apparently, however, the IRS was never convinced of the correctness of its new position. In G.C.M. 36732 (May 19, 1976), which considered the proposed Revenue Ruling ultimately adopted as Rev. Rul. 78-176, the IRS noted that “we had no alternative but to modify our rulings position to conform to that of the Social Security Administration,” which apparently had decide to treat back pay awarded under Title VII of the Civil Rights Act of 1964 as “wages” for Social Security benefits purposes. Moreover, the following comments at the end of the G.C.M. suggest that the IRS applied Nierotko for FICA purposes primarily because of revenue concerns:

“We think any lingering doubts about the legal validity of the position of the Social Security Administration taken in this matter should be resolved in favor of accepting it, at least for the present, in the interest of protecting the fisc. This is because, unless and until a judicial test compels a different view, the Social Security Administration might accept ‘back pay’ like that under consideration here as a basis for the payment of Social Security benefits later to be paid, which means that such benefits would be paid without proper funding (by corresponding taxes earlier paid) if the Service declines to treat the “back pay” in question as subject to the FICA tax.”

[b] Case Law and Analysis

There is no support in the case law for the IRS’ determination that Nierotko’s rule regarding the computation of Social Security benefits also applies for tax purposes. In fact, in Bennett v. United States, 94-2 U.S.T.C. ¶ 50,044 (Fed. Cl. 1994), the Court of Federal Claims stated:

“The court also rejects defendant’s argument that [Nierotko] requires holding the back pay awards taxable as wages. Nierotko concerned the narrow issue of whether back awarded under the [NLRA] to a wrongfully discharged employee should be treated as wages for purposes of computing Social Security Act benefits. … The Court declines to apply Nierotko to this case because that decision addressed neither the interpretation nor the application of exclusions from gross income for federal income tax purposes.”

Since, in Bennett, the court held that the back pay award at issue was excludable from gross income under I.R.C. § 104(a)(2), the implication of this passage is that a back pay award may be nontaxable for income tax and FICA tax purposes yet still may be taken into account in computing Social Security benefits.\(^\text{10}\)

The weakness of the IRS’ reliance on Nierotko is brought into even sharper focus by the government’s litigating position in Bowman v. United States, 824 F.2d 528 (6th Cir. 1987). In Bowman, the taxpayer received a back pay settlement and took the position that the FICA tax should be computed by treating the settlement payment as having been received in the years to which it related, rather than in the year of payment.\(^\text{11}\) The government took the position that the payment should be included in taxable wages in the year in which it was received. The Sixth Circuit noted that Nierotko had held that back pay must be

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\(^{10}\) In Central Illinois Public Service Co. v. United States, 435 U.S. 21, 28 (1978), the Supreme Court similarly referred to Nierotko as a case “where the definition of wages under the Social Security Act was at issue.”

\(^{11}\) The more fundamental issue of whether a back pay settlement is subject to FICA taxes was not before the court, which stated: “The parties agree that the settlement award constituted wages for employment.” 824 F.2d at 529.
allocated back to the prior periods to which it relates for purposes of computing Social Security benefits and asked the government to address the reasoning of Nierotko. The following passage in the Bowman opinion describes the government’s argument:

“[T]he Government argues that Nierotko is inapposite since the ‘determination in Nierotko that, for purposes of determining an employee’s eligibility for Social Security benefits, an award of back wages should be allocated to the periods in which the wages were or would have been earned simply has no bearing on the separate question presented here as to the year in which an award of back pay is subject to the F.I.C.A. tax.’

“The Government argues further that Nierotko implicated different policy concerns than the present case. The Government states with respect to Nierotko ‘that for purposes of determining an employee’s eligibility and benefits an allocation of an award of back pay to the periods to which such pay relates is necessary to protect the employee’s rights. No similar policy considerations are involved in the taxation question presented in the case at bar.’”

824 F.2d at 530.¹² Of course, precisely the same argument may be made regarding the inclusion of back pay awards in wages for FICA purposes. The Supreme Court reasoned in Nierotko that back pay should be treated as wages in computing Social Security benefits in order to give effect to the employee-protection policy expressed in the NLRA. Certainly, that policy does not require the employee to be taxed!

