

APPLICATION OF THE INCOME EXCLUSION OF I.R.C. § 104(A)(2) TO LIQUIDATED DAMAGES IN AGE DISCRIMINATION ACTIONS UNDER THE ADEA

BRYAN P. ROBERTSON, J.D., M.P.A., CPA†

Whether liquidated damages awarded to plaintiffs in actions under the Age Discrimination in Employment Act of 1967 are taxable to the recipient is an issue about which several circuits are now clearly divided. When viewed in light of recent United States Supreme Court decisions and congressional action, however, it appears clear that such awards will likely be taxable to the large majority of recipients. The Supreme Court will soon resolve this issue.¹

I. THE AGE DISCRIMINATION IN EMPLOYMENT ACT

The Age Discrimination in Employment Act of 1967 ("ADEA") made it illegal for employers to discriminate against employees and potential employees on the basis of age.² The ADEA also made it unlawful for employers to use age as the basis to refuse employment, to discharge employees, or to "otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment."³

Litigants seeking relief from discriminatory practices under the ADEA may pursue either legal or equitable remedies.⁴ Likewise, litigants may recover lost wages and compensation earnings and, in cases of willful violation of the ADEA, an equal amount of liquidated damages.⁵

† The author is a tax senior consultant in the Lincoln, Nebraska office of Deloitte & Touche L.L.P.

1. See *Commissioner of Internal Revenue v. Schleir*, No. 94-500, 1994 WL 528122 (Nov. 14, 1994) (granting certiorari to an unpublished opinion of the Fifth Circuit).

2. 29 U.S.C. §§ 621-34 (1988).

3. *Id.* § 623(a).

4. See *id.* § 626(b). "In any action brought to enforce this chapter the court shall have jurisdiction to grant such legal or equitable relief as may be appropriate to effectuate the purposes of this chapter, including without limitation judgments compelling employment, reinstatement or promotion, or enforcing the liability for amounts deemed to be unpaid minimum wages or unpaid overtime compensation under this section." *Id.*

5. 29 U.S.C. § 626(b) (1988).

II. THE EXCLUSION FROM INCOME OF COMPENSATION FOR INJURIES AND SICKNESS

The concept of gross income for federal income tax purposes is broadly defined. Specifically enumerated exceptions to the general rule notwithstanding, the concept includes "all income from whatever source derived."⁶

Section 104(a)(2) of the Internal Revenue Code ("section 104(a)(2)") is a statutory exception to the rule of inclusion that excludes from gross income the amount of "any damages received . . . on account of personal injuries or sickness."⁷ Such damages are excludable, regardless of payment structure, whether received through satisfaction of a legal action or related agreement. For purposes of the section 104(a)(2) exclusion, the excluded amounts are those amounts 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."⁸

In 1989, Congress amended the statutory exception to limit its application.⁹ For damages received after July 10, 1989, the exclusion does not apply to punitive damages in connection with cases not involving physical injury or physical sickness.¹⁰

III. JUDICIAL PRECEDENTS

A. CLEAR DIVISION OF AUTHORITY

A number of courts have addressed application of the exclusionary provision as it applies to the Age Discrimination in Employment Act ("ADEA"). The analysis of the issues, and the resulting determinations, has been largely jurisdiction-dependent and is widely divergent. It is a matter with respect to which the circuit courts are now clearly divided,¹¹ and an issue which the Supreme Court appears destined to resolve.

6. *Id.* § 61(a).

7. *Id.* § 104(a)(2).

8. 26 C.F.R. § 1.104-1(c) (1994).

9. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2379 (1989).

10. 26 U.S.C. § 104(a) (Supp. V 1993).

11. On August 30, 1994, the United States Court of Appeals for the Seventh Circuit, in *Downey v. Commissioner of Internal Revenue*, ruled that liquidated damages are not excludable. *Downey v. Commissioner of Internal Revenue*, 33 F.3d 836 (7th Cir. 1994). On the same day, the United States Court of Appeals for the Ninth Circuit, in *Schmitz v. Commissioner of Internal Revenue*, ruled that liquidated damages are excludable. *Schmitz v. Commissioner of Internal Revenue*, 34 F.3d 790 (9th Cir. 1994).

