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Down and Out: RIFed Employees, Taxes, and Employment Discrimination Claims After Schleier

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I. INTRODUCTION

The downsizing of corporate America continues apace. In 1993 and 1994, employers fired over one million workers.[1] Nearly all fired employees are paid a termination package consisting of cash, outplacement service, short-term continuation of employer-provided health insurance,[2] or a combination of the three.[3] For that consideration,

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* Associate Professor, California Western School of Law. I thank my friend and colleague Daniel B. Yeager for his thoughtful review of the manuscript and his sustained contributions to my work, the members of the Kansas Law Review, especially Andrew F. Halaby and Joyce Rosenberg, for their helpful editing, and the California Western School of Law for support through its faculty research grants program.

1. *More Than Half a Million Job Cuts in 1994; Year-end Research Indicates Layoffs Are Way of Life for Corporations*, PR Newswire, Jan. 5, 1995 (citing THE CHALLENGER EMPLOYMENT REPORT, a publication of Challenger Gray & Christmas, an employment consulting firm). Job losses are concentrated highly in the nation's largest employers; the 25 largest staff reductions announced since early 1991 cost over 600,000 jobs. *The Pain of Downsizing*, BUS. WK., May 9, 1994, at 1. "Downsizing" encompasses corporate contraction in areas in addition to number of employees, including contractions of equity, working capital, and corporate investment. Because I am concerned only with the tax treatment of "downsized" employees, I use the older term "reduction in force" or "RIF" to refer specifically to contractions in employment. RIFs by large, publicly-held corporations likely will continue, for they are part of a systemic shift in corporate financial structure. Harvard Business School Professor Gordon Donaldson recently observed that "[t]he corporate agenda of the 1980s was dominated by the interests of the investors of financial capital, in contrast to the decades of the 1960s and 1970s, when it was dominated by the interests of the investors of human capital: the organizational priorities of career employees." GORDON DONALDSON, CORPORATE RESTRUCTURING: MANAGING THE CHANGE PROCESS FROM WITHIN 12 (1994). He also observed that

> the erosion of claims on the corporate income stream on the part of the work force, from middle management down to unionized workers through decline in job opportunity, wages, and benefits, which has characterized the early 1990s, has been accompanied by a loss of bargaining power that only full employment will restore. Only then will the investors of human capital have the potential to begin to regain some of the lost ground yielded to shareholders.

Id. at 45.

2. Under the "continuation coverage requirements of group health plans," I.R.C. § 4980B (1988), all terminated employees may continue employer-provided health insurance coverage for a period, usually 18 months, at the employee's expense. *See id.* § 4980B(f). Under buyouts, the employers agree to absorb the charges for some or all of that period.

3. Evan Ramstad, *After Cuts, Ex-IBM Workers Taking on IRS*, CHI. TRIB., June 5, 1994, at C11 ("There's no question that most everybody who leaves a company today gets a severance of

employees quit employment and usually execute general releases of all claims against the employer, specifically including employment discrimination claims, for federal law requires specific reference before a waiver is effective.[4]

During the past two years, employees fired in programmatic reductions in force ("RIFs") have been paid tens of billions of dollars; if taxable, the federal income tax on that amount would exceed ten billion dollars.[5] Some RIFed employees exclude the cash portion of the

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some kind.") (quoting John Challenger, Executive Vice President, Challenger Gray & Christmas).

4. *See* 29 U.S.C. § 626(f) (Supp. V 1993); 3 CHARLES A. SULLIVAN ET AL., EMPLOYMENT DISCRIMINATION § 35.2A (2d ed. Supp. 1992). In 1990, Congress amended the Age Discrimination in Employment Act to establish conditions for waivers of ADEA rights. For programmatic terminations, the requirements are (A) an agreement "written in a manner calculated to be understood;" (B) which specifically references ADEA claims; (C) which waives no rights arising after execution of the document; (D) which is in return for consideration in addition to that to which the releasor already is entitled; (E) which advises the releasor in writing to consult an attorney; (F) which is signed no less than 21 days after presentation to the releasor; and (G) which provides a seven day period during which the waiver may be revoked. *Id.* A waiver in an individual case, rather than a program, need meet only (A) through (E). Although the above criteria expressly apply only to ADEA waivers and not to other employment discrimination statutes, most releases specifically reference "employment discrimination claims, including the ADEA" rather than just the ADEA, because the requirements for ADEA waivers are incorporated into the other employment discrimination laws by judicial decision. *See infra* note 61. Consequently, virtually all programmatic terminations now contain waivers designed to meet those criteria.

5. About one million employees were fired in 1993 and 1994. *See supra* note 1. Determining an average of termination consideration per fired employee is difficult. Employers do not announce the amount when RIFs are announced; the cost announced usually is the total charge to earnings taken for a restructuring plan, of which the RIF is part. Supposing each fired employee receives $10,000 in termination consideration, the total amount of consideration is $10 billion. Sporadic data from tax cases in which the tax treatment of termination consideration is litigated suggests an average of $20,000 to $30,000, which would aggregate to between $20 and $30 billion.

Like virtually all tax issues, the tax treatment of termination consideration has two sides, both equally substantial. This article addresses only the tax consequences to employees receiving termination packages. The other side is the tax treatment of the employer, who wants to deduct currently the substantial costs of the RIF. Following the Court's decision in INDOPCO v. Commissioner, 503 U.S. 79 (1992), the deductibility as a current expense of termination payments came into question. In *INDOPCO*, the Court decided that capitalization of expenses is the general rule, rather than the exception, and that an expense must be capitalized whenever it yields more than incidental future benefits. *Id.* at 84, 87. The capitalization/current deduction question is a particularly high stakes issue for the employer; if currently deductible, the expenses yield a large tax deduction in the year incurred; if not currently deductible, the expenses probably would not be deductible until the employer sold or abandoned the business, for it is unlikely that the employer could show an ascertainable useful life of the RIF program, necessary to depreciating a capital expense. A strong argument can be made that RIF program expenses do yield more than incidental future benefits through reduced operating costs and increased efficiency, and therefore should be capitalized and not currently deducted. Nonetheless, the Service conceded the issue in late 1994. In Rev. Rul. 94-77, 1994-2 C.B. 19, the Service ruled that, notwithstanding *INDOPCO*, termination consideration from their taxable incomes—the Internal Revenue Code ("Code") excludes personal injury damages from gross income—and the employees contend that the cash is "damages received . . . on account of personal injur[y]."[6] RIFed employees argue that (1) they are within a group protected from discrimination by an employment discrimination statute,[7] (2) by virtue of the releases they have settled employment discrimination claims, (3) the cash paid is allocable to settlement of the discrimination claims, and (4) damages received on account of discrimination are thus "damages received . . . on account of personal injur[y]."[8]

The Internal Revenue Service ("Service") disagrees, announcing in a March 1994 News Release:

> A new mistake affects some people who lost their jobs due to corporate downsizing or restructuring. They often receive severance pay, which is taxable. As part of their separation agreements, they may also sign waivers releasing their former employers from potential future claims. Some have mistakenly treated the payments as nontaxable damages because of the waivers. According to the IRS, however, such waivers do not change the taxable nature of the severance pay, a conclusion reached in two 1993 court cases.[9]

The News Release does not identify the cases, Code sections, or other authority for its conclusions, nor does it disclose how the normally fact-sensitive determination of whether a payment is "severance pay" or "damages" can be decided on a broad basis. Undeterred, groups of

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severance payments are currently deductible because they relate principally to previously rendered services of the RIFed employees.

6. I.R.C. § 104(a)(2) (1988); *see* Edward P. Jones, *IBM's, Other Early Retirees Could Be In For Large Refunds*, 63 TAX NOTES 325 (1994):

> Attorneys for a number of workers who retired early during IBM's "downsizing" claim that at least part of their severance pay should be exempt from taxes. The money amounts to a settlement of possible age discrimination claims, they say, and such settlements are not subject to income tax. IBM says the payments are taxable.

Id. at 325.

7. Discrimination in employment on the basis of race, color, religion, sex, national origin, handicap, or age (if the employee is at least 40 years of age) is prohibited. Title VII of the Civil Rights Act of 1964 § 703, 42 U.S.C. § 2000e-2 (1988); Americans with Disabilities Act § 102, 42 U.S.C. § 12112 (Supp. V 1993); Age Discrimination in Employment Act § 4, 29 U.S.C. §§ 623, 631 (1988 & Supp. V 1993).

8. I.R.C. § 104(a)(2). *See* Loren C. Rosenzweig, *Careful Planning May Establish Excludability of Damages Awarded for Age Discrimination*, 81 J. TAX'N 254 (1994) (prior to *Schleier*, noting that the vast majority of post-*Burke* ADEA cases held ADEA damages excludable, and suggesting the structuring of RIF terminations as settlements of ADEA and other tort claims, together with the employee's separate agreement to indemnify the employer if the tax planning does not work).

9. I.R.S. News Release IR-95-25 (March 17, 1994), *available in* Westlaw, FTX-CSRELS Database.

former IBM workers in Colorado, Florida, Georgia, North Carolina, New York, and Texas, and former workers in Texas of USAA, a financial services firm, are working on refund claims; tax refunds have been received by some, but the Service has said that it would correct those "mistakes."[10] Royce Powell, a lawyer representing 1,500 former IBM employees, has filed a tax refund suit in the Court of Federal Claims. Mr. Powell agreed with the Justice Department to file one representative case for each taxable year involving his many clients.[11]

Deciding when "damages" (as opposed to something like wages, salary, or "severance pay") are paid and whether employment discrimination damages are "on account of personal injur[y]"[12] vexes the federal courts. For instance, on the same day (August 30, 1994), the Seventh and Ninth Circuits on near identical records reached opposite conclusions on whether damages recovered under the Age Discrimination in Employment Act ("ADEA") are "damages received . . . on account of personal injur[y]."[13] Following those decisions, the Government filed a petition for certiorari in a Fifth Circuit case excluding ADEA damages from income, and the Court granted the petition.[14]

The bulk of this Article addresses the question of whether employment discrimination damages are on account of personal injury.[15] I also consider the tax consequences of receiving two other pieces of the typical termination package: medical insurance[16] and outplacement services,[17] especially as those benefits extend after termination. Two exclusions from income are relevant. Section 106 excludes the health plan coverage if it is "employer-provided coverage under an accident or health plan,"[18] and section 132 excludes outplacement service from income if it is a qualified fringe benefit.[19]

I make the following three conclusions. Section 104(a)(2) does not permit exclusion of the cash termination consideration because even if

10. *Moneyline* (CNN television broadcast, July 5, 1994), *transcript available in* LEXIS, News Library, Scripts File; Ramstad, *supra* note 3, at C11.

11. Lee A. Sheppard, *The Tax Treatment of IBM's Golden Handshakes*, 65 TAX NOTES 946, 946 (1994).

12. I.R.C. § 104(a)(2) (1988).

13. *Id.*; *see* Downey v. Commissioner, 33 F.3d 836, 838, 840 (7th Cir. 1994) (quoting § 104(a)(2) in holding ADEA damages not excludable), *cert. denied*, 115 S. Ct. 2576 (1995); Schmitz v. Commissioner, 34 F.3d 790, 792, 796 (9th Cir. 1994) (quoting § 104(a)(2) in holding ADEA damages excludable), *vacated*, 115 S. Ct. 2573 (1995).

14. Commissioner v. Schleier, *cert. granted*, 63 U.S.L.W. 3380 (U.S. Nov. 14, 1994) (No. 94-500). Neither the Tax Court nor the Fifth Circuit opinion was reported.

15. *See infra* subpart II.A.

16. *See infra* subpart II.B.

17. *See infra* subpart II.C.

18. I.R.C. § 106 (1988).

19. *Id.* § 132(a).

payments made under a RIF program are made in settlement of tort claims (a point that I prove, but that the Service and a few courts deny), no consideration normally is allocable to those claims under prevailing allocation rules, nor could an allocation meaningfully be made.[20] Conversely, section 106 excludes all employer-provided health insurance coverage,[21] notwithstanding unexplained employer representations to the contrary, for the Service interprets section 106 to require only an employment relationship at some time and has excluded every post-termination coverage it has considered.[22] Finally, section 132 excludes employer-provided outplacement service,[23] notwithstanding a revenue ruling that adds an *ultra vires* but ultimately meaningless requirement to section 132.[24] My proof for these three conclusions follows.[25]

II. ANALYSIS

A. *Section 104(a)(2)*

For our purposes the Code framework is simple. While section 61 includes in gross income "all income from whatever source derived,"[26] section 104(a)(2) excludes from gross income "damages received . . . on account of personal injuries."[27] When determining whether damages

20. *See infra* subpart II.A.

21. *See infra* subpart II.B.

22. *See id.*

23. *See infra* subpart II.C.

24. *See infra* notes 182-86 and accompanying text.