Moreover, the weight of the case law strongly favors not treating damages compensating for wages lost due to termination of employment or failure to hire as “wages” for tax purposes. In Dotson v. United States, 87 F.3d 682 (5th Cir. 1996), the Fifth Circuit considered the application of I.R.C. § 104(a)(2) to a judicially fashioned Employment Impairment Additur award (“EIA”), which compensated wrongfully discharged employees for their “long-term loss in employment prospects.” The court first held that the applicability of I.R.C. § 104(a)(2) to the EIA depended on whether the earnings impairment being compensated was due to (1) the discharge or (2) the emotional damage or loss of reputation that resulted from the discharge. The court then stated:

“Even if the district court determines [on remand] that some portion of the [EIA] is taxable, it still does not constitute ‘remuneration for employment’ subject to wages taxation. I.R.C. §§ 3101, 3111, 3121(a), 3306(b). The EIA compensated for ‘loss in earning capacity,’ not for services already performed, and is thus not subject to wage taxation.”

87 F.3d at 690. This conclusion, which is based squarely on the statutory definition of wages as “remuneration for services performed,” should apply to back pay awarded to claimants who were not employed by the payor during the period for which back pay is calculated, including both (1) claimants whose application for employment was wrongfully denied and (2) claimants whose employment was wrongfully terminated.

The only case suggesting that a back pay award relating to periods when the taxpayer was not performing services is subject to withholding has little precedential value. Melani, et al. v. Bd. of Higher Ed. of the City of N.Y., 652 F. Supp. 43 (S.D.N.Y. 1987), involved the application of tax withholding rules to payments from a fund established for the benefit of a successful plaintiff class in a sex discrimination suit. For most of the class members, the discrimination at issue involved salary discrimination during periods when they actually performed services. A small subclass had applied for, and been refused, employment. The district court rendered a single decision, applicable to the entire class, stating: “Payments for settlement of claims for back pay are wages. Rev. Rul. 84-92; Rev. Rul. 80-364; Rev. Rul. 72-341.” Notably, Rev. Rul. 84-92 and Rev. Rul. 72-341 involve payments by a corporation to its employees (presumably for salary

¹²Similarly, in AOD/CC-1988-006 (May 6, 1988), in which the IRS stated that it would not follow the Bowman decision, the IRS stated: “The Nierotko decision is inapposite to the issue in this case. The determination as to qualification for social security benefits has no bearing on the computation of FICA taxation for back wages.”
discrimination), and the issue considered in Rev. Rul. 80-364 is “whether interest and an attorney’s fee awarded by a court in connection with a claim for back pay are wages for federal employment tax purposes.” Thus, it does not appear that the Melani court even considered the specific issue of whether back pay distributable to class members who had never performed services should be treated as wages.


[a] IRS Position

As noted above, Reg. § 31.3401(a)-1(b)(4) provides: “Dismissal payments. Any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments.”

The IRS has applied this regulation in a number of Revenue Rulings. Those Rulings reveal that the IRS takes an extraordinarily expansive view of the regulation, essentially disregarding the statutory definition of “wages” as well as the phrase “on account of dismissal.”

In Rev. Rul. 71-408, 1071-2 C.B. 340, a company terminated its operations and, pursuant to an agreement with the union representing its hourly employees, made payments to eligible employees whose services were terminated. To be eligible, an employee had to be on the active payroll and had to have at least five years of service with the company at the time of termination. The amount of each payment “took into account” the employee’s rate of pay and years of service. The Ruling does not state when the agreement with the union was entered into, but the language of the Ruling implies that the agreement did not predate the company’s decision to terminate operations. The Ruling holds: “In the instant case the dismissal payments were made upon the involuntary separation of the employee from the service of the employer. Accordingly, it is held that the amounts of dismissal payments are ‘wages’ ….”

In support of this conclusion, the Ruling cites Reg. § 31.3401(a)-1(b)(4), quoted above, and the legislative history of the Social Security Act Amendments of 1950, P.L. 734, 81st Cong., 1950-2 C.B. 217. The Ruling correctly points out that, although the regulation technically applies only to income-tax withholding and there is no comparable regulation applicable to FICA taxes, the 1950 legislation repealed a prior-law FICA exclusion applicable to “dismissal payments which the employer was not legally required to make.” The Ruling emphasizes a 1950 Act committee report statement to the effect that, for FICA purposes, “a dismissal payment, which is any payment made by an employer on account of involuntary separation of the employee from the service of the employer, will constitute wages … irrespective of whether the employer is, or is not, legally required to make such payment.”