B. *RICKEL*

The issue was first addressed by a circuit court in *Rickel v. Commissioner of Internal Revenue*.¹² In *Rickel*, a fifty-six-year-old general sales manager was not offered the position of corporate president, despite his apparent qualifications and past suggestions from corporate officials regarding his abilities. The company subsequently hired an individual much younger than Rickel as president, replaced Rickel with a thirty-seven-year-old sales manager, placed Rickel on partial pay, and eventually discharged him.

Rickel filed suit alleging violations of the ADEA. Rickel sought damages for back pay and an equal amount as liquidated damages. During jury deliberations, the litigants reached a settlement. The settlement agreement, however, did not specifically allocate the settlement payment to the elements of the relief sought in the complaint.

The Tax Court held that half of the settlement received by Rickel was not excludable. The United States Court of Appeals for the Third Circuit, however, determined that classification of the action as a tort was the extent of the necessary analysis, reversed the Tax Court, and held that the entire amount of damages received were excludable. The Third Circuit found that "whether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim."¹³

The Third Circuit focused upon the nature of the taxpayer's injury and discounted arguments regarding the fact that the award is measured in terms of compensatory wage-related damages. The court held that age discrimination was "more analogous to a personal injury tort than a breach of contract claim" and that the duty of an employer to refrain from discrimination on the basis of age arises outside the contractual relationship.¹⁴

C. *PISTILLO*

In *Pistillo v. Commissioner of Internal Revenue*,¹⁵ a case decided shortly after *Rickel*, the United States Court of Appeals for the Sixth Circuit reversed the Tax Court and held that the entire amount of damages awarded pursuant to an ADEA action were excludable. In *Pistillo*, a fifty-seven-year-old commissioned salesman was subjected

12. 900 F.2d 655 (3d Cir. 1990).

13. *Rickel v. Commissioner of Internal Revenue*, 900 F.2d 655, 659 (3d Cir. 1990) (citing *Threlkheld v. Commissioner of Internal Revenue*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)).

14. *Id.* at 662.

15. 912 F.2d 145 (6th Cir. 1990).

to disparaging remarks relative to his age, was terminated, and was replaced by a younger worker.

Drawing heavily upon the *Rickel* analysis, the *Pistillo* court sought to differentiate the nonpersonal consequences of a personal injury from the personal nature of the damages sustained. The court concluded that the age discrimination action was analogous to the assertion of a tort-type right to redress personal injuries, and that "Pistillo's loss of wages — a substantial nonpersonal consequence of his employer's age discrimination — did not transform the discrimination into a nonpersonal injury."¹⁶

D. *REDFIELD*

The issue was next addressed by the Ninth Circuit in *Redfield v. Insurance Co. of North America*.¹⁷ In *Redfield*, the plaintiff sought relief from the age related discriminatory behavior of his employer. The initial complaint included causes of action for violation of the ADEA, wrongful discharge, breach of implied duties, and intentional infliction of emotional distress.

Redfield prevailed at trial and was awarded "economic damages," "emotional distress damages," and "punitive damages."¹⁸ The amounts of the awards were not specifically identified as to the respective causes of action from which they resulted.

The court examined application of the exclusion as it related to the award of economic damages, and was unwilling to allocate the award among the several causes of action alleged by the plaintiff. The court found noncompelling the contractual nature of certain of the actions:

Even if we were to posit that some portion of the "economic damages" was based upon a contract measure of damages pursuant to another of Redfield's causes of action, there is no indication in the record that these same damages would not have been available as [ADEA] personal injury damages.¹⁹

The court subsequently concluded that the entire amount of the award was excludable from income.

E. *BURKE*

The United States Supreme Court, in *United States v. Burke*,²⁰ addressed the scope of Internal Revenue Code Section 104(a)(2) ("sec-

16. *Pistillo v. Commissioner of Internal Revenue*, 912 F.2d 145, 150 (6th Cir. 1990).

17. 940 F.2d 542 (9th Cir. 1991).

18. *Redfield v. Insurance Co. of North America*, 940 F.2d 542, 544 (9th Cir. 1991).