25. I represent a taxpayer who accepted IBM's Marketing and Services Company Transition Payment and received cash and short-term continuation of medical insurance. My advice to her was consistent with the conclusions of this Article: cash termination pay is taxable, notwithstanding her waiver of any sex discrimination claims, but employer-provided medical insurance coverage is excludable from gross income, notwithstanding IBM's curious representation to the contrary. Moreover, because I filed a joint return with that client (I am married to her), I am jointly liable for the tax if my conclusion about § 106 is wrong. *See* I.R.C. § 6013(d)(3) (1988). I do not think that the § 106 issue is even close—no post-termination coverage provided by a former employer ever has been ruled taxable by the Service, much less by a court. Further, absent application of § 106, all "COBRA continuation coverage," *see* Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 10001, 100 Stat. 82, 222-37 (1986) (codified at 29 U.S.C. §§ 1161-1168), even when the employee pays the premium, would create gross income. *See* I.R.C. § 61 (1988); Downey v. Commissioner, 33 F.3d 836, 837 (7th Cir. 1994) ("Congress has defined taxable income to include, generally, all income not specifically excluded by the code."), *cert. denied*, 115 S. Ct. 2576 (1995). No one ever has suggested the possibility that COBRA benefits are taxable. Consequently, I do not believe that my "self interest" in the § 106 issue affects my analysis in any way.

26. I.R.C. § 61(a) (1988).

27. *Id.* § 104(a)(2).

payments are "gross income" under section 61, damages payments are treated identically with the thing for which the damages substitute[28]—we ask, "in lieu of what were the damages awarded?" Employment termination payments are made in lieu of many things, all of which constitute gross income under section 61, and no one credibly disputes that employment termination payments would be included in taxable income absent the exclusion of section 104(a)(2).[29] When deciding the section 104(a)(2) exclusion, the focus intertwines the nature of the *damages* (as under section 61) and the nature of the *claim* giving rise to the right to relief.[30] If the claim is in tort or is "tort-like,"[31] then all damages that are sufficiently caused by personal injury, and received on behalf of the claim, are excludable from income.

But before we fully can answer a section 104(a)(2) exclusion question, we must learn some case-specific facts—what claims are in the case, and what was paid for them. Courts interpreting section 104(a)(2) implicitly, if not explicitly, apply a three-part test. First,

28. *See, e.g.*, Hort v. Commissioner, 313 U.S. 28, 30 (1941) (holding that income received in consideration of a lease cancellation is treated as the receipt of rent and not as a sale of property).

29. No one credibly disputes that termination payments would be gross income absent specific exclusion. The simple analytical framework of a broad definition of "gross income" followed by some exclusions is lost on the Service. As recently as late March 1994, an apparently exasperated Tax Court wrote:

> Respondent argues that the Court of Appeals for the Fifth Circuit would hold that the entire settlement proceeds should be included in petitioners' gross income because the proceeds represent an accession to wealth. The only support respondent cites for that contention, however, is a footnote in a dissent in United States v. Garber, 607 F.2d 92, 103 n.4 (5th Cir. 1979) (Ainsworth, J., dissenting), a criminal tax evasion case, which states: "The touchstone of the exclusion [amended by section 104(a)(2)] is the notion that the funds received represent a restoration of funds rather than an accession to wealth." Respondent, however, apparently misses the import of the Supreme Court's opinion in United States v. Burke, 504 U.S. [229], 112 S. Ct. 1867 (1992). It is now quite clear that damages received on account of a tort-like personal injury are excludable under section 104(a)(2).

McKay v. Commissioner, 102 T.C. 465, 485 (1994).

30. Recognition of those two separate modes of analysis, "in lieu of what" versus "in lieu of what claims," has not come easily. *See infra* notes 157-77 and accompanying text.

31. In *United States v. Burke*, the Supreme Court confirmed the point:

> Neither the text nor the legislative history of § 104(a)(2) offers any explanation of the term "personal injuries." Since 1960, however, IRS regulations formally have linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles: "The term 'damages received (whether by suit or agreement)' means an amount received . . . 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."

United States v. Burke, 504 U.S. 229, 234 (1992) (footnote omitted) (citing 26 C.F.R. § 1.104-1(c) (1991)).

what, if any, claims did the payment settle?[32] Second, are any of those claims tort-like, and for such claims, were damages paid on account of personal as opposed to economic injuries?[33] Third, what portion of the payment is allocable to the tort (or tort-like) claims?[34]

In a typical RIF program, no tort claims seem to exist at first glance; the employer appears to have paid only contract consideration or gratuitous severance pay. Yet the pervasive application of the employment discrimination laws, and the recent confirmation by Congress that those laws regulate waivers of their protection,[35] prove that employees protected by the employment discrimination laws preemptively settle employment discrimination claims in RIF waivers. In only one case has a taxpayer even approached such an argument;[36] recent legislative changes, however, not applicable to that case and not argued to the court, make the argument even stronger.[37] Nonetheless, even if accepted, the argument satisfies only the first part of the test.

Second, the taxpayer must prove that employment discrimination claims are tort-like and that the damages received on account of the tort-like claims were for personal as opposed to economic injuries. Resolving those questions splits the courts of appeals;[38] the Supreme Court recently entered the fray,[39] but raised as many questions as it answered. Third, the RIFed employee must prove the amount that the employer intended to pay the employee for the waiver of his or her employment discrimination claims. The cumulative probability of success on all three parts is negligible. Here is why.

1. What, If Any, Claims Did the Payment Settle?

The taxpayer loses the vast majority of employment-related section 104(a)(2) cases on the first part because the court typically decides that a settlement of claims did not occur, either because the taxpayer asserted no claims or because the payor did not intend to pay anything for those claims asserted. When the payment arises from a typical RIF program, we seemingly encounter no claims at all because the employer, not the employee's claims, precipitated the termination. Consequently, cases like *Stocks v. Commissioner*,[40] in which a particular employee

32. *See infra* notes 41-65 and accompanying text.
33. *See infra* notes 67-90 and accompanying text.
34. *See infra* notes 91-102 and accompanying text.
35. *See infra* notes 41-65 and accompanying text.
36. *See infra* notes 51-56 and accompanying text.
37. *See infra* notes 57-60 and accompanying text.
38. *See infra* notes 59-60 and accompanying text.
39. *See* Commissioner v. Schleier, 115 S. Ct. 2159 (1995).
40. 98 T.C. 1 (1992). In *Stocks*, the plaintiff professor settled her breach of contract and race

asserts employment discrimination claims and subsequently accepts a negotiated termination payment in compromise of all claims against the employer, would be exotic in the RIF context. More likely, a RIFed employee accepts a standardized agreement and executes a form release untailored to her individual claims. Without the express assertion of a claim, the RIFed employee may have no basis to conclude that the termination payment is "damages received." "A claim must be asserted," the Southern District of New York told us, "before it can be settled."[41] In six of the seven reported RIF cases involving section 104(a)(2), the taxpayer lost because she asserted no tort claim before releasing the employer.[42] The typical view is that an employer adds a release in a RIF for independent policy reasons[43] or in settlement of non-tort claims as well as any tort claims.[44]

A recent tax case considering a RIF, and typical of them, is *Taggi v. United States*.[45] AT&T terminated Taggi in a RIF and offered a

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discrimination claims against her former employer. The court held that only the amount allocable to the discrimination claim, as determined by the intent of the payor, was excludable. The court allocated one-sixth of the settlement to that claim. *Id.* at 17-18.

41. Taggi v. United States, 835 F. Supp. 744, 746 (S.D.N.Y. 1993), *aff'd*, 35 F.3d 93 (2d Cir. 1994). In affirming, the Second Circuit emphasized the same point. "Where the issue is an asserted exclusion from taxable income, it is imperative that a 'settlement agreement' involve a bona fide dispute." Taggi v. United States, 35 F.3d 93, 96 (2d Cir. 1994); *see also* Galligan v. Commissioner, 66 T.C.M. (CCH) 1669, 1672 (1993) ("On the facts before us, we cannot conclude that [employer] recognized any claims for personal injuries, accorded them any weight whatsoever, or allocated any portion of the consideration paid pursuant to the agreement to settling such claims."); Lindsey v. Commissioner, 66 T.C.M. (CCH) 488, 492 (1993) ("Moreover, we do not find in the record of this case any evidence linking the subject payment . . . , either directly or by implication, to a personal injury tort claim asserted by petitioner against [employer]. In fact, to the contrary, petitioner's acknowledgement letter expressly states the opposite."); Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965) ("No proof was ever presented to [employer] of the existence of any personal injuries from which it could evaluate a proper settlement.").

42. *See Taggi*, 835 F. Supp. at 746; Ray v. United States, 25 Cl. Ct. 535, 537 (1992) (under "intent of the payor" standard, employer intended to settle a contract action, not a tort action), *aff'd*, 989 F.2d 1204 (Fed. Cir. 1993); Dible v. Commissioner, 58 T.C.M. (CCH) 556, 558 (1989) (where no evidence was presented that employer was aware of employee's threatened actions when employee accepted RIF offer and executed general release, under "intent-of-the-payor" standard, no tort claims were asserted or settled); Whitehead v. Commissioner, 41 T.C.M. (CCH) 365, 368 (1980) (employer's following of program settlement guidelines evidenced intent not to settle taxpayer's individualized claims, tort or otherwise); Anderson v. Commissioner, 38 T.C.M. (CCH) 1206, 1207 (1979) (taxpayer made no tort claim); Gunderson v. Commissioner, 38 T.C.M. (CCH) 464, 465 (1979) (taxpayer made no tort claim). In the other RIF case, the taxpayer had made claims but the court decided that none of the payment was allocable to them; the failure of the settlement agreement to allocate any consideration to the tort claims was dispositive. Evans v. Commissioner, 40 T.C.M. (CCH) 260, 263 (1980).

43. *See Dible*, 58 T.C.M. (CCH) at 558 (employer made payment in order to induce early retirement).

44. *See, e.g.*, *Evans*, 40 T.C.M. (CCH) at 263.

45. 835 F. Supp. 744 (S.D.N.Y. 1993), *aff'd*, 35 F.3d 93 (2d Cir. 1994).

termination payment of either 3% or 5% of base pay times number of years of service (up to twenty), with the higher payment conditioned upon execution of a general release that expressly named employment discrimination claims.[46] Taggi chose the higher amount, executed the release, included the entire termination payment in income, and then filed a claim for refund asserting that the incremental amount (2%) paid by AT&T for the release was excludable from income as damages received on account of age discrimination.[47] The district court agreed with the Service's denial of the refund claim,[48] and the Second Circuit affirmed.[49] Both courts concluded that the payment was not damages because Taggi asserted no age discrimination claim before he released AT&T.[50]

A clever attempt to succeed where Taggi failed came in *Galligan v. Commissioner*.[51] Galligan and his employer disagreed about whether his performance was satisfactory;[52] Galligan accepted a termination payment and executed a general release.[53] Although Galligan asserted no claims against his employer, he argued before the Tax Court that the termination payment was damages received on account of age discrimination.[54] His argument was that an age discrimination claim was created and compromised by the same event—the employer's

46. *Id.* at 745.

47. *Id.*

48. *Id.* at 746.

49. Taggi v. United States, 35 F.3d 93, 96 (2d Cir. 1994).

50. *Taggi*, 835 F. Supp. at 746, *aff'd*, 35 F.3d at 96. Alternatively, both courts concluded that even if the payment was damages, the agreement's failure to allocate any consideration to an age discrimination claim was fatal. *Id.* at 746-47, *aff'd*, 35 F.3d at 97.

> [P]laintiffs may not simply pick and choose between various potential claims included in a general release for the purpose of excluding the payment made for that release from gross income. Since the release was broad and inclusive, it encompassed any claims plaintiff might have had for breach of contract as well as traditional tort-type claims. Where a settlement agreement is silent as to what portion, if any, of a settlement payment should be allocated towards damages excludable under 26 U.S.C. § 104(a)(2), the courts will not make that allocation for the parties.

Taggi, 835 F. Supp. at 746 (citing Villaume v. United States, 616 F. Supp. 185, 190 (D. Minn. 1985)), *aff'd*, 35 F.3d at 96. Because of their conclusions that no claims were settled and even if claims were settled, no consideration was allocable to them, the courts declined to reach the issue of whether an ADEA claim is tort-like. *Id.* at 747; *aff'd*, 35 F.3d at 97.

51. 66 T.C.M. (CCH) 1669 (1993).

52. *See id.* at 1670.

53. *Id.*

54. *Id.* at 1672.

proposing, and his accepting, the termination and release agreement.[55] The Tax Court gave short shrift to the argument:

> Petitioner has failed to convince us that [employer's] agents had in mind age discrimination, or some other tortious injury, any more than they had in mind any other possible cause of action that petitioner might have initiated. If we were to accept petitioner's argument, then any general release might, in theory, be viewed to cover some potential claims for personal injuries, so as to cause at least *some* of a related payment to be excludable under section 104(a)(2). The existence of an agreement that contains a release of undisclosed or potential claims is not sufficient evidence on its own that the amounts paid under that agreement are eligible for section 104(a)(2) exclusion.[56]

Galligan's case involved an individually negotiated termination, but his argument raises a point which applies with substantially greater force to RIF cases. While RIF termination agreements do not compromise preexisting age discrimination claims, the termination act itself potentially gives rise to such claims, which the settlement preemptively compromises. So phrased, RIFed employees who fall within the protected groups of various employment discrimination statutes could argue that an employment discrimination claim—even if never asserted against the employer—is a necessary part of every RIF case in which a general release is executed. The argument gathers greater strength following enactment in October 1990 of the Older Workers Benefit Protection Act[57] ("OWBPA"), which applied neither to Taggi nor to Galligan.[58] Enacted to make clear that the ADEA's prohibition against age discrimination covers virtually all employee benefit plans and to ensure that "older workers are not coerced or manipulated into waiving their rights,"[59] the OWBPA imposes threshold burdens on all ADEA waivers, requiring, *inter alia*, the payment of consideration exceeding that to which the releasor already was entitled by contract or law, and expanding those burdens for waivers in group termination programs.[60]

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55. *Id.*

56. *Id.*

57. Pub. L. No. 101-433, 104 Stat. 978 (1990).

58. Both Taggi and Galligan released their employers in 1986. *See* Taggi v. United States, 835 F. Supp. 744, 745 (S.D.N.Y. 1993), *aff'd*, 35 F.3d 93 (2d Cir. 1994); *Galligan*, 66 T.C.M. (CCH) at 1670.

