Schleier v. Commissioner: The Supreme Court's Response to the Split among Circuits over Taxability of ADEA Awards

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"Do not go gentle into that good night, old age should burn and rave at close of day . . ."

—Dylan Thomas


I. INTRODUCTION

GROWING OLDER. While it can bring wisdom and experience, in many American workplaces, it can also bring pain-
ful consequences. An employer seeking youthful enthusiasm in his work force might make an older worker's job unbearable in the hope that the employee will become frustrated and quit. Alternatively, that employer might decide to take matters into his own hands and unfairly fire the aging worker.

Since 1967, age discrimination in the workplace has been unlawful in the United States. The ADEA, or Age Discrimination in Employment Act,2 has given older workers the statutory means to "burn and rave"3 at unfair treatment in their professional lives as a result of their age. It was enacted by Congress "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment."4 The ADEA has served as a significant protection against age-related bias for employees nationwide since its passage by Congress.

However, under section 104 of the Internal Revenue Code (I.R.C.),5 the tax treatment of damages received in age-related ADEA claims has been unclear. Section 104(a)(2) allows taxpayers to exclude from gross income the amount of any damages received "on account of personal injuries or sickness."6 The broad wording of this section has resulted in many interpretations; its application in various contexts, including the taxability of age-related damages, has been inconsistent.

On August 30, 1994, uncertainty as to the meaning of section 104(a)(2) with respect to such age-related damages became even more pronounced when the Seventh and the Ninth Circuits split, rendering opposite opinions on the same day as to taxability of ADEA damages under I.R.C. section 104(a)(2).

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3 Thomas, supra note 1. Though the "good night" to which Thomas refers in the poem is death, age-based loss of work can result in feelings of loss, pain, and darkness for the affected employee—effectively, a "dark night."
5 I.R.C. § 104(a)(2) (West 1994). The term "damages" is used in this comment to refer to damages received both through judgments and settlements, since § 104(a)(2) specifically includes both in the exception. Id. Section 104(a)(2) provides, in part, "[G]ross income does not include . . . (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." Id.
6 Id.
The circuit courts’ rulings came in two factually similar cases, *Downey v. Commissioner*\(^7\) and *Schmitz v. Commissioner*.\(^8\) Though the *Downey* and *Schmitz* courts reached opposite conclusions on the taxability of the ADEA damages, both circuits relied on the Supreme Court decision *United States v. Burke*\(^9\) to reach these differing conclusions.

The same-day holdings of the two circuit courts in *Downey* and *Schmitz* joined an already varied range of interpretations among circuits of the meaning of section 104(a)(2) as applied to age-related ADEA damages.\(^10\) The Fifth Circuit had joined the debate just before *Downey* and *Schmitz* came down in the form of a very brief per curiam opinion, *Schleier v. Commissioner*,\(^11\) enunciated on June 21, 1994. The analysis and results in *Downey*, *Schmitz*, and *Schleier*, the three cases on which this comment focuses, reflect the underlying analytical confusion that existed concerning both the purpose and scope of section 104(a)(2) and the means of applying the test for exclusion of non-physical damages established by the Supreme Court in *Burke*, for each of the three circuits applied what it perceived to be the law pertaining to that section differently.\(^12\)

Recognizing this deepening confusion, the Supreme Court in November of 1994 responded to an appeal of the Fifth Circuit decision by the Solicitor General of the Internal Revenue Service by granting certiorari.\(^13\) After hearing oral arguments the following March, the Court handed down its decision in June of 1995.\(^14\) The holding surprised many who had followed the issue through the deepening split among circuits.

The split in circuits leading to the grant of certiorari and the Supreme Court’s decision in *Schleier* are important for a number of reasons. First, the issue of the taxability of age-related damages under the ADEA has been the subject of intense speculation, as this comment notes, in the years since *Burke* was handed

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

\(^8\) 34 F.3d 790 (9th Cir. 1994).


\(^10\) See *Rickel v. Commissioner*, 990 F.2d 655, 664 (3d Cir. 1990); *Pistillo v. Commissioner*, 912 F.2d 145, 150 (6th Cir. 1990); *Byrne v. Commissioner*, 883 F.2d 211, 216 (3d Cir. 1989). All held that ADEA awards were excludable from income.


\(^12\) See infra parts IV and V for a discussion of each circuit’s approach.


\(^14\) *Schleier*, 115 S. Ct. at 2159 (holding that amounts received in settlement of ADEA claims were not excludable from gross income).
down. The Schleier court technically addressed that issue, but at the same time, the decision highlighted the many unanswered questions that exist about the scope of section 104(a)(2). Schleier is an important decision in that respect as well. Thirdly, the split and the subsequent Supreme Court decision may lead to much-needed steps for further clarification of what the policies and goals of the exclusion are.

And finally, Schleier’s resolution of the taxability issue concerning ADEA damages is significant in that it will affect the airline industry, its management, and its employees. Schleier and the two cases that comprised the Seventh and Ninth Circuit split all involved airline employees who were part of age discrimination suits against their airlines. In Downey and Schmitz, the taxpayers were former United Airlines pilots, each of whom had received settlement awards based on claims of ADEA violations. The plaintiff in Schleier was also a United pilot who had been forced to retire at age 60. These three pilots are not unique; the ADEA has been the basis of claims against airlines for many years. The taxability issues confronting the three pilots involved in the cases examined herein, therefore, are representative of the positions of many pilots and other airline employees who have received ADEA-based awards from their employers, some as part of significant class action suits. This comment examines the historical and present-day interpretations of section 104(a)(2) and the Burke decision as backdrops to the August 30 split between the two circuits. It then sets forth the three positions taken in the Seventh and Ninth Circuit opinions and the Fifth Circuit’s position in Schleier. After describing the Supreme Court’s decision to grant certiorari, it lays out the high court’s analysis and holding in Schleier and describes the reaction of commentators to the decision. Finally, this comment discusses additional considerations for the future, as well as some of the possible implications to airlines and their employees of the Supreme Court’s holding in Schleier.

16 Lyle Denniston, High Court to Rule on Taxation of Damage Awards, THE BALTIMORE SUN, Nov. 14, 1994, at 9C.
17 Downey, Schmitz, and Schleier are only three among many age-related discrimination cases brought against the airlines.
18 This comment describes the majority opinions in Schmitz and Downey as well as Judge Trott’s concurrence in Schmitz.
II. HISTORICAL AND CURRENT INTERPRETATION OF I.R.C. SECTION 104(a)(2): WHAT DOES “ON ACCOUNT OF PERSONAL INJURIES OR SICKNESS” MEAN?

A. BACKGROUND

Section 61(a) of the I.R.C. defines “gross income” as “all income from whatever source derived.”\(^{19}\) The Supreme Court has long interpreted that language as a reflection of Congressional intent to exert “the full measure of its taxing power,”\(^{20}\) and accordingly, has given the concept of gross income a liberal construction.\(^{21}\)

In the landmark case of Commissioner v. Glenshaw Glass Co.,\(^{22}\) the Supreme Court set forth a definition for gross income that has become a standard. The Court stated that “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion” constitute gross income.\(^{23}\) The Glenshaw Court stated that it would afford a liberal interpretation of gross income based on the Court’s “recognition of the intention of Congress to tax all gains except those specifically exempted.”\(^{24}\)

B. SECTION 104(a)(2)’S EXCLUSION FOR DAMAGES RESULTING FROM PERSONAL INJURY OR SICKNESS

Section 104(a)(2) is one such specific exception. Its predecessor, section 213(b)(6), was adopted by Congress in the Revenue Act of 1918 to provide for exclusion of damages resulting

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\(^{19}\) I.R.C. § 61(a) (West 1994).


\(^{22}\) 348 U.S. at 426.

\(^{23}\) Id. at 431.

\(^{24}\) Id. at 430. The Court noted two other cases in support of its proposition: Commissioner v. Jacobson, 336 U.S. 28, 49 (1949); and Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87-91 (1934). Id.
from personal injury or sickness.\textsuperscript{25} Boris Bittker and Martin McMahon give one explanation for inclusion in the Code of this exception to taxation: "The rationale for this exclusion, which is interpreted by the regulations to embrace claims based on 'tort or tort type rights,' is presumably that the recovery does not generate a gain or profit but only makes the taxpayer whole by compensating for a loss."\textsuperscript{26} The current version of I.R.C. section 213(b)(6) is I.R.C. section 104(a)(2), which was enacted in 1990. Like section 213, section 104(a)(2) allows taxpayers to exclude from taxable gross income damages received "on account of personal injuries or sickness."\textsuperscript{27}

C. The Scope of the Section 104(a)(2) Exclusion, Including the Effect of the 1989 Amendment

The term "personal injuries" is not, however, defined in either the statute or the legislative history of section 104(a)(2).\textsuperscript{28} Given the absence of a congressional definition of scope, interpretation has evolved over time. Initially, the phrase "personal injuries" was interpreted to pertain to physical injuries only.\textsuperscript{29} Courts then began to expand the exemption to nonphysical personal injury awards.\textsuperscript{30} After this gradual expansion, "the phrase 'personal injuries or sickness' as used in Section 104(a)(2) now embraces emotional distress, libel, slander, and other nonphysical wrongs."\textsuperscript{31}

\textsuperscript{27} I.R.C. § 104(a)(2) (1994).
\textsuperscript{30} Andrews, supra note 29, at 757 n.19; see also Burke, 504 U.S. at 237 n.6 (discussing the broadening of the section 104(a)(2) exclusion to include damages resulting from nonphysical personal injuries); Robert Nath, Damage Awards: Included or Excluded?, 94 Tax Notes Today 202-08 (Oct. 14, 1994) (briefly tracing the movement from a requirement of physical injury to inclusion of other torts beginning with Threlkeld v. Commissioner, 87 T.C. 1285, 1294 (1986), aff'd, 848 F.2d 81 (6th Cir. 1988)).
\textsuperscript{31} Bittker & McMahon, supra note 26, § 7-6.
Given the movement to exclude more than strictly physical injuries, excludability under section 104(a)(2) of certain types of damages received has become the source of considerable controversy.\textsuperscript{32} In 1989, Congress responded by attempting to clarify section 104(a)(2) through an amendment included in the Omnibus Budget Reconciliation Act of 1989.\textsuperscript{33} At the time, there was some movement to modify the section to severely restrict exclusions.\textsuperscript{34} As the legislative history reflects, however, there was ambivalence in both houses about any such severe restriction,\textsuperscript{35} and ultimately, the change was limited to amending the statute to prevent the use of the section 104(a)(2) exclusion for punitive damages in nonphysical injury and sickness cases.\textsuperscript{36} The inclusion of punitive damages was expressly limited to punitive damages received after June 10, 1989.\textsuperscript{37} However, even the amendment to section 104(a)(2) has been inconsistently applied and has generated considerable controversy; some courts have held that post-1989 punitive damages may still be excluded if a connection exists between the punitive damages and a physical condition developed by the taxpayer as a result of his or her personal injury.\textsuperscript{38}

Despite this movement to reform section 104(a)(2) in 1989, the exclusion of awards for physical and non-physical injuries was left intact—and ambiguous.\textsuperscript{39} Apart from the Congressional attempt to remove nonphysical personal injury punitives from the section’s exception, the cornerstone of analysis of section 104(a)(2) has remained fairly consistent: for over twenty-five years, courts have analyzed whether something fell within the section 104(a)(2) exception by looking to “traditional tort principles.”\textsuperscript{40} Relying on language found in Treasury Regula-

\textsuperscript{32} Andrews, \textit{supra} note 29, at 757.
\textsuperscript{34} Andrews, \textit{supra} note 29, at 757-58.
\textsuperscript{35} \textit{Id.} at 758.
\textsuperscript{36} \textit{Id.}
\textsuperscript{37} OBRA of 1989; \textit{Schmitz}, 34 F.3d at 792 n.1.
\textsuperscript{39} Andrews, \textit{supra} note 29, at 758.
\textsuperscript{40} \textit{Id.} at 758 n.24.
tion 1.104-1(c), the Internal Revenue Service and courts have said that if the injury is found to be "tort or tort-type," the resulting damages are excludable.\textsuperscript{41}

To determine whether an injury is "tort or tort-type," courts judge the nature of the injury not by its effects, but by looking to the nature of the underlying claim.\textsuperscript{42} If the nature of the underlying claim is such that an award or settlement adds to the plaintiff's wealth, it falls within the \textit{Glenshaw Glass} concept of "undeniable accession to wealth"\textsuperscript{43} and is deemed taxable. In contrast, if the underlying claim involves a loss of some type, the award or settlement merely compensates the plaintiff for his loss by restoring him to his status prior to the injury. In that case, the plaintiff realizes no new wealth, and such amounts are not taxable.\textsuperscript{44}

Even with that level of definition, exclusions under the section 104(a)(2) exceptions continued to be granted inconsistently by courts. Determination of what was "tort or tort-type" using the "nature of the underlying claim" test was elusive, and courts were mired in confusion over how that test should be applied.\textsuperscript{45} In 1992, the Supreme Court attempted to clear up the confusion by validating the "nature of the underlying claim" test being used in some circuits and explaining how it was to be applied in a decision of major importance, \textit{United States v. Burke}.\textsuperscript{46} Until \textit{Schleier}, it was the single most significant statement on the

\textsuperscript{41} See Treas. Reg. § 1.104-1(c) (1993) (stating that the phrase "damages received" in § 104(a)(2) refers to damages received through legal actions or settlements "based upon tort or tort-type rights." ); United States v. Burke, 504 U.S. 229 (1992), and the cases cited therein.

\textsuperscript{42} Andrews, \textit{supra} note 29, at 759. Threlkeld v. Commissioner, 87 T.C. 1294, 1299, aff'd, 848 F.2d 81 (6th Cir. 1988).

\textsuperscript{43} \textit{Glenshaw Glass}, 348 U.S. at 431.

\textsuperscript{44} Andrews, \textit{supra} note 29, at 759.