19. *Id.* at 547.

20. 112 S. Ct. 1867 (1992).

tion 104(a)(2)”) as it relates to a sex discrimination action brought pursuant to Title VII of the Civil Rights Act of 1964.²¹ In *Burke*, the Supreme Court addressed only the award of back pay,²² and did not address application of the exclusion to liquidated damages. The case is important to the ADEA liquidated damages recipient, however, in terms of its impact upon the analysis of certain threshold issues identified by the Court.

The Court significantly restricted the analysis under the exclusion, and focused almost entirely upon the scope and availability of remedial relief for purposes of making its determination. As a result, the Court focused primarily upon the statutory remedial scheme pursuant to which the action was maintained. Referring to the availability of a broad range of damages as one of the “hallmarks of traditional tort liability,”²³ the Court reasoned that “the concept of a ‘tort’ is inextricably bound up with remedies — specifically damages actions. Thus, we believe that consideration of the remedies available under Title VII is critical in determining the ‘nature of the statute’ and the ‘type of claim’ brought . . . for purposes of [section] 104(a)(2).”²⁴

The Court concluded that nothing in the Title VII remedial scheme purported to recompense the plaintiff for the traditional harms associated with personal injury. The Court likewise concluded, however, that there was “[n]o doubt discrimination could constitute a ‘personal injury’ for purposes of [section] 104(a)(2) if the relevant cause of action evidenced a tort-like conception of injury and remedy.”²⁵

F. *DOWNEY*

The United States Court of Appeals for the Seventh Circuit recently addressed the ADEA liquidated damages issue in *Downey v. Commissioner of Internal Revenue*.²⁶ In *Downey*, the Seventh Circuit reversed the Tax Court and held that both the back pay and liquidated damage components of an ADEA settlement were taxable to the recipient.²⁷

21. See *United States v. Burke*, 112 S. Ct. 1867 (1992); 42 U.S.C. § 2000e-2 (1988).

22. The case was decided prior to a 1991 congressional amendment to Title VII that authorized the recovery of compensatory and punitive damages in certain circumstances. Prior to the amendment, such additional relief was unavailable to Title VII litigants.

23. *Burke*, 112 S. Ct. at 1871.

24. *Id.* at 1872 n.7.

25. *Id.* at 1873.

26. 33 F.3d 836 (7th Cir. 1994).

27. *Downey v. Commissioner of Internal Revenue*, 33 F.3d 836 (7th Cir. 1994). Note that the settlement was paid prior to the 1989 congressional amendment that pre-

In *Downey*, an airline pilot was forced into retirement and filed an action alleging violations of the ADEA. The parties reached a settlement, half of which was designated to represent back pay, and half of which was designated to represent liquidated damages.

The court, interpreting the *Burke* tort analysis, focused upon the intangible elements of the traditional tort injury. The court stated that "*Burke* stands for the proposition that a federal anti-discrimination statute must provide compensatory damages for intangible elements of personal injury (such as pain and suffering, emotional distress, or personal humiliation) to constitute a tort-type personal injury and receive tax exempt treatment under section 104(a)(2)."²⁸

The court concluded that litigants under the ADEA may not recover the broad range of compensatory damages for intangible elements of injury that characterize tort-type personal injury statutes and that therefore any such settlements were taxable.

The court, referring to the division in the courts of appeals over the character of the ADEA liquidated damages, stated that "liquidated damages, as the name implies, compensate a party for those difficult to prove losses that often arise from a delay in the performance of obligations — as a type of contract remedy."²⁹

The court, however, held that the classification of liquidated damages is unnecessary, applied an intangible gloss to the *Burke* analysis, and concluded that "whatever the appropriate characterization of ADEA liquidated damages (be they punitive or contractual), as a matter of law they do not compensate for the intangible elements of a personal injury."³⁰

G. *SCHMITZ*

On the same day that the Seventh Circuit decided *Downey*, the Ninth Circuit decided *Schmitz v. Commissioner of Internal Revenue*.³¹ In *Schmitz*, the Ninth Circuit Court affirmed the Tax Court and held that the back pay and liquidated damage components of an ADEA settlement were excludable from income as damages received on account of personal injury or sickness.³²

cludes application of the exclusion to punitive awards not involving physical injury or sickness.