59. S. Rep. No. 263, 101st Cong., 2d Sess. 5 (1990), *reprinted in* 1990 U.S.C.C.A.N. at 1509, 1510.

60. *Id.* at 32, *reprinted in* 1990 U.S.C.C.A.N. at 1537-38:

> Group termination and reduction programs stand in stark contrast to the individual separation . . . . [T]he terms of the programs generally are not subject to negotiation between the parties. In addition, employees affected by these programs have little or no basis to suspect that action is being taken based on their individual characteristics. Indeed the employer generally advises them that the termination is *not* a function of

The ADEA waiver provisions therefore now contemplate that *every* ADEA waiver is paid for, so some part of any termination consideration paid pursuant to a waiver must be allocable to the ADEA waiver or that waiver is not effective. Further, while the OWBPA's waiver provisions expressly apply only to ADEA waivers, its principles have been used to decide the effectiveness of waivers of other employment discrimination claims. Most circuit courts of appeal deciding the effectiveness of a waiver of employment discrimination claims apply so-called "totality of the circumstances" criteria, one factor of which is whether consideration was paid exceeding that to which the employee already was entitled by contract or law.[61] Consequently, any time an older worker's employment is terminated, and more generally any time a protected-group member's employment is terminated, and a release of employment discrimination claims is made, some consideration must be allocable to the waiver.

The question of precisely who is protected by the employment discrimination statutes is debated hotly. While discrimination in employment on the basis of race, color, religion, sex, national origin, handicap, or age (if the employee is at least 40 years of age) is prohibited,[62] discrimination on those bases against majority group

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their individual status.

61. From the cases deciding whether releases of employment discrimination claims are binding, two analytical modes emerge: normal contract rules and "totality of the circumstances." Under the more rigorous totality of the circumstances test,

> [t]he factors considered include the plaintiff's education and business experience, the amount of time he or she had to consider the agreement, the clarity of the agreement, whether the plaintiff consulted an attorney or had a fair opportunity to do so, whether the employer encouraged or discouraged the employee to consult an attorney, and whether the consideration given in exchange for the waiver exceeds the benefits to which the employee was already entitled.

Gormin v. Brown-Forman Corp., 963 F.2d 323, 327 (11th Cir. 1992) (citing Bormann v. AT&T Communications, 875 F.2d 399, 403 (2d Cir. 1989)), *cert. denied*, 493 U.S. 924 (1989). Besides the Second and Eleventh Circuits, the test is also applied by the following circuits: Third, *see* Coventry v. United States Steel, 856 F.2d 514, 523 (3d Cir. 1988), Fifth, *see* O'Hare v. Global Natural Resources, Inc., 898 F.2d 1015, 1017 (5th Cir. 1990), Ninth, *see* Stroman v. West Coast Grocery, 884 F.2d 458, 462 (9th Cir. 1989), *cert. denied*, 498 U.S. 854 (1990), Tenth, *see* Torrez v. Public Serv. Corp., 908 F.2d 687, 690 (10th Cir. 1990), and probably the Seventh. *See* Fortino v. Quasar Co., 950 F.2d 389, 395 (7th Cir. 1991) (finding that waiver was effective under the "totality of the circumstances," but saving for another case the decision whether to adopt the test).

The Fourth, Sixth, and Eighth Circuits apply less rigorous contract principles, enforcing waivers if supported by consideration. *See* O'Shea v. Commercial Credit Corp., 930 F.2d 358, 362 (4th Cir.), *cert. denied*, 502 U.S. 859 (1991); Lancaster v. Buerkle Buick Honda Co., 809 F.2d 539, 541 (8th Cir.), *cert. denied*, 482 U.S. 928 (1987); Runyan v. National Cash Register Corp., 787 F.2d 1039, 1045 (6th Cir. 1986).

62. *See supra* note 7.

members, as a practical matter, may be permitted under other federal statutory schemes.[63] Consequently, the protection for "any individual" effectively is for "certain individuals who fall into a protected class."[64] The precise contours of the affirmative action defense to discrimination claims of majority group members are unknown,[65] but may safely be set aside for our purposes. Important is the recognition that there is some group of employees whose termination realistically cannot contravene an employment discrimination statute. I would define those unprotected-group members, the success of whose employment discrimination claims is so unlikely as to be exotic, as "not-disabled, native-born-American, white males less than 40 years of age not alleging religious discrimination." Everyone else is a protected-group member. However, granting that proposition—that a protected-group member's release settles employment discrimination claims—satisfies only part one of the three-part section 104(a)(2) test. The employees also must show that the asserted employment discrimination claim is tort-like and, more saliently, prove the portion of the payment allocable to that claim.

2. Are Employment Discrimination Claims Tort-like? Are Employment Discrimination Damages Received on Account of Personal as Opposed to Economic Injuries?

The tax cases deciding whether money recovered under various employment discrimination acts is excludable from income follow a sinusoidal course, alternating between claims-focused and damages-focused tests, and ultimately resting on a test combining both.[66] The

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63. *See* RICHARD A. EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS 399 (1992).

64. *See id.* at 395-96.

65. *See generally* DERRICK A. BELL, JR., RACE, RACISM AND AMERICAN LAW § 9.11 (2d ed. 1980).

66. Nowhere is the sinusoidal course of analysis more evident than in the three decisions rendered in O'Gilvie v. United States: The first was rendered before *Burke*, the second after *Burke*, and the third after *Schleier*. Professor Kahn described the first oscillation when the district court changed its decision on account of the Supreme Court's decision in United States v. Burke, 504 U.S. 229 (1992).

> No more vivid example of [the effect of *Burke*'s exclusive focus on claims] can be found than the two decisions of the federal district court of Kansas in *O'Gilvie I* and *O'Gilvie II*. In *O'Gilvie I*, the court, granting the government's motion for summary judgment, held punitive damages in a wrongful death action to be taxable because they serve no compensatory purpose and therefore are not received "on account of personal injury," as required by section 104(a)(2). *O'Gilvie I* was decided the same day that the Supreme Court promulgated its *Burke* decision. O'Gilvie moved for reconsideration in light of *Burke*. In *O'Gilvie II*, the court granted the motion and changed its decision entirely. Relying on its reading of *Burke*, the court determined that it had erred in its prior ruling by focusing on the nature of the punitive damage award, rather than on the

Tax Court first decided that when physical injuries are not involved, section 104(a)(2) requires each damages component to be analyzed separately,[67] with the nonpecuniary loss components excludable and the pecuniary loss components taxable.[68] Because no physical injuries are involved in employment discrimination, the Tax Court, beginning with *Hodge v. Commissioner*,[69] applied this damages components analysis[70]

> nature of the underlying claim. Since the underlying claim was tort-type, the court decided that "its previous order is contrary to *Burke* and must be reversed." Summary judgment was granted for the taxpayer.

Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?* 2 FLA. TAX REV. 327, 362-63 (1995) (citing O'Gilvie v. United States, 92-2 U.S. Tax Cas. (CCH) ¶ 50,344, 70 A.F.T.R.2d (P-H) 92-5069 (D. Kan. 1992) (*O'Gilvie I*) and O'Gilvie v. United States, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567, 71 A.F.T.R.2d (P-H) 93-547 (D. Kan. 1992) (*O'Gilvie II*)).

The second oscillation occurred when the Tenth Circuit reversed the District Court following the Supreme Court's decision in Schleier v. Commissioner, 115 S. Ct. 2159 (1995). The Tenth Circuit interpreted *Schleier* to mean that punitive damages are not sufficiently caused by personal injury to make them excludable. O'Gilvie v. United States, Nos. 94-3004, 94-3031, 94-3058, 1995 WL 552053, at *6 (10th Cir. Sept. 19, 1995) ("Thus *Schleier* made plain that *Horton*, and the district court in the instant case, misconstrued *Burke* as holding that 104(a)(2) required only that there be a tort-type injury.").

67. Threlkeld v. Commissioner, 87 T.C. 1294, 1300 (1986) ("Where, however, the damage award is received for a nonphysical injury, we have previously mounted an inquiry to determine whether the components of the injuries for which the award is made are personal or professional."), *aff'd*, 848 F.2d 81 (3d Cir. 1988).

68. In a case involving Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e to 2000e-17 (1988 & Supp. V 1993), which prohibits discrimination in employment on the basis of race, color, religion, sex, or national origin, the Tax Court said that

> we need not reach . . . whether, as a matter of law, amounts recovered under the Civil Rights Act of 1964 may constitute personal injury damages within the meaning of sec. 104(a)(2). We have concluded that back pay recovered under the Civil Rights Act of 1964 is taxable; in the second issue of this case, we decided that the entire amount recovered by the petitioner is, in fact, back pay. In the second issue, had we decided, as a matter of fact, that a portion of the recovery constituted personal injury damages instead of back pay, we would have also had to decide whether such recovery was excludable from gross income under sec. 104(a)(2).

Hodge v. Commissioner, 64 T.C. 616, 619 n.7 (1975).

The Tax Court's analysis in *Hodge*—concluding that one component of a racial discrimination award under Title VII, back pay, was taxable, and leaving open whether other components might be excludable—effectively views each component of damages as a separate claim. In a later case, the Tax Court phrased the issue precisely that way: "The determinative inquiry here involves the characterization of the nature of petitioner's liquidated damages claim." Rickel v. Commissioner, 92 T.C. 510, 518 (1989), *rev'd*, 900 F.2d 655 (3d Cir. 1990). Although the Tax Court professed to apply the component analysis to employment discrimination claims, exceptions existed. *See infra* text accompanying notes 121-127.

69. 64 T.C. 616 (1975).

70. *Id.* at 620-21. In some circumstances, employment discrimination remedies are limited to wage loss (called "back pay") and liquidated damages equal to back pay. *See* 29 U.S.C. § 216(b) (1988). Availability of liquidated damages sometimes turns on the mental state of the

and concluded that back pay (the actual wage losses arising from the discriminatory employment action) was taxable, but that liquidated damages (which sometimes are awarded in an amount equal to back pay[71]) were excludable.[72] Next, while the Fourth Circuit appeared to agree with the Tax Court's components analysis,[73] other courts of appeal rejected the approach. They wrote that the component approach confuses the nature of a claim with its consequences (the components of its relief), and thus concluded that whenever a claim arises under a statute, the claim is tort-like, for the duty arises by operation of law rather than express or implied contract.[74] Consequently, the near-

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defendant. *See id.* § 626(b) ("liquidated damages shall be payable only in cases of willful violations"); *see also id.* §§ 215(a)(3), 216 (prescribing liquidated damages as partial remedy for discharge of or discrimination against an employee because they have launched Chapter 8 proceedings). Employment discrimination statutes also typically include the remedy of reinstatement, *see, e.g., id.* § 216(b); 42 U.S.C. § 2000e-5(g) (Supp. V 1993), and often money, called "front pay," is awarded in lieu of reinstatement. *See* MICHAEL J. ZIMMER ET AL., CASES AND MATERIALS ON EMPLOYMENT DISCRIMINATION 1070 (3d ed. 1994). In addition, attorneys' fees are awarded to the prevailing party, prejudgment interest is paid, and the court is authorized to grant injunctive relief. *See, e.g.,* § 2000e-5(g).

71. *See* 29 U.S.C. § 216(b) (1988).

72. *Hodge*, 64 T.C. at 619 (Title VII back pay taxable); *see also* Thompson v. Commissioner, 89 T.C. 632, 648 (1987) (back pay under Equal Pay Act taxable; liquidated damages under Equal Pay Act excludable), *aff'd*, 866 F.2d 709 (4th Cir. 1989); *Rickel*, 92 T.C. at 521-22 (ADEA back pay taxable; ADEA liquidated damages excludable)), *aff'd in part and rev'd in part*, 900 F.2d 655 (3d Cir. 1990), *overruled by* Downey v. Commissioner, 97 T.C. 150 (1991); Wirtz v. Commissioner, 56 T.C.M. (CCH) 1596, 1598 (1989) (ADEA front pay taxable); Sparrow v. Commissioner, 57 T.C.M. (CCH) 816, 821 (1989) (title VII front pay taxable), *aff'd*, 949 F.2d 434 (D.C. Cir. 1991), *cert. denied*, 112 S. Ct. 3009 (1992).

73. *See* Thompson v. Commissioner, 866 F.2d 709, 712 (1989) ("[W]e conclude that Thompson received the liquidated damages through prosecution of a tort-type claim for personal injuries. We conclude, however, that the claim for back pay was essentially a contractual claim for accrued wages.").