\textsuperscript{45} For a snapshot of the pre-\textit{Burke} case law existing in the spring of 1992, see Margaret Henning, \textit{Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries}, 45 TAX LAW. 783 (1992). Henning's article describes the struggle courts faced at that time in determining the parameters of the personal injury exclusion of § 104(a)(2), including how courts had analyzed the distinctions between physical and nonphysical injuries, compensatory and punitive damages, personal and professional injuries, and personal and nonpersonal injuries. The article also looks at the courts' treatment at that time of punitive damage recoveries and employment-related recoveries, pointing to the marked inconsistencies in treatment that parties were receiving. Henning asserts that these inconsistencies stem from the absence of a clear explanation of the underlying policy of the statute. Many of these issues remain unresolved today, despite the \textit{Burke} decision, and the definitive policy explanation remains to be made.

\textsuperscript{46} 504 U.S. 229 (1992).
scope of section 104(a)(2) from the Supreme Court, and the Court relied heavily on it in Schleier. Burke, therefore, has proved to be an extremely important decision in determination of the taxability of damages under the section, especially in the realm of nonphysical personal injury. Yet the Burke decision itself has been confusing in its application.

The Seventh, Ninth, and Fifth Circuit Courts of Appeal in Downey, Schmitz, and Schleier, respectively, also relied heavily on the test articulated in Burke in reaching their conclusions. Therefore, detailed examination of the Supreme Court's rationale in Burke is critical both to analysis of the three opinions and to the broader determination of the appropriateness of taxing ADEA settlement awards.

D. United States v. Burke

In United States v. Burke, the Supreme Court granted certiorari to resolve the disagreement existing at the time among the courts of appeal as to whether Title VII backpay awards should be excludable under section 104(a)(2). Burke held that backpay awards in settlement of Title VII claims are not excludable from gross income under section 104(a)(2).

Burke involved allegations of unlawful discrimination based on sex. Female employees of the Tennessee Valley Authority (TVA) claimed that they were being denied salary increases on the basis of their sex and in some cases, were even being subjected to the lowering of salaries for the same reason. The Tennessee Valley Authority chose to settle the suits and awarded the

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47 For thorough pre-Schleier discussions of United States v. Burke and its importance in understanding § 104(a)(2), see Richard T. Helleloid & Lucretia S.W. Mattson, Has the Scope of the Personal Injury Exclusion Been Changed by the Supreme Court?, 77 J. TAX’N 82 (1992); Carolyn F. Kolks, United States v. Burke—Does It Definitively Resolve the Analytical Confusion Created by the Section 104(a)(2) Personal Injury Exclusion?, 46 Ark. L. Rev. 657 (1993); Cynthia A. Sciuto, Note, A Tort By Any Other Name: Taxation of Non-Physical Personal Injury Damages After United States v. Burke, 38 ST. LOUIS U. L.J. 285 (1993). These articles provide detailed insights into Burke’s impact on the types of nonphysical personal injury claims, other than those associated with ADEA, on which this comment focuses.

48 See infra parts IV & V.

49 Burke, 504 U.S. at 232. To demonstrate the confusion, the Court points to the different results reached by the courts of appeals in Sparrow v. Commissioner, 949 F.2d 434 (6th Cir. 1991); Thompson v. Commissioner, 866 F.2d 709 (4th Cir. 1989); and the Sixth Circuit’s opinion in United States v. Burke, 929 F.2d 1119 (6th Cir. 1992), the opinion being reviewed at that time by the Supreme Court. Burke, 504 U.S. at 233 n.3.

50 Id. at 238.
employees varying sums calculated using a formula that factored in length of service and pay rates.

The tax dispute involved in Burke arose when the respondents claimed that their settlement payments fell within the section 104(a)(2) exclusion from taxability since they were "damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." The district court classified the settlement proceeds as "back wages" and found that they could not be excluded because they were not "damages received on account of personal injuries." The Sixth Circuit Court of Appeals reversed. It held that the exclusion rested on whether the injury and claim are "personal and tort-like in nature;" if so, the award was not taxable. In the TVA employees' case, the Sixth Circuit held that the discrimination the employees suffered was personal and tort-like. Therefore, it held that under section 104(a)(2), backpay damages granted under Title VII were excludable. In the process, the court rejected the Commissioner's argument that the circumscribed range of damages available under Title VII distinguished it from other statutes providing relief for personal injuries.

The Supreme Court granted certiorari and handed down its opinion on May 26, 1992. Justice Blackmun wrote the majority opinion (joined by six other justices), in which the Court announced its reversal of the court of appeals' finding that the ADEA damages received by the employees were excludable.

In writing for the Court, Blackmun began by confirming that, under the Internal Revenue Code, gross income is properly construed broadly for taxation purposes to mean "all income from whatever source derived" that does not qualify for exclusion under a specific code provision. He then turned to section

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52 Burke, 504 U.S. at 232.
54 Id. at 1121.
55 Id.
56 Id. at 1123.
57 Id. at 1121-23.
58 Burke, 504 U.S. at 242. Those joining in the majority opinion were Chief Justice Rehnquist and Justices White, Stevens, and Kennedy. Justices Scalia and Souter filed separate concurring opinions. Justice O'Connor filed a dissenting opinion in which Justice Thomas joined. Id. at 248.
59 Id. at 233 (citing I.R.C. § 61(a)).
60 Id.
104(a)(2), the exception in question, and began the process of determining its scope.

To that end, he first noted that I.R.S. regulations had, since 1960, "formally . . . linked identification of a personal injury for purposes of Section 104(a)(2) to traditional tort principles." To determine what these traditional tort principles were, Blackmun looked to the writings of tort scholars Prosser and Keeton, who define a "tort" as a "civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages." Blackmun then cited R.V.F. Heuston's statements that "an action for damages [is] an essential characteristic of every true tort," and that "it is solely by virtue of the right to damages that the wrong complained of is to be classed as a tort." From these, Blackmun and the Burke majority concluded that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff . . . fairly for injuries caused by violation of his legal rights." That conclusion provided the groundwork for the Burke Court's establishment of a test based on the nature of the remedial scheme included in the statute involved, which the Court believed would serve as the proper indicator of the nature of the claims.

The Burke Court then confirmed the court of appeals' use of the "nature of the underlying claim" test, but stated that, under the correct method of analysis outlined in the opinion, the court of appeals should have judged what that nature was by examining the remedial scheme of Title VII. At the time of the Burke plaintiffs' injury, the Court notes, Title VII remedies

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61 Id. at 234 (quoting 25 Fed. Reg. 11,490 (1960); 26 C.F.R. § 1.104-1(c) (1991)). Justice Blackmun included the oft-quoted language of Threlkeld v. Commissioner, 87 T.C. 1294 (1986), aff'd, 848 F.2d 81 (6th Cir. 1988), where the court stated, "The essential element of an exclusion under section 104(a)(2) is that the income involved must derive from some sort of tort claim against the payor . . . ." Threlkeld 87 T.C. at 1305.
62 Burke, 504 U.S. at 234 (quoting W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 2 (1984)).
63 Id. (citing R. V. F. HEUSTON, SALMOND ON THE LAW OF TORTS 9 (12th ed. 1957)).
64 Burke, 504 U.S. at 235 (quoting Carey v. Piphus, 435 U.S. 247, 257 (1978)).
65 Andrews, supra note 29, at 765.
66 Burke, 504 U.S. at 245.
67 As the Court notes, Title VII was significantly amended by the Civil Rights Act of 1991; Pub. L. No. 102-166, § 1745, 105 Stat. 1071 (1991). Burke, 504 U.S. at 238 n.8. However, all parties recognized that those amendments did not apply to the case at bar since they occurred subsequent to the injuries. Id.
were limited to "back pay, injunctions, and other equitable relief." Burke, 504 U.S. at 238. The Court looked to 42 U.S.C. § 2000e-5(g) (Supp. III 1991) to determine what remedies were available prior to the 1991 amendment of the section noted supra note 67. See also Are Age Discrimination Awards Excludable? 76 J. Accfr. (No. 3) Sept. 1993, at 1, which describes the remedies available to Title VII plaintiffs as consisting of back pay and court orders forcing an employer to rehire, hire, or promote an employee.

Therefore, the Court stated, "[T]he 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." Burke, 504 U.S. at 239. Since Congress "declined to recompense Title VII plaintiffs for anything beyond the wages properly due them," the remedial scheme was not broad and tort-like and the damages were not excludable from gross income under section 104(a)(2).

While Burke is a Title VII case, it is considered, as noted above—along with the more recent decision in Schleier—as the Supreme Court’s most definitive ruling on the section 104(a)(2) exception. The Court’s reasoning in Burke figured heavily into Schleier; it was against the background of Burke that Schleier’s claim of exclusion and the broader issue of taxability of damages awarded under the ADEA were considered. The remedial scheme test set forth in Burke also figured heavily into the reasoning of the three circuit cases (the Seventh, the Ninth, and the Fifth, described below) involved in the ADEA dispute existing prior to the Supreme Court’s ruling in Schleier. Burke remains an important part of the landscape of the debate over the taxability of ADEA damages and of the high Court’s view of the section 104(a)(2) exclusion.

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68 Burke, 504 U.S. at 238. The Court looked to 42 U.S.C. § 2000e-5(g) (Supp. III 1991) to determine what remedies were available prior to the 1991 amendment of the section noted supra note 67. See also Are Age Discrimination Awards Excludable? 76 J. Accfr. (No. 3) Sept. 1993, at 1, which describes the remedies available to Title VII plaintiffs as consisting of back pay and court orders forcing an employer to rehire, hire, or promote an employee.

69 Burke, 504 U.S. at 239.

70 Id. at 240.

71 Id. at 241. It is important to note here that Justice O’Connor, who was joined by Justice Thomas, registered a significant dissent in Schleier, which is discussed at length below. See infra notes 254-69 and accompanying text. Scalia’s Burke concurrence, also of importance, is likewise considered below. See infra notes 217-25 and accompanying text.
III. PRE-BURKE INTERPRETATION OF THE SECTION 104(a)(2) EXCEPTION IN ADEA AWARDS

A. BACKGROUND

At the time of the Supreme Court's decision to grant certiorari in Schleier, age discrimination damages had evolved into a major battleground for the section 104(a)(2) debate, as the different views as to the taxability of ADEA damages expressed by the Seventh, Ninth, and Fifth Circuit Courts of Appeals demonstrated. Some fundamental understanding of the ADEA and of a pair of highly significant pre-Burke cases involving age discrimination damages is important in assessing the reasoning of the Ninth and Seventh Circuits in the opposite conclusions they reached, as well as the Fifth Circuit's interpretation of the taxability of ADEA damages.

B. THE AGE DISCRIMINATION IN EMPLOYMENT ACT OF 1967

1. Stated Purpose of the Act

The Act's purpose is "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment." The ADEA's legislative history indicates that Congress recognized that Title VII of the Civil Rights Act did not adequately address what Congress perceived to be a major problem: age discrimination. Therefore, Congress directed the Secretary of Labor to study the area. From that study came the ADEA.

2. Types of Remedies Available Under the Statute

The ADEA incorporates remedies available in the Fair Labor Standards Act, which provides for liquidated damages and the doubling of back pay for cases of willful violations. Section 626(b) of the ADEA also allows the courts to grant "such legal

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72 Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994); Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994); Schleier v. Commissioner, 26 F.3d 119 (5th Cir. 1994) (per curiam), rev'd, 115 S. Ct. 2159 (1995).
74 Id.
75 29 U.S.C. § 621, Interpretive Notes and Decisions.
77 29 U.S.C. § 626(b).
and equitable relief as may be appropriate to effectuate the purposes of the ADEA, 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.”

C. TAX TREATMENT OF SIGNIFICANT ADEA-BASED DAMAGE AWARDS PRIOR TO BURKE

Two ADEA cases representative of pre-Burke ADEA analysis are Rickel v. Commissioner and Pistillo v. Commissioner. In Rickel, the Third Circuit Court of Appeals held that the entire amount of an ADEA settlement was excludable. The court found that the damages arose from discrimination, and the fact that the consequences (lost wages) were not personal did not remove the personal nature of the discrimination claim.

In Pistillo, the Sixth Circuit Court of Appeals held that the plaintiff’s age discrimination settlement under the ADEA was excludable under section 104(a)(2). Citing Rickel, the court found that Pistillo’s loss of wages, while nonphysical, did not turn the age discrimination into a non-personal injury. According to the court, Pistillo suffered the same type of injury as does a typical tort victim who is physically injured and receives a settlement as a result.

The judicial interpretation of section 104(a)(2) in the ADEA context by the Rickel and Pistillo courts, along with the remedial scheme of the ADEA itself, are important foundations for examining the majority opinions in the two cases handed down the same day, Downey v. Commissioner and Schmitz v. Commissioner, and the concurring opinion in Schmitz. Understanding those background matters is also necessary for understanding the Fifth Circuit’s holding in Commissioner v. Schleier, which led to the grant of certiorari by the Supreme Court. This comment now turns its examination to these circuit opinions.

78 Heen, supra note 29, at 587.
80 912 F.2d 145, 150 (6th Cir. 1990).
81 Rickel, 900 F.2d at 660-61.
82 Id.
83 Id.
84 Id.
85 Id.
IV. THE THREE POSITIONS EXPRESSED IN *DOWNEY* AND *SCHMITZ* IN THE AUGUST 30, 1994, SEVENTH AND NINTH CIRCUIT SPLIT REGARDING TAXABILITY OF ADEA AWARDS

A. OVERVIEW

The *Downey* and *Schmitz* decisions came down on the same day, August 30, 1994. Immediately, it was predicted that this split in opinions might bring about the long-needed Supreme Court review of taxability of ADEA damages.86

The two cases may have seemed particularly well-suited to trigger such high court review because of their remarkable factual and legal similarity. Both involve former United Airlines pilots who received back pay and liquidated damages in settlements under the ADEA. Both cases address a question left open by the Supreme Court in *Burke* may damages or settlements awarded pursuant to the ADEA be excluded under section 104(a)(2)?87 Although the courts reach opposite conclusions, both use the *Burke* analysis to reach their holdings.88 This comment considers the *Downey* and *Schmitz* opinions in this section and examines the Fifth Circuit’s opinion in *Schleier* in Part V.

