No Exclusion for ADEA Claims Under I.R.C. § 104(a)(2): An Analysis of *Commissioner v. Schleier*

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CASENOTES

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In order to resolve inconsistent conclusions between the courts of appeals as to the taxability of damages received under the Age Discrimination in Employment Act of 1967 (ADEA), the United States Supreme Court granted certiorari in *Commissioner v. Schleier*.[1] After receiving damages in an ADEA settlement with United Airlines, Inc., Erich Schleier included as gross income the back pay portion of the settlement, but excluded the portion of the settlement attributed to liquidated damages on his 1986 federal income tax return.[2] The Tax Commissioner issued a deficiency notice, claiming Schleier should have included the liquidated damages as gross income.[3] Schleier responded by initiating proceedings in Tax Court claiming that he had properly excluded the liquidated damages.[4] In addition, Schleier sought a refund of the taxes paid on the back pay portion of the settlement.[5] The Tax

1. 115 S. Ct. 2159, 2163 (1995).
2. *Id.* at 2162.
3. *Id.*
4. *Id.*
5. *Id.*

Court agreed with Schleier, holding that the entire settlement satisfied the requirement of "damages received . . . on account of personal injury or sickness" within the meaning of section 104(a)(2) of the Internal Revenue Code and was, therefore, excludable from gross income.[6] The Fifth Circuit Court of Appeals affirmed.[7] The United States Supreme Court reversed the Tax Court and the court of appeals, holding that recovery under ADEA was not excludable from gross income.[8]

The exclusion from gross income of damages received on account of personal injury was first codified in section 213(b)(6) of the Revenue Act of 1918.[9] Later, Congress enacted the modern version of the personal injury exclusion, section 104(a)(2) of the 1954 Code.[10] In 1960 the Internal Revenue Service issued regulations that defined the phrase "damages received (whether by suit or agreement)" to mean amounts linked to actions based on tort or tort type rights.[11] Against these narrowly construed codified exclusions to gross income, section 61(a) broadly provides that gross income includes "all income from whatever source derived."[12] The Supreme Court in *Commissioner v. Glenshaw Glass*[13] expanded the concept of gross income to include all "accessions to wealth, clearly realized, over which the taxpayers have complete dominion."[14] The Tax Court applied these prior interpretations in *Threlkeld v. Commissioner*[15] and developed a test for determining

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6. *Id.*

7. *Id.* at 2162-63. (Relying on prior circuit decisions and the United States Supreme Court decision in United States v. Burke, 504 U.S. 229 (1992), the Fifth Circuit affirmed. 26 F.3d 1119 (5th Cir. 1994)).

8. 115 S. Ct. at 2163. The court's reasoning was based on the plain language of section 104(a), the text of the regulation implementing section 104(a)(2), and the Court's reasoning in *Burke*.

9. I.R.C. § 213(b)(6) (1918) provided for the exclusion of "[a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness."

10. Section 104(a)(2) provided in part that 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 . . . ." I.R.C. § 104(a)(2) (1954). This portion of the statute remained unchanged after Congress' 1989 amendment of section 104(a)(2).

11. The applicable regulation provided: "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." 25 Fed. Reg. 11, 490 (1960); 26 C.F.R. § 1.104-1(c) (1991).

12. I.R.C. § 61(a) (1986).

13. 348 U.S. 426 (1955).

14. *Id.* at 431.

15. 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

whether damages received from a lawsuit were excludable under section 104(a)(2).[16] The Court concluded that the "origin and character of the claim" determined whether the damages received from a lawsuit were excludable.[17] The Court held that "[e]xclusion under section 104 will be appropriate if compensatory damages are received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."[18] Following this expansive "nature of the claim" test, the United States Court of Appeals for the Third Circuit, in *Rickel v. Commissioner*,[19] reversed the Tax Court, in part, holding that section 104(a)(2) excluded all damages received by the taxpayer on account of age discrimination from gross income.[20] The Tax Court had held that the liquidated portion of the award was excludable, but that the wage-related damages were based in contracts and therefore not excludable.[21] The Third Circuit stated that "once it found that age discrimination was analogous to a personal injury and that the taxpayer's ADEA action amounted to the assertion of a tort type right, the Tax Court should have ended its analysis."[22] Likewise, in *Pistillo v. Commissioner*,[23] the United States Court of Appeals for the Sixth Circuit reversed a Tax Court decision and held that section 104(a)(2) excluded the entire settlement from gross income.[24] Subsequently, in *Downey v. Commissioner*,[25] a case involving a settlement award to a United Airlines pilot, the Tax Court overruled its holdings in *Rickel* and *Pistillo* and held that section 104(a)(2) excluded both liquidated and nonliquidated damages from gross income.[26] In reaching its decision, the Tax Court stated that the nature of the underlying claim, rather than the claim's consequences, determines excludability, and the Tax Court articulated a two-part test requiring that (1) the claim is tort or tort-like and (2) the nature of the injury is personal.[27] The Tax Court applied this test and concluded that ADEA claims are tort-like and that