The result in Rev. Rul. 71-408 is probably correct, since the relatively minimal facts stated in the Ruling suggest that the union negotiated the payments to provide long-term employees with additional compensation for their past services.

Nonetheless, given the language of Reg. § 31.3401(a)-1(b)(4) and the 1950 Act legislative history, it is odd that Rev. Rul. 71-408 explains its conclusion by stating that the dismissal payments were made “upon” the involuntary separation of the employee from service, rather than “on account of” the separation. The phrase “on account of” implies that the separation must be the reason for the payment. Where the sole reason for a payment is separation from service (as opposed to, e.g., a desire to induce some act other than the performance of services), it may be argued that there is a high degree of probability that the payment is made to reward the employee for past services. The term “upon,” on the other hand, implies only that the separation was the occasion for the payment. Where separation from service is merely the occasion for a payment, that probability that it is made for a compensatory purpose vanishes, since a payment on the occasion of separation from service may be made for a variety of noncompensatory reasons.13 The Rulings

13 The IRS has itself stressed this distinction in a somewhat related context. Rev. Rul. 69-286, 1969-1 C.B. 253, holds that incentive compensation allotments that are payable to employees upon termination of their services are not paid “on account of retirement, disability, or death” within the meaning of former I.R.C. § 3121(a)(2). The Ruling emphasizes: “The occasion upon
discussed below demonstrate that the IRS’ substitution of “upon” for “on account of” has led the IRS to apply the regulation in inappropriate cases.

In Rev. Rul. 72-572, 1972-2 C.B. 535, an employee whose services were terminated by her employer filed a complaint with the State Department of Human Rights, alleging discrimination. Thereafter, her employer paid her an amount equal to three weeks’ pay as consideration for her withdrawal of the complaint. Citing Reg. § 31.3401(a)-1(b)(4) and the 1950 Act legislative history, the IRS concluded:

“In the instant case, the payments were made upon the involuntary separation of the employee from the service of the employer. See Revenue Ruling 71-408 … . Accordingly, it is held that the amount paid by the company to its former employee is a dismissal payment and thus ‘wages’ … .”

In this Ruling, although the payment arguably was made “upon” the employee’s involuntary separation from service, it clearly was not made “on account of” the separation. Rather, it was made as consideration for the withdrawal of the employee’s discrimination complaint. Thus, under standard “origin of the claim” analysis, the treatment of the payment should depend on the nature of the employee’s discrimination claim, the kinds of remedies the employee could have obtained from successful prosecution of that claim, etc. As it stands, the analysis in the Ruling is simply wrong.

In Rev. Rul. 73-166, 1973-1 C.B. 411, certain striking workers were not allowed to return to their jobs at the end of the strike because their positions had been filled by non-union personnel during the strike. The union and the company entered into an agreement pursuant to which the company paid an amount to each of the workers and the union agreed not to pursue any action against the company. The amount of each payment was equal to the wages the worker would have earned had he worked during the period of the strike. Citing Reg. § 31.3401(a)-1(b)(4) and the 1950 Act legislative history, the IRS concluded:

“In the instant case, the payments were made upon the involuntary separation of the employee from the service of the employer. See Revenue Ruling 71-408 … . Accordingly, it is held that the amounts paid to the strikers who were not reemployed by the company are dismissal payments and thus ‘wages’ … .”

This Ruling suffers from the same defect as Rev. Rul. 72-572. That is, although the payments arguably were made “upon” the employees’ involuntary separation from service, they clearly were not made “on account of” the separation. Rather, the payments were made as consideration for the union’s agreement not to pursue any action against the company, and the treatment of the payments should depend on the nature of the actions the union might have taken.

Interestingly, G.C.M. 34888 (May 30, 1972), which considered both Rev. Rul. 72-572 and Rev. Rul. 73-166, stated that each of the Rulings involved “payments to involuntarily terminated employees for past services.” (Emphasis added.) If the payments were in fact made to compensate the terminated employees for past services, it is appropriate to treat them as wages. The facts stated in the Rulings, however, do not provide any basis for concluding that that was the reason for the payments.