B. OPINION OF THE SEVENTH CIRCUIT IN *DOWNEY* V. COMMISSIONER (JUDGE JOEL M. FLAUM)

In *Downey*, United Airlines forced one of its employees, a pilot named Burns Downey, to retire at the age of sixty. Downey filed suit under the ADEA alleging age discrimination. Subsequently, the parties decided to settle for $120,000, labeling half of the settlement money “back pay” and the other half of it “liquidated damages.”89

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86 Ninth and Seventh Circuits Reach Opposite Holdings on Tax Treatment of Age Bias Damages, Employment Pol’y L. & Daily (BNA), at d9 (Sept. 6, 1994), available in Westlaw, BNA-EPLD database [hereinafter *Opposite Holdings*].

87 See Are Age Discrimination Awards Excludable?, supra note 68, at 1.

88 Both holdings apply only to punitive damages received prior to June 10, 1989, the effective date of the 1989 amendment to § 104(a)(2) which disallowed exclusion of nonphysical injury punitive damages, as noted in the Ninth Circuit’s opinion and in *Opposite Holdings*, supra note 86. This fact does not mean, however, that the cases will have no implications for post-1989 airline liability and pilot awards, because it is currently unclear how punitive damages will be treated in the wake of *Schleier*. See infra part VII.

89 *Downey*, 33 F.3d at 837.
Downey and his wife paid taxes on the $60,000 back pay half of the settlement. The IRS filed a deficiency notice against them for the liquidated damages portion, and the Downeys filed in tax court for a redetermination of the assessment, claiming that they should have been exempted from taxes on both the back pay and the liquidated damages portions of the settlement. The case brought squarely before the tax court the issue of whether settlement payments pursuant to an ADEA lawsuit fall within the section 104(a)(2) exception to taxable income.

The Downey tax court waited for issuance of United States v. Burke so that it could make its decision relying on the Supreme Court's ruling in that case. After the Burke opinion was handed down, the tax court looked to that opinion to hold that "(1) the ADEA 'evidenced a tort-like conception of injury and remedy' for purposes of Burke, and (2) all of the Downeys' damages received through their ADEA litigation were excludable from tax."

However, the Seventh Circuit reversed the tax court, holding that the damages the Downeys received under the ADEA were taxable income because an ADEA settlement does not compensate for a tort-like injury, which Burke requires in order for the recipient to be able to use the section 104(a)(2) exclusion.

Writing for the court, Judge Joel Flaum looked to Burke for its interpretation of section 104(a)(2). He first stated that the text of that section indicated that the taxable character of a settlement payment must be the same as it would have been had the payment arisen from an award on the underlying claim. Therefore, wrote Flaum, the court "must analyze the character of the damages available under an ADEA suit."

Flaum looked at the language of section 104, which limits the exception to "damages received ... on account of personal injuries or sickness." Laying the foundation for his ultimate conclusion, Flaum started his analysis by citing with favor Justice Scalia's statement in his Burke concurrence that the plain language of section 104 indicated that only damages to an individ-

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90 Id. at 888.
91 Id. at 837.
92 Id.
93 Id. at 840.
94 Id. at 838.
95 Id. See Burke, 504 U.S. at 229, 245.
96 Downey, 33 F.3d at 838.
97 I.R.C. § 104(a)(2), quoted in Downey, 33 F.3d at 838.
ual's physical or mental health should be excluded. 98 Flaum then looked to Treasury Regulation 1.104-1(c), which interpreted the term "damages" in section 104(a)(2) "to mean an amount received through prosecution or settlement of an action based on tort or tort-type rights." 99

Flaum noted that, while the issue of whether ADEA claims are tort-like is one of first impression in the Seventh Circuit, it had been analyzed by other courts of appeals. 100 Flaum stated, however, that those cases were inconsistent with Burke's later analysis, which he and the majority chose to apply as the "most pertinent teaching on this matter." 101

Turning then to Burke, Flaum wrote:

Burke teaches us that the hallmark of tort liability is the availability of a broad range of damages to compensate the plaintiff for injuries caused by the violation of a legal right, and while such damages often are described in compensatory terms, tort damages usually "redress intangible elements of injury." 102

Therefore, in the court's view, Burke reduced the case before it to a question of whether the ADEA "provide[s] compensatory damages for those intangible elements of injury essential to a personal injury tort action." 103 Flaum gave examples of that type of compensatory damages, such as pain and suffering, emotional distress, or personal humiliation. 104

The Downey court then analyzed the character of ADEA damages available. It noted that, under the ADEA, one cannot recover for pain and suffering or emotional distress; therefore, the court found that the range of remedies was not broad enough to meet the Burke "hallmark of tort liability" test. 105 In comparing the ADEA scheme to the Title VII remedies available at the time of the Burke decision, Flaum stated that, "[w]ith respect to remedies, the only difference between a scheme embodied under the ADEA and that under Title VII is that under the ADEA a plaintiff may often recover liquidated damages in addition to lost

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98 Downey, 33 F.3d at 838; see Burke, 504 U.S. at 242 (Scalia, J., concurring).
99 Downey, 33 F.3d at 838.
100 Id. Flaum pointed to Rickel v. Commissioner, 900 F.2d 655 (3d. Cir. 1990), Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990), and Redfield v. Insurance Co. of N. Am., 940 F.2d 42 (9th Cir. 1991). Downey, 33 F.3d at 838.
101 Downey, 33 F.3d at 838.
102 Id. at 839 (emphasis added).
103 Id.
104 Id.
105 Id. at 840.
wages when the employer's violation of the statute has been willful. He then took the position that, since liquidated damages were a replacement for prejudgment interest, a type of contract remedy, they did not compensate for the "intangible elements of a tort-type injury." Therefore, the Downey court held that an ADEA suit "does not even clear the Treasury's low hurdle of being 'tort-type," and that the court was "bound by Burke" to find the ADEA settlement damages taxable for that reason. Since the ADEA does not provide a wide range of compensatory damages for tort-like injuries, which the Downey court interpreted Burke as requiring, ADEA damages are not ones that plaintiffs receive "on account of personal injuries or sickness and are not excludable under Section 104(a)(2)." Therefore, the Seventh Circuit found the damages taxable.

C. OPINION OF THE MAJORITY OF THE NINTH CIRCUIT IN 
SCHMITZ v. COMMISSIONER (JUDGE ALFRED GOODWIN)

John Schmitz received $115,050 in a settlement arising from an ADEA class action against United Airlines, his former employer. Half of the settlement was designated "back pay" and the other half "liquidated damages."

The Schmitzes initially reported only the back pay portion of the income. The Commissioner issued a notice of deficiency on the rest of the award. Based on Rickel the Schmitzes filed a claim for exclusion of the entire settlement. The tax court held the entire award excludable, and the Commissioner appealed.

The issue before the Ninth Circuit in Schmitz was the same one addressed by the Seventh Circuit in Downey: whether the ADEA settlement amount was excludable under section 104(a)(2). To decide, the Schmitz court looked to the two-part test the court had set forth earlier in the year in a case.

106 Id. at 839.
107 Id.
108 Id. at 838, 839.
109 Id. at 840.
110 Id. at 839.
111 Schmitz, 34 F.3d at 791.
112 Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990).
113 Schmitz, 34 F.3d at 791.
114 Id.
115 Id.
called *United States v. Hawkins*.\(^{116}\) Under the *Hawkins* test, "a taxpayer must show both (1) that the underlying cause of action was tort-like within the meaning of *United States v. Burke* ... and (2) that the damages were received 'on account of' the taxpayer's personal injury."\(^{117}\)

Judge Goodwin, writing for the *Schmitz* majority, applied the *Hawkins* test to the case before it. First, the majority held that the first prong of the test was satisfied because the ADEA created tort-like causes of action as those are defined in *Burke*,\(^{118}\) which the *Schmitz* court interpreted as recognizing that "discrimination could constitute a 'personal injury' for purposes of [section] 104(a)(2)."\(^{119}\) Goodwin then distinguished the remedial scheme in *Burke* from the one under analysis in *Schmitz*. He wrote that the ADEA's remedial scheme, unlike that of Title VII (which was scrutinized in *Burke*), was broad enough to "evidence a tort-like conception of remedy."\(^{120}\)

The court found support for this distinction within the ADEA's remedial scheme, which it noted provides for jury trials and liquidated damages in cases of willful violations.\(^{121}\) The court found additional support for its position in the fact that most post-*Burke* courts have continued to find ADEA damages excludable, despite the Supreme Court's more restrictive test.\(^{122}\) Furthermore, the court noted 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;"\(^{123}\) therefore, the court found, the ADEA does not have to provide damages for emotional distress or pain and suffering in order to be characterized as a tort-type remedy.\(^{124}\)

Judge Goodwin also wrote that the case law and legislative history associated with the ADEA make it clear that ADEA liquidated damages have a compensatory as well as a punitive purpose.\(^{125}\) Therefore, as the *Schmitz* court saw it, the settlement

\(^{116}\) *Schmitz*, 34 F.3d at 792 (citing *United States v. Hawkins*, 30 F.3d 1077, 1083 (9th Cir. 1994)).

\(^{117}\) *Hawkins*, 30 F.3d at 1082.

\(^{118}\) *Schmitz*, 34 F.3d at 792.

\(^{119}\) *Id.* (quoting *Burke*, 504 U.S. at 239).

\(^{120}\) *Id.* at 793.

\(^{121}\) *Id.* at 792.

\(^{122}\) *Id.* at 792-93 (listing cases that have so held).

\(^{123}\) *Schmitz*, 34 F.3d at 793 (quoting *Bennett v. United States*, 30 Fed.Cl. 396, 399 (1994)).

\(^{124}\) *Id.*

\(^{125}\) *Id.*
damages under the ADEA do more than merely give plaintiffs their due, as was the case in Title VII. The court stated that because these compensatory liquidated damages and jury trials are available under the ADEA and because discrimination is a personal injury, the ADEA establishes a tort-like cause of action, and the first prong of the Hawkins test is met.

The Schmitz court then went on to consider the second prong of the Hawkins test: whether the Schmitzes' damages were received "on account of" personal injuries. The Hawkins court used this "on account of" language to test for a compensatory nature in damages; if the damages were received for personal injury and not for the egregious conduct of the tortfeasor, then they had the requisite compensatory nature.

In Schmitz, the Commissioner argued that this second prong was not met because the liquidated damages were due to United's misconduct, not the plaintiff's injuries; therefore, the Commissioner argued, they were not compensatory, but punitive. The majority disagreed. Goodwin looked to the plain language of the ADEA remedial provisions (which are noted above) and wrote that "the mere fact that liquidated damages are available in cases of 'willful' discrimination does not transform them into punitive damages or eliminate their compensatory purpose." The court stated that liquidated damages in general, and in the Fair Labor Standards Act in particular, are not punitive in nature, but compensatory and proportional to the damages suffered by the plaintiff. Relying on the plain language of the statute and on congressional intent, the court stated that Congress used the term "liquidated" because it

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126 Id.
127 Id. at 794.
128 Hawkins, 30 F.3d at 1080.
129 Id.
130 Schmitz, 34 F.3d at 794.
131 Id. at 796. According to the Schmitz court, support for the assertion that ADEA liquidated damages serve both a compensatory and a deterrent function is found in the Conference Report for the 1978 Amendments to the ADEA, which states that, "'[ADEA] liquidated damages (calculated as an amount equal to the pecuniary loss) ... compensate the aggrieved party for nonpecuniary losses arising out of a willful violation of the ADEA,' and '[t]he ADEA as amended by this act does not provide remedies of a punitive nature." (quoting H.R. Rep. No. 950, 95th Cong., 2d Sess., 13-14 (1978), reprinted in 1978 U.S.C.C.A.N. 528, 535). The court also provides at this point in the opinion a list of cases in support of its assertion that "most courts recognize that ADEA liquidated damages serve both a compensatory and a deterrent function." Schmitz, 34 F.3d at 796.
132 Schmitz, 34 F.3d at 794-95.
meant liquidated, not something else, and that its use of that term was dispositive.\footnote{Id. at 795.}

Therefore, the Schmitz majority found that the second prong of the Hawkins test was met and held that “[b]ecause 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.”\footnote{Id. at 796.} Consequently, the Schmitz court held that the liquidated damages in question could be excluded under section 104(a)(2)\footnote{Id. at 794 n.4.} and that the backpay could be excluded as well.\footnote{Id. at 794.} The court reasoned that, since the ADEA creates a tort-like cause of action, the result is the exclusion of both categories under section 104(a)(2).\footnote{Id. at 796 (Trott, J., concurring).}

D. Concurrence in Schmitz v. Commissioner
(Judge Stephen S. Trott)

In a concurring opinion in Schmitz, Judge Trott agreed with the majority that all ADEA settlement damages are excludable under I.R.C. section 104(a)(2).\footnote{Id. at 796 (Trott, J., concurring).} Trott disagreed, however, with the majority’s adoption of the two-part test from Hawkins, which he felt improperly analyzed the suitability of a claim for exclusion under section 104(a)(2).\footnote{Id. at 797.} He stated his view that the determinative factor in questions of excludability was “whether the ADEA redresses a tort-like personal injury claim.”\footnote{Id. at 796-97 (Trott, J., concurring).} Based on his belief that ADEA causes of action are tort-like, Trott agreed with the majority holding that no part of the resulting awards should be taxed.\footnote{Id. at 797.} Trott then registered his objection to the Hawkins test: in his opinion, the “on account of” prong of that test forced the court to ignore, as the majority did, many indicators of the punitive nature of the liquidated damages provision of the ADEA if the court were to find that an

\begin{footnotes}{\footnotesize
\item[133] Id. at 795.
\item[134] Id. at 796.
\item[135] Id.
\item[136] Id. at 794 n.4.\footnote{Id. at 794.}
\item[137] Id.
\item[138] Id. at 796 (Trott, J., concurring).
\item[139] Id. Judge Trott explained that he dissented in Hawkins based on his belief that the Hawkins test was not the correct method of determining § 104(a)(2) excludability. Id.
\item[140] Id. at 796-97 (Trott, J., concurring).
\item[141] Id. at 797.
\end{footnotes}
age-related award under the ADEA was compensatory, and thus excludable.\textsuperscript{142}

Trott proceeded to list some of these indicators that, to him, evidenced the punitive nature of the liquidated damages provided for by the ADEA. He stated that the Ninth Circuit had long treated liquidated damages as punitive damages, even before the Supreme Court acknowledged their punitive character.\textsuperscript{143} Second, he noted that the legislative history reflected congressional intent that the ADEA's liquidated damages provision served a punitive purpose.\textsuperscript{144} Finally, he asked why the statute would make a distinction between willful violations and those where the violator lacked intent if the purpose of the damages was to compensate, not to punish, since all had suffered "the same intangible or incalculable harm," regardless of whether the violation was willful or not.\textsuperscript{145}

As a result, Trott stated his belief that ADEA liquidated damages should be viewed and treated as punitives and, as punitive damages, the \textit{Hawkins} test would require they be taxed.\textsuperscript{146} Yet Trott concurred rather than dissented in \textit{Schmitz} based on his belief that \textit{Hawkins} was wrongly decided on the taxability of punitive damages and that the court's bad decision in that case forced the \textit{Schmitz} majority to take a contorted view of ADEA liquidated damages in order to avoid the undesired result of nonexclusion.\textsuperscript{147} Trott advocated a rethinking of the \textit{Hawkins} test so that the right result, in his opinion, concerning exclusion of ADEA damages could be reached by Ninth Circuit courts without such judicial maneuvering.\textsuperscript{148}

\textsuperscript{142} Id. at 797-98.