74. *See, e.g.,* Byrne v. Commissioner, 883 F.2d 211, 215 (3d Cir. 1989) ("This duty [against unlawful employment discrimination] is independent of any duty an employer might owe his employee pursuant to an express or implied employment contract; it arises by operation of law. Thus, the statutory claim seeks to remedy a statutory violation that the law has defined as wrongful." (footnote omitted)); Pistillo v. Commissioner, 912 F.2d 145, 149-50 (6th Cir. 1990) ("Reviewing the nature of Pistillo's claim, we conclude that his age discrimination lawsuit is analogous to the assertion of a tort-type right to redress personal injuries. [Employer] discriminated against Pistillo on the basis of his age and invaded the rights Pistillo 'is granted by virtue of being a person in the sight of the law.' Contrary to the arguments of the Commissioner, Pistillo has not brought separate actions to seek back pay damages for his pain and suffering.") (citing *Threlkeld*, 87 T.C. 1294, 1308 (1986)); Redfield v. Insurance Co. of N. Am., 940 F.2d 542, 546 (9th Cir. 1991) ("Nothing in the ADEA reflects a congressional attempt to rewrite the terms of employment contracts. ADEA actions are analogous to other federal discrimination causes of action, many of which have been described in explicitly tort-like language." (citations omitted)). The Third Circuit stridently rejected the components analysis of the Tax Court and the Service:

uniform rule of the circuits was to exclude *all* damages recovered on account of employment discrimination claims. Later, the Tax Court confessed error in the components analysis, agreed with the circuit courts that section 104(a)(2) depends on a claims analysis, and reversed itself.[75] Next, the Supreme Court in *United States v. Burke*[76] seemingly agreed with the circuit courts' nature-of-the-claim focus when it concluded that a claim is tort-like only if it provides broad remedial components consistent with "traditional tort liability."[77] Sex discrimination under Title VII of the Civil Rights Act of 1964, which prohibits discrimination in employment on the basis of race, sex, religion, and national origin, the Court concluded, was not tort-like because Title VII then limited remedies to back pay.[78]

> [O]nce 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 and found that all damages flowing therefrom were excludable under § 104(a)(2). By going further and rummaging through the taxpayer's prayers for relief in order to determine the nature of his claim, the Tax Court was simply defining the nature of the taxpayer's injury by reference to its nonpersonal consequences, an approach we explicitly rejected in both *Bent* and *Byrne*, and the full Tax Court rejected in *Threlkeld* . . . . Thus, to the extent that the Commissioner, in spending an inordinately large part of his brief attempting to establish that at least half of the settlement comprised payment for back pay, is arguing that 'because the settlement was intended to compensate [the taxpayer] for economic losses it is therefore compensating [him] for non-personal injuries, we find this argument to have been rejected in *Bent* [and *Byrne*] and we reject it again here' for the *third* time.

Rickel v. Commissioner, 900 F.2d 655, 661-62, 662 n.9 (3d Cir. 1990) (quoting *Byrne*, 883 F.2d at 214), *rev'g* 92 T.C. 510 (1989).

75. *See Downey v. Commissioner*, 97 T.C. 150, 161 (*Downey I*) ("Although the direction of the necessary inquiry would seem straightforward, some confusion has arisen in the past when the focus has shifted from the source and character of the injury (a tortious invasion of personal rights) to its consequences. Those consequences are irrelevant for purposes of the inquiry required by section 104(a)(2)." (citations omitted)), *aff'd on reh'g*, 100 T.C. 634 (1993) (*Downey II*), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995). In *Downey I*, the Tax Court concluded that ADEA damages are "damages received on account of personal injury," and consequently not included in the recipient's gross income. 97 T.C. at 165-66.

76. 504 U.S. 229 (1992).

77. *See id.* at 237 ("We thus agree with the Court of Appeals' analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents' damages award.") (citing Burke v. United States, 929 F.2d 1119, 1121 (6th Cir. 1991)).

78. *Id.* at 238. The Court noted that Title VII "limits available remedies to back pay, injunctions, and other equitable relief." *Id.* The "injunctions and other equitable relief" are the source of power for courts to order reinstatement or monetary relief in lieu of reinstatement, which sometimes is called "front pay." *See supra* note 70. Consequently, to keep consistent the discussion, I say that Title VII then was limited to back pay and front pay, leaving aside (as not meaningful to the ensuing analysis) the additional remedies of interest, attorneys' fees, and ancillary injunctive relief. *See, e.g.*, Lewis v. Federal Prison Indus., 953 F.2d 1277, 1281 (11th Cir. 1992) (discussing attorney fee remedy). *See generally* 2 SULLIVAN ET AL., *supra* note 4, § 14.1 (1988) (discussing broad remedial scope of Title VII's back pay provisions).

Under the circuit courts' nature-of-the-claim test, remedial components are considered only at the threshold—to decide whether a claim is tort-like—but once the nature of the claim is decided, all components rise and fall together as either all taxable or all not taxable. In *Burke*, the Court did not address that aspect, for it concluded that the claim was not tort-like, but the Court strongly implied that if broad remedies were available, all damages recovered would be excludable.[79] Following *Burke*, the Service and every court deciding the issue (except one district court), including the Tax Court, three federal circuit courts of appeal, and five federal district courts, all read *Burke* to hold that once a claim is judged "tort-like" under *Burke*, all components of its relief are excluded from income.[80] The only extent of their disagreement was how broad remedies had to be before the underlying claim achieved "tort-like" status.[81]

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79. *Burke* contrasted Title VII with 42 U.S.C. § 1981 (1988 & Supp. IV 1992) (prohibiting race-based employment discrimination) and with Title VIII of the Civil Rights Act of 1968 (prohibiting housing discrimination), noting that § 1981 and Title VIII provide for awards of compensatory and punitive damages, while Title VII awards only back pay, and thereby implying that employment discrimination claims for which broad damages are available are tort-like. *Burke*, 504 U.S. at 240.

80. *See infra* notes 71 and 98; Rev. Rul. 93-88, 1993-2 C.B. 61, *suspended by* I.R.S. Notice 95-45, 1995-34 I.R.B. 20. Sometimes the Service applied pure components analysis in § 104(a)(2) cases. In Technical Advice Memorandum 93-48-002, the Service concluded that payments received were not excludable under § 104(a)(2) because they compensated for lost income. The ruling made little, if any, attempt to discern the claim underlying the payment, much less any attempt to decide whether such claim is a tort, and thereby implicitly applied a pure components analysis to a § 104(a)(2) question. *See* Tech Adv. Mem. 93-48-002 (Dec. 3, 1993), *available in* Westlaw, FTX-ALL Database.

Most commentary written after *Burke* also agreed that once the tort-like nature of the claim was shown, all damages were excludable without further inquiry. Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 TAX LAW. 755, 772, 774 n.154 (1993) (reading *Burke* to have a pure claims focus, but adding that, specifically with employment discrimination, the identification of the "claims" may be such that a Title VII back pay claim is separate from a § 1981a claim, even when both arise from the same discrimination); Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries Under Federal Civil Rights Statutes: Income from Human Capital, Realization, and Nonrecognition*, 72 N.C. L. REV. 549, 599-600 (1994) (suggesting that *Burke* will be read to have a pure claims focus, but could also have a specific case focus; that is, a court might conclude that, although amended Title VII is tort-like, a plaintiff who recovers only back pay may be taxed); Kahn, supra note 66, at 361. For pre-*Burke* commentary, see Heen, *supra*, at 561-64 and sources cited in notes 65-76.

81. *Burke* created a two-pronged test for § 104(a)(2) purposes: (1) the claim must be for personal injury, and (2) the remedies must be tort-like (*i.e.*, broad). "In order to come within the § 104(a)(2) income exclusion, respondents therefore must show that Title VII, the legal basis for their recovery of backpay, redresses a tort-like personal injury in accord with the foregoing principles." *Burke*, 504 U.S. at 237. The contours of the first prong are not clear, but can be put aside, because *Burke* made clear that employment discrimination is a personal injury for this purpose: "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." *Id.* at 239.

Most recently in *Commissioner v. Schleier*,[82] the Court rejected *Burke*'s implication. It decoupled the nature-of-the-claim and components analyses, holding that the nature-of-the-claim test is but the first prong of a two-pronged test.[83] Under the second prong, the taxpayer, using principles of proximate causation, must show that the damages were received "on account of personal injur[y] or sickness."[84]

The issue in *Burke* was whether under Title VII the concededly personal injury of discrimination was remedied in a tort-like manner. Consequently, in deciding the application of § 104(a)(2) to other employment discrimination claims, only the second prong—whether remedies are broad—needs to be examined.

Without the first prong, all torts would fall within the exclusion, including tort recoveries by corporations for interference with contract, hardly a "personal injury." Deciding a limiting principle, however, will prove difficult. For instance, in *Every v. United States*, commercial salmon fishermen settled claims "against Exxon for damages suffered as a result of the Exxon Valdez oil spill in Cook Inlet, Alaska." Every v. United States, No. C93-5648S, 1994 WL 597137, at *1 (W.D. Wash. July 19, 1994), *aff'd*, 51 F.3d 279 (9th Cir. 1995). The court did not identify the claims, summarily dismissing the plaintiffs' argument for application of § 104(a)(2) as follows:

> I conclude that while the claim clearly sounded in tort, the settlement amount did not arise from an injury to the person in the traditional tort sense. It is economic in nature to redress the loss of plaintiffs' livelihood from fishing. The case is more analogous to the hypothetical loss suffered by one who has a license to farm a plot of land and whose crop is destroyed by a crop duster negligently using DDT. While such a claim sounds in tort, no one could seriously argue that recovery of damages in such a case would be excludable under section 104(a)(2).

Id. The court decided the case entirely on the basis that the damages were in lieu of something that would be taxable income had the tort not occurred. But the "in lieu of what" test does not decide a § 104(a)(2) case. After *Burke*, the court must examine the claims and decide if (1) the claim is for personal injury, and (2) the remedies are tort-like.

82. 115 S. Ct. 2159 (1995).

83. "[S]atisfaction of *Burke*'s 'tort or tort type' inquiry is a necessary condition for excludability[;] . . . it is not a sufficient condition." *Id.* at 2167.

84. *Id.* "First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is 'based upon tort or tort type rights'; and second, the taxpayer must show that the damages were received 'on account of personal injuries or sickness.'" *Id.* The Court held that neither ADEA back pay nor ADEA liquidated damages met either of the "two independent requirements that a taxpayer must meet before a recovery may be excluded under § 104(a)(2)." *Id.* Although not cited by the Court, the first decision to apply proximate, or sufficient, causation principles to deciding whether damages are received on account of personal injury was Judge Murnaghan's opinion in Commissioner v. Miller, 914 F.2d 586, 589-90 (4th Cir. 1990). Judge Murnaghan illustrated the point as follows:

> Baltimore Orioles pitcher Jim Palmer's recent induction into the Baseball Hall of Fame illustrates, in a non-legal context, the difficulty with the Tax Court's conclusion that "on account of" plainly suggests but-for causation. It is certainly true that being associated with baseball is a prerequisite or a but-for cause to Hall of Fame induction. However, it would seem to strain ordinary usage to say that Palmer was inducted "on account of" his being associated with baseball. It would be equally if not more natural to employ a sufficient causation approach and say that Palmer was inducted "on account of" his superb career as a Major League baseball player.

Schleier, therefore, brings the analysis full-circle. We began with the Tax Court (at least in nonphysical injury cases) focusing purely on damages components individually without regard to the claims from which they arose, and excluding only the nonpecuniary damages components;[85] courts of appeal rejected the components focus, focused on the nature of the claim (statute = tort), and excluded all damages if the claim was tort-like;[86] the Supreme Court agreed with the focus on the claim,[87] but later held that section 104(a)(2) contains both a claims-focused prong and a pure-damages-focused prong.[88]

Now we apparently consider damages components for two independent purposes. Under *Burke*, for each claim, we examine the aggregate damages components possibly recoverable under the claim and decide whether they "evidence[] a tort-like conception of injury and remedy."[89] If the claim is not tort-like, no damages actually recovered are excludable, as was held in *Burke*. If the claim is tort-like under *Burke*, then under *Schleier*, we individually examine the damages components actually recovered and test whether each is received "on account of personal injur[y]."[90]

a. The Claims-Focused Prong (The *Burke* Prong)

Under the *Burke* prong, which *Schleier* affirmed and made the first prong of the two-pronged section 104(a)(2) test, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery permits recovery of broad "tort-like" remedies.[91] According to *Burke*, traditional tort liability includes damages for lost wages, medical expenses, diminished future earning capacity, emotional distress, pain and suffering, impairment of reputation and standing in the community, personal humiliation, mental anguish and suffering, and where the defendant's misconduct was intentional or reckless, punitive or exemplary damages.[92]

Miller, 914 F.2d at 590 n.7. In *Miller*, the Fourth Circuit concluded that punitive damages are not received on account of personal injury and consequently are not excludable from income under § 104(a)(2). *Miller* has been followed by four other circuit courts. *See infra* note 104.

85. *See supra* notes 69-72 and accompanying text.

86. *See supra* notes 73-74 and accompanying text.

87. *See supra* notes 76-78 and accompanying text.

88. *See supra* notes 82-84 and accompanying text.

89. United States v. Burke, 504 U.S. 229, 239 (1992).

90. Commissioner v. Schleier, 115 S. Ct. 2159, 2167 (1995) ("The critical point this hypothetical illustrates is that each element of the settlement is recoverable not simply because the taxpayer received a tort settlement, but rather because each element of the settlement satisfies the requirement . . . that the damages were received 'on account of personal injuries or sickness.'").

91. *Burke*, 504 U.S. at 234-37; *Schleier*, 115 S. Ct. at 2166-67.

92. *Burke*, 504 U.S. at 235-37.