16. 87 T.C. at 1299.
17. *Id.*
18. *Id.* at 1308.
19. 900 F.2d 655 (3d Cir. 1990).
20. *Id.* at 664.
21. 92 T.C. 510, 522 (1989), *aff'd in part, rev'd in part*, 900 F.2d 655 (3d Cir. 1990).
22. *Rickel*, 900 F.2d at 661.
23. 912 F.2d 145 (6th Cir. 1990).
24. *Id.* at 148.
25. 97 T.C. 150 (1991), *opinion supplemented on reconsideration*, 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994).
26. 97 T.C. at 173.
27. *Id.* at 161.

age discrimination is a personal injury for purposes of section 104(a)-(2).[28] Thus, the Tax Court found both the liquidated and nonliquidated damages excludable.[29] However, the Supreme Court in *United States v. Burke*,[30] a non-ADEA claim settlement, held that back pay awards in settlement of pre-1991 Title VII claims are not excludable from gross income under section 104(a)(2).[31] The Court focused its analysis on what constitutes a tort and reasoned that the availability of a broad range of damages was a critical factor in determining that a claim was tort-like.[32] The Court found that pre-1991 Title VII remedies were limited to back pay, injunctions, and equitable relief; in stark contrast to those available under traditional tort law.[33] Based on the Supreme Court's decision in *Burke*, the Tax Court reconsidered its decision in *Downey* and reaffirmed its earlier holding.[34] The Tax Court distinguished pre-1991 Title VII claims by arguing that the ADEA offered a broad range of remedies including back pay and liquidated damages.[35] After the Tax Court appeared to firmly establish its position on ADEA recoveries, the United States Court of Appeals for the Seventh Circuit reversed the Tax Court in *Downey* and held that section 104(a)(2) does not exclude settlements resulting from ADEA actions because the damages do not compensate the taxpayer for those intangible elements of injury essential to personal injury tort actions.[36] In reaching its decision, the Seventh Circuit limited its analysis to the approach taken in *Burke* as the most pertinent teaching on the matter, ignoring previous circuit court decisions.[37] In contrast, the United States Court of Appeals for the Ninth Circuit in *Schmitz v. Commissioner*,[38] a case almost factually identical to *Downey*, held that section 104(a)(2) excluded ADEA damages because the ADEA creates a tort-like cause of action.[39] The court in *Schmitz* distinguished *Burke* because, unlike the pre-1991 version of Title VII, the ADEA provides for jury trials and liquidated

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28. *Id.* at 165.
29. *Id.*
30. 504 U.S. 229 (1992).
31. *Id.* at 242.
32. *Id.* at 235-37.
33. *Id.* at 238.
34. Downey v. Commissioner, 100 T.C. 634, 637 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994).
35. 100 T.C. at 637.
36. Downey v. Commissioner, 33 F.3d 836, 840 (1994), *cert. denied*, 115 S. Ct. 2576 (1995).
37. 33 F.3d at 838.
38. 34 F.3d 790 (1994), *cert. granted and judgment vacated*, 115 S. Ct. 2573 (1995).
39. 34 F.3d at 796.

damages.[40] The Ninth Circuit also noted that case law and legislative history indicate that ADEA liquidated damages have a compensatory as well as a punitive purpose.[41]

In *Commissioner v. Schleier*,[42] the United States Supreme Court settled these inconsistencies between the Courts of Appeals, holding that damages received under the ADEA are not excludable from gross income under section 104(a)(2).[43] The Court framed its discussion by emphasizing the "sweeping scope" of 26 U.S.C. § 61(a)'s definition of gross income as construed by *Glenshaw Glass*.[44] The Court then buttressed section 61(a)'s broad construction by emphasizing the "default rule of statutory interpretation that exclusions from income must be narrowly construed."[45] The Court first analyzed the "plain language" of the statute by considering a typical recovery in a personal injury case to illustrate the usual meaning of "on account of personal injury."[46] The Court used an automobile accident hypothetical to illustrate the reason an accident victim's settlement—consisting of medical expenses; lost wages; and pain, suffering, and emotional distress—would be excluded under section 104(a)(2).[47] The Court reasoned that each element of the settlement must be excludable not simply because the taxpayer received a tort settlement, but because each element satisfied the "plain language" of section 104(a)(2) requiring that damages be received "on account of personal injuries or sickness."[48] Initially, the Court distinguished Schleier's settlement, reasoning that neither him reaching age sixty nor his being laid off can be described as a "personal injury" or "sickness."[49] Thus, the back wages portion of the settlement did not satisfy the "on account of personal injuries or sickness" requirement.[50] Next, the Court stated that although the taxpayer's unlawful termination may have caused some psychological or personal injury analogous to pain and suffering caused by an automobile accident, no portion of the recovery of back wages was attributable to that injury.[51] Therefore, section 104(a)(2) does not provide for the exclusion of Schleier's back

