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AN ALTERNATIVE APPROACH TO THE TAXATION OF EMPLOYMENT DISCRIMINATION RECOVERIES UNDER FEDERAL CIVIL RIGHTS STATUTES: INCOME FROM HUMAN CAPITAL, REALIZATION, AND NONRECOGNITION

MARY L. HEEN*

The taxation of employment discrimination recoveries under federal civil rights statutes, according to the United States Supreme Court's pronouncement in United States v. Burke, turns on whether a particular claim is sufficiently "tort-like" to warrant exclusion from income as a personal injury. In place of the "tort-like" standard, Professor Mary L. Heen offers a human capital approach that she believes is both more responsive to the goals of the civil rights statutes at issue and more consistent with income tax policy.

Like personal injuries in tort, injuries caused by employment discrimination diminish an individual's human capital—they are just as surely "personal" losses. Thus, Professor Heen posits that employment discrimination awards should be taxed like personal injury awards, i.e., excluded from income under § 104(a)(2) of the Internal Revenue Code. Professor Heen first discusses the implications—both in theory and in practice—for tax and employment law raised by the taxation of employment discrimination awards. Next she analyzes the development of the law, culminating in a detailed discussion of the Supreme Court's decision in Burke. Professor Heen then sets out a human capital approach in replacement of Burke's tort-like standard.

Professor Heen concludes that economic recoveries such as back pay should be excluded from income as compensation for injury to human capital, and that back pay should be computed net of taxes at the remedial stage of the civil rights action.

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Noneconomic recoveries such as damages for pain and suffering should also be excluded, just as they are in the tort context. Punitive damages should be included in income, because they are not intended as compensation for the victim of discrimination. In addition to its theoretical consistency with tax and civil rights law, the human capital approach would be much easier to administer and would yield more predictable results.

I. INTRODUCTION

The taxation of employment discrimination awards and settlements raises fundamental policy questions about the exclusion from gross income of damages received on account of personal injuries,¹ the nature of recoveries under various federal civil rights statutes,² and the proper taxation of human capital.³ Although *United States v. Burke*⁴ presented the United States Supreme Court with an opportunity to address some of these issues, the Court ruled very narrowly.⁵ The decision in *Burke* leaves many techni-

1. The exclusion from gross income for personal injury damages is provided by § 104(a)(2) of the Internal Revenue Code of 1986, as amended. It provides in relevant part that "gross income does not include the amount of any damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injuries or sickness." I.R.C. § 104(a)(2) (West Supp. 1993).

The regulations define the term "damages received" as "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." Treas. Reg. § 1.104-1(c) (1993).

2. This Article focuses on several federal civil rights statutes prohibiting discrimination in employment, primarily Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e (1988), but also the Age Discrimination in Employment Act (ADEA) of 1967, 29 U.S.C. §§ 621-634 (1988), the Equal Pay Act of 1963, 29 U.S.C. § 206(d) (1988), the Americans With Disabilities Act of 1990, 42 U.S.C. §§ 12101-12213 (Supp. III 1991), and employment-related claims brought under 42 U.S.C. §§ 1981 and 1983 (1988).

3. Human capital investments have been defined as "activities that influence future monetary and psychic income by increasing resources in people." GARY S. BECKER, *HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION* 9 (2d ed. 1975). Human capital is a product of birth and social inheritance, is increased by education, health care, migration, and on-the-job training, and is affected by factors such as opportunities and social and technological changes. Paul B. Stephan III, *Federal Income Taxation and Human Capital*, 70 VA. L. REV. 1357, 1358-59 (1984). It has been defined in economic terms as "the present value of the flow of future satisfactions that an individual can command in the course of his [or her] life." *Id.* at 1358 (citing economic literature).

4. 112 S. Ct. 1867 (1992).