A threshold issue in applying *Burke* is how broad remedies must be to "evidence[] a tort-like conception of injury and remedy."[93] In *Burke*, the Court opined, "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."[94] For reasons that will later become clear, the testing ground for applying *Burke* was the ADEA. ADEA claims do not fit neatly within common law classifications; as statutorily created causes of action, they resemble torts, but unlike most statutory tort causes of action (which are silent on damages and thereby incorporate broad common law tort remedies), the ADEA provides its own more narrow remedies. Although the ADEA makes available such "legal or equitable relief as may be appropriate,"[95] the incorporation into the ADEA of the remedial provisions of the Fair Labor Standards Act[96] limits the damages which may be awarded in ADEA actions to back pay, and if the violation is willful, liquidated damages equal to back pay.[97]

All ten courts considering ADEA exclusions after *Burke* (and before *Schleier*) concluded that *Burke* requires only some, and not all, components of traditional tort liability for a claim to be tort-like; in fact, those courts read *Burke* to require only a single component of relief resembling traditional tort liability.[98] Those courts disagreed, however,

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93. *Id.* at 239.

94. *Id.*

95. 29 U.S.C. § 626(b) (1988).

96. The enforcement section of the ADEA, 29 U.S.C. § 626 (1988 & Supp. V 1993), incorporates the enforcement provisions of the Fair Labor Standards Act, 29 U.S.C. §§ 201-219 (1988 & Supp. V 1993). Section 626(a) of the ADEA states that "[t]he provisions of this chapter shall be enforced in accordance with the powers, remedies, and procedures provided in sections 211(b), 216 (except for subsection (a) thereof), and 217 of this title, and subsection (c) of this section." 29 U.S.C. § 626(a) (1988 & Supp. V 1993). Sections 211(b), 216, and 217 of Title 29 are enforcement provisions of the Fair Labor Standards Act, of which § 216 sets forth the remedies available under the FLSA. It provides that employers who violate the minimum wage and overtime requirements of the FLSA are liable to the affected employees for "unpaid minimum wages, or their unpaid overtime compensation, as the case may be, and in an additional equal amount as liquidated damages." 29 U.S.C. § 216 (1988 & Supp. V 1993).

97. *E.g.*, Downey v. Commissioner, 33 F.3d 836, 839 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Lewis v. Federal Prison Indus., 953 F.2d 1277, 1204 (11th Cir. 1992). *See generally* 2 SULLIVAN ET AL., *supra* note 4, § 20.11.1 (1988) (First through Tenth Circuits deny damages other than back pay and liquidated damages in ADEA cases).

98. Prior to *Burke*, the three courts of appeals deciding the issue, and ultimately the Tax Court as well, decided that ADEA claims were tort-like because they arise under a statute. *See* Redfield v. Insurance Co. of N. Am., 940 F.2d 542, 545 (9th Cir. 1991); Pistillo v. Commissioner, 912 F.2d 145, 149-50 (6th Cir. 1990); Rickel v. Commissioner, 900 F.2d 655, 658-61 (3d Cir. 1990); Downey v. Commissioner, 97 T.C. 150, 165 (1991) (*Downey I*), *modified*, 100 T.C. 634 (1993) (*Downey II*), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995). *Burke* rejected that analysis, and focused instead on the remedies available for a claim.

on whether the liquidated damages component of ADEA relief resembles traditional tort damages. Those that found that ADEA liquidated damages were tort-type damages almost uniformly concluded that the ADEA evidences a "tort-like conception of injury and remedy."[99] Only the Northern District of Illinois in *Drase v. United States*[100] saw the question as one of degree. It concluded that while liquidated damages are tort-type punitive damages, they are but one type of a "long litany of damages recoverable in tort" and insufficient to make ADEA a tort.[101]

The Supreme Court in *Schleier* appeared to adopt the *Drase* analysis:

> Like the pre-1991 version of Title VII, the ADEA provides no compensation "for any of the other traditional harms associated with personal injury." Monetary remedies under the ADEA are limited to back wages, which are clearly of an "economic character," and liquidated damages, which we have already noted serve no compensatory function. Thus, though this is a closer case than *Burke*, we conclude that a recovery under the ADEA is not one that is "based upon tort or tort type rights."[102]

Consequently, the ADEA decisions required reconsideration after *Burke*; the Tax Court and nine other courts decided the issue. Decisions of the Fifth Circuit, Ninth Circuit, Tax Court, Court of Federal Claims, Eastern District of California, and District of New Jersey concluded that damages received on account of ADEA claims are excludable from income. *See* Purcell v. Sequin State Bank & Trust Co., 999 F.2d 950, 961 (5th Cir. 1993); Schmitz v. Commissioner, 34 F.3d 790, 794 (9th Cir. 1994), *vacated*, 115 S. Ct. 2573 (1995); Downey v. Commissioner, 100 T.C. 634, 637 (1993) (*Downey II*), *rev'd*, 33 F.3d 836 (7th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Bennett v. United States, 30 Fed. Cl. 396, 399 (1994), *rev'd*, 60 F.3d 843 (Fed. Cir. 1995); Rice v. United States, 834 F. Supp. 1241, 1245 (E.D. Cal. 1993), *aff'd*, 35 F.3d 571 (9th Cir. 1994), *vacated sub nom.* Commissioner v. Schmitz, 115 S. Ct. 2573 (1995); Abrams v. Lightolier, Inc., 841 F. Supp. 584, 596 (D.N.J. 1994), *aff'd*, 50 F.3d 1204 (3d Cir. 1995). The Seventh Circuit, two district courts in the Eleventh Circuit, and a District Court in Illinois, which rendered its decision two weeks before the Seventh Circuit's decision in another ADEA case, concluded otherwise. *See* Downey v. Commissioner, 33 F.3d 836, 839 (7th Cir. 1994); Shaw v. United States, 853 F. Supp. 1378, 1382 (M.D. Ala. 1994); Maleszewski v. United States, 827 F. Supp. 1553, 1556 (N.D. Fla. 1993); Drase v. United States, 866 F. Supp. 1077, 1079 (N.D. Ill. 1994). Additionally, the General Counsel of the Equal Employment Opportunity Commission opined that under the *Burke* analysis, ADEA damages are excludable from income. Memorandum from Donald R. Livingston, EEOC General Counsel, to Regional Attorneys (Feb. 22, 1993), *reprinted in* 34 Daily Lab. Rep. (BNA) E-1 (Feb. 23, 1993), *available in* Westlaw, BNA-DLR Database. Within approximately one week, however, he rescinded that conclusion "pursuant to the view of the Commissioner of Internal Revenue." Memorandum from Donald R. Livingston, EEOC General Counsel, to Regional Attorneys (Mar. 1, 1993), *reprinted in* 41 Daily Lab. Rep. (BNA) F-1 (March 4, 1993), *available in* Westlaw, BNA-DLR Database.

99. United States v. Burke, 504 U.S. 229, 239 (1992).

100. 866 F. Supp. 1077 (N.D. Ill. 1994).

101. *Id.* at 1079-80 (quoting *Burke*, 504 U.S. at 238). Two weeks after *Drase* was decided, the Seventh Circuit decided *Downey* and held ADEA damages outside the exclusion because ADEA liquidated damages are contract-type damages. *See Downey*, 33 F.3d at 840.

102. Commissioner v. Schleier, 115 S. Ct. 2159, 2167 (1995).

Schleier's discussion of the *Burke* prong is conclusory; consequently, we still do not know how broad the damages must be before the claim achieves "tort-like" status. We know only that (1) back pay only and (2) back pay, liquidated damages equal to back pay, and a jury trial are not sufficiently broad.

b. The Pure-Damages-Components-Focused "Causation" Prong (The *Schleier* Prong)

While the first prong of the section 104(a)(2) test, the *Burke* prong, focuses on the aggregate of the remedies potentially available for the claim, the second prong, the *Schleier* prong, focuses on the damages actually recovered, and applies proximate causation to decide whether each component is "received on account of personal injury."[103] The logic of the *Schleier* prong, as noted by Justice O'Connor in dissent, is "rather hard to follow."[104] Because the analysis was not developed in lower federal courts or earlier Supreme Court cases, we have only the one-paragraph analysis in the opinion. The Court illustrated the causal link as follows.

In an automobile accident, "the accident causes a personal injury which in turn causes a loss of wages."[105] In an age discrimination case, on the other hand, "the discrimination causes both personal injury and loss of wages, but neither is linked to the other."[106] So, while automobile accidents proximately cause loss of wages, and while age discrimination causes loss of wages, with discrimination there exists some intervening, more proximate cause of the loss of wages.[107] The Court offered two possible causes of Schleier's lost wages more proximate than age discrimination: Plaintiff's 60th birthday, or plaintiff's being laid off (the passive construction is the Court's; this was an immaculate firing—it happened, but not because of age discrimination).[108] According to the Court, neither turning age 60 nor being fired are personal injuries; feeling bad about turning age 60 (the Court *really* said that the legally relevant cause of the plaintiff's injury was his 60th birthday) or feeling bad about being fired for age discrimination are personal injuries, but no part of an ADEA recovery compensates for feeling bad about being discriminated against.[109]

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103. *Id.* at 2166-67.
104. *Id.* at 2170.
105. *Id.* at 2164.
106. *Id.*
107. *See id.*
108. *Id.*
109. *See id.*

It strains the imagination to say that while age discrimination caused plaintiff's loss of wages, plaintiff's "being fired" (by whom and why, we may ask) was a closer, independent, and more proximate cause sufficient to make age discrimination no longer a legally relevant cause of plaintiff's lost wages. Remember, a defendant is liable under the ADEA only if the defendant takes some adverse employment action against the plaintiff, like reducing his pay or firing him on account of age. Yet, when we consider taxation, somehow the loss of wages was not "caused" by the age discrimination. If that really is true, the defendant is not liable under the ADEA—because the event of his birthday, or his "being fired" (and not the age discrimination), caused his loss of wages.[110] Nonetheless, the Court concluded that ADEA back pay was not received on account of personal injury, but on account of "being fired" or "attaining the age of 60."[111]

The *Schleier* Court also concluded that ADEA liquidated damages were not received "on account of personal injury."[112] The cause of the liquidated damages was discerned from the congressional purpose in enacting the ADEA, which disclosed that (1) those damages exist to punish the defendant, and (2) even to the extent they remedy rather than punish, they "do[] not necessarily"[113] compensate for injuries that are "personal rather than economic."[114] According to the Court, neither damages received to punish the defendant[115] nor damages received to

110. Professor Paul Gudel comprehensively discusses the causal relation between "discriminatory animus," "motivating factor," and "employment action" requisite to liability under the employment discrimination statutes in light of Price Waterhouse v. Hopkins, 490 U.S. 228 (1989) and the Civil Rights Act of 1991. *See* Paul J. Gudel, *Beyond Causation: The Interpretation of Action and the Mixed Motives Problem in Employment Discrimination Law*, 70 TEX. L. REV. 17, 68-70 (1991).

111. *Schleier*, 115 S. Ct. at 2164.

112. *Id.* at 2165.

113. *Id.*

114. *Id.*

115. Whether punitive damages recovered in a personal injury tort action are excluded from income under § 104(a)(2) is another great open question. After amendment in 1989, § 104(a) provides that the § 104(a)(2) exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." I.R.C. § 104(a) (Supp. V 1993). The 1989 amendment thereby expressly extricates from the exclusion punitive damages recovered in a post-1989 personal injury case not involving physical injury or physical sickness. Courts disagree on the state of pre-amendment law. The Tax Court and Sixth Circuit say that pre-1989 personal injury punitive damages are excludable, *see* Miller v. Commissioner, 93 T.C. 330, 341 (1989) (reviewed by the court), *rev'd*, 914 F.2d 586 (4th Cir. 1990); Horton v. Commissioner, 33 F.3d 625, 630 (6th Cir. 1994), but the Fourth, Fifth, Ninth, Tenth, and Federal Circuits say they are not. *See* Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir. 1990); Wesson v. United States, 48 F.3d 894, 895, 900-01 (5th Cir. 1995); Hawkins v. United States, 30 F.3d 1077, 1084 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); O'Gilvie v. United States, Nos. 94-3004, 94-3031, 94-3058, 1995 WL 552053, at *6 (10th Cir. Sept. 19, 1995); Reese v. United States, 24 F.3d 228, 235

remedy economic injuries are damages received "on account of personal injury."[116]

In this pure-damages-focused prong, the Court appears to be trying to distinguish, for section 104(a)(2) purposes, personal injuries from economic injuries, but precedent prohibits it from expressly doing so. A result searches for a reason.

If section 104(a)(2) really does not extend to economic injuries, then recovery of lost wages should be taxable in all cases, including automobile accident cases and discrimination cases. But that broad rule is not available, because everyone, even the Court, assumes that lost wages recovered in automobile accident cases are excludable.[117] Consequently, the Court, as have others in the past, struggled for a reason to distinguish lost wages in automobile accidents from those in employment discrimination cases. It decided upon proximate causation. Earlier, the Tax Court had used the absence of physical injury in discrimination cases to distinguish employment discrimination cases from intentional torts, but the physical/nonphysical distinction was not

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(Fed. Cir. 1994). In *Schleier*, the Court held that pre-1989 punitive damages are not excludable in a case not involving physical injury. *See* 115 S. Ct. at 2165 (refusing to exclude Schleier's liquidated damages because, in part, "Congress intended for liquidated damages to be punitive") (quoting Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 126 (1985)).