28. *Downey*, 33 F.3d at 839.

29. *Id.* at 840.

30. *Id.*

31. 34 F.3d 790 (9th Cir. 1994).

32. *Schmitz v. Commissioner of Internal Revenue*, 34 F.3d 790 (9th Cir. 1994). Note that, like *Downey*, the settlement was paid prior to the 1989 Congressional amendment to the exclusion. The *Schmitz* court, referring to the amendment, expressly refused to opine on the treatment of liquidated damages received after the amendment date stating "that issue is not before us." *Schmitz*, 34 F.3d at 792 n.1.

In *Schmitz*, an airline pilot joined in a class action suit against his employer alleging violations of the ADEA. Of the settlement amount reached, half was identified in the settlement agreement as back pay, and half was identified as liquidated damages.

The court first examined whether the ADEA created a tort-like cause of action. Concluding that the action satisfied this inquiry, the court stated that "*Burke* does not require that a statute provide the complete spectrum of tort remedies before it may be deemed to redress a tort-type right,"³³ and that the ADEA "liquidated damages provision, as well as its provision for jury trials, distinguishes ADEA from the statute discussed in *Burke*."³⁴

The court next examined whether the liquidated damages were received on account of personal injuries. Stating that the liquidated damages available under the Act have a compensatory and a punitive purpose, the court refused to conclude that the liquidated relief has no relation to the personal injury sustained. The court did not agree "that ADEA liquidated damages are solely punitive in nature or that they do not bear any relation to the underlying personal injury."³⁵ The court concluded that liquidated damages are damages received on account of personal injury:

Because ADEA liquidated damages serve both to punish the employer and to compensate the taxpayer for intangible losses, and because Congress chose to label them "liquidated" rather than "punitive," ADEA liquidated damages are, from the taxpayer's perspective, damages received on account of personal injury. They are therefore excludable under section 104(a)(2).³⁶

IV. APPLICATION OF THE EXCLUSION TO THE ADEA

Examination of the potential for application of the income exclusion to an Age Discrimination in Employment Act ("ADEA") action is clearly a two-part analysis. First, the determination must be made whether the action is sufficiently tort-like to invoke the exclusion. Second, the nature of the injury sustained must be evaluated in terms of its physical or nonphysical nature.³⁷

33. *Schmitz*, 34 F.3d at 793 (quoting *Bennett v. United States*, 30 Fed. Cl. 396, 400 (1994)).

34. *Id.*

35. *Id.* at 794.

36. *Id.* at 796.

37. Note, however, that for those cases like *Schmitz* and *Downey* that were decided prior to the congressional amendment to the statutory exclusion, the latter part of the analysis is unnecessary. Because the amendment clearly added the requirement that an injury must be physical in nature in order to exclude the resulting damages, cases

The United States Supreme Court, in *United States v. Burke*,³⁸ has made it clear that the nature and extent of available remedies will determine the potential application of the income exclusion of Internal Revenue Code section 104(a)(2) ("section 104(a)(2)"). The initial focus of that analysis, as it relates to an action under the ADEA, will be upon classification of the liquidated damages as either punitive or nonpunitive in nature.³⁹

If the determination is made that the liquidated damages are merely compensatory, and not punitive,⁴⁰ an action under the ADEA will fail the threshold test. The availability of compensatory damages alone will not make the action sufficiently tort-like to justify application of the exclusion.⁴¹

If, however, the determination is made that the award of liquidated damages is intended to punish the defendant,⁴² the action will satisfy the threshold determination. The focus, then, is upon whether the injury sustained is physical or nonphysical in nature.

The second part of this two-part analysis is made necessary by the 1989 congressional action that amended the statutory language of section 104(a)(2) viewed in light of a footnote by the Supreme Court in *Burke*. The matrix that follows compares, for purposes of the statutory exclusion from income, the punitive nature of the award to the physical characteristics of the injury sustained.

decided under prior law need to satisfy only the threshold inquiry. *See supra* note 10 and accompanying text.