\textsuperscript{143} Id. (citing the following cases as examples of this Ninth Circuit position: Kelly v. American Standard, Inc., 640 F.2d 974, 979 (9th Cir. 1981); Criswell v. Western Airlines, Inc., 709 F.2d 544, 556 (9th Cir. 1983), aff'd 472 U.S. 400 (1985); and Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 125 (1985)).

\textsuperscript{144} Schmitz, 34 F.3d at 797-98. Trott referred to the view expressed by the Supreme Court in Trans World Airlines v. Thurston, 469 U.S. 111, 125 (1985), that the fact that Congress chose not to incorporate the FLSA's criminal provision into the ADEA, replacing it instead with a liquidated damages award in cases of "willful" violation of the ADEA, indicated Congress' intent that ADEA liquidated damages be punitive in nature. Schmitz, 34 F.3d at 797.

\textsuperscript{145} Schmitz, 34 F.3d at 798.

\textsuperscript{146} Id. at 799.

\textsuperscript{147} Id.

\textsuperscript{148} Id. at 798-99.
V. THE POSITION TAKEN BY THE FIFTH CIRCUIT IN SCHLEIER V. COMMISSIONER ON THE TAXABILITY OF ADEA DAMAGES AND THE SUBSEQUENT GRANT OF CERTIORARI BY THE SUPREME COURT

A. BACKGROUND OF THE CASE AND FIFTH CIRCUIT OPINION

Erich E. Schleier, like Burns Downey and John Schmitz, was a United Airlines pilot. He had been employed by the airline for twenty years in 1979 when he was forced to retire at age sixty under a mandatory retirement rule. He and other United pilots forced to retire under the rule filed suit for age discrimination, claiming the retirement requirement violated their rights under the ADEA. In 1982, United agreed to settle with Schleier and the other pilots involved, and in 1986, Schleier was paid approximately $145,000, half of which was termed "back pay" and the other half of which was "liquidated damages."

Schleier's tax battle over the damages began with his 1986 tax return, in which he reported the back pay portion of the settlement as taxable income but did not report the liquidated damages portion. He was informed by the Internal Revenue Service that tax payment was required on the liquidated damages amount as well.

Schleier took his case to the United States Tax Court. There, he sought a redetermination of the deficiency asserted by the Commissioner. In his petition to the tax court, Schleier claimed that the liquidated damages portion of the settlement was properly excluded under section 104(a)(2) because it was an award for damages received "on account of personal injuries or sickness." Schleier also sought a determination of...

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149 Denniston, supra note 16, at 9C.
150 Steve McGonigle, Supreme Court to Hear Pilot's Case Against IRS: Age Discrimination Victims Say Back Pay Should Not Be Taxed, DALLAS MORNING NEWS, Nov. 15, 1994, at 4D. For a discussion of the Age Sixty Rule, see infra part VII.
151 Denniston, supra note 16, at 9C.
152 McGonigle, supra note 150, at 4D.
153 Supreme Court to Decide if Back Pay Awards Are Taxable, LIABILITY WEEK, Vol. 9, No. 46, Nov. 21, 1994.
154 Id.
155 Id.
157 Id.
overpayment and a return of the taxes he had paid on the back pay portion of the settlement; his petition to the court alleged that, under section 104(a)(2), the back pay also qualified for exclusion from gross income.\textsuperscript{158}

Disposition of Schleier's case was delayed pending a tax court decision on \textit{Downey v. Commissioner}.\textsuperscript{159} In its original disposition of that case, the \textit{Downey} tax court held that both the back pay and the liquidated damages portion of Downey's settlement were excludable, and though the court subsequently agreed to reconsider the \textit{Downey} decision based on the Supreme Court's just-released decision in \textit{Burke}, the tax court reached the same conclusion as it had originally, but this time on the \textit{Burke} "nature of the remedial scheme" grounds.\textsuperscript{160} The ADEA damages were excludable.\textsuperscript{161} Based on that ruling by the tax court in \textit{Downey} that the ADEA damages were wholly excludable, the tax court granted summary judgment to Schleier in July 1993.\textsuperscript{162}

The Commissioner appealed this decision to the Fifth Circuit Court of Appeals in \textit{Schleier v. Commissioner}.\textsuperscript{163} The Fifth Circuit's response left little room for doubt as to its position on the issue of the taxability of ADEA awards. Understanding the Fifth Circuit Court's response to the government's appeal in \textit{Schleier} requires looking back to 1993, the period during which the tax court ruled for the second time on \textit{Downey}.\textsuperscript{164}

Shortly after the second post-\textit{Burke} tax court holding of excludability, the Fifth Circuit was faced with an ADEA damages issue in a case titled \textit{Purcell v. Seguin State Bank & Trust Co}.\textsuperscript{165} A year later, when \textit{Schleier} was appealed to the Fifth Circuit, \textit{Purcell} proved to be the critical case in the Fifth Circuit's disposition of \textit{Schleier}.\textsuperscript{166} The court's reasoning in \textit{Purcell} assumes particular

\textsuperscript{158} Id.
\textsuperscript{159} 97 T.C. 150 (1991), \textit{supplemental opinion}, 100 T.C. 634 (1993), \textit{rev'd}, 33 F.3d 836 (7th Cir. 1994).
\textsuperscript{160} Petition for Certiorari at 4-5, \textit{Schleier} (No. 93-5555). The tax court further noted that the ADEA "evidences a tort-like conception of injury and remedy," since the liquidated damages provided for by the statute serve both a deterrent or punitive purpose and compensate recipients for nonpecuniary losses. \textit{Id}. at 6.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\textsuperscript{164} Petition for Certiorari at 6-7, \textit{Schleier} (No. 93-5555).
\textsuperscript{165} 999 F.2d 950 (5th Cir. 1993).
\textsuperscript{166} \textit{Schleier}, No. 93-5555, slip op. at 2.
significance given the manner in which the Fifth Circuit used that decision in its Schleier opinion.

In Purcell, plaintiff Walter Purcell was replaced at age sixty as manager of the trust department of Seguin State Bank and Trust Company; his replacement was thirty-seven years old.\(^\text{167}\) Purcell brought a claim of an ADEA violation\(^\text{168}\) in federal district court, and the jury there found for Purcell on the ADEA claim, awarding him $250,000 in damages for the Bank's violation.\(^\text{169}\)

The Bank then appealed the ADEA judgment against it to the Fifth Circuit.\(^\text{170}\) The Fifth Circuit affirmed the jury's finding of age discrimination, but it reversed the jury's finding of willfulness, concluding that the award of damages was excessive, thus remanding the case for further proceedings on those two issues.\(^\text{171}\)

Most importantly, though, the Fifth Circuit Court of Appeals used the opportunity presented by Purcell to make an unequivocal statement of its view on the issue of the taxability of ADEA damages awards. Citing section 104(a)(2), the Purcell court stated that, "[a]s far as income taxes are concerned, damages awarded 'on account of personal injuries or sickness' are exempt from federal income tax."\(^\text{172}\) The court went on to incorporate the Supreme Court's Burke analysis into its reasoning, noting that under its reading of that case, "[b]ack pay awards are nontaxable when they redress a tort-like injury. When Title VII awarded only backwages, it did not contemplate a tort-like injury, and back pay awards under Title VII were taxable."\(^\text{173}\) The Purcell court noted it had followed Burke in the Title VII context to reflect the taxability of such awards in a prior case, Johnston v. Harris County Flood Control Dist.\(^\text{174}\)

\(^{167}\) Purcell, 999 F.2d at 953.

\(^{168}\) Purcell also asserted a claim of a violation of the Employee Retirement Income Security Act (ERISA) and a state claim of self-compelled defamation. Id. However, only the ADEA claim has significance in the context of Schleier.

\(^{169}\) Id. at 955. The jury, to reach its verdict, found that "1. Purcell was discharged; 2. age was a 'determining' factor in Purcell's discharge; 3. the bank's actions were willful; and 4. Purcell had sustained damages in the amount of $250,000." Id. This is representative of the findings commonly required in ADEA causes of action.

\(^{170}\) Id. Purcell also cross-appealed the judgment reached by the district court on the defamation claim, the claim on which the court granted the Bank judgment as a matter of law. Id. at 953.

\(^{171}\) Id. at 962.

\(^{172}\) Id. at 960.

\(^{173}\) Id. (citing Burke, 504 U.S. at 239-40).

Yet the Purcell court perceived a critical difference between the Title VII cases and Purcell. Palpably shifting its analysis as it turns to the ADEA, the court stated, “[n]either Burke nor Johnston, however, involved the ADEA. The Third, Sixth, and Ninth Circuit Courts of Appeal view the ADEA as redressing a tort-like injury.”175 Citing Jay v. International Salt Co.,176 it continued, “We have held that age discrimination is a tort claim for purposes of calculating the statute of limitations.”177

Then, referring to the post-Burke supplemental decision of the tax court in Downey v. Commissioner,178 the Purcell court wrote:

Recently, the Tax Court reconsidered this issue in light of Burke, holding that ADEA claims are tort-like and that an entire ADEA award is nontaxable. Applying Downey, we find the evidence properly presented a lost earnings amount net of tax. Increasing the award to reflect tax liability is improper.179

The Fifth Circuit, therefore, adopted the reasoning set forth in the Downey tax court decision and held that Purcell’s ADEA award (whatever it might ultimately amount to after reconsideration of the award on remand) was indeed excludable under section 104(a)(2).180

What gives Purcell particular significance is the way the Fifth Circuit Court of Appeals chose to dispose of the Commissioner’s appeal of the tax court’s decision in Schleier. The Fifth Circuit Court handed down its decision on the Commissioner’s appeal on June 21, 1994, prior to the Seventh Circuit’s reversal of Downey on August 30, 1994.181 As noted in the Petition for Certiorari, which followed the court’s ruling on the appeal, “[t]he three-judge panel assigned to [the] case . . . entered a decision in favor of respondent solely on the authority of Purcell.”182

175 Purcell, 999 F.2d at 961. The court cites Redfield v. Insurance Co. of N. Am., 940 F.2d 542 (9th Cir. 1991); Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990); and Rickel v. Commissioner, 900 F.2d 655 (3d Cir. 1990). Purcell, 999 F.2d at 960.
176 868 F.2d 179, 180 (5th Cir. 1989).
177 Purcell, 999 F.2d at 961.
178 97 T.C. 150 (1991), supplemental opinion, 100 T.C. 634 (1993), rev’d, 33 F.3d 836 (7th Cir. 1994).
179 Purcell, 999 F.2d at 961 (citations omitted).
180 Id.
181 As noted above, on that same day, August 30, 1994, the Ninth Circuit handed down the opposite opinion on taxability of ADEA damages in Schmitz v. Commissioner, 54 F.3d 790 (9th Cir. 1994).
182 Petition for Certiorari at 7, Schleier (No. 93-5555) (emphasis added).
How strongly the court apparently felt that the taxability issue presented in *Schleier* was already decided in the Fifth Circuit is reflected in the form of the opinion it issued when the case came before it. The per curiam opinion, in its entirety, is one paragraph long, and the court chose to invoke a local rule allowing non-publication when an opinion has “no precedential value and merely decides particular cases on the basis of well-settled principles of law.”

The core of the Fifth Circuit’s opinion lies in a few concise sentences. After a brief recital of Schleier’s tax status and the procedural history of the case, the court summarily dismissed the Commissioner’s appeal, writing:

The United States Tax Court concluded that the entire settlement under the ADEA was excludable from Schleier’s income pursuant to Section 104(a)(2) of the Internal Revenue Code. 26 U.S.C. § 104(a)(2). The government appeals. We have already decided the issue. Money recovered under the ADEA is excludable from income for the purposes of taxation. *Purcell v. Seguin Bank and Trust Co.*, 999 F.2d 950 (5th Cir. 1993). We AFFIRM.

One tax commentator, capturing the Fifth Circuit’s tone, described this cursory decision based on *Purcell* as an opinion “with curtness that should suggest to the IRS it shouldn’t bother appealing ADEA cases to the Fifth Circuit anymore.” Seemingly, the Fifth Circuit attempted to send a strong signal that the issue of taxability of ADEA damages was settled in its jurisdiction.