Finally, in Rev. Rul. 74-252, 1974-1 C.B. 287, an employee entered into a three-year employment contract under which the employer could terminate the relationship at any time provided the employee was paid an amount equal to an additional six months’ salary. The employer subsequently terminated the relationship

which the employee elects to receive it does not change the character of the payment. If an employee chooses to take payment at the time he retires, that event does not serve to convert a payment that is in the nature of a bonus to a payment ‘on account of retirement.’ “ In PLR 8344037 (July 29, 1983), the IRS clarified that this reasoning applies to a plan under which a severance benefit may be paid to certain employees whose employment is voluntarily or involuntarily terminated. Citing Rev. Rul. 69-286, this private ruling states: “Since the payments under the severance pay plan are made for termination for any reason… they are not considered to have been paid on account of retirement.” In other words, the IRS recognizes that a payment is made “on account of” a specified event only when that event is the reason for the payment, and not when the event is merely the occasion for the payment.
and made the required payments. Citing Reg. § 31.3401(a)-1(b)(4) and the 1950 Act legislative history, the IRS concluded:

“In this case, the payments were made by the company to the employee upon his involuntary separation from the service of the company and were in the nature of dismissal payments …

Accordingly, it is held in the instant case that these payments are ‘wages’ ….”

The IRS acknowledged that, in Rev. Rul. 58-301, 1958-1 C.B. 23, the IRS had ruled that consideration received by an employee for the cancellation of an employment contract is not “wages.” The IRS distinguished the payments in Rev. Rul. 74-252 from those in Rev. Rul. 58-301, however, by asserting: “They were made pursuant to the provisions of the contract rather than as consideration for the relinquishment of interests the employee had in his employment contract in the nature of property.”

This distinction is hard to accept. The payments described in Rev. Rul. 74-252 were simply liquidated damages for breach of the employment contract. The employee in that Ruling would have received the same payments had the company breached the contract before he performed any services at all. Thus, the payments were independent of the performance of services and should not be considered “remuneration for services.” Correlatively, it is inconceivable that the settlement payment that the employee in Rev. Rul. 58-301 accepted in connection with the employer’s anticipatory breach of his employment contract (which the IRS concluded was not in the nature of wages) would be transformed into wages if the employer in that Ruling had simply fired the employee and the employee had received the same payment as actual damages for breach of contract. See Rev. Rul. 55-520, 1955-1 C.B. 393, in which the IRS ruled that a payment to settle litigation following an employee’s forced resignation before the completion of a two-year contract was not wages.

[b] Case Law and Analysis

The cases that have considered the IRS’ expansive position regarding “dismissal payments” have rejected that position. In Dotson v. United States, 87 F.3d 682, 690 (5th Cir. 1996), the Fifth Circuit quoted with approval the following passage from the district court decision in Slotta v. Texas A&M Univ. System, No. 6-93-92 (S.D. Tex. August 10, 1994): “A dismissal payment is not subject to withholding if it cannot be fairly classified as remuneration for services performed.” Dotson, as noted above, held that a payment of damages to a wrongfully discharged employee to compensate for lost future earnings was not subject to FICA taxes or income-tax withholding.

In Slotta, the district court held that a university that settled litigation with a tenured university professor by making a payment in exchange for his relinquishment of tenure rights was not entitled to withhold income and FICA taxes from the payment. In response to the argument that the payment was a “dismissal payment” subject to Reg. § 31.3401(a)-1(b)(4), the district court stated:

“[T]he Court has located no statute giving the Treasury Department the discretion to make such a regulation to the extent it expands on the statutory definition of ‘wages.’ Therefore, a dismissal payment is not subject to withholding if it cannot be fairly classified as remuneration for services performed. For example, the IRS has conceded that the lump-sum buy-out of the remaining three years of a five-year employment contract does not constitute ‘wages’ for the purpose of withholding, although it is certainly income, because these breach of contract damages do not relate to past service.”

The district court emphasized that, since Mr. Slotta had previously taught at other institutions and had been granted tenure by Texas A&M as a “term of his initial employment,” he did not earn his tenure rights by performing services for the institution making the payment. The court wrote: “The theory that tenure could be the payment by one university to an individual for his past services to another university is simply ridiculous. The university makes the offer of tenure, like the offer of any other attractive contract, simply to entice the individual to perform future services.”

