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# Is an Employment-Discrimination Award Taxable?

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## *Is an employment-discrimination award taxable?*

by L. Scott Stafford

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**United States of America**

**v.**

**Therese A. Burke, et al.**

(Docket No. 91-42)

*Argument Date: Jan. 21, 1992*

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### ISSUE

Section 104(a)(2) of the Internal Revenue Code [26 U.S.C. § 104(a)(2)] excludes from a taxpayer's gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injury or sickness." In *Burke*, the Court will decide whether the amount recovered by plaintiff for violation of Title VII of the Civil Rights Act of 1964 is excluded from gross income by section 104(a)(2).

### FACTS

The taxpayers—Therese A. Burke, Cynthia R. Center, and Linda G. Gibbs—are female employees of the Tennessee Valley Authority (TVA) and members of the Office and Professional Employees International Union (OPEIU). In 1984, Judy Hutcheson, a TVA employee, sued TVA under Title VII of the Civil Rights Act of 1964 (42 U.S.C. § 2000e et seq.). The OPEIU intervened in the suit on behalf of the taxpayers and other TVA employees. Hutcheson and the OPEIU alleged that TVA discriminated against female employees in 1981 when it adopted new pay schedules that increased the salaries of male-dominated employee groups while leaving the salaries of female-dominated employee groups unchanged or lower. In 1987, prior to trial, TVA settled the case by agreeing to pay \$4,200 to Hutcheson and \$5 million to other affected TVA employees based on length of service and rate of pay. The settlement agreement authorized TVA to withhold federal income taxes and Social Security taxes from the funds distributed to its employees. Based on the distribution formula in the settlement agreement, Burke received \$794.94, Carter received \$927.55, and Gibbs received \$572.95. TVA withheld federal income tax and FICA taxes from these amounts and paid the taxes to the Internal Revenue Service.

The three taxpayers filed refund claims with the Internal Revenue Service for the federal income taxes withheld by TVA. After the Internal Revenue Service disallowed the claims, the three filed suit in the United States District Court for the Eastern District of Tennessee, alleging that the amounts received from TVA were excluded from gross income by section 104(a)(2). The district court characterized the amounts received from TVA as the "recovery of wage deficiencies" which were not damages for personal injury within the meaning of section 104(a)(2). 90-1 U.S. Tax Cas. (CCH) 50,203 (E.D. Tenn. 1990). A divided panel of the Sixth Circuit Court of Appeals reversed. 929 F.2d 1119 (6th Cir. 1991). The majority concluded that section 104(a)(2) excludes from income damages for injuries that are "tort-like in nature," a classification that includes damages for sex discrimination because "injuries resulting from invidious discrimination, be it on the basis of race, sex, national origin, or some other unlawful category, are injuries to the individual rights and dignity of the person." The dissenting judge argued that section 104(a)(2) did not apply to a recovery of earned, but unpaid, wages that would have been taxable if received by the taxpayer in the normal course of employment.

### BACKGROUND AND SIGNIFICANCE

Although section 104(a)(2) excludes from gross income any damages received on account of "personal injuries," the Internal Revenue Service's application of section 104(a)(2) has traditionally distinguished personal injuries that are physical in nature from personal injuries that are nonphysical. When dealing with a recovery for *physical* injury to the taxpayer, the IRS treats all damages as excludable under section 104(a)(2), including those damages, such as lost earnings and loss of future earning capacity, that represent economic injury. Rev. Rul. 85-97, 1985-2 C.B. 50.

The Service's approach to damages recovered for *non-physical* injury (such as damages for defamation of character, alienation of affection, malicious prosecution, or employment discrimination) has been different. Instead of focusing on whether or not the cause of the injury is personal, the Service has analyzed the consequences of the injury. Damages for injury to the taxpayer's person, such as pain and suffering or mental distress, are excluded, but economic injuries, such as lost earnings or damage to professional reputation, are not. The IRS distinction between physical and nonphysical injuries was accepted by the Tax Court in two early cases holding that backpay

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awards for employment discrimination were not excluded from gross income by section 104(a)(2). *Hodge v. Commissioner*, 64 T.C. 616 (1975); *Coats v. Commissioner*, 36 T.C.M. (CCH) 1650 (1977).

Eventually, in *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), which involved the taxability of damages recovered by an insurance agent from a credit agency that had misrepresented his credit history, the Ninth Circuit rejected the IRS approach to section 104(a)(2) and held that: "The relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries." The *Roemer* decision, coupled with mounting criticism of the physical-nonphysical distinction, prompted the Tax Court to meet *en banc* and reconsider its acceptance of the IRS view of section 104(a)(2). In *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988), which dealt with a recovery for damages to the taxpayer's professional reputation, the full Tax Court acknowledged that its differing treatment of physical and nonphysical injury awards was "analytically irreconcilable" and concluded that "whether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry" under section 104(a)(2).