### B. GRANT OF CERTIORARI BY THE UNITED STATES SUPREME COURT

The Solicitor General, however, did not feel the same. The Fifth Circuit opinion was, of course, only one viewpoint in a

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183 *Schleier*, No. 930-5555. A copy of the opinion is on file with the SMU Law Review Association.

184 5th Cir. R. 47.5.1 provides, “The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens the legal profession.” The court noted this rule in a footnote in its decision in *Schleier*, adding, “Pursuant to that Rule, the Court has determined that this opinion should not be published.” *Schleier*, No. 93-5555, slip op. at 1.

185 *Schleier*, No. 93-5555, slip op. at 2. Note that the *Schmitz* court also relied to some degree on the *Downey* tax court’s post-*Burke* reasoning, making that decision likely to come under consideration as part of the Supreme Court’s analysis in its hearing of *Schleier*.

widening split among circuits. So, on September 19, 1994, the Solicitor General petitioned the United States Supreme Court for a writ of certiorari to provide the Court the opportunity to determine whether \textit{Schleier} was correctly decided.\footnote{Petition for Certiorari, \textit{Schleier} (No. 93-5555).}

In her petition, the Solicitor General described the procedural history and the current posture of \textit{Schleier}\footnote{Id. at 3-4.} and stated the question presented as "\textit{w}hether back pay and liquidated damages received in settlement of litigation under the Age Discrimination in Employment Act of 1967 are excluded from gross income under Section 104(a)(2) of the Internal Revenue Code as 'damages received . . . on account of personal injuries or sickness.' "\footnote{Id. at 1.} The petition then describes the growing split among circuits, noting specifically the conflicting interpretations in the Seventh, Ninth, and the Fifth Circuits of \textit{United States v. Burke} and of the tax court's subsequent holding in \textit{Downey}.\footnote{Id. at 8-9.}

In support of her request that the Supreme Court grant the hearing, the Commissioner gave two reasons. First, the petition stated that, "\textit{a}bsent further review by this Court, these conflicting understandings of \textit{Burke} by the Courts of Appeal will result in disparate tax treatment of otherwise identically situated taxpayers (including the many parties who participated in the same class action settlement of the United Airlines ADEA litigation)."\footnote{Id. at 7.} Second, the petition noted that "\textit{t}he proper treatment of ADEA recoveries . . . under Section 104(a)(2) of the Internal Revenue Code represents a recurring question of substantial administrative importance."\footnote{Id., at 7.} The petition continued, "The issues addressed in this case affect many thousands of individuals who have received, or will receive in the future, damage awards under the ADEA and other state and federal statutory schemes."\footnote{Id. at 7.}

As did her formulation of the statement of the question presented, the Solicitor General's second rationale suggested that a Supreme Court ruling would have implications broader than an impact on tax reporting of age discrimination damage awards.\footnote{Denniston, \textit{supra} note 16, at 9C.} She indicated that a Supreme Court holding would
also affect discrimination cases in a variety of other federal and state contexts.\textsuperscript{195}

In Respondents' Brief in opposition to the granting of certiorari by the Supreme Court,\textsuperscript{196} Schleier's attorneys first disagreed with what they termed the Solicitor General's "unsubstantiated allegations that the issues in this case 'affect many thousands of individuals who have received, or will receive in the future, damage awards under the ADEA and other state and federal statutory schemes."\textsuperscript{197} The attorneys argued that the applicability to those beyond Schleier and others in the class action suit was "speculative," especially given the change in the tax code contained in the Omnibus Budget Reconciliation Act of 1989.\textsuperscript{198} The respondents, therefore, tried to narrow the scope of the projected impact of a Supreme Court decision.

The Respondents' Brief proceeded to explain why the petitioners' writ should be denied.\textsuperscript{199} First, the respondents asserted that the Burke test had been correctly applied in the Fifth Circuit's decision because the range of ADEA damages was sufficiently broad, and therefore review was not warranted.\textsuperscript{200} Second, the respondents argued that the Supreme Court is not the right forum in which to settle the Internal Revenue Service's interpretive problems with section 104(a)(2). Instead, the respondents asserted that "in the interest of judicial economy," the Commissioner of the Internal Revenue Service should "formalize her position through rulemaking or other appropriate administrative proceedings."\textsuperscript{201} Third, the respondents argued that the passage of the Omnibus Reconciliation Act in 1989 would limit the impact of a decision and would thereby give a Supreme Court decision "little continuing significance" since the issues involved in Schleier's case arose under pre-1989 tax law.\textsuperscript{202}

\textsuperscript{195} Id.
\textsuperscript{196} On Petition for a Writ of Certiorari to the United States Court of Appeals For the Fifth Circuit: Brief for Respondents in Opposition, Schleier v. Commissioner, 115 S. Ct. 2159 (1995) (No. 94-500) microformed on, U.S. Supreme Court Records and Briefs (Congressional Information Service) [hereinafter Brief in Opposition].
\textsuperscript{197} Id. at 2.
\textsuperscript{198} Id. at 3.
\textsuperscript{199} Id.
\textsuperscript{200} Id. at 3-7.
\textsuperscript{201} Id. at 7.
\textsuperscript{202} Id. at 10.
In a Reply Brief to the Respondent’s Brief,\textsuperscript{203} the Solicitor General, as petitioner, disagreed with the respondents’ view on each of the three points asserted. First, the Solicitor General argued that the case did have significance; without resolution, she asserted, determinations of taxability under section 104(a)(2) would, in light of the existing split in circuits, depend on the “happenstance of geography.”\textsuperscript{204} Second, argued the Solicitor General, a new interpretation through rulemaking might be accorded uncertain deference (as section 104(a)(2) currently is) and “could not obtain equal treatment for the various litigants now before the Court,” whose claims, while similar, were inconsistently addressed by lower courts.\textsuperscript{205} Third, concerning the 1989 amendment, the Solicitor General stated that many issues remained unsettled despite that amendment’s passage, including the excludability of back pay and liquidated damages under the ADEA (since back pay was not a punitive damage and liquidated damages were not awarded “on account of” any personal injury, as the statute requires for exclusion, but instead to deter “willful violations” of the ADEA).\textsuperscript{206}

Considering the assertions of both the Solicitor General and the respondents is important since the Supreme Court granted the petitioner’s writ for certiorari without comment, thereby not revealing its specific motivation in deciding to hear Schleier or the scope of the issue it sought to address in hearing the case. At the time the Court agreed to hear the case, interest in the Court’s resolution in legal and taxation circles was great; this fact was evident in the numerous reports of the grant of certiorari in legal, taxation, and more general news sources.\textsuperscript{207}


\textsuperscript{204} Id. at 2.

\textsuperscript{205} Id. at 3.

\textsuperscript{206} Id. at 1-2.

\textsuperscript{207} See, e.g., Supreme Court Agrees to Review Tax Treatment of Age Bias Settlement, DAILY LAB. REP. (BNA), at 218 d3 (Nov. 15, 1994), available in Westlaw BNA-DLR database; Laurie Asseo, Justices Take Case Involving Tax on Verdicts: Age Bias Suit at Issue, THE LEGAL INTELLIGENCER, Nov. 3, 1994, at 11; Marlis L. Carson, Supreme Court Will Rule on Excludability of Damages Received Under ADEA, 94 TAX NOTES TODAY 223-2 (Nov. 15, 1994); Joan Biskupic, Supreme Court Sets Aside Ruling on N.Y. Professor’s Speech Rights, WASH. POST, Nov. 15, 1994, at A7; News, CHICAGO TRIBUNE, Nov. 14, 1994, at 3C; Denniston, supra note 16, at 9C; McGonigle, supra note 150, at 4D.
VI. THE SUPREME COURT'S RESPONSE: SCHLEIER V. COMMISSIONER

A. OVERVIEW

*Schleier* was argued before the Supreme Court on March 27, 1995, and the Court handed down its decision a few months later on June 14.\(^{208}\) Called by Court watchers “the most important federal tax case of the term”\(^{209}\) and “much-anticipated,”\(^{210}\) the Supreme Court’s decision resolved the circuit split by ruling that damages recovered in ADEA claims are taxable income under I.R.C. section 104(a)(2).\(^{211}\)

For many informed about the issue, the holding came as a surprise. As lawyer and taxation specialist Robert W. Wood\(^{212}\) noted a few weeks after the opinion came down:

Many employment lawyers, tax lawyers, and accountants have been waiting for the U.S. Supreme Court to resolve the split in circuit courts concerning the tax treatment of recoveries under the Age Discrimination in Employment Act. In mid-June, the [C]ourt ruled in *Commissioner v. Schleier* . . . that ADEA recoveries are taxable. Many people—including me—had predicted that the Supreme Court would go the other way.\(^{213}\)

“After all,” he continued, “the majority of the circuit courts had concluded that ADEA recoveries were non-taxable; only the Seventh Circuit U.S. Court of Appeals had held to the contrary.”\(^{214}\) As further grounds for the belief he and others had that the Supreme Court would find the damages excludable, Wood pointed to decisions and rulings of the last few years suggesting that “a goodly number of statutory claims like those under the ADEA would fit within” the section 104(a)(2) personal injury exclusion; Revenue Ruling 93-88 and the explicit ruling by the IRS that recoveries for Title VII gender and racial discriminatory acts would not be viewed as income to the claimant; and finally, the Supreme Court’s “suggestion” in *Burke* that


\(^{209}\) *Taxation and Federal Procedure* U.S.L.W. No. 64, at 3079 (Aug. 8, 1995).


\(^{211}\) *Schleier*, 115 S. Ct. at 2163.


\(^{214}\) *Id.*
Title VII recoveries for race and gender violations would "probably be excludable."\textsuperscript{215}

Yet the Supreme Court found the ADEA settlement damages received by Erich Schleier taxable. To shed light on the Court's reasoning, the majority and dissenting opinions are set forth in this section; in the section that follows, commentators' views on the decision and its anticipated impact, as well as other potential implications of the Court's holding, are examined.

B. MAJoRrIY OPINION OF THE SChLIErER COrT (JUsTICE JOHnP AUL STEvEnS)

After laying out the issue ("whether § 104(a)(2) of the Internal Revenue Code authorizes a taxpayer to exclude from his gross income the amount received in settlement of a claim for backpay and liquidated damages under the Age Discrimination in Employment Act of 1967")\textsuperscript{216} the facts, and the procedural history of the case, Stevens stated the holding and set forth three grounds for it. He wrote, "Our consideration of the plain language of [section] 104(a), the text of the regulation implementing [section] 104(a)(2), and our reasoning in Burke convinces us that a recovery under the ADEA is not excludable from gross income."\textsuperscript{217} The Court then proceeded to explain those grounds, including an examination of Schleier's argument as to each.

First, the Court looked to the Internal Revenue Code to explain its view that the plain language of section 104(a)(2) supported the Court's holding that ADEA damages were taxable. Before reaching section 104, though, Stevens laid the groundwork for the majority's narrow reading of that section by acknowledging the "broad" definition of "gross income" in section 61(a) and noting, "We have repeatedly emphasized the 'sweeping scope' of this section and its statutory predecessors."\textsuperscript{218} He continued by recognizing what he called the "corollary to Section 61(a)'s broad construction," namely, the "default rule of statutory interpretation that exclusions from income must be narrowly construed."\textsuperscript{219} These interpretive presumptions

\textsuperscript{215} Id.
\textsuperscript{216} Schleier, 115 S. Ct. at 2161.
\textsuperscript{217} Id. at 2163 (emphasis added).
\textsuperscript{218} Id. at 2163 (citing Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955). See also United States v. Burke, 504 U.S. 229 (1992); Helvering v. Clifford, 309 U.S. 331 (1940)).
\textsuperscript{219} Id. Stevens again cites to Burke for support, this time pointing to Justices Souter's and Scalia's concurring opinions.
formed the foundation of the Court’s position on the taxability of the settlement before it.

Turning its attention next to section 104 of the Code, the Court acknowledged Schleier’s assertion that his settlement fell within the section 104(a)(2) “on account of personal injuries or sickness” exception to the sweeping definition of gross income.\textsuperscript{220} The Court’s response was direct: “In our view, the plain language of the statute undermines respondent’s contention.”\textsuperscript{221} To demonstrate the flaw in the respondent’s position, Stevens used a hypothetical in which he painted a picture of a taxpayer who is injured in an automobile accident and as a result of that injury suffers “(a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision.”\textsuperscript{222} The taxpayer receives a settlement of $30,000 for those damages. The entire amount of that settlement, Stevens reasoned, would be excludable because both the damages (medical and pain and suffering) and the back wages were clearly “on account of personal injuries.”\textsuperscript{223} To explain the significance of this example of a common section 104(a)(2) exception, Stevens wrote:

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 set forth in 104(a)(2) . . . that the damages were received “on account of personal injuries or sickness.”\textsuperscript{224}

In contrast, the Court did not view either part of Schleier’s claim as falling within the section 104(a)(2) exception. The majority first stated that the back wages portion of Schleier’s recovery did not qualify because “it does not satisfy the critical requirement of being ‘on account of personal injury or sickness.’”\textsuperscript{225} Unlike the automobile accident hypothetical, a situation the Court described as one in which “the accident

\textsuperscript{220} Id.
\textsuperscript{221} Id.
\textsuperscript{222} Id. at 2163-64.
\textsuperscript{223} Id. at 2164. As to the back wages, Stevens noted, “as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries.” Id. He directed the reader at this point to *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), another pivotal case discussed above.
\textsuperscript{224} *Schleier*, 115 S. Ct. at 2164.
\textsuperscript{225} Id. (emphasis added).
causes a personal injury which in turn causes a loss of wages."

"[i]n age discrimination, the discrimination causes both personal injury and loss of wages, but neither is linked to the other. The amount of back wages recovered is completely independent of the existence or extent of any personal injury."