Thus, Dotson and Slotta suggest that, consistently with the statutory definition of “wages” as “remuneration for services performed,” a payment made on account of an employee’s involuntary separation from service
may properly be treated as wages only if the payment is made to compensate the employee for past services. This is a factual issue to be determined on a case-by-case basis. The skeletal facts presented in Rev. Rul. 71-408 suggest that compensation may have been the only purpose of the payment described therein, and the holding of the Ruling may therefore be correct. Rev. Rul. 72-572, Rev. Rul. 73-166, and Rev. Rul. 75-252, however, all present situations in which the payments under consideration appear (with varying degrees of certainty) to have been made for some purpose other than compensating the recipient for services. Accordingly, if the persuasive reasoning in Dotson and Slotta is followed by other courts, there is a good chance that the holdings of those Rulings will not be followed.

[7] Treatment of Early Retirement Incentive Payments

During the last two decades, many employers have reduced the size of their workforces by means of programs in which each employee who leaves employment under the terms of the particular program receives a sum of money. The precise purpose of the payment varies from case to case. In some cases, the purpose of the payment is to extract a release of the employee's potential employment-related claims against the company. In other cases, the payment may be made to induce employees to relinquish seniority rights accrued contractually through their years of past service. In other cases, inducements may be paid to employees who have no contractual rights and pose minimal risk of employment litigation simply because voluntary resignations are expected to yield higher employee morale than involuntary terminations. This section considers the treatment of retirement incentive payments as "wages" in circumstances where the payments are included in taxable income because they are not made to avoid litigation of tort claims.

[a] IRS Position

The IRS has not issued any published Revenue Rulings dealing squarely with the FICA treatment of early retirement incentive payments, but, through private letter rulings, General Counsel Memoranda, and the litigating position of the Justice Department, the IRS has clearly staked out the position that all such payments are included in wages.

Historically, the IRS' position has been based on Rev. Rul. 75-44, 1975-1 C.B. 15, and the manner in which that Ruling distinguishes Rev. Rul. 58-301, 1958-1 C.B. 23. As we shall see later, however, the IRS appears to be searching for a broader basis for its position.

In Rev. Rul. 58-301, an employee in the second year of a five-year employment contract was given a lump-sum payment as consideration for the cancellation of the contract. The Ruling held that the payment was not "wages" for FICA purposes.

In Rev. Rul. 75-44, an employee received a lump-sum payment as consideration for relinquishing seniority rights that had been earned through past services performed for the employer. In this Ruling, the IRS distinguished Rev. Rul. 58-301 on the ground that, in the earlier Ruling, the relinquished employment rights had been acquired in the original contract, rather than through the performance of services.

In at least four private letter rulings, the IRS has relied squarely on Rev. Rul. 75-44 as a basis for finding that early retirement incentive payments are wages for FICA purposes. In PLR 7612222110A (December 22, 1976), an employer established a plan to encourage the early retirement of certain employees who had rights to continued employment under what appears to have been a collective bargaining agreement with a union. Eligible employees agreeing to retire under the plan were given payments of money. Notably, the ruling does not state that the eligible employees obtained their employment rights under the union contract through past services (although it is likely that only employees with seniority had such rights). Nonetheless, the ruling states:

“The facts in your case closely resemble those in Rev. Rul. 75-44. Your employees who receive payment for relinquishing their rights to continued employment are not being paid for a right which they acquired under an individual, original contract of employment as was the case in Rev. Rul. 58-301. Rather, this right has come from circumstances and agreements separate from the actual contract of employment.”
In **PLR 7733062 (May 19, 1977)**, an employer offered special payments to induce marginally performing management employees to terminate their employment. Managers receiving such offers were not threatened with involuntary terminations, but they were told that, if they did not accept the offers, they would be demoted with corresponding cuts in pay. As in **PLR 761222110A**, the IRS did not present any facts suggesting that the managers had rights to continued employment that they had earned through past services. Nonetheless, the IRS concluded:

> “The facts presented show that employees receiving early retirement payments voluntarily give up the right to continued employment until retirement in exchange for a lump sum payment. This is analogous to the rail employee in **Rev. Rul. 75-44** who relinquished his seniority rights to receive a lump sum payment and another job. In effect your Company is giving the departing employee additional compensation so that he will relinquish rights to continued employment.”

**PLR 8447103** is similar. Although there are no facts in the ruling suggesting that the employee in question had any rights to continued employment that were earned through past services, the IRS stated: “In your case, as in **Rev. Rul. 75-44**, you are being compensated for relinquishing your right to continued employment. Your right to continued employment was acquired by having provided prior service, not under a contract for a specified period of time.”