*Roemer* and *Threlkeld* transformed the application of section 104(a)(2) to employment discrimination awards. Instead of separating such awards into nontaxable damages for injury to person and taxable damages for economic injury, courts began to focus on whether employment discrimination was a "personal injury." The Third Circuit endorsed the approach of *Roemer* and *Threlkeld* in *Bent v. Commissioner*, 835 F.2d 67 (3d Cir. 1987). There a teacher denied re-employment in violation of his constitutional right of free speech recovered a sum under 42 U.S.C. § 1983 designed in part to compensate him for lost wages. The Third Circuit concluded that denial of a civil right was a personal injury and held that the entire award was excluded by section 104(a)(2). The Third Circuit later extended its holding in *Bent* to an award for a retaliatory discharge in violation of the Fair Labor Standards Act of 1938 (29 U.S.C. § 201 et seq.), *Byrne v. Commissioner*, 883 F.2d 211 (3rd Cir. 1989), and to an award under the Age Discrimination in Employment Act (ADEA) of 1967 (29 U.S.C. § 621 et seq.), *Rickel v. Commissioner*, 900 F.2d 655 (3rd Cir. 1990).

In *Wulf v. City of Wichita*, 883 F.2d 842 (10th Cir. 1989), the Tenth Circuit concluded that an award for damages specifically allocated to backpay resulting from a wrongful discharge under 42 U.S.C. § 1983 was nontaxable. The Sixth Circuit considered the issue in *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990), where it ruled that discrimination in violation of the Age Discrimination in Employment Act was a personal injury. In *Burke*, the case now before the Supreme Court, the Sixth Circuit reached the same conclusion in a Title VII case.

Two circuit courts of appeal ruled that employment dis-

crimination awards are taxable. The Fourth Circuit held that section 104(a)(2) did not exclude the recovery of backpay and liquidated damages under Title VII and the Equal Pay Act of 1983 [29 U.S.C. § 206(d)]. *Thompson v. Commissioner*, 866 F.2d 709 (4th Cir. 1989). Late last year the Court of Appeals for the District of Columbia refused to apply section 104(a)(2) to an award in a Title VII case. *Sparrow v. Commissioner*, 949 F.2d 434 (1991).

The Supreme Court's decision in *Burke* will resolve whether employment discrimination is a "personal injury" within the meaning of section 104(a)(2). There is considerable support for treating employment discrimination as a nonphysical personal injury analogous to defamation of character, alienation of affection, or malicious prosecution. The Treasury regulations interpreting section 104(a)(2) state that it applies to an "action based upon tort or tort type rights." 26 C.F.R. § 1.104-1(c). The term "tort" is defined in a standard legal reference work as "a violation of some duty owing to plaintiff, . . . generally . . . (arising) by operation of law and not by mere agreement of the parties." *Black's Law Dictionary* 1489 (6th ed. 1990). Title VII creates a duty not to discriminate against an employee or prospective employee on the basis of race, sex, national origin, or religion. Violation of that duty is a tort-type personal injury to the individual rights and dignity of the victim of discrimination. The fact that damages for the injury are measured by the victim's lost earnings does not alter the personal nature of the injury.

A 1989 amendment to section 104(a)(2) bolsters the conclusion that employment discrimination is a personal injury. The legislative history of the amendment indicates that Congress was well aware that some courts had applied section 104(a)(2) to employment discrimination cases. The original House bill would have made section 104(a)(2) inapplicable to any damages involving nonphysical injury or sickness, but the amendment ultimately approved by Congress made section 104(a)(2) inapplicable to any punitive damages involving nonphysical injury or sickness. Section 7641(a) of the Revenue Reconciliation Act of 1989 (103 Stat. 2379). By specifically excluding punitive damages in nonphysical injury cases from section 104(a)(2), Congress implied that section 104(a)(2) does apply to compensatory damages for nonphysical injury including employment discrimination.

On the other hand, there are several possible grounds for concluding that employment discrimination is not a personal injury within the scope of section 104(a)(2). First, the history of section 104(a)(2) suggests that its exclusion of damages for personal injury was originally premised on the notion that the human body is a form of personal capital. Damages received by the taxpayer for the loss of a limb, even when measured by lost earnings or loss of future earning capacity, are not income because they merely make up for the loss of personal capital. Damages received for employment discrimination, however, do more than simply restore lost personal capital; they represent an in-

crease in wealth of the taxpayer that should be taxed.

A second argument against treating employment discrimination as a personal injury is that the victim of employment discrimination who recovers backpay from his employer is really receiving additional compensation for work already performed for the employer. The victim of an automobile accident who is compensated for lost earnings and loss of future earning capacity never performed work for the person paying the damages. This reasoning could resolve *Burke* because the taxpayers did perform work for TVA, but it cannot be applied to future employment discrimination cases, such as those involving discrimination in hiring or firing, in which the victim performed no services for the person paying damages.

A third possible basis for concluding that employment discrimination is not a personal injury is to treat the statutory duty not to discriminate as an implied condition of all employment contracts. Violation of the duty then becomes a breach of the employment contract, not a tort-like personal injury. Again, it may be difficult to apply this reasoning to future cases where no employment relationship ever exists between the taxpayer and the person paying damages.