Yet to be decided is the effect of the 1989 amendment on post-1989 physical injury or sickness-based punitive damages. For even if pre-1989 punitive damages are not excludable, the 1989 amendment's exclusion (of post-1989 non-physical injury or sickness-based punitive damages) from the exclusion may imply an *inclusion* of post-1989 physical injury or sickness-based punitive damages in the exclusion. This so-called question of whether the 1989 amendment has both an "inclusionary component" as well as an "exclusionary component," while not the subject of a decision, is the subject of commentary. *See generally* Kahn, *supra* note 66, at 367. The Supreme Court in United States v. Burke, 504 U.S. 229, 236 n.6 (1992), and several courts citing *Burke*, *e.g.*, *Horton*, 33 F.3d at 631, suggest that the 1989 amendment includes physical injury or sickness-based punitive damages with the exclusion. Commentators agree and disagree. *Compare* Andrews, *supra* note 80 (post-1989 physical injury or sickness-based punitive damages are excludable) *with* Kahn, *supra*, at 376-77 (pre- and post-1989 punitive damages should not be excludable); James M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 188 (1992) (prior to *Burke*, arguing that pre- and post-1989 punitive damages and damages for noneconomic harms should not be excludable). In *Schleier*, the Court noted the 1989 amendment, but made no mention of its effect on the decision. *Schleier*, 115 S. Ct. at 2163 n.3; *see also* Robert Wood, Schleier *Strikes Taxpayers Three Times*, 68 TAX NOTES 475 (1995) (noting *Schleier*'s implication that all punitive damages are taxable, and raising the question of how to define punitive damages) (citing F. Philip Manns, Jr., *When Does the Payment of Damages Punish the Payor?*, 66 TAX NOTES 276 (1995)).

116. *Schleier*, 115 S. Ct. at 2165.

117. Some commentators examining the tax theories underlying § 104(a)(2) have suggested that under "human capital" theories, all wage recoveries should be taxable if they were calculated on a pre-tax basis when awarded. Heen, *supra* note 80, at 614; Dodge, *supra* note 115, at 165 (1992). No court has held that lost wages in a physical injury are not excludable.

available to the Court, because *Burke* rejected it.[118] The D.C. Circuit, in *Sparrow v. Commissioner*,[119] seized on the ancient distinction of damages and equitable relief, finding back pay recovered in an employment discrimination claim was taxable equitable relief, rather than damages recovered for a common law tort.[120]

All of the attempts to explain why lost wages in discrimination cases are different from lost wages in automobile accident cases have had problems. For instance, while the Tax Court professed to apply its components analysis to employment discrimination claims, exceptions existed. In *Bent v. Commissioner*,[121] Bent sued his former employer, a public school district, for violating Bent's constitutional right to free speech in firing him for something he said.[122] The case was settled after the trial court held that the school district had abridged Bent's freedom of speech in violation of 42 U.S.C. § 1983.[123] Bent's proof of damages included lost wages, medical expenses, and general damages,[124] and the Tax Court concluded that the entire amount received was excludable.[125] It "conclude[d] that the element of lost wages was not an independent basis for recovery but only an evidentiary factor in determining the amount by which petitioner was damaged."[126] The court never reasoned how lost wages were a "claim" in one case and a mere evidentiary factor in another, or why recoveries under section 1983 are more like automobile accident cases than recoveries under the employment discrimination acts. Professor Morgan harmonized the Tax

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118. *Schleier*, 115 S. Ct. at 2164 n.4 ("Though the text of § 104(a)(2) might be considered ambiguous on this point, it is by now clear that § 104(a)(2) encompasses recoveries based on intangible as well as tangible harms.") (citing *Burke*, 504 U.S. at 235 n.6.); *Burke*, 504 U.S. 229:

> Although the IRS briefly interpreted § 104(a)(2)'s statutory predecessor . . . to restrict the scope of personal injuries to physical injuries, the courts and the IRS long since have recognized that § 104(a)(2)'s reference to "personal injuries" encompasses, in accord with common judicial parlance and conceptions nonphysical injuries to the individual, such as those affecting emotions, reputation, or character, as well. . . .
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> . . . .
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> Notwithstanding Justice SCALIA's contention in his separate opinion that the term "personal injuries" must be read as limited to "health"-related injuries, the foregoing authorities establish that § 104(a)(2) in fact encompasses a broad range of physical and nonphysical injuries to personal interests.

Id. at 235-36 n.6 (citations omitted).

119. 949 F.2d 434 (1991), *cert. denied*, 112 S. Ct. 3009 (1992).

120. *See id.* at 437-38.

121. 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987).

122. *Id.* at 240-41.

123. *Id.* at 243.

124. *See id.* at 241.

125. *Id.* at 243.

126. *Id.* at 251.

Court cases in the only way they could be: "[A]ny recovery that is purely for back pay will be found taxable."[127]

There is little reason to believe that the Court's attempt to explain why lost wages in discrimination cases are different from those in automobile accident cases will fare any better. Recoveries under the racial discrimination statute, 42 U.S.C. § 1981, expose the difficulty. In *Burke*, the Court unambiguously distinguished section 1981 and unamended Title VII:

> Indeed, the circumscribed remedies available under Title VII stand in marked contrast not only to those available under traditional tort law, but under other federal antidiscrimination statutes, as well. For example . . . 42 U.S.C. § 1981, permits victims of race-based employment discrimination to obtain a jury trial at which "both equitable and legal relief, including compensatory and, under certain circumstances, punitive damages" may be awarded. The Court similarly has observed that Title VIII of the Civil Rights Act of 1968, whose fair housing provisions allow for jury trials and for awards of compensatory and punitive damages, "sounds basically in tort" and "contrasts sharply" with the relief available under Title VII.[128]

Unless *Burke* is repudiated, we must conclude that section 1981 is tort-like under the *Burke* prong. How does the *Schleier* prong apply? Under section 1981, lost wages form part of the compensatory damages recoverable by the plaintiff, in addition to damages for nonpecuniary harms, like loss of dignity.[129] Do we apply a pure-damages-components analysis, because "being fired" caused the loss rather than racial discrimination, or do we treat section 1981 like an automobile accident case?

Similarly, the damages recoverable under the employment discrimination statutes were broadened significantly by the Civil Rights Act of 1991. A new section, 42 U.S.C. § 1981a, applies concurrently with and in addition to Title VII.[130] It permits recovery of "compensatory and punitive damages,"[131] subject to aggregate limits of between $50,000 and $300,000, depending on the size of the employer,[132] for (1) "unlawful intentional discrimination" in employment on the basis of race, sex, religion, and national origin under Title VII[133] and (2)

127. Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 LA. L. REV. 875, 916 (1988).

128. United States v. Burke, 504 U.S. 229, 240 (1992) (footnote and citation omitted).

129. *See, e.g.*, Rowlett v. Anheuser-Busch, Inc., 832 F.2d 194, 204-05 (1st Cir. 1987).

130. 42 U.S.C. § 1981a (Supp. V 1993).

131. *Id.* § 1981a(a)(1).

132. *Id.* § 1981a(b)(3)(A)-(D).

133. *Id.* § 1981a(a)(1); 42 U.S.C. § 2000e-2(a)(1) (1988). These practices, comprising "disparate treatment," are distinguished from "disparate impact" practices in that the former require discriminatory intent; the latter do not. *See* Hazen Paper Co. v. Biggins, 113 S. Ct. 1701, 1705

Americans with Disabilities Act ("ADA") disparate treatment claims.[134] Additionally, a jury trial is available for section 1981a claims.[135]

After *Burke* but before *Schleier*, the Service in Revenue Ruling 93-88 acknowledged exclusion for all amounts recovered under (1) Title VII gender-based disparate treatment claims as amended by the Civil Rights Act of 1991,[136] (2) Title VII racial discrimination claims as amended,[137] and (3) Americans With Disabilities Act claims,[138] because the claims, as amended, gave rise to sufficiently broad remedies to be tort-like. The ruling based itself on the Court's dicta in *Burke*,[139] in which the Court implied that all damages recovered under section 1981 would be excludable. Thus, before *Schleier* the testing ground for applying *Burke* was the ADEA, because exclusion for virtually all other employment discrimination recoveries had been conceded. Following the decision in *Schleier*, the Service suspended Revenue Ruling 93-88 and requested public comment concerning *Schleier*'s effect on the ruling.[140]

How does *Schleier* apply to the broadened employment discrimination claims? There appear three possible results. First, even with the broadened remedies, the aggregate limitations still mean that these employment discrimination acts are not tort-like. Under the *Burke* prong, therefore, no part of the recovery is excludable.

Second, under the *Burke* prong, these claims are tort-like; under the *Schleier* prong, the Title VII damages component (back pay) is taxable, the section 1981a nonpunitive component is excludable, and the section 1981a punitive component is not excludable because of the blanket rule

(1993) (quoting Teamsters v. United States, 431 U.S. 324, 325 n.15 (1977)). Disparate impact claims may not be brought under section 1981a. *See* 42 U.S.C. § 1981a(a)(1) (Supp. V 1993).

134. *See* 42 U.S.C. § 1981a(a)(2).

135. *Id.* § 1981a(c). In Landgraf v. USI Film Products, 114 S. Ct. 1483 (1994), the Supreme Court held that the provisions of the Civil Rights Act of 1991 do not apply retroactively. *Id.* at 1508.

136. Rev. Rul. 93-88, 1993-2 C.B. 61, *suspended by* I.R.S. Notice 95-45, 1995-34 I.R.B. 20. The Civil Rights Act of 1991 amended Title VII to provide for a "full range of compensatory damages, as well as punitive damages where appropriate," *id.*, for disparate treatment claims. The Service distinguished sex-based disparate impact claims, not amended by the Civil Rights Act of 1991, for which the remedies continue to be limited to those applicable in *Burke*. *Id.*

137. *Id.*

138. With respect to ADA claims, the ruling in its entirety states, "Similar results will apply to amounts received under the Americans With Disabilities Act, 42 U.S.C. §§ 12101-12213." Because all other claims considered by the ruling deal with employment discrimination, we do not know whether the ruling means that (1) damages received on account of all ADA claims, (2) damages received on account of employment-related ADA claims, or (3) damages received on account of employment-related disparate treatment ADA claims, are excludable.

139. *See supra* text accompanying note 118.

140. Notice 95-45, 1995-34 I.R.B. 20.

for punitive damages.[141] While this result would continue to treat back pay in discrimination cases differently from lost wages in automobile accident cases (which *Schleier* seemingly requires), it would still leave open section 1981 and section 1983 cases, because in those cases back pay is not a separate claim (as under Title VII) but is part of the damages recoverable under sections 1981 and 1983. Under this result, section 1981 and 1983 cases either would have to be reexamined (with lost wage recoveries found taxable) or found to be exceptions to *Schleier*.

Finally, under the *Burke* prong, these claims are tort-like; under the *Schleier* prong, all nonpunitive damages, including back pay under Title VII and compensatory damages under section 1981a, are excludable because Title VII/section 1981a recoveries are treated like excludable section 1981 and 1983 recoveries, with punitive damages components taxable as in result two.

The Service apparently will take the first crack at the answer when it decides what to do with Revenue Ruling 93-88. The Tax Court and the lower federal courts will have their chance, and without doubt we will need at least one more Supreme Court decision construing section 104(a)(2) in light of the employment discrimination statutes (which will be the third such decision since 1992). Congressional action appears likely.[142]

Following *Schleier*, we know that a RIFed employee over 40 years of age cannot succeed on the legal point that an ADEA claim is a tort for section 104(a)(2) purposes. Until the next Supreme Court decision, all other protected group members can succeed on the legal point that the other employment discrimination claims are tort-like, and that some portion of the damages recovered under a Title VII/section 1981a action is excludable. No doubt a lot of lawyerly and judicial energy (not to mention ink and printer toner) will be spilled in deciding which components of recovery under a Title VII/section 1981a action are excludable.[143] Nonetheless, all protected-group employees under Title

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141. This result leaves open, of course, what happens with post-1991 punitive damages in cases involving physical injury.

142. On September 22, 1995, the Ways and Means Committee forwarded reconciliation tax recommendations to the House Budget Committee. Section 13611 of the proposed bill, the "Revenue Reconciliation Act of 1995," would amend § 104(a)(2) to limit the exclusion to damages received "on account of personal physical injuries or physical sickness," and would expressly exclude punitive damages from the exclusion. The amendments would be effective for amounts received after December 31, 1995, unless the amounts were received pursuant to a binding agreement, court decree, or mediation award issued on or before September 13, 1995. Joint Committee Print JCX-44-95, Oct. 16, 1995, *available in* LEXIS, Fedtax Library, Legis File.

143. *See* Andrews, *supra* note 80 (written after *Burke* but before Rev. Rul. 93-88 or *Schleier*, and concluding that a Title VII back pay claim is a separate claim from a § 1981a claim, even

VII can establish that the employment discrimination claims they compromise in a RIF waiver give rise, at least in part, to excludable damages. In order ultimately to prevail, however, they must show what part of the payment is attributable to damages for such claims.

3. What Portion of the Termination Payment is Allocable to Tort Claims?

After (1) proving that an employment discrimination claim was settled by the termination payment, and (2) proving that the employment discrimination claim is tort-like and that some or all damages paid pursuant to that claim redress personal as opposed to economic injuries, RIFed employees have to prove the portion of the termination payment allocable to damages for such claims. Here the proof will be impossible.