Finally, in **PLR 9510031 (December 9, 1994)**, the IRS ruled that **Rev. Rul. 75-44** governed the treatment of early retirement incentive payments to tenured teachers and other, nontenured, employees who “enjoyed certain rights on the basis of seniority.”

With the exception of **PLR 9510031**, these rulings suggest that the IRS treats all early retirement incentive payments as consideration for the relinquishment of rights earned through past service, regardless of whether or not there is evidence supporting this factual premise.

Nonetheless, the IRS has revealed that it desires to avoid force-fitting early retirement payments into the **Rev. Rul. 75-44** mold and would prefer to take the position that the payments are wages simply because there is no exception from the “wages” definition that expressly applies to them. This position, which clearly begs the critical statutory question of whether the payments are made as “remuneration for services performed,” first surfaced in **PLR 7733062 (May 19, 1977)**, supra. While the IRS relied on **Rev. Rul. 75-44** in that ruling, the IRS also cited the regulations, legislative history, and Rulings relating to “dismissal payments.” In an interesting dictum, the IRS stated:

> “**Rev. Ruls. 71-408** and **Temp. Treas. Reg. §§ 1.6011-4T(b)(2)** are peripherally relevant. Those rulings involve dismissal payments for involuntary separation rather than payments to voluntarily retire. However, those rulings show an example of payments that are wages because they do not fall within an exception specifically defined in the Code or regulations.”

Around the time **PLR 7733062** was released, the IRS was considering publishing a Revenue Ruling involving facts similar to those in **PLR 761222110A**, supra. In **G.C.M. 37784 (December 11, 1978)**, the Office of Chief Counsel expressed its view that the distinction between 301.6111-2T(b)(2) and **Rev. Rul. 58-301** was valid and that it was appropriate to rely on **Rev. Rul. 75-44** as a basis for imposing FICA taxes on early retirement incentive payments to employee’s whose eligibility for the payments was based on “services performed as a union member with the employer and/or a previous employer.” Nonetheless, the following passage from **G.C.M. 37784** reveals doubts within the IRS about the conclusion:

> “It is arguable, of course, that what is being surrendered here is, in the last analysis, a negotiated contract right to continued employment and the basis for determining those employees who are entitled to that contractual right is of no significance at this stage of events. On this theory, one could conclude that what has occurred is simply an exchange of a contract right for a sum of money and no payment of ‘wages’ for services performed is involved, as was the case in **Rev. Rul. 58-301**.”

The revenue ruling proposed by Chief Counsel in **G.C.M. 37784** was not approved by the Commissioner. As **G.C.M. 38098 (September 19, 1979)** explains:

> “The Commissioner, in reviewing the revised proposed ruling, found this distinction between **Rev. Rul. 58-301** and **Rev. Rul. 75-44** ‘hard to support’ and therefore did not approve the ruling. … [W]e note that it is not entirely clear whether the Commissioner felt the conclusion reached in the proposed ruling is in error or simply felt the ruling reaches a harsh result insupportable in a court test. … If the latter, it is
certainly true that a contrary argument can be made, as noted in [G.C.M. 37784]. However … we believe this position to be deserving of perpetuation in the absence of contrary authority.”

G.C.M. 38098 was not persuasive, however, and the proposed ruling was put on hold for further study. Later, in G.C.M. 38534 (October 7, 1980), the Office of Chief Counsel reiterated its belief that the distinction between Rev. Rul. 75-44 and Rev. Rul. 58-301 was reasonable. However, in an apparent attempt to move the project forward, the latter G.C.M. states:

“After further consideration of the rationale of the ruling, we continue to view the nexus between the payments in question and past services rendered as a key element in the holding. However, rather than contrast the facts here with those in the 1958 ruling, a preferable approach may be to emphasize the statute’s broad definition of ‘wages’ and draw an analogy with the tax treatment of amounts received by an employee upon, and because of, separation from employment.