38. 112 S. Ct. 1867 (1992).

39. The fact that the ADEA litigant, in addition to liquidated damages, may seek additional equitable relief pursuant to 29 U.S.C. § 626(b) will not drive the determination since the United States Supreme Court refused to be moved by the availability of such injunctive or other equitable relief in *Burke*. *See* 29 U.S.C. § 626(b) (1988); *see supra* note 5 and accompanying text.

40. The issue, for purposes of making this determination, is whether the award of liquidated damages under the ADEA action is intended to punish the defendant, or whether the award is designed merely to recompense the plaintiff for damages otherwise difficult to quantify.

41. General compensatory damages, for example, would be available damages pursuant to an ordinary breach of contract claim.

42. It is particularly important to this determination that the award of liquidated damages under the ADEA is available only in cases involving willful violations of the Act. This presumably indicates the noncompensatory nature of the award since the difficulty in determining actual damages, the definitional hallmark of liquidated relief, is not dependent upon the willfulness of defendants' actions. Difficulty in determining the actual amount of damage sustained by the plaintiff, for example, would exist whether or not the defendant acted willfully to violate the employment privileges of the plaintiff.

Punitive	Physical	NonPhysical
	Nontaxable ⁴³	Taxable ⁴⁴
		1989 Congressional Amendment to I.R.C. § 104(a)(2)
Non-Punitive	Nontaxable ⁴⁵	Nontaxable ⁴⁶
	Supreme Court in <i>Burke</i> footnote 6	Supreme Court in <i>Burke</i> footnote 6

The majority of awards of liquidated damages under the ADEA, when viewed in light of the above matrix, will be taxable to the recipient. If, for example, the availability of liquidated damages is determined to be insufficient to render the action tort-like, the analysis fails the threshold inquiry. If, on the other hand, the availability of liquidated damages is determined to satisfy the threshold test, it is necessary to examine the injury sustained relative to its physical or nonphysical characteristics. Presumably, the large majority of ADEA plaintiffs will fail to sustain the physical injury element of the action and will therefore be subject to the statutory exception to the exclusionary rule.⁴⁷

After *Burke*, then, it is the presence of punitive damages that justifies classification of an ADEA action as sufficiently tort-like to secure the exclusion of section 104(a)(2). However, if the damages are declared punitive in nature, unless the injury is declared to be physical in nature, the award is taxable pursuant to the 1989 congressional amendment to the statutory language of the exclusion. If the

43. The nontaxable nature of punitive damages awarded for physical injury is the necessary implication of the 1989 statutory change.

44. Under the conference agreement of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2379 (1989), the exclusion from income for damages received for personal injury does not apply to punitive damages in cases not involving physical injury or sickness. The exclusion from gross income, then, "shall not apply to any punitive damages in connection with a case not involving physical injury or sickness." I.R.C. § 104(a) (1994). The provision is effective for punitive damages received after July 10, 1989, and for actions filed after that date.

45. After reviewing the amendment adopted by Congress to the statutory language of I.R.C. § 104(a), and recounting the scope of congressional proposals that were ultimately rejected during the amendment process, the Court concluded as to the congressional intent of the change. *United States v. Burke*, 112 S. Ct. 1867, 1871 n.6 (1992). The Court stated that "[t]he enactment of this limited amendment addressing only punitive damages shows that Congress assumed that other damages (i.e., compensatory) would be excluded in cases of both physical and nonphysical injury." *Id.* at 1871 n.6.

46. *Burke*, 112 S. Ct. at 1872 n.6.

47. Although it may be somewhat uncommon, it is not difficult to imagine an action that would satisfy the physical element of the exclusion. It would be necessary for the plaintiff, in such a case, to show that the discrimination resulted in either physical injury or physical sickness. The plaintiff, for example, might demonstrate certain physical manifestations of the discriminatory behavior of the defendant.

Supreme Court, in *Commissioner of Internal Revenue v. Schleir*,⁴⁸ adopts the two-part test I have proposed, it will be faithfully following the logic of its prior decisions.

48. 1994 WL 528122 (granting certiorari); *see supra* note 1.