40. *Id.* at 792-93.
41. *Id.* at 793.
42. 115 S. Ct. at 2167.
43. *Id.*
44. *Id.* at 2163.
45. *Id.*
46. *Id.*
47. *Id.* at 2163-64.
48. *Id.* at 2164.
49. *Id.*
50. *Id.*
51. *Id.*

wages because the recovery was not "on account of" any personal injury and because no personal injury affected the amount of back wages received.[52] Schleier further argued that in any event the liquidated damages portion of his settlement was excludable under the plain language of section 104(a)(2).[53] Schleier contended that the liquidated damages under the ADEA served to compensate plaintiffs for personal injuries that are difficult to quantify.[54] However, the Court quickly dismissed this argument relying on its holding in *Trans World Airlines, Inc. v. Thurston*,[55] where it held that "Congress intended for liquidated damages to be punitive in nature" for recoveries under the ADEA.[56] Thus, the liquidated damages under the ADEA are not received "on account of personal injury or sickness."[57] The Court then addressed Schleier's argument that section 1.104-1(c) of the Treasury Regulations only requires that the amount be received as a result of an action "based upon tort or tort type rights."[58] Even accepting Schleier's characterization of the present action as tort type, the Court stated that the regulatory requirement of a tort type action was no substitute for the statutory requirement that the amount be receive "on account of personal injuries or sickness", but it was instead an additional requirement.[59] The Court recognized that the Commissioner had previously interpreted the regulation as requiring only a tort type action, but such interpretation was not given any special deference due to inconsistencies in the Commissioner's opinion.[60] Finally, the Court analyzed Schleier's case under its decision in *Burke* and found that Schleier's recovery was not excludable for two reasons.[61] First, Schleier's recovery was not "based upon tort or tort type rights" as construed in *Burke*.[62] The Court agreed that it had emphasized the lack of a right to a jury trial and the absence of any provision for punitive damages as factors distinguishing pre-1991 Title VII action from traditional tort actions.[63] However, the Court stated that it did not indicate that the presence of either or both of these factors would be sufficient to bring a statutory

52. *Id.*
53. *Id.*
54. *Id.*
55. 469 U.S. 111, 125 (1985).
56. 115 S. Ct. at 2165.
57. *Id.*
58. *Id.* at 2165-66.
59. *Id.* at 2166.
60. *Id.* at 2166 n.7.
61. *Id.* at 2166.
62. *Id.*
63. *Id.*

claim within the regulatory meaning of tort or tort type rights.[64] Second, the Court narrowed the holding in *Burke* to address only the determination of whether the underlying action is "based upon tort or tort type rights."[65] The Court asserted that it did not hold that the inquiry into tort or tort type rights constituted the beginning and the end of the analysis.[66] In conclusion, the Court held that the plain language of section 104(a)(2) and its holding in *Burke* established two independent requirements for a recovery to be excluded under section 104(a)(2).[67] First, the underlying cause of action must be "based upon tort or tort type rights."[68] Second, the taxpayer must show that the any damages to be excluded were received "on account of personal injuries or sickness."[69] The Court held that Schleier failed to satisfy either requirement, and therefore neither the back wages nor liquidated damages were excludable under section 104(a)(2).[70]

Although a departure from the generally consistent lower court decisions providing that ADEA recoveries are excludable and arguably a departure from the Court's reasoning in *Burke*, the Court's decision in *Schleier* represents a reasonable interpretation of section 104(a)(2). However, many questions remain as to how narrow the section 104(a)(2) exclusion is after *Schleier's* interpretation of *Burke* and the added scrutiny of the "on account of personal injuries" requirement. Applying the Court's decision to antidiscriminatory statutes, this uncertainty appears to require a close fact-based analysis of not only each statute providing recovery for illegal discrimination, but also each claim under the statute. While a claim may be sufficiently tort-like, each element of that claim must also be on account of personal injury. Also, as Justice O'Connor noted, under the majority's automobile accident hypothetical, a taxpayer will have difficulty showing the causal relationship required in the case of nonphysical personal injury.[71] In effect, a nonphysical injury would have to rise to the level of a physical injury preventing the taxpayer from going to work to make back wages excludable. Finally, punitive damages will probably not satisfy the on-account-of-personal-injury requirement under the majority's analysis. Suprisingly, even in the majority's car crash hypothetical, punitive damages would arguably

64. *Id.*
65. *Id.* at 2167.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. Id. at 2169 (O'Connor, J., dissenting).

be received on account of the punishment of the negligent party and not on account of personal injury and therefore would not be excludable. Legislative action is needed to either support the narrow allowance of section 104(a)(2) exclusions defined by the Court in *Schleier* or to redefine the exclusions intended by Congress.

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