Therefore, the Court held that exclusion of that portion of the settlement was not permitted under the plain language of section 104(a)(2) because the recovery of back wages was not "on account of" personal injury, and because the amount recovered was not affected by personal injury to the one suffering age discrimination.

Schleier also argued, however, that the liquidated damages portion of the settlement fit within the plain language of section 104(a)(2) since the Court had, in an earlier FLSA case, deemed that liquidated damages were not punishment, but compensation for "damages too obscure and difficult of proof to estimate." He asserted that Congress must be presumed to have known of that decision and thus have intended to accord liquidated damages granted for obscure injuries that same compensatory nature when it incorporated FLSA's liquidated damages provision into the ADEA.

The Court, however, found two weaknesses in Schleier's argument. First, the Court asserted that Congress could indeed have known of the interpretation given FLSA's liquidated damages by the Court and still not interpreted the "obscure" injuries described in the opinion to refer to personal injuries. Second, and "more importantly," according to the majority, the Court had already rejected Schleier's argument and concluded that "the liquidated damages provisions of the ADEA were a significant departure from those in the FLSA." Stevens continued,
“[A]nd we explicitly held in *Thurston*: ‘Congress intended for liquidated damages to be punitive in nature.’”232 He concluded that the Court’s holding in *Thurston* necessitated the conclusion that “liquidated damages under the ADEA, like back wages under the ADEA, are not received on account of personal injury or sickness.”233

The Supreme Court then moved to its second stated reason for rejecting the respondent’s assertion that his ADEA damages should be excluded from taxation: section 1.1.04-1(c) of the Treasury Regulations,234 the Commissioner’s interpretation of I.R.C. section 104(a) (2). As the Court noted, that treasury regulation states that, in section 104(a) (2)’s exclusion of “damages received . . . on account of personal injuries or sickness[,] [t]he term ‘damages received’ 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.”235 Schleier’s assertion was that ADEA actions are “based upon tort or tort type rights.” Therefore, he contended, they should be excluded under the regulation’s plain language.236

The Court responded by stating that even if it agreed with the respondent as to the characterization of the action as tort or tort type, that would not be a sufficient basis for exclusion of his settlement proceeds.237 Stevens wrote, “The regulatory requirement that the amount be received in a tort type action is not a substitute for the statutory requirement that the amount be received ‘on account of personal injuries or sickness’; it is an additional requirement.”238

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232 *Id.* at 2165 (quoting *Thurston*, 469 U.S. at 126). Of final note regarding the characterization in *Thurston* of liquidated damages as punitive in nature is Stevens’ observation that, under that decision, liquidated damages were only available under the ADEA if “the employer . . . knew or showed reckless disregard for the matter of whether its conduct was prohibited by the ADEA.” *Id.* at 2165 n.5 (quoting *Thurston*, 469 U.S. at 126). Stevens pointed to this as further proof that liquidated damages were not designed to compensate discrimination victims under the ADEA. *Id.* If they had been, the employer’s knowledge of his wrongdoing or reckless disregard of ADEA standards would not be the critical factor in award determinations. *Id.*

233 *Id.* at 2165.

234 *Id.*

235 *Id.*

236 *Id.* at 2165-66.

237 *Id.* at 2166.

238 *Id.* at 2166 (emphasis added).
In this very significant statement, the Court indicated its acceptance of the Commissioner's argument that exclusion is authorized only when two conditions are met: (1) when the amount was received pursuant to an action (whether through settlement or prosecution) “based upon tort or tort type rights”; and (2) when the amount was received “on account of personal injuries or sickness.” In a footnote, the Court acknowledged that “arguably” this had not always been the treatment that the Commissioner had given the provision. But, the Court maintained that “the Commissioner unambiguously contends that the regulation is not intended to eliminate the ‘on account of’ requirement from the statutory language” and that the Justices in the majority “agree that she reads the regulation correctly in this case.” Therefore, the Court found, Schleier could not rely on the text of the regulation for exclusion.

Third and finally, the Court held that the respondent’s damages are not excludable under its reasoning in United States v. Burke. Schleier had argued that Burke compelled a finding of excludability in that the Supreme Court’s holding there rested on a determination of whether the claim was based on “tort or tort type rights” within the meaning of Treasury Regulation 1.104-1(c). The Court, however, held that for two independent reasons, Burke provided “no foundation” for Schleier’s assertion.

First, the Court found that Schleier’s ADEA recovery was not based on tort or tort type rights as the Burke Court had construed that term. In Burke, as discussed above, the Court found that the pre-1991 version of Title VII did not create such tort or tort type rights because it did not allow for compensatory damages or punitive damages. The Court found that remedies were limited to back pay, injunctions, and other forms of equitable relief: “Title VII was not tort-like because it addressed ‘legal injuries of an economic character.’”

Schleier attempted to identify two elements of the remedial scheme of the ADEA that he believed distinguished it from the

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239 See Reply Brief, supra note 203.
240 Schleier, 115 S. Ct. at 2165.
241 Id. at 2166 n.7.
242 Id. at 2166.
243 Id.
244 Id.
245 Id.
246 Id. (quoting United States v. Burke, 504 U.S. at 238).
remedies on which *Burke* was decided: jury trial and liquidated damages. However, the Court found that neither was sufficient to meet the tort-type right test because they lacked "what the *Burke* Court recognized as the primary characteristic of an 'action based upon tort type rights': the availability of compensatory remedies."\(^{247}\) The Court continued, referring to its opinion in *Burke*, "Indeed, we noted that 'one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff 'fairly for injuries caused by the violation of his legal rights.' "\(^{248}\) Therefore, concluded the Court, while the situation in *Schleier* presented a closer call than in *Burke*, a recovery under the ADEA was not one based upon tort or tort-type rights because, like "the pre-1991 version of Title VII[,] [it] provide[s] no compensation 'for any of the other traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages.' "\(^{249}\) As a result, the remedial scheme of the ADEA was held to be insufficiently tort-like to bring it within *Burke*'s conception of tort type rights.

Secondly, and "more importantly," said the *Schleier* Court, the respondent read the holding of *Burke* more broadly than he should have.\(^{250}\) Stevens wrote that the "tort or tort type rights" analysis described above was part of what *Burke* required; he wrote:

> [H]owever, we did not hold that the inquiry into "tort or tort type rights" constituted the beginning and end of the analysis . . . . [W]e did not intend to eliminate the basic requirement found in both the statute and the regulation that only amounts received "on account of personal injuries or sickness" come within [section] 104(a) (2)'s exclusion. Thus, though satisfaction of Burke's "tort or tort type" inquiry is a necessary condition for excludability under [section] 104(a)(2), it is not a sufficient condition.\(^{251}\)

Therefore, the majority concluded that section 104(a)(2)'s plain language, the text of the regulation in question, and the

\(^{247}\) Id.

\(^{248}\) Id. at 2166-67 (quoting *Burke*, 504 U.S. at 235).

\(^{249}\) Id. at 2167 (quoting *Burke*, 504 U.S. at 239).

\(^{250}\) Id.

\(^{251}\) Id. The Court noted here that IRS Rev. Rul. 93-88 seemingly interpreted *Burke* as the respondent had, but also noted that the revenue ruling was not currently before the Court and that, in any event, it did not have the force and effect of regulations. *Id.* at 2167 n.8.
Court’s prior decision in *Burke* “establish two independent requirements that a taxpayer must meet” for excludability under section 104(a)(2): “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.’”252 Since in the Court’s view Schleier met neither part of this two-pronged test, the Court held that under section 104(a)(2), no part of his settlement was excludable.253

C. DISSENT IN *SCHLEIER* (JUSTICE SANDRA DAY O’CONNOR)

In what has been termed a “vigorously dissent,”254 Justice O’Connor responded to the majority’s opinion, opening her dissent with the “emphatic pronouncement”255 that “[a]ge discrimination inflicts a personal injury.”256 Justice Thomas joined Justice O’Connor in dissenting; Justice Souter joined Part II of the opinion, the section in which Justice O’Connor discussed precedent.

In the first portion of her dissent, O’Connor took issue with the majority over what constitutes personal injury. She argued that even under the principles set forth in *Burke*, age discrimination should include ADEA damages because they are received “on account of” the personal injury associated with age discrimination.257 In her view, the majority effectively limited the section 104(a)(2) exception to tangible injuries, a position she called “a reading rejected by eight Members of the Court in *Burke* and contradicted by an agency’s reasonable interpretation of the statute it administers.”258

For O’Connor, the proper standard for exclusion under section 104(a)(2) was set forth in the test found in *Threlkeld v. Commissioner*,259 where the Court stated, “To determine whether the

252 Id. at 2167.
253 Id.
254 Linda Greenhouse, *High Court Rules an Award on Age Prejudice Is Taxable*, N.Y. TIMES, June 15, 1995, at D2. See also Friedman & Sanders, supra note 210, at Outside Counsel, 1. The authors comment that “Justice Sandra Day O’Connor vigorously disputed the majority’s contention that damages received under the ADEA are not received on account of personal injuries or sickness.” Id.
256 *SCHLEIER*, 115 S. Ct. at 2167.
257 Id.
258 Id. at 2167-68.
259 87 T.C. 1294, 1299 (1986), aff’d, 848 F.2d 81 (6th Cir. 1988).
injury complained of is personal, we must look to the origin and character of the claim . . . and not to the consequences of the injury." Therefore, O'Connor wrote, under Threlkeld, section 104(a)(2) allowed exclusion of damages so long as they were "on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law." O'Connor noted that this view had prevailed until Burke, an opinion from which she dissented because of her disagreement with the idea that the nature of the remedies available determine the character of the underlying rights. She continued with the observation that "whether a remedy sounds in tort often depends on arbitrary characterizations." The majority had, however, in her view, avoided the issue by laying down a per se rule that an age discrimination-based discharge does not fall within the "personal injury or sickness" language of the exclusion, a position she found to be in direct conflict with the position of eight justices in Burke that discrimination does inflict personal injury.

In Part II of her dissent, O'Connor argued that under the Court's precedents, ADEA damages should be excludable. She noted that, for thirty-five years, the IRS had consistently viewed Regulation 1.104-1(c) as determining conclusively the requirements of section 104(a)(2), right up through Burke, a case in which the Commissioner asserted that interpretation should be followed and in which the Court deferred to the IRS regulation and the Commissioner's interpretation of it. She then stated, "It is only in one sentence in her reply brief that the Commissioner expressed a view at odds with 35 years of administrative rulings, agency practice, and representations to the courts—a sentence that the Court expands into its holding today." "Unless the Court is willing to declare these positions to be unreasonable," she concluded, "they cannot be ignored."

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260 Schleier, 115 S. Ct. at 2168 (quoting Threlkeld, 87 T.C. at 1299).
261 Id.
262 Id. at 2169.
263 Id. at 2169. Interestingly, for support of this comment, O'Connor directed readers to Schmitz and Downey and the different approaches the two circuit courts took regarding the nature of liquidated damages. Id. at 2167.
264 Id.
265 Id. at 2171.
266 29 C.F.R. § 1.104-1(c) (1995).
267 Schleier, 115 S. Ct. at 2171.
268 Id.
269 Id.
VII. COMMENTATORS’ VIEWS ON SCHLEIER AND ITS ANTICIPATED IMPACT

A. OVERVIEW

As noted above, Schleier’s case was closely followed, and the Supreme Court’s decision was much anticipated. Within the legal profession, attorneys with specializations in employment and taxation were particularly interested in the outcome as were other professionals such as tax advisors, accountants, and human resource and personnel directors. While it is too early to gauge the full impact of the Supreme Court’s decision in Schleier, a few common threads of expectation have emerged from the comments made by tax experts and legal practitioners after the decision was handed down.

B. CONFUSION FOLLOWING THE SUPREME COURT’S DECISION IN SCHLEIER AS TO THE DECISION’S IMPACT

Commentators have broadly noted that much uncertainty and confusion remains as to the scope and impact of the Supreme Court’s decision in Schleier and that, consequently, it is difficult to predict with accuracy the legal landscape that the decision will shape. According to Gary Friedman and Harvey Sanders, it seems clear from the decision that damages received under the ADEA and other statutes with like remedial provisions are not excludable. However, they comment, “While clarifying the tax treatment of awards and settlements under the ADEA, the court remained conspicuously silent on such treatment of damages received under the numerous other federal, state, and


271 Friedman & Sanders, supra note 210, at Outside Counsel 1.
local anti-discrimination statutes . . . ." According to Friedman and Sanders, the main question left open in Schleier is "[h]ow damages received under current Title VII, and those anti-discrimination statutes that provided for remedies which are compensatory in nature, should be treated for tax purposes." Other commentators agree that this is a major question left unsettled by the decision. In comments he made about the taxability of discrimination recoveries at a November 8, 1995, meeting of the District of Columbia Bar Association, Thomas F. Joyce, who argued the case before the Supreme Court on Schleier’s behalf, said, “We can all only speculate.” He continued with the observation that while discrimination victims’ potential tax liability had been increased by each of the three branches of the federal government over the past six months, the increases had occurred without any additional clarity concerning the issue. Joyce believes that Schleier will “likely . . . add to the state of confusion surrounding ADEA awards rather than resolve it." He continues, “There is the uncertainty of when there is a sufficiently close link between damages and personal injury. Unfortunately, we don’t know what that [link] is.”

In any event, commentators seem to think that discrimination plaintiffs will face a rather stiff test in meeting the two prongs set forth in Schleier. Philip G. Cohen writes:

With respect to discrimination claims, in general plaintiffs will have to jump through two hoops. First, they must base their claim on statutes that provide tort-like remedies, jury trials and punitive damages being insufficient in this regard. Second, they must establish that the damages received are provided to compensate them for some injury, e.g., psychological harm resulting from the illegal discrimination.