When multiple claims are settled, the allocation of the total consideration paid among the claims settled is a question of fact. The determinative inquiry is "'the intent of the payor' as to the purpose in making the payment."[144] The first and often conclusive evidence examined is express language in a settlement agreement. If "negotiated at arm's length between adverse parties," the allocations control,[145] but if the allocations are "uncontested, nonadversarial, and entirely tax motivated," they will be rejected.[146] If there is no express allocation, as

when both arise from the same discrimination, and concluding that the back pay is taxable, but that the § 1981a compensatory and punitive damages are excludable).

144. Stocks v. Commissioner, 98 T.C. 1, 10 (1992) (citing Knuckles v. Commissioner, 349 F.2d 610, 612 (10th Cir. 1965)); Metzger v. Commissioner, 88 T.C. 834, 847-48 (1987), *aff'd*, 845 F.2d 1013 (3d Cir. 1988); Glynn v. Commissioner, 76 T.C. 116, 120 (1981), *aff'd*, 676 F.2d 682 (1st Cir. 1982).

145. In two recent cases, the Tax Court has reviewed its law with respect to allocations in section 104(a)(2) cases. Both stated the same rule, "express language in a settlement agreement is the most important factor in deciding whether a payment was made on account of a tortious personal injury for purposes of exclusion under section 104(a)(2)," but "in order to be respected, the express allocations must be negotiated at arm's length between adverse parties." McKay v. Commissioner, 102 T.C. 465, 482-83 (1994). In *McKay*, the court found that the parties "were hostile adversaries with respect to the allocations made in the settlement agreement," *id.* at 487, and "[a]ccordingly . . . accept[ed] the express allocations in the settlement agreement and h[e]ld the $12,250,215 payment allocated to the wrongful discharge tort claim represent[ed] a payment for a tort-type personal injury which is excludable from petitioners' income under section 104(a)(2)." *Id.* In the other case, *Robinson*, the court found that the allocation in the final judgment was uncontested, nonadversarial, and entirely tax motivated; the court rejected the allocation, and "proceed[ed] to determine the correct allocation." Robinson v. Commissioner, 102 T.C. 116, 129, 134 (1994).

146. I previously have argued that, owing to the unique purpose of § 162(f), the parties' allocation absolutely is binding upon the Government in § 162(f) cases:

nearly always will be the case in a RIF, much depends on whether the Service or the taxpayer is arguing for the allocation. While the Service's right to force an allocation is clear,[147] the cases are irreconcilable on whether the taxpayer will be permitted to prove an allocation to tort claims if the settlement contains none. For example, the Tax Court sometimes concludes that the absence of an express allocation to tort-like claims by the parties absolutely precludes application of section 104(a)(2).[148] More often, the court permits the taxpayer to present evidence on the "intent of the payor" and makes a factual finding on allocation among the tort-like and non-tort-like claims.[149] Tax cases outside the Tax Court similarly are confused.[150]

> The purpose of section 162(f) of the Code is to deny a deduction when allowance of the deduction would "frustrate state policy in severe and direct fashion by reducing the "sting" of the penalty prescribed by the state legislature.
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> . . . .
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> When a settling government has disavowed an intent to punish with respect to an entire settlement or has functionally done the same in an integrated settlement by allocating consideration to not-punitive claims, there is no "sting" to be reduced. Application of a "substance over form" analysis is nonsensical because it causes the federal government's taxing authorities to conclude that a state or agency of the federal government should have punished when the state or agency had indicated that it was not doing so. Whether a government actually punished when it indicated that it did not, or a government did not punish but should have, is of no moment to the section 162(f) analysis. Section 162(f) merely denies deductions for declared punishments.

F. Philip Manns, Jr., *Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?*, 13 VA. TAX REV. 271, 297, 302 (1993) (footnotes omitted).

147. *See* Eisler v. Commissioner, 59 T.C. 634, 640-41 (1973) (at the Service's urging, court allocated a settlement payment between deductible and capital expenditures where parties had made no allocation, but it was clear that claims of both types had been settled).

148. *See, e.g.*, Whitehead v. Commissioner, 41 T.C.M. (CCH) 365, 369 (1990).

149. In two Tax Court cases, the lack of an allocation to tort claims in a settlement agreement disposed of the taxpayer's § 104(a)(2) argument. *See* Evans v. Commissioner, 40 T.C.M. (CCH) 260, 263 (1980); McKim v. Commissioner, 40 T.C.M. (CCH) 9, 13 (1980).

In five cases, the Tax Court permitted the taxpayer to prove the "intent of the payor" and allocate settlement proceeds to tort claims notwithstanding an unallocated settlement agreement. *See* Huff v. Commissioner, 69 T.C.M. (CCH) 2551, 2554 (1995); Fitts v. Commissioner, 67 T.C.M. (CCH) 2136, 2140 (1994), *aff'd*, 53 F.3d 335 (8th Cir. 1995); Stocks v. Commissioner, 98 T.C. 1, 17 (1992); Matray v. Commissioner, 56 T.C.M. (CCH) 1107, 1110 (1989); Metzger v. Commissioner, 88 T.C. 834, 847-48 (1987), *aff'd*, 845 F.2d 1013 (3d Cir. 1988). In other unallocated settlement cases, the Tax Court permitted the taxpayer to prove an allocation to tort claims, but concluded that the taxpayer had not sustained the burden. Taylor v. Commissioner, 70 T.C.M. (CCH) 729 (1995); Britell v. Commissioner, 69 T.C.M. (CCH) 2904 (1995); Guidry v. Commissioner, 67 T.C.M. (CCH) 2507 (1994).

150. In Taggi v. United States, 835 F. Supp. 744, 746 (S.D.N.Y. 1993), *aff'd*, 35 F.3d 93 (2d Cir. 1994), the district court and Second Circuit, citing Villaume v. United States, 616 F. Supp. 185, 190 (D. Minn. 1985), advanced an alternative holding that the settlement agreement's failure to allocate consideration disposed of the § 104(a)(2) argument. *See supra* note 50. In Ray v. United States, 25 Cl. Ct. 535 (1992), *aff'd*, 989 F.2d 1204 (Fed. Cir. 1993), the agreement

Even assuming that RIFed employees are permitted to adduce evidence in the face of a silent settlement, they nearly always will be unable to prove either (1) what amount the payor intended to pay for an employment discrimination claim, or (2) what part of the payment on the employment discrimination claim is paid on account of personal as opposed to economic injuries.[151] Under a RIF, the amount paid to the employee does not depend upon an employee's potential employment discrimination claims (much less the employer's valuation of such claims). Rather, it depends upon the program guidelines; often the payment is tied to annual salary and length of service.[152] An employee outside the protected groups, for whom the termination practically could not contravene an employment discrimination statute,[153] receives the same under the formula as one inside the protected groups. In addition, to the extent that the plans permit variation for individual circumstances, such variations usually are limited to provisions for vacation pay, leaves-of-absence, and retirement plan considerations, not employment discrimination claims. Further, the plans sometimes require employees who believe the RIF process is discriminatory to raise the matter with management prior to participating in the program.[154] Consequently, there is nothing upon which an employee can base proof of an amount paid by the employer for her release of her discrimination claims. The only manner in which the waiver arguably is paid for is that the formula of the termination package was increased to entice acceptances and consequent waivers, in which case the non-protected employees receive

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compromising the taxpayer's claims contained no allocation among claims. *Id.* at 538. Nonetheless, the taxpayer was permitted to try to prove an allocation; ultimately he failed. *See id.* at 541. The court concluded that the intent of the payor was to settle a contract claim. *See id.*

151. Sometimes, after finding that the taxpayer failed to prove that the payor intended to pay for a tort claim, the Tax Court adds the lack of an allocation of settlement proceeds to tort claims as an independent basis for decision. *See* Fono v. Commissioner, 79 T.C. 680, 699-700 (1982), *aff'd*, 749 F.2d 37 (9th Cir. 1984); *Whitehead*, 41 T.C.M. (CCH) at 369; Anderson v. Commissioner, 38 T.C.M. (CCH) 1206, 1209 (1979); Hodge v. Commissioner, 64 T.C. 616, 621 (1975). More often, however, it does not. *See* Galligan v. Commissioner, 66 T.C.M. (CCH) 1669, 1671 (1993); Lindsey v. Commissioner, 66 T.C.M. (CCH) 488, 491 (1993), *aff'd*, 42 F.3d 1400 (9th Cir. 1994); Dible v. Commissioner, 58 T.C.M. (CCH) 556, 558 (1989); Kurowski v. Commissioner, 57 T.C.M. (CCH) 32, 35 (1989), *aff'd*, 917 F.2d 1033 (7th Cir. 1990); Glynn v. Commissioner, 76 T.C. 116, 120 (1981), *aff'd*, 676 F.2d 682 (1st Cir. 1982); Gunderson v. Commissioner, 38 T.C.M. (CCH) 464, 465 (1979); Knuckles v. Commissioner, 23 T.C.M. (CCH) 182, 184 (1964), *aff'd*, 349 F.2d 610 (10th Cir. 1965); Agar v. Commissioner, 19 T.C.M. (CCH) 116, 119 (1960), *aff'd*, 290 F.2d 283 (2d Cir. 1961).

152. *See, e.g.*, *Taggi*, 835 F. Supp. at 745 (AT&T Communications, Inc. RIF program offered termination payment plans of 3% and 5% of base pay times number of years worked, up to twenty).

153. *See supra* text accompanying notes 62-65.

154. *See* IBM U.S. Marketing and Services Company Transition Payment General Release and Covenant Not to Sue 1 (1993) (on file with author).

a windfall. In either event, the protected-group member receives no more than a similarly situated non-protected employee.

Although the substantive employment discrimination cases binding RIFed employees to their releases find consideration for the release,[155] they do so by concluding that any amount in addition to what an at-will employee is entitled to receive by contract or law (usually zero) is consideration for the waiver.[156] Still, the minority-group member receives nothing more under the formula than a similarly situated non-protected employee. Consequently, insofar as tax allocation rules are concerned, even if the employee is permitted to adduce evidence of the intent of the payor, she nearly always will be unable to prove that the employer meant to pay anything for *her* waiver of *her* claims. Because she cannot show the amount paid for her waiver, no amount of the termination cash consideration can be excluded from income as personal injury damages, even if the RIFed employee can show that an employment discrimination claim was settled and that the claim is "tort-like" for tax purposes.

For the RIFed employee, the news gets better when deciding whether short-term continuation of health insurance or provision of outplacement services is excludable from income.

B. Section 106

Section 106 provides that "gross income of an *employee* does not include employer-provided coverage under an accident or health plan."[157] When former employers continue a former employee's health plan coverage following termination of employment, the language of section 106 dictates neither application nor rejection of the exclusion. The language alternatively could be read to require a current employer-employee relationship or to require only that such a relationship have existed at some time.

Every authority interprets section 106 to require only an employment relationship at some time; all post-termination coverage considered to date falls within the exclusion.[158] The only such coverage not within the exclusion is when the employee can elect either cash or coverage, but that rule exists throughout tax-free employee benefits law.[159]

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155. *E.g.*, O'Shea v. Commercial Credit Corp., 930 F.2d 358, 362 (4th Cir.), *cert. denied*, 502 U.S. 859 (1991).

156. *See* Forbus v. Sears Roebuck & Co., 958 F.2d 1036, 1042 (11th Cir.), *cert. denied*, 113 S. Ct. 412 (1992).

157. I.R.C. § 106 (1988) (emphasis added).

158. *E.g.*, Rev. Rul. 85-121, 1985-2 C.B. 56, 57.

159. A cash option renders an otherwise tax-free benefit taxable to all employees, even those not exercising the cash option. *See* Rev. Rul. 75-539, 1975-2 C.B. 45, 46-47.

The first post-termination coverage considered was coverage to retirees. Revenue Ruling 62-199[160] excluded from income post-retirement health insurance provided to a retiree.[161] Revenue Ruling 82-196[162] extended the retiree exclusion to post-retirement coverage for retirees' spouses, surviving spouses, and dependents, as well as to coverage for a deceased employee's surviving spouse and dependents.[163] The post-termination exclusion extends beyond retirees and deceased employees' dependents, however.[164] Revenue Ruling 85-121[165] applied the exclusion to coverage for laid-off employees,[166] and private letter rulings have applied the exclusion to employees terminated before retirement.[167]

The instances of employer-provided post-termination health insurance coverage exist far beyond RIFed employees. Since 1986, the Code and ERISA require all group health plans to provide "continuation cover-

160. 1962-2 C.B. 38.

161. *Id.* The ruling is silent about whether an agreement to provide post-retirement coverage occurred during the retiree's employment. *See id.*

162. 1982-2 C.B. 53.

163. *Id.* The synopsis, but not the recitation of facts, provides that the health plan was adopted during the employee's employment. *Id.* Revenue Ruling 62-199 contained no such statement. *See* 1962-2 C.B. 38.

164. *See* Rev. Rul. 85-121, 1985-2 C.B. 57.