5. In *Burke*, the Court only partially decided the threshold statutory issue of whether the exclusion for personal injury damages reaches such civil rights recoveries. The Court held that a payment received in settlement of a back pay claim under Title VII of the Civil Rights Act of 1964 was not excludable from the recipient's gross income under § 104(a)(2) of the Code as "damages received . . . on account of personal injuries." 112 S. Ct. at 1874 (quoting I.R.C. § 104(a)(2) (West Supp. 1993)). The Court noted that "neither the text nor the legislative history of § 104(a)(2) offer[ed] any explanation of the term 'personal injuries.'" *Id.* at 1870. The IRS regulations, however, "linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles." *Id.* Relying on the remedial scheme of Title VII as it existed prior to

cal issues unanswered; much therefore remains for clarification and development by the lower courts.⁶ More significantly, however, the Court declined an opportunity to bring greater theoretical coherence and rationality to a difficult area of federal income tax law.

This Article considers whether the exclusion for personal injury damages *ought to* encompass employment-related civil rights awards and settlements—an inquiry more comprehensive than the statutory issue decided in *Burke*. That question relates to the fundamental issue of whether the exclusion for damages received on account of personal injuries provided by § 104(a)(2) of the Internal Revenue Code (the “Code”) of 1986, as amended,⁷ makes sense as a matter of policy. The policy basis for § 104(a)(2) has been much debated. This Article will not revisit that ground, other than to use the debate concerning § 104(a)(2) as a framework for considering the more specific question of the section’s application in the employment discrimination context.⁸

Personal injury suits typically include claims for compensatory damages such as medical expenses, lost wages, pain and suffering, and lost future earnings due to impairment of earning capacity; they also may include claims for punitive damages.⁹ It is well established that all compensatory damages for physical injuries, including any lost past or future wages resulting from such injuries,¹⁰ are excludable from the victim’s gross income under § 104(a)(2). The tax treatment of punitive damages for personal injuries,¹¹ and of compensatory damages for nonphysical injuries such as libel or defamation, malicious prosecution, or employment discrimination, has been more problematic.¹² With regard to nonphysical injuries, the Internal Revenue Service (the “Service”) has argued that recovery for these injuries or damages ought not to be excluded from gross income because they are actually economic or business-related rather than “personal.”¹³ The courts have rejected the government’s personal/business distinction in cases in-

amendments adopted by Congress in 1991, the Court held that back pay awards in certain Title VII employment discrimination cases are not excludable from gross income as damages received on account of a “personal injury.” *Id.* at 1873-74. Thus, the statutory construction issue has been decided by the Court only with regard to back pay awards under the pre-amended version of Title VII applicable in *Burke*.

6. See *infra* notes 265-97 and accompanying text.

7. See *supra* note 1 for the text of § 104(a)(2).

8. See *infra* notes 57-94 and accompanying text.

9. *E.g.*, DAN B. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 540-90 (1973); JACOB A. STEIN, STEIN ON PERSONAL INJURY DAMAGES (2d ed. 1991).

10. See, *e.g.*, Rev. Rul. 85-97, 1985-2 C.B. 50; Rev. Rul. 61-1, 1961-1 C.B. 14.

11. See *infra* notes 214-18, 277-85 and accompanying text.

12. See *infra* notes 159-212 and accompanying text.

13. See *infra* notes 154-57 and accompanying text.

volving defamation¹⁴ and malicious prosecution¹⁵ and have looked instead to the "nature of the claim" asserted.¹⁶ If the claim relates to an injury that is personal in nature, the loss of income resulting from the injury is excludable under § 104(a)(2).

In *Burke*, the Court considered these issues in the context of an employment discrimination claim. Some of the most troubling tax questions with regard to employment discrimination cases concern the treatment of back pay recoveries¹⁷ or compensation for injuries measured by lost past or future wages.¹⁸ The Court held in *Burke* that amounts paid in settlement of sex-based wage discrimination claims under Title VII of the Civil Rights Act of 1964,¹⁹ as applied prior to amendment by the Civil Rights Act of 1991,²⁰ are not excludable from gross income under § 104(a)(2).²¹ The Court rejected application of the personal/business distinction to an employment discrimination claim and adopted instead the "nature of the claim" test.²² The Court then analyzed Title VII's remedial scheme to determine whether the Title VII claim was sufficiently "tort-like" to constitute a personal injury action. Because the remedial scheme provided for back pay and injunctive relief but not other compensatory or punitive damages, the Court concluded that Title VII actions are not sufficiently "tort-like" to war-

14. *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983).