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272 Id.
273 Id.
274 Rod Garcia, IRS and Discrimination Lawyers Puzzle Over Taxes on Awards, 95 Tax Notes Today 220-24 (Nov. 9, 1995).
275 Id.
277 Id.
278 Philip G. Cohen, Schleier Requires Congress to Clarify When Damages Received for Discrimination Are Not Taxable: Commissioner v. Schleier, 47 Tax Executive No. 5, Sept. 19, 1995, at 365.
He expresses concern that the taxability of illegal discrimination recoveries could depend on "a whole range of factors," such as the statute under which the claimant is suing, the type of harm involved (physical or financial), the intentional or unintentional nature of the discrimination, and when the discrimination claim is made.\textsuperscript{279}

Furthermore, observing that the two-part standard set forth in \textit{Schleier} gives discrimination victims a higher duty than automobile victims,\textsuperscript{280} Cohen asserts his belief that the holding will result in a system in which the tax treatment tort victims receive may "differ for a number of reasons that do not appear fair or rational."\textsuperscript{281} He concludes, "Ironically, as a result of \textit{Schleier}, a new caste system has been established, albeit not as invidious as a classification based on race, sex, and age, but just as irrational."\textsuperscript{282}

Besides the discrimination statutes noted above, an additional area of uncertainty involves the tax treatment that punitive damages will receive after \textit{Schleier}. According to Robert W. Wood, "[O]ne of the more insidious effects of [\textit{Schleier}] would appear to be in the context of punitive damages. Although [\textit{Schleier}] is not explicitly a punitive damages case, it certainly suggests that the Supreme Court will favorably view the IRS claims that all punitive damages should be taxable."\textsuperscript{283} He continues, "The Supreme Court virtually says as much, because it treats the liquidated portion of ADEA damages as punitive, and then concludes that as punitive damages, such liquidated amounts must be taxable."\textsuperscript{284} Wood notes that the \textit{Schleier} approach, if it is being interpreted correctly as an impediment to any finding of excludability, is in striking contrast to U.S. Tax Court decisions regarding punitive damages.\textsuperscript{285}

Yet Wood and other commentators express their views about the taxability of punitives in terms of "likelihoods" and

\textsuperscript{279}Id.

\textsuperscript{280}This is similar to Stevens' hypothetical in \textit{Schleier}, discussed \textit{supra} notes 221-227. In the hypothetical, the automobile victim must prove that mental or physical injuries were caused by the illegal discrimination.

\textsuperscript{281}Cohen, \textit{supra} note 278, at 365.

\textsuperscript{282}Id.


\textsuperscript{284}WOOD, \textit{supra} note 212, at 8.

\textsuperscript{285}Id.
"probabilities," reflecting the uncertain scope of Schleier's reach. Friedman and Sanders write:

[I]t appears that, after [Schleier], punitive damages awarded under Title VII, and under other anti-discrimination statutes, likely will be taxable. Like the liquidated damages under the ADEA punitive damages are not determined on the basis of the injury suffered by the plaintiff, but rather on whether the employer acted "with malice or reckless indifference to the plaintiff's rights."

Two governmental actions have come about in response to this uncertainty; both Congress and the IRS seem to recognize the confusion existing around Schleier and are responding. First, the Internal Revenue Service, on August 3, 1995, (1) suspended Revenue Ruling 93-88, which directed that disparate treatment discrimination awards under the Civil Rights Act and the Americans With Disabilities Act be excluded; and (2) asked for public comment and guidance after the Supreme Court's holding in Schleier as to the anticipated effect the decision would have on the treatment of recoveries.

Second, as part of the Revenue Reconciliation Bill of 1995, Congress is considering sweeping changes in the scope of the tax exclusion as it has stood. According to Claudia MacLachlan, the changes are "aimed primarily at clearing up conflict in decisions in the appeals courts, where there is a split on how to treat punitives arising from physical injuries, with some courts granting exclusions and others denying them." She continues that "[t]he legislation would clarify the problem by taxing those awards" and by "eliminat[ing] the tax exclusion that many courts have allowed for damages awards in cases involving non-physical injuries such as age discrimination." She notes a comment by Thomas Joyce, discussed above, who said that the legislation is designed to "shore up" the six-to-three decision in

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286 Friedman & Sanders, supra note 210, at 1.
287 Tax Liability, IRS Asks for Comment on Court's Holding That Awards in Age Bias Case Are Taxable, 1995 DAILY REPORT FOR EXECUTIVES 150 d63 (BNA) at G150 (Aug. 4, 1995). In Schleier, as noted above, the majority acknowledged in a footnote that its decision was inconsistent with Revenue Ruling 93-88, but noted that an interpretive ruling cannot overturn the plain language of a statute. Schleier, 115 S. Ct. at 2167 n.8.
289 MacLachlan, supra note 276, at A7.
290 Id.
the Schleier case because of a fear that a different interpretation could occur if the Court were to receive a similar case again. 291

The results of these initiatives by the IRS and Congress are unknown at the time of this writing, but they further indicate that the state of the law in this area, and the scope of the section 104(a)(2) exception, are not fully known. Schleier may prove to be the catalyst for further legislation or court decisions delineating excludability under that provision. At this point, however, as Friedman and Sanders note, "the [Schleier] decision may well be remembered for the issues it left open rather than the single issue it resolved." 292

C. Effects of Schleier Anticipated by Commentators

At the same time, commentators believe that they can predict some results with a fair degree of certainty. First, commentators expect heightened difficulty and cost after Schleier in reaching settlements in discrimination cases involving, at a minimum, ADEA claims. This view is widely expressed by commentators. 293 For example, Stuart Bompey and Rachael Jeck comment that, in settlements, the tax characterization of the amounts involved:

[Cannot significantly affect the dynamics of the settlement process—especially in light of the recent Supreme Court decision Commissioner of Internal Revenue v. Schleier. Schleier's immediate impact is clear—it will be harder to settle ADEA claims since plaintiffs are likely to raise their settlement demands to compensate for awards which will be deemed taxable under Schleier. 294

Friedman and Sanders agree, predicting that settlement demands "invariably will be higher" to meet the heightened tax burden under Schleier, and that employers' out-of-pocket costs for settlement will also grow. 295

291 Id. (quoting Thomas F. Joyce).
292 Friedman & Sanders, supra note 210, at Outside Counsel 1.
293 See David G. Savage, U.S. Supreme Court Rules Age Bias Damages Are Taxable, L.A. TIMES, June 15, 1995, at A6; Friedman & Sanders, supra note 210, at Outside Counsel 1; Lovitz & Gold, supra note 270, at Business Law 9; MacLachlan, supra note 276, at B1. MacLachlan writes, "In an opinion that only the Internal Revenue Service could love, the U.S. Supreme Court has disappointed employers and employees ... [with its holding in Schleier.]" MacLachlan, supra note 276, at B1.
295 Friedman & Sanders, supra note 210, at Outside Counsel 1. The predicted increase on the employer's part will be, according to the writers, due to the need to make contributions to social security, unemployment insurance, and medicare, for example, to meet the tax withholding obligations imposed as a result of
Douglas S. McDowell, general counsel to the Equal Employment Advisory Counsel, described the probable result of *Schleier* as making it "more difficult and expensive to settle." Lawyers for management and employees alike seem to agree with this assessment. And although the impact on other discrimination cases is not yet totally clear, Lovitz and Gold assert that *Schleier* will have a significant impact on other discrimination cases because settlement agreements and severance packages will have to be carefully structured to attempt to avoid the tax treatment given *Schleier*.

Concern over the societal implications of the decision was reflected in many of the comments. The Los Angeles Times wrote, "The 6-3 decision . . . could . . . prove a costly setback for thousands of workers who lose their jobs through a corporate downsizing and accept a settlement of age-discrimination charges." And the Washington Post noted the difficult timing of the decision in terms of its impact on many Americans, describing the time as one when "the nation’s workforce is aging and corporate downsizing is the trend." Accordingly, an increasing number of older workers are filing age discrimination claims, and the decision "effectively reduce[s] money awards that older people win." The desirability of this outcome deserves examination. Legal commentator Robert Wood predicts "dire results" for many workers and their former employees who are attempting to settle.

A second anticipated effect is that plaintiffs may begin to assert related but attenuated claims solely on the basis of taxation considerations. Discrimination claimants may begin to make decisions regarding which causes of action to press based on a desire to avoid *Schleier*'s negative tax implications. Friedman

*Schleier*. *Id.* Of course, employers’ settlement costs will also increase in direct proportion to the higher demands of plaintiffs, should the employer attempt to pursue settlement.

296 A body with approximately 300 members, most of which are Fortune 500 companies.


298 *Id.*


302 *Id.*


304 Friedman & Sanders, *supra* note 210, at Outside Counsel 1.
and Sanders suggest, as well, that there may be a rise in pendent state law claims or collateral tort claims, both of which often allow for compensatory damage recovery. As Robert Wood puts it, "The presence of such other claims will likely become even more important now that age discrimination (at least for federal ADEA claims) is no longer on the plaintiff's preferred tax-free hit list." Statute shopping could easily result.

The assertion of additional claims seems fairly certain; however, whether this will result in more litigation remains to be seen. Some think a related effect will likely be the increase in litigation predicted by Thomas Joyce; others believe that plaintiffs may be hesitant to take their cases to court for fear that damages will be allocated unfavorably. Certainly, if settlement becomes increasingly difficult as employers and employees have to reach further to arrive at resolutions acceptable to both parties, litigation may become a plaintiff's only option if she wishes to pursue her claim.

A final effect noted by commentators is that further narrowing of the scope of excludability to eliminate various types of relief under like statutes should be expected. According to one commentator, "It has long galled the IRS that any employment-related dispute should result in excludable amounts; ... [t]he IRS is now armed with a decision in Schleier that might be seen as substantially undercutting the IRS's admission of non-taxability for Title VII recoveries in Revenue Ruling 93-88." Another report on the decision characterized it as part of the Supreme Court's "consistent pattern of protecting federal and state tax sources." Wood concludes:

In the wake of Schleier, employees, employment lawyers and tax professionals will have to get used to a changing landscape that is increasingly hostile to excludability. The apparent two-level requirement to now satisfy section 104 may well be applied to types

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305 Id.
306 Wood, supra note 212, at 1.
307 MacLachlan, supra note 276, at B1.
308 Id. (citing Thomas F. Joyce).
309 Friedman & Sanders, supra note 210, at Outside Counsel 1.
310 Dean L. Surkin & Joseph J. Handlin, Schleier Narrows the Window for Exclusion of Damages, 95 Tax Notes Today 146-78 (July 27, 1995).
311 Wood, supra note 213, at 8.
of injuries well beyond the ADEA context, and indeed well beyond the employment context.\textsuperscript{313}

VIII. ADDITIONAL CONSIDERATIONS FOR THE FUTURE

Certainly, \textit{Schleier} was a disappointing decision to those who had hoped for a more liberal interpretation of section 104(a)(2)'s exception to taxability. A finding of excludability of ADEA damages under that section had appeal for several reasons. The first reason is that such a finding would have been consistent with a perceived judicial trend to broaden the section's exception to cover more non-physical causes of action,\textsuperscript{314} many of which are employment-related,\textsuperscript{315} thereby favoring discrimination victims. The Supreme Court in \textit{Burke} specifically held that employment discrimination awards could constitute tort or tort-type damages if the cause of action was due to a tort-like injury for which a discrimination statute provided an appropriate remedy, as defined therein.\textsuperscript{316} The Ninth Circuit majority in \textit{Schmitz} picked up on this theme in its assertion that the remedy provided by the ADEA does compensate for a tort-like injury.\textsuperscript{317} This judicial trend, including the Supreme Court's prior endorsement of sorts, was not an ill-conceived example of a judicial ad hoc approach to the law. Instead, it was part of a steady movement toward recognition of the seriousness of such non-physical personal injuries. This movement is very much in keeping with the nationwide trend in the law toward greater sensitivity to discrimination in many contexts, including that practiced against the elderly.

\textsuperscript{313} Wood, \textit{supra} note 213, at 8.
\textsuperscript{315} See Annotation, \textit{Damages for Allegedly Wrongful Interference With Employment Rights as Received "On Account of Personal Injuries" so as to Be Excludable from Income Tax Under 26 USCS \$ 104(a)(2)}, 106 A.L.R. FED. 321 (1992), for an overview of federal cases involving employment-related injuries that have been considered for the purpose of determining whether damages received could be excluded under \$ 104(a)(2). They include causes of action grounded in the First Amendment, equal protection, civil rights, Title VII, the Equal Pay Act, and the Fair Labor Standards Act, all of which have given rise to tort or tort-like claims. \textit{See also} Heen, \textit{supra} note 29, at 551 n.1 (adding the Americans With Disabilities Act to the list).
\textsuperscript{316} \textit{Burke}, 504 U.S. 229, 239 (1992) ("No 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."). With the remedies available under the ADEA, that tort-like conception is evidenced.
\textsuperscript{317} \textit{Schmitz} v. Commissioner, 34 F.3d 790 (4th Cir. 1994).
Age discrimination, moreover, can be extremely damaging, both physically and emotionally, to the person subjected to it.\textsuperscript{318} One reason that section 104(a)(2) damages are excluded is to avoid hitting the unfortunate taxpayer twice; since he has already suffered enough loss in the form of personal injury, he should not be forced to "suffer further" through taxation of a damage award.\textsuperscript{319} Many are of the opinion that plaintiffs who receive ADEA damages, like other tort victims, suffer significant personal injury, and as the courts in \textit{Rickel, Pistillo}, and \textit{Schmitz} persuasively argue, they should not be treated any differently than any other tort-sufferer.\textsuperscript{320} Their view is that the taxpayer should not be penalized for the non-physical nature of the tort, but treated the same as a tort victim who suffers from physical injuries.\textsuperscript{321} Whether there will be any outcry based on these policy concerns that might cause either Congress or the Court to take steps back toward this more generous interpretation of the exclusion is unclear at this point.