165. *Id.*

166. *Id.* The ruling cited Revenue Ruling 82-196 for the general proposition that "an employee-participant in an employer-funded accident or health plan . . . continue[s] to be an 'employee' for purposes of section 105 and 106 even after termination of employment." *Id.* (citing Rev. Rul. 82-196, 1982-2 C.B. 53). Revenue Ruling 85-121 held that "[d]uring the period of layoff, the laid-off worker is an 'employee' for purposes of sections 105 and 106 of the Code." *Id.*

167. Employer contributions made to a trust upon an employee's termination, measured by that employee's unused sick and vacation days and used to purchase accident or health insurance, were excluded from the employee's gross income whether terminated by retirement or for other reasons. Priv. Ltr. Rul. 93-40-054 (Oct. 8, 1993), *available in* Westlaw, FTX-ALL Database. The ruling said that employees had "no choice" whether contributions would be made. *Id.* Under the plan, if terminated employees had no post-retirement medical coverage through other employment, their "severance pay" was paid to them in accident and health insurance, *id.*, an elegant alternative to the cash or health insurance option plans which preclude exclusion under § 106. Here, the plan forces the election upon the terminated employee. Those employees who would have chosen cash under a cash option, because they already have other health insurance coverage, get cash anyway under the "no choice" terms of the plan. In Priv. Ltr. Rul. 87-33-014 (May 18, 1987), *available in* Westlaw, FTX-ALL Database, employees terminating employment prior to age 65 could elect to receive either a bonus, equal to 10 percent of the employee's final annual salary, or to be enrolled in a program providing for the payment, until age 65, of both life insurance and medical insurance premiums on the policies in effect with respect to the employee at retirement. Because of the cash bonus option, all employees constructively received the cash bonus available to them. *Id.* For those that elected the program, the bonus was the limit of their income. *Id.* Any amount paid by the employer in excess of the bonus available to them (but not elected) was excludable under § 106. *Id.*

age" to employees and their dependents for 18 months after the coverage otherwise would end.[168] The cost of that coverage may be borne by either the employer or the employee, but if by the employee, the cost may not exceed 102 percent of the coverage's cost to the employer.[169]

Regardless of whether the employer or the employee pays the cost of post-RIF continuation coverage, the valuable right to purchase health coverage at the employer's favorable group rate transfers from employer to former employee, and that value is includible in the former employee's gross income absent some exclusion.[170] Under the continuation coverage requirements, the employer therefore invariably sells health insurance coverage to the former employee at less than its fair market value.[171] Consequently, the employer always charges less than the fair market value because the maximum it can charge—its cost—always is less than what the former employee would have to pay as an individual.[172] When the employer charges less than its cost, or even nothing, the only analytic difference is quantitative, not qualitative; the difference between fair market value and the employer's charge simply increases as the charge to the former employee decreases.

Whenever an employer sells a service to a former employee at less than fair market value, the difference is a taxable fringe benefit, absent exclusion.[173] Consequently, in all post-termination continuation coverage situations, whether the employer charges the former employee all, some, or none of its cost, if section 106 does not apply, then the former employee realizes gross income. No suggestion ever has been made that section 106 does not apply to post-termination continuation coverage, perhaps because it is so clear that it does.[174]

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168. Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 82, 222 (1986) (codified at 29 U.S.C. §§ 1161-1168); *see* I.R.C. § 4980B(f)(2) (1988). Continuation coverage for periods longer than 18 months apply for some "qualifying event[s]." I.R.C. § 4980B(f)(2)(B)(i). Failure to provide continuation coverage subjects the plan to an excise tax. *Id.* § 4980B(a), (e)(1).

169. *See id.* § 4980B(f)(2)(C)(i) (1988). In some RIFs, the employer agrees to absorb the cost of the coverage, although in non-RIF terminations the employer requires the former employees to pay the employer's cost.

170. *See id.* § 61(a) (1988). Extending the valuable right to purchase health insurance at favorable group rates was an important component of several recent efforts at national health care reform. *See* Woodrow E. Eno, *Private Market-Based Health Reform Is the Answer*, KAN. J.L. & PUB. POL'Y, Fall 1993, at 35, 39.

171. The fair market value of the coverage is the cost that the former employee would have to pay as an individual purchasing the coverage. *See* Treas. Reg. § 1.61-21(b)(2)-(3) (1995).

172. *See id.*

173. *See* I.R.C. § 61 (1988); Treas. Reg. § 1.61-21(b)(1) (1995).

174. The continuation coverage requirement was enacted in 1986 and amended five times. *See* I.R.C. § 4980B(f)(2) (1988 & Supp. V 1993). The possibility of post-termination continuation

In summary, section 106 always has been construed to require only an employer-employee relationship at some time; health insurance coverage provided after termination of employment always has been included with the exclusion.[175] Although post-termination continuation coverage never has been the subject of a section 106 case or ruling, it falls squarely within the existing rulings because an employer-employee relationship existed prior to the termination and all continuation coverage legislation implicitly has assumed that continuation coverage is within the section 106 exclusion.[176]

Nonetheless, IBM, which completed the largest downsizing in history and which provided short-term continuation of medical insurance coverage at its expense, told its employees, without citation, that health insurance premiums paid for up to 12 months on behalf of former employees "w[ould] be considered taxable income to the former employee."[177]

C. Section 132

Employers engaging in programmatic terminations of employees sometimes provide assistance to those employees in securing new employment. Often called outplacement service, the assistance includes counseling with outplacement firms; instructions on resume writing, interviewing, networking, and negotiating; and use of private offices and secretarial staff.[178]

Because an employee is engaged in the "trade or business" of performing services as an employee separate and apart from the perform those services for her existing employer, expenses incurred in seeking new employment in the same trade or business are allowed as a deduction under section 162(a) as a "trade or business expense[]."[179] Thus, if an employee paid for the outplacement service, she may deduct it under section 162(a).[180]

When an employer pays for services provided to an employee and the employee could take a deduction under section 162 had the employee paid for the services, then the employer's payment is excluded from the employee's gross income under section 132(d) as a "working condition

coverage being outside § 106, while pre-termination coverage is inside § 106, never was raised. *See id.*

175. *See supra* note 158.

176. *See supra* notes 160-67, 174 and accompanying text.

177. IBM U.S. Marketing and Services Company Transition Payment E-12 (1993) (on file with author).

178. *See id.* at E-17 through E-21.

179. I.R.C. § 162 (1988).

180. *Id.* § 162(a).

fringe" benefit.[181] Under that statutory wash rule—no income if there would be a deduction—employer-provided outplacement services are excludable from the gross incomes of RIFed employees who receive them.

The Service appeared to reach that conclusion in Revenue Ruling 92-69,[182] but then gratuitously added a requirement to section 132(d) which was found neither in the statute nor the regulations:[183] the employer must also derive a "substantial business benefit" beyond what it would derive from the mere payment of additional compensation, such as promoting a positive corporate image, maintaining employee morale, or avoiding wrongful termination suits.[184] While that addition is *ultra vires*, there is no harm, for the requirement is meaningless. The consequence of no additional "substantial business benefit" is that "the value of employer-provided outplacement services" must be included in the employer's gross income, and the employee then may deduct the payment amount under section 162.[185] The ruling then purports to explain how the inclusion of income followed by deduction of an employee business expense is not a wash because sections 62, 63, and 67 combine to limit the employee's deduction.[186]

The ruling flatly is wrong when it doubts whether the inclusion and deduction completely would wash. "Employer-provided outplacement services" are "reimbursed" expenses under any sensible definitions of "reimbursed" and "employer."[187] Under section 62(a)(2)(A), reimbursed

181. *Id.* § 132(d) (1988); *see* Rev. Rul. 92-69, 1992-2 C.B. 51.

182. Rev. Rul. 92-69, 1992-2 C.B. 51.

183. *Id.* Revenue Ruling 92-69 purports to find in the regulations a general requirement that a working condition fringe benefit must yield a "substantial business benefit" to the employer, *see id.* at 53, but the reasoning is flimsy at best, and disingenuous at worst. The ruling cites examples 3 and 4 of Treasury Regulation section 1.132(a)(ii) for the broad proposition, but the examples have a far narrower application, applying only to an exception. *See id.* When an employer pays expenses *unrelated to an employee's trade or business*, the expenses nonetheless are treated as related to the employee's trade or business (and excludable as a working condition fringe benefit) if the employee derives a substantial business benefit from the employee's service, as, for example, service on the board of a charity. *Id.* at 52. Consequently, the substantial business benefit is a term of a taxpayer-favored exception created by the regulations: it is not, and cannot be, part of the general working condition fringe benefit definition created under the statute.

The ruling makes a material omission of fact from the description of the facts of examples 3 and 4, failing to say that in the regulations, both examples expressly incorporate the facts of example 1 which unambiguously states, "Assume that, unrelated to company X's trade or business and unrelated to employee A's trade or business of being an employee of company X . . . ." Treas. Reg. § 1.132-5(a)(2)(ii), *Ex.* (1) (1995); *see* Rev. Rul. 92-69, 1992-2 C.B. 51.

184. *Id.* at 53.

185. *See id.*

186. *Id.*

187. More than "reimbursing" the expense to the employee, the employer is paying the expense.

expenses of employees are deductible in computing adjusted gross income.[188] All such "above-the-line" deductions thereby escape the Byzantine network of sections 62, 63, and 67, and are deductible in full.[189] Therefore, the income inclusion and deduction completely would wash.

To conclude, according to the Service, "employer-provided outplacement services" are excludable working condition fringe benefits if the employer receives a substantial business benefit distinct from the benefit derived from the mere payment of additional compensation.[190] If, however, no such benefit accrues to the employer, the employee must include the value of employer-provided outplacement services in income. Then, apparently unknown to the Service, the employee becomes entitled to a deduction in an equal amount, which results in a complete wash.[191] Accordingly, with or without a "substantial benefit," RIFed employees will have no income tax consequences from the receipt of "employer-provided outplacement services."

III. CONCLUSION

In the last two years, one million or more fired employees have received a combination of cash, continuation health insurance coverage, and outplacement service. Receipt of health insurance coverage and outplacement service is excludable from gross income under sections 106 and 132, respectively, but receipt of cash is not excludable under section 104(a)(2).

Courts interpreting section 104(a)(2) implicitly apply a three-part test: First, what, if any, claims did the payment settle? Second, are any of those claims tort-like, and were damages received on their account for personal, not economic, injuries? Third, what portion of the payment is allocable to the tort (or tort-like) claims? Amendments made to the ADEA in 1990, and judicial application of those principles to other employment discrimination statutes, make clear both that the discrimination statutes apply to job reduction programs and that waivers executed as part of such programs must be supported by consideration beyond that to which the employee already was entitled by contract or law. Consequently, the waiver settles employment discrimination claims.

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188. I.R.C. § 62(a)(2)(A) (1988). The Code requires that the reimbursement occur under a "reimbursement or other expense allowance arrangement." *Id.* In a typical RIF, the programmatic termination is itself an ERISA plan, and the "business connection," "substantiation," and "returning amounts in excess of expenses" requirements would be met. *See* Treas. Reg. 1.62-2(c) (1992).

189. I.R.C. § 63(d) (1988) (excluding from the term "itemized deductions" deductions allowable in "arriving at adjusted gross income").

190. Rev. Rul. 92-69, 1992-2 C.B. 51.

191. *Id.*

Following *Schleier*, we know that a RIFed employee over 40 years of age cannot succeed on the legal point that an ADEA claim is a tort for section 104(a)(2) purposes. Until the next Supreme Court decision, all other protected group members can succeed on the legal point that the other employment discrimination claims are tort-like, and that some portion of the damages recovered under a Title VII/section 1981a action is excludable. Determining which damages are personal and which are economic remains cloudy.

Under part three of the test, the RIFed employee must demonstrate the portion of the cash consideration allocable to the waiver. Because there is no express allocation of consideration in the agreement between employer and employee, many courts would foreclose application of section 104(a)(2). Further, even in those courts that permit the taxpayer to adduce evidence of the intent of the payor in the face of a silent settlement, the taxpayer will lose. Although the substantive employment discrimination cases binding RIFed employees to their releases find consideration for the release, they do so by concluding that any amount in addition to what an at-will employee is entitled to receive by contract or by law (usually zero) is consideration for the waiver. The older worker or minority-group member receives nothing more under the RIF program formula than a similarly situated non-protected employee. Consequently, insofar as tax allocation rules are concerned, even if the employee is permitted to adduce evidence of the intent of the payor, she nearly always will be unable to prove that the employer meant to pay anything for *her* waiver of *her* claims. Because she cannot show the amount paid for her waiver of her claims, no amount of the cash consideration can be excluded from income as personal injury damages, even though the RIFed employee can show that an employment discrimination claim was settled and that such claim is "tort-like" for tax purposes.

Conversely, receipt of the other two pieces of the typical termination package, medical insurance and outplacement service, is excludable from gross income. Section 106 excludes from income "employer-provided coverage under an accident or health plan." Section 106 always has been construed to require only an employer-employee relationship at some time; health insurance coverage provided after termination of employment always has been included with the exclusion. Although post-termination continuation coverage under COBRA never has been the subject of a section 106 case or ruling, it falls squarely within the existing rulings because an employer-employee relationship existed prior to the termination, and all continuation coverage legislation implicitly has assumed that continuation coverage is within the section 106 exclusion. When an employer pays for services provided to an employee, and the employee could have taken a deduction under section 162 had the employee paid for the services, then the employer's payment is excluded from the employee's gross income under section 132(d) as a "working condition fringe" benefit. Under that statutory wash rule—no income if there would be a deduction—employer-provided outplacement services are excludable from the gross incomes of RIFed employees who receive them. By definition, "employer-provided outplacement services" are "reimbursed" expenses, under any sensible definitions of "reimbursed" and "employer." Reimbursed expenses of employees are deductible in full when computing adjusted gross income, so the income inclusion and deduction would wash completely; the limits applicable to *unreimbursed* employee expenses do not apply.