15. *Threlkeld v. Commissioner*, 848 F.2d 81, 84 (6th Cir. 1988).

16. See *infra* notes 159-68 and accompanying text.

17. For discussion of back pay as a remedy provided under federal statutes prohibiting discrimination in employment, see *infra* notes 111-19, 123 and accompanying text.

18. For example, recoveries measured by lost wages may be awarded to successful claimants under 42 U.S.C. § 1981 or § 1983. *E.g.*, *Johnson v. Chapel Hill Indep. Sch. Dist.*, 853 F.2d 375, 383 (5th Cir. 1988); *Allen v. Amalgamated Transit Union Local 788*, 554 F.2d 876, 885 (8th Cir. 1977), *cert. denied*, 434 U.S. 391 (1977). For pre-*Burke* cases discussing the tax consequences of such awards, see *Wulf v. City of Wichita*, 883 F.2d 842, 871-75 (10th Cir. 1989); *Bent v. Commissioner*, 835 F.2d 67, 70 (3d Cir. 1987). For a discussion of employment discrimination claims asserted under 42 U.S.C. §§ 1981 and 1983, see *infra* notes 174-81 and accompanying text.

19. Under Title VII, it is "an unlawful employment practice for an employer . . . to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1) (1988). In addition, it is an "unlawful employment practice" for an employer "to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee [because of] race, color, religion, sex, or national origin." *Id.* § 2000e-2(a)(2). Title VII also prohibits unlawful discrimination by employment agencies, *id.* § 2000e-2(b), and unions, *id.* § 2000e-2(c).

20. Pub. L. No. 102-166, 105 Stat. 1071 (1991). The *Burke* majority suggested in a footnote that its decision did not reach the tax treatment of awards under the more expansive version of Title VII's remedial scope adopted by Congress in the Civil Rights Act of 1991, and thus the Court was not addressing the statutory construction issue regarding employment discrimination awards or settlements under the amended version of Title VII. *United States v. Burke*, 112 S. Ct. 1867, 1874 n.12 (1992).

21. *Burke*, 112 S. Ct. at 1874.

22. *Id.* at 1872.

rant exclusion from gross income of back pay received by victims of discrimination.²³

Regardless of the Court's statutory construction of § 104(a)(2) in *Burke*, troublesome theoretical questions underlying the application of the exclusion remain. This Article explores some of the theoretical issues and practical problems raised by the taxation of employment discrimination recoveries. The Article pays particular attention to lost past and future earnings and suggests an analysis that differs from the "tort-like" standard applied by the Court in *Burke*. Under the "tort-like" standard, post-*Burke* litigation focuses on technical examination of the statutory remedies available under federal employment discrimination laws, making the tax result turn on tort/contract distinctions. Those distinctions are quite difficult to discern, however, especially when evaluating the various federal antidiscrimination statutes. The tax result should instead depend upon a theory more compatible with the purpose of the antidiscrimination statutes and with income tax policy. A theory focusing on the taxation of human capital offers such an alternative approach.

The human capital approach offers insight into the appropriate tax result because it addresses the theoretical issues raised by § 104(a)(2) and their application to employment discrimination recoveries. Compensation received for bodily injuries (including earnings lost as a result of the injuries), for example, raises questions concerning the proper taxation of human capital recoveries. Similarly, in the employment discrimination context, the appropriate inquiry is whether employment discrimination results in human capital loss and whether the remedies provided by federal antidiscrimination statutes compensate for that loss.²⁴

An exploration of these issues requires closer consideration of the proper taxation of human capital and the effects of antidiscrimination law on human capital accumulation. Pure theory poses certain perils in this context, however, because of the difficulty of distinguishing between the "rules" and the "exceptions"—a problem well described by Professor Boris Bittker.²⁵ Responding to the suggestion that we should lean over backward to avoid tax preferences,²⁶ Professor Bittker observed that we cannot comply because "in the absence of a generally acceptable or scientifically determinable vertical, we cannot know whether we are leaning forward or

23. *Id.* at 1873-74.