The Supreme Court can avoid deciding whether employment discrimination is a personal injury if it adopts the reasoning of the District of Columbia Court of Appeals in a decision that came down after the government filed its brief in *Burke*. In *Sparrow v. Commissioner*, 949 F.2d 434 (1991), which involved the taxability of a Title VII award, the court focused not on the meaning of "personal injuries" but on the meaning of "damages." Courts grant two distinct types of remedies: legal relief, by awarding monetary damages, and equitable relief, by ordering the defendant to perform one or more acts. The relief available for discrimination in violation of Title VII is equitable in nature. The court can enjoin the employer from engaging in future discrimination, it can order the reinstatement or hiring of employees, and it can award other relief, including the payment of backpay. The equitable nature of Title VII relief led the Court of Appeals in *Sparrow* to conclude that backpay in a Title VII case is not "damages" and therefore not excluded by section 104(a)(2).

The Supreme Court's decision in *Burke* will resolve the current split among the circuit courts of appeal regarding the taxability of employment discrimination awards. It will also affect the tax liability of numerous individual taxpayers who have received or will receive awards in employment discrimination suits under Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act of 1967, the Equal Pay Act of 1983, and similar statutes allowing recovery for invidious discrimination in employment.

The decision in *Burke* may also reduce the amount of damages awarded in future employment discrimination suits. The Supreme Court has previously ruled that the amount of damages awarded by federal courts in suits arising under federal statutes must take into account whether

or not the award is taxable. *Norfolk & W. R.R. v. Liepelt*, 444 U.S. 490 (1980). Currently, wage-related employment discrimination awards are based on the gross amount of compensation that a victim of discrimination should have received; no adjustment is made on the grounds that the award is excluded from gross income. *Johnston v. Harris County Flood Control Dist.*, 869 F.2d 1565, 1580 (5th Cir. 1989), *cert. denied*, 493 U.S. 1019 (1990); *Sears v. Atchison, T. & S.F. Ry.*, 749 F.2d 1451, 1456 (10th Cir. 1984), *cert. denied*, 471 U.S. 1099 (1985). If the Court decides in *Burke* that employment discrimination awards are not taxable, then wage-related awards in future employment discrimination cases may be reduced to reflect the federal income taxes saved by the victim.

## ARGUMENTS

**For the United States** (*Counsel of Record, Kenneth W. Starr, Solicitor General, Department of Justice, Washington, DC 20530; telephone (202) 514-2217*):

Payments received in settlement of back-wage claims under Title VII of the Civil Rights Act of 1964 are not excluded from gross income under section 104(a)(2) of the Internal Revenue Code as "damages received \* \* \* on account of personal injuries or sickness."

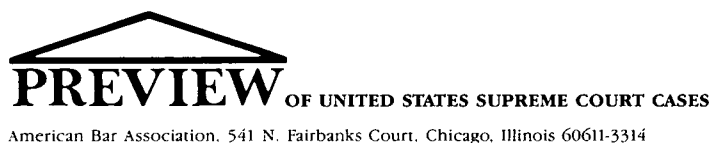
- A. Section 104(a)(2) excludes from gross income payments received by individuals that restore the losses they suffer "on account of personal injuries or sickness."
- B. The settlement payments received by respondents represent an enhancement of their wealth that is not excluded from income by section 104(a)(2).
  1. The back pay awarded to respondents under Title VII of the Civil Rights Act of 1964 represented compensation for work already performed.
  2. Compensation for work already performed represents an enhancement of wealth.
  3. The court of appeals erred in refusing to apply the foregoing principles.

**For Therese A. Burke, et al.** (*Counsel of Record, Joseph E. Finley, 4201 Underwood Road, Baltimore, MD 21218; telephone (410) 889-5056*):

- I. The proper inquiry for exclusion under section 104(a)(2) is whether the underlying claim seeks to redress "personal injuries."
  - A. The statute and regulations exclude "any damages" defined as any "amounts," received "on account of personal injuries," and do not distinguish between recoveries for economic loss and for nonpecuniary loss.
  - B. The compensation for either economic loss or nonpecuniary loss that flows from nonphysical personal injuries is excludable under section 104(a)(2).
  - C. The fact that compensation for economic loss, such as back pay, is determined based on salary, does not turn it into compensation for services rendered rather than a monetary recovery for loss on account

- of personal injury.
- II. Title VII involves a tort-type right to be free from invidious discrimination, and such discrimination is a personal injury that cuts to the heart of one's status as an equal human being.
- A. Claims under Title VII to redress employment discrimination are tort-like claims within the meaning of 26 C.F.R. § 1.104-1(c).

- B. Because Title VII secures fundamental personal rights, injuries to those rights are inherently personal injuries.
- C. Excluding Title VII monetary recoveries for the economic loss caused by discrimination from gross income for tax purposes furthers both the purposes of Title VII and section 104(a)(2).



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