Additionally, the question remains as to whether the \textit{Burke} "examination of the remedial scheme" test, despite the Court's utilization and clarification of it in \textit{Schleier}, is the best possible test for taxability of claims brought under section 104(a)(2) or whether it is part of the interpretive problem that exists concerning that section. The \textit{Burke} test, with its heavy focus on the nature of the remedial scheme, has been considered by many scholars, tax and law professionals, and students to be an unsat-

\textsuperscript{318} See Pistillo v. Commissioner, 912 F.2d 145, 150 (6th Cir. 1990). The Sixth Circuit Court of Appeals, in terming Pistillo's treatment at his employer's hands a non-taxable tort, writes, "Pistillo endured his employer's indignities, insults and age discrimination; suffered a dignitary tort; and was personally injured." \textit{Id.}


\textsuperscript{320} Pistillo, 912 F.2d at 150. The \textit{Pistillo} court quotes from \textit{Rickel} the proposition that "[t]he successful ADEA plaintiff is being treated no better . . . than the typical tort victim who suffers a physical injury. We see no reason to treat one personal injury any differently than another." \textit{Id.} (citing Rickel v. Commissioner, 900 F.2d 655, 664 (3d Cir. 1990)). The court in \textit{Schmitz} also quotes from \textit{Rickel}, stating, "The successful ADEA plaintiff is being treated no better (or worse now) than the typical tort victim who suffers a physical injury." \textit{Schmitz}, 34 F.3d at 794 (citing \textit{Rickel}, 900 F.2d at 664).

\textsuperscript{321} For an interesting approach to the problem of exclusion of non-physical personal injury torts, see Heen, \textit{supra} note 29. Heen suggests that employment-related injuries reduce an individual's human capital investments (activities that increase a person's resources, therefore increasing his or her future income—both monetary and non-monetary). \textit{Id.} at 569. She would therefore tax all such employment discrimination awards in the same way as personal injury awards are taxed. \textit{Id.} at 608.
isfactory tool for determining exclusions under section 104(a)(2). As a result, reformulating the test has been suggested.

While there are many ideas as to how the Burke test might be reshaped, Justice O'Connor's dissent in that case, which is echoed in Judge Trott's concurrence in Schmitz and in O'Connor's dissent in Schleier, focused the inquiry to determine applicability of the section 104(a)(2) exclusion on the nature of the harm suffered rather than on the remedies available. O'Connor, joined by Justice Thomas, wrote, "In my view, the remedies available to title VII plaintiffs do not fix the character of the right they seek to enforce." Instead, she says, the "purposes and operation" of the statute in question should be examined. If those statutory purposes and operation are closely analogous or similar to the purposes and operation of tort law, then, she writes, the damages should be excluded.

This seems to be one sound approach to the section that could be taken. Moreover, O'Connor's approach would allow the judicial trend toward greater protection of employees against discrimination under section 104(a)(2) noted above to continue. This view, however, does not seem to have enjoyed much support in the Court to date. Whether and how that test will be changed is another unanswered question.

And finally, the question remains whether Internal Revenue Code section 104(a)(2) itself needs clarification so that it may clearly direct determinations of exclusion or inclusion for not

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323 See, e.g., Heen, supra note 29, at 606 (taking an alternative human capital approach). See also Helleloid & Mattson, supra note 47, at 86 (discussing factors other than the Burke remedial scheme test that might be part of a multifaceted § 104(a)(2) exclusion analysis, including payor's intent to settle tort-like claims, settlement agreement language, payroll treatment of settlement for tax purposes by payor, type of claims pursued by the settlement recipient, and others).

324 Sciuto, supra note 47, at 304-305. She states that "[m]ost of us, like Justice O'Connor, look to the nature of the conduct—rather than the nature of the remedy—to determine whether it is tortious." Id. She notes that most of the briefs submitted in Burke on behalf of the respondents took that position. Id.

325 Burke, 112 S. Ct. at 1878.

326 Id.

327 Id.
just ADEA damages, but for all forms of physical or nonphysical personal injuries or sickness. Many believe that the heart of the confusion about the taxability of discrimination-related damages and determinations under the Burke test lies in the lack of a coherent philosophy or approach to section 104(a)(2) exclusions.\textsuperscript{328} As noted, the confusion has also affected determinations of excludability of punitive awards.\textsuperscript{329}

While detailed discussions of or proposals for congressional or administrative reform of section 104(a)(2) are beyond the scope of this comment, the need for such reform deserves note. Congressional reform of the section would be beneficial for a number of reasons. First, section 104(a)(2) is a very significant Internal Revenue Code provision and is one of the last remaining "loopholes" in the Code. If it is to continue to benefit the injured taxpayers it is intended to help, it should be carefully thought out and drafted with clear parameters for applicability that are in keeping with a congressional determination of who should be served by the section. Or if it is to be closed, that should be a legislative decision as well.

Second, as it is currently read, the exception found in section 104(a)(2) is granted inconsistently due to its unclear scope. Based on this uneven application, some analysts advocate repeal of the section’s exception entirely.\textsuperscript{330} Without the clearly indicated reform, if exclusion abuses mount or application (and the accompanying loss of revenue to the government) continues to broaden, the "solution" of repeal might be considered more seriously. Bittker and McMahon write that the section 104(a)(2) exclusion from gross income of damages from personal injuries or wrongful death is "deeply entrenched in private tort law," and "thus, a repeal of section 104(a)(2) would create shock waves throughout the personal injury area and would no doubt lead to larger verdicts and higher insurance premiums."\textsuperscript{331} Such repeal could also lead to public outcry and other undesirable consequences, including the denial of the exclusion (and to subse-
sequent tax liability) to those with traumatic injuries and inadequate recoveries who are arguably deserving of the section's benefits.

In his *Burke* dissent, Justice Scalia reveals his own frustration with the broadening application of the section. He advocates a solution short of repeal of the section, but one with far-reaching implications, just the same. He asserts that the plain language of the exception suggests it should be read to include only injuries to physical (and mental) health. In her dissent in *Schleier*, as noted above, Justice O'Connor expresses concern that this analysis, while not stated, underlies the majority opinion in that case.

If O'Connor is correct or if Scalia's suggestion were to gain adequate support, that approach, too, would lead to a significant change in the section 104(a)(2) exclusion and would likely remove its effect from those with awards for nonphysical personal injuries arguably as severe as those in the included physical category. This possibility brings into sharp focus the question of whether this outcome would reflect Congress' intent in establishing the section's exception. It again demonstrates the risk of inaction on the part of Congress in the face of the existing confusion regarding the section's application.

Congressional clarification of section 104(a)(2), if well-conceived, could significantly reduce the criticism leveled against it and allow compassion for personal injury victims to be maintained within the nation's income taxation system. Even simple definitional sections could reflect Congress's intent for the proper boundaries of the exception.

Apart from avoiding the risk of repeal or significant reduction, clarification would also insure that similarly situated taxpayers suffering different types of injuries would be treated

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332 *Burke*, 112 S.Ct. at 1875-76 (Scalia, J., dissenting) (suggesting what Scalia calls a "common sense interpretation" of the section limiting it to "injuries to physical (or mental) health" and removing such dignitary torts as defamation from its scope).
333 *Id.* at 1875.
334 *Schleier*, 115 S. Ct. at 2169-70 (O'Connor, J., dissenting).
335 See Jones, supra note 322, at 938, for his proposal for reform of the section. He writes, "As [§ ] 104(a)(2) is written, the terms 'personal injury' and 'damages' have no content from which the courts can decide if an award fits within the scope of [§ ] 104(a)(2)." *Id.* at 937. "There simply is no cohesive tax theory justifying the exclusion of such awards." *Id.* at 938. He then sets forth very specific suggestions as to definitions of certain words that should be included in a reformation of the section. *Id.* at 940-45.
similarly. Thus, the policy interests of fairness and consistency would be better served if the section were revisited by Congress. And, as the above indicates, Congress may be interested in strengthening Schleier through legislation, so clarification of section 104(a)(2) may indeed result, one way or the other.\textsuperscript{336}

**IX. EFFECT ON THE AIR INDUSTRY**

Age discrimination is both a historical and present-day concern for airline employees, and the ADEA is one of the statutes considered to have a special impact on the airline industry.\textsuperscript{337} Two distinct types of problems exist in the area of age discrimination in aviation employment law: conflicts related to the Age-Sixty Rule,\textsuperscript{338} and cases of individual discrimination unrelated to Age-Sixty. Significant ADEA cases have arisen in both categories.

First, individual airline employees with issues unrelated to the Age-Sixty Rule have brought suits under the ADEA based on personal claims of age discrimination against them. Some have been part of class action suits against their airline employers, while others are individual plaintiffs. Whether brought by single plaintiffs or members of class action suits, several of the major age discrimination cases of recent years involve airlines and their workers.\textsuperscript{339}

The Age-Sixty Rule is a second area in which age-related issues impact airline workers. Two lines of cases have developed

\textsuperscript{336} While lack of clarity and other problems associated with this section are obviously of extreme significance to the taxability of non-physical personal injury damages, the need for overall reform of the section is not the focus of this comment; the taxability of ADEA damage awards is.

\textsuperscript{337} WILLIAM E. THOMS & FRANK J. DOOLEY, AIRLINE LABOR LAW: THE RAILWAY LABOR ACT AND AVIATION AFTER DeregULATION 127 (1990). Other statutes and regulations that impact airline workers in a significant fashion are the Civil Rights Act of 1964, the Fair Labor Standards Act, the Occupational Safety and Health Administration regulations, the Airline Deregulation Act, and the National Labor Relations Act, among others. *Id.*

\textsuperscript{338} The Age-Sixty Rule is found at 14 C.F.R. § 121.383(c) (1991). It states that No certificate holder may use the services of any person, and prohibit any person from serving, as a pilot on any plane engaged in operations under Part 121, Certification and Operations: Domestic, Flag, and Supplemental Air Carriers and Commercial Operators of Large Aircraft, if that person has reached his or her 60th birthday. *Id.*

\textsuperscript{339} In addition to Schmitz, Downey, and Schleier, see Criswell v. Western Airlines, 709 F.2d 544 (9th Cir. 1983); Trans World Airlines v. Thurston, 469 U.S. 111 (1985).
under that rule: those involving removal of personnel from flight duty at age sixty and those based on airlines' refusals to hire pilots past a certain maximum hiring age.\textsuperscript{430} Several Age-Sixty Rule cases have been litigated under the ADEA, including the oft-cited \textit{Western Airlines v. Criswell}.\textsuperscript{431}

The decision in \textit{Schleier} regarding the taxability of ADEA damages affects several groups involved in the airline industry. First, pilots with pre-1989 suits or settlements still pending are directly affected by the resolution of the case.\textsuperscript{432} Airline employees with post-1989 damages may be affected by this ruling on the test for taxability under section 104(a)(2), since the scope of the 1989 rule on inclusion of punitive damages is unclear and the test for what constitutes a section 104(a)(2) injury may be changed so that a finding that damages have some punitive nature would not preclude exclusion.\textsuperscript{433}

One very important outcome of \textit{Schleier} noted above is the effect it is expected to have on the structure of settlements and decisions about litigation related to section 104(a)(2) causes of action.\textsuperscript{434} On the employee side, it is critical that attorneys or advisors are apprised of the current criteria for section 104(a)(2) exclusion so that they can structure damage classifications in such a way as to benefit their clients.\textsuperscript{435} How sections of the award are labelled may or may not have serious tax implications for the plaintiff employee.

On the management side, the inability of employees to exclude ADEA damage awards from gross income for taxation purposes will certainly affect settlement negotiations;

\textsuperscript{430} Thoms & Dooley, \textit{supra} note 337, at 137.


\textsuperscript{432} As noted by the \textit{Schmitz} court, the holdings in the cases are limited to pre-1989 awards. \textit{Schmitz}, 34 F.3d at 793-94. After 1989, the issue of classification as punitive damages becomes important, but the courts did not have to pass on that type of case to rule on \textit{Downey} and \textit{Schmitz}.

\textsuperscript{433} See \textit{supra} part II.B.

\textsuperscript{434} Gardner & Willey, \textit{supra} note 38, at 230. The authors suggest that practitioners should consider the tax implications under § 104(a)(2), both in structuring litigation (evidence, pleadings, and arguments) and settlements, and advise their clients carefully. \textit{Id}. They note that terming damages "punitive" is risky in the current legal environment, but that even punitives may be nontaxable if attached to a physical malady developed by the plaintiff that results from his personal injury. \textit{Id}.

\textsuperscript{435} \textit{Id}. 
management's willingness to work in settlement situations toward tax situations advantageous to the claimant may be a bargaining chip that an airline can use to achieve more reasonable settlements. The decision could have an effect on the approach each side takes in settlement discussions where damages could result; each might be willing to adjust the amount of settlement dollars (or require the other side to do so) in keeping with the new tax implications. On the other hand, it may prove a polarizing force that makes settlement more difficult.

And finally, airlines and their employees should keep the issue of taxability of damage awards in mind when shaping future contractual arrangements between them. The label that is ultimately affixed to liquidated damages and back pay may affect how the parties to airline employment contracts choose to structure their settlement agreements and the language they use to express their intentions.

X. CONCLUSION

Schleier and the resolution of the split in circuits that it represents is important to the airline industry and to any taxpayer who might receive age-related damages on an ADEA cause of action. But, as this comment reflects, other issues concerning taxation and exclusions under section 104(a)(2) and the adequacy of the Burke test loom large, making Schleier important to other discrimination victims and tort sufferers both because of the attention it has brought to these issues and because its rationale may be applied far beyond the scope of age-related issues.

Therefore, if the confusion surrounding the tax treatment of ADEA damages causes careful consideration of the goals of section 104(a)(2), it could have the beneficial result of helping the Supreme Court, Congress, or the Internal Revenue Service shape answers to the remaining questions that will best accomplish sound policy and well reasoned government goals. Maintaining the exclusion for those harmed by discrimination seems a worthwhile end, even if limitations are more carefully prescribed. Hopefully, the Supreme Court or Congress will shape a sound solution that will end the existing confusion and allow the exclusion to serve the beneficial purpose for which it was written.