24. See *infra* notes 96-97 and accompanying text.

25. Boris I. Bittker, A "Comprehensive Tax Base" As a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 985 (1967).

26. Walter J. Blum, *Federal Income Tax Reform—Twenty Questions*, 41 TAXES 672, 679 (1963) ("There is nothing about the combination of rate reduction and base broadening which dictates that all preferential provisions be eliminated, but there are potent reasons for leaning over backwards before allowing any of them to remain."); see *infra* note 59 (defining tax preferences).

backward."²⁷ That problem is particularly acute when trying to determine the proper taxation of human capital.

Among other things, the realization requirement itself represents a departure from the theoretically correct taxation of accretion to wealth (relating to either investment capital or human capital). In addition, the difficulty of discerning the personal/business borderline, which is theoretically critical, but practically quite blurred, further complicates this inquiry. Because no theoretically correct result is also practically feasible, any solution must also consider the Code's "second best" approach to the taxation of human capital.²⁸

The alternative approach suggested here attempts to reconcile the taxation of employment discrimination recoveries with the Code's approach to the taxation of human capital, the effects of employment discrimination on human capital accumulation, and the tax treatment of personal injury recoveries under § 104(a)(2). The discussion of these issues is divided into the next three parts. Part II discusses the theoretical and practical considerations concerning the tax and employment law issues at stake.²⁹ Part III outlines the development of the law and includes a description of early administrative interpretation, a summary of pre-*Burke* decisions applying § 104(a)(2) to employment discrimination cases, and a more detailed discussion of the Supreme Court's decision in *Burke*.³⁰ After previewing some of the post-*Burke* problems created by the Court's adoption of the "tort-like" standard, the Article proposes that the standard be discarded.³¹ Part IV discusses an alternative approach, which applies a human capital analysis to economic recoveries (such as back pay received by victims of employment discrimination), and a compensatory versus noncompensatory approach for noneconomic recoveries (such as recoveries for pain and suffering and punitive damages).³² The Article concludes that employment discrimination recoveries such as back pay and front pay³³ should be excluded from income as compensation for human capital loss, a "personal" injury, and that the recoveries should be computed on an after-tax basis at the remedial stage of the civil rights action. Punitive damages, on the other hand, serve noncompensatory functions such as deterrence and retribution. Punitive damages should therefore be included in income.³⁴ Damages for

27. Bittker, *supra* note 25, at 985.

28. See *infra* notes 44-50 and accompanying text.

29. See *infra* text accompanying notes 35-143.

30. See *infra* text accompanying notes 144-263.

31. See *infra* text accompanying notes 264-304.

32. See *infra* text accompanying notes 305-29.

33. See *infra* text accompanying notes 120-22 for a description of front pay.

34. As discussed *infra* at text accompanying notes 216-18 and notes 277-85, the tax treatment of punitive damages for physical injuries is unsettled.

pain and suffering or emotional distress should be excluded, as they are in the tort context. This alternative human capital approach should be adopted in place of the "tort-like" standard because it is more consistent with the theoretical rationale of § 104(a)(2) and with the remedial purposes of federal antidiscrimination laws. It also results in greater uniformity and ease of administration in the taxation of employment discrimination recoveries.

II. THE THEORETICAL DEBATE ABOUT THE EXCLUSION FOR PERSONAL INJURY DAMAGES AND THE SCOPE OF EMPLOYMENT DISCRIMINATION REMEDIES: THE PRACTICAL LIMITATIONS

The theoretical underpinnings of § 104(a)(2) should inform the standard for determining whether the exclusion applies in a given setting. As described below, § 104(a)(2) has been most convincingly rationalized as providing a somewhat imprecise mechanism for ensuring that personal injury awards are taxed in a manner consistent with what would have occurred under the Code if there had been no injury to human capital. That approach provides a useful framework for considering the proper taxation of employment discrimination recoveries.

This part of the Article compares the taxation of human capital and investment capital, summarizes the policy debate concerning § 104(a)(2), and examines employment discrimination recoveries to determine whether they compensate for human capital loss. How civil rights law should remedy the loss of human capital, if at all, has been the subject of vigorous national debate.³⁵ The debate most recently resulted in the Civil Rights Act of 1991, which amended Title VII and various other employment discrimination statutes by broadening the relief available in certain types of cases.

An understanding of the remedial design of employment discrimination statutes is important for two purposes: (1) to analyze how employment discrimination recoveries redress the loss of human capital caused by discrimination, an inquiry relevant to the theory of how these recoveries should be taxed, and (2) to understand the implications of the "tort-like" standard adopted in *Burke*. Part II concludes with an example illustrating Title VII claims and relief, which readers unfamiliar with the statute may find helpful as background for the later discussion.

A. Comparing the Taxation of Human Capital and Investment Capital

In theory, an income tax system taxes income measured as personal consumption plus the market value of the net change in wealth during the

35. See *infra* notes 96-110 and accompanying text.

taxable period.³⁶ A model income tax taxes investment "twice": once, when the investment asset is purchased with the taxpayer's after-tax earnings; and again, when the investment incrementally increases in value or generates additional earnings.³⁷ The Code frequently departs from this ideal, as exemplified by its general failure to tax the unrealized appreciation of property and the imputed income from property or services.³⁸ For example, because unrealized appreciation and imputed income improve a taxpayer's economic position and therefore constitute "income" in an economic sense, it has been suggested that taxing the market value of imputed income from owner-occupied housing and certain big-ticket consumer durables, such as cars, may be desirable.³⁹ Problems of valuation, administration, and the relative absence of significant economic distortions (after taking into account offsetting deductions for maintenance and depreciation, for example) counsel against the inclusion of most such imputed income.⁴⁰ In many respects, therefore, the Code takes a "second best" approach to taxing income.

Similar considerations have militated against taxing increments of human capital or the imputed income from such capital, such as increased job satisfaction or security. Taxable income could include increments to human capital, assuming they could be identified and valued. For example, attending vocational school may increase the lifetime earning capacity of a high school graduate wishing to become a mechanic. The increase in human capital produced by her training, measured by the present value of her future earnings as a mechanic (as compared to the present value of her future earnings without such training, e.g., as a fast-food clerk), constitutes income during her school years, just as if she owned stocks or bonds that

36. This idealized version of an income tax system derives from the Haig-Simons concept of income. HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938) ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."); Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 7 (Robert M. Haig ed., 1921) reprinted in *AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION* 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959) ("Income is the money value of the net accretion to one's economic power between two points of time.").

37. See *infra* text accompanying notes 50, 55-56.

38. Imputed income includes, for example, the market value of services a taxpayer performs for himself, such as cooking a meal or sweeping a floor, and the value of leisure time, such as reading a novel or going to a concert. See SIMONS, *supra* note 36, at 52 (explaining that leisure income could be imputed to persons "according to what they might earn per hour if otherwise engaged"). It also includes the annual rental value of property owned by the taxpayer, such as the house she lives in or the toaster, car, and lawn mower she uses during the year. See DEPARTMENT OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM* 7, 89 (1977) [hereinafter *BLUEPRINTS*].

39. *BLUEPRINTS*, *supra* note 38, at 7, 85-89; see also Bittker, *supra* note 25, at 947-48 (discussing imputed income from taxpayer's assets).

40. *BLUEPRINTS*, *supra* note 38, at 7; Bittker, *supra* note 25, at 948.

increased in value by a similar amount during the same time. Like the appreciation in the value of the stocks or bonds, the increase in value of human capital constitutes economic gain even though it is not realized. Under the current Code, the gain from the securities generally will not be taxed unless realized through a sale or exchange.⁴¹ Similarly, the gain from the increment in human capital will not be taxed until realized in the form of wages.⁴²

The major difference between human capital and investment capital, however, is that although the securities can be sold or exchanged, human capital and the imputed income from it are inherently personal. Human capital cannot be transferred except in the form of one taxpayer providing services to another.⁴³ The personal nature of human capital creates special valuation issues for income tax purposes and also raises independent concerns about individual liberty and autonomy. These problems raise serious theoretical obstacles to taxing human capital like other investment capital.

Under current law, human capital is not taxed as an investment asset with basis,⁴⁴ although in the abstract, it could be so treated. The present discounted value of future wage-earning capacity could be included in income as it is acquired and the basis resulting from such inclusions could be

41. I.R.C. § 1001, 61(a)(3) (West Supp. 1993). Exceptions apply in certain specialized contexts. See, e.g., I.R.C. §§ 475 (applying mark-to-market accounting method for dealers in securities); I.R.C. § 1256 (requiring that certain regulated futures contracts, foreign currency contracts, and nonequity and dealer equity options be marked to market).

42. Gross income includes "compensation for services, including fees, commissions, fringe benefits, and similar items." *Id.* § 61(a)(1).

43. 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 3.5.2 (2d ed. 1989). Even human capital transfer in the form of an exchange of services is subject to significant limitations compared to the legal treatment of more traditional property rights. For a recent discussion of restrictions on the alienability of human capital in the employment context, see Stewart E. Sterk, *Restraints on Alienation of Human Capital*, 79 VA. L. REV. 383, 386-412 (1993) (discussing existing doctrinal limitations on enforceability of assignments of human capital and arguing for fewer restrictions).

44. The basis of an investment asset, generally speaking, is the cost of the asset. I.R.C. § 1012 (West Supp. 1993). When the asset is sold, any excess of the amount realized over the adjusted basis of the asset is "gain," *id.* § 1001(a), which is includable in gross income under § 61(a)(3). The cost basis of human capital would be quite difficult to determine, and thus is generally ignored. See Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 152-55 (1992). For criticism of current law, see David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793, 796-802 (1992) [hereinafter *Education and Human Capital*]; David S. Davenport, *The "Proper" Taxation of Human Capital*, 52 TAX NOTES 1401, 1401-11 (1991); Brian E. Lebowitz, *On the Mistaxation of Investment in Human Capital*, 52 TAX NOTES 825, 825-31 (1991); John K. McNulty, *Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education*, 61 CAL. L. REV. 1, 16-36 (1973); see also Loretta C. Argrett, *Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive*, 41 SYRACUSE L. REV. 621, 622-27 (1990) (urging allowance of recovery for post-secondary education expenditures); John J. Mylan, *Current Tax Treatment of Education Costs*, 32 U. FLA. L. REV. 387, 408-13 (1980) (discussing the amortization of educational expenses).

amortized against actual wages earned.⁴⁵ Liquidity problems could be addressed by deferring tax with interest until the earnings are received by the taxpayer.⁴⁶ Taxing such human capital increments would result in overwhelming definitional and valuation problems,⁴⁷ however, and would entangle us in weighty discussions over the moral and philosophical advisability of attempting to define and measure unrealized earning potential.⁴⁸ Thus, the income tax model of taxing investments twice may not be appropriate for human capital.

In any event, regardless of whether the Code is making a principled departure from the income tax model for human capital investments or simply taking a "second-best" approach when the model poses certain practical difficulties, the Code ignores human capital increases (the present value of increased future earning capacity). Generally speaking, it also ignores their cost recovery (either by way of a current deduction or by amortizing or depreciating vocational or professional school tuition and fees).⁴⁹ The Code taxes the wages only when received (with no basis offset)—in short, only the realized income from the human capital investment is taxed. In

45. 1 BITTKER & LOKKEN, *supra* note 43, at ¶ 3.5.2.; Dodge, *supra* note 44, at 153.

46. William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461, 466-67 (1977).

47. See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1145-46 (1974) (discussing the practical difficulty of isolating changes in human wealth from changes in comprehensive material wealth). See also Mary L. Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 780-83 (1990) (discussing the difficulties of applying a time-adjusted realization event tax to human capital).

48. See, e.g., Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 841-44 (1979); Klein, *supra* note 46, at 468-69. Some commentators have suggested middle ground solutions. For example, Professor McNulty has proposed permitting a fixed amount of after-tax foregone earnings to be treated as recoverable costs, based on average or median incomes of school-aged persons and average effective income tax rates on such earnings. McNulty, *supra* note 44, at 21 n.62; see also, e.g., Davenport, *