“[Reg. §31.3401(a)-1(b)(4)] provides that any payment made by an employer to an employee on account of dismissal from service constitutes wages … It is true, of course, that the above-noted regulation defines such dismissal payments as those precipitated by an involuntary separation from service of the employer, but the only difference between those compensatory disbursements and the payments in this case is that here the employees voluntarily agree to the binding separation once they have qualified by sufficient longevity as an employee. In other words, the employees in this proposed ruling are not being terminated against their will, but so long as the payments are being made in the context of the employer-employee relationship and are indeed attributable to services performed, we see no reason why the tax result should be different from the severance payment situation.” (Emphasis added)

The proposed revenue ruling was never published. Nonetheless, the reasoning described in G.C.M. 38534 has surfaced elsewhere. In PLR 9331007 (May 5, 1993), the IRS considered a situation in which an employer, seeking to “remove certain individuals from their positions of authority … offered each employee a package of benefits as inducement to retire early.” Each employee accepting the offer was required to sign a release of claims and to agree to perform certain limited services for the employer for a period of years. Citing only Reg. §31.3401(a)-1(b)(4) and the legislative history of the Social Security Act Amendments of 1950, the IRS ruled that the portion of the payments not constituting compensation for future services represented “a severance payment, which is not excludible from wages.”

Even more recently, in a brief filed on July 22, 1996 in Abbott, et al. v. United States, Civ. No. 3:96-CV-510 (N.D.N.Y., Binghamton Division), the Justice Department stated:

“[The United States] contends that all payments made by an employer to an employee constitute remuneration for employment and, consequently, are wages subject to employment taxes, unless an express statutory, regulatory, or IRS administrative exception applies or unless they are provided in exchange for the relinquishment of a contractual right or entitlement.”

In sum, the IRS clearly adheres to the position that all early retirement incentive payments constitute wages, although the rationale for that position is not entirely clear.

[b] Case Law and Analysis

The author is aware of only one court case actually adjudicating the FICA treatment of an early retirement incentive payment. In Kleckner v. Sullivan, No. 3:CV 90-0524, 1991 WL 333703 (M.D. Pa. July 22, 1991), an unreported district court decision, a payment received by a tenured public school teacher whose tenure rights were earned through past services was held to constitute “wages.” The Kleckner court relied entirely on Rev. Rul. 75-44, as evidenced by the following passage in the Magistrate’s Report, which was “adopted and approved” by the Kleckner court per the court’s July 16, 1991 order:

“[In Rev. Rul. 75-44, the] IRS concluded that the amount received by the employee was a lump sum settlement for the past performance of services reflected in the employment rights he was giving up and was money remuneration for his services and, therefore, wages under the Internal Revenue Code.

“The present case is similar. The relationship between the plaintiff and his employer was one in which no term of years was specified but instead contemplated to continue indefinitely unless specific just
cause conditions were met so that plaintiff would be terminated. Because the plaintiff did not violate the just cause conditions of his employment agreement, he accrued the right to continue employment. The [payment] given to plaintiff was in consideration for plaintiff’s relinquishing the right he had accrued to future employment based on his previous service.” (Emphasis added.)

Kleckner, therefore, provides no guidance regarding the treatment as “wages” of early retirement incentive payments to employees who have not earned employment rights through past services (i.e., (1) employees at will and (2) employees who have rights to continued employment but did not acquire them through the past performance of services). In fact, the author is aware of no case that addresses such payments. Nonetheless, in connection with a closely analogous question, the district court stated in Slotta, supra: “A dismissal payment is not subject to withholding if it cannot be fairly classified as remuneration for services performed.” This statement applies a fortiori to early retirement incentive payments, as no regulation even facially treats such payments as wages. As noted above, the statement was quoted by approval by the Fifth Circuit in Dotson v. United States, 87 F.3d 682, 690 (5th Cir. 1996). Finally, the analysis in Kleckner is questionable. The payment in that case was made expressly in exchange for the employee’s agreement not to perform additional services and did not reflect a benefit to which the employee was entitled simply because of his past services. If the employee had not retired early, he would have been compensated as usual for future services and would have received no additional compensation for past services.

On the basis of Slotta, Dotson, and the unambiguous language of the statute itself, an early retirement incentive payment should not be treated as wages unless the facts show that the payment was made for the purpose of remunerating the employee for services performed. In most cases, the IRS will have great difficulty making such a factual showing, since the mere inducement of an early retirement is not itself remuneration for services. Any doubt about the latter point was laid to rest in a dictum in the recent ERISA case, Lockheed Corp., et al. v. Spink, 116 S.Ct. 1783 n.7 (1996). There, the Supreme Court categorically stated that benefits paid “as part of an early retirement plan [do] not compensate the employee so much for services rendered as for the distinct act of leaving the company sooner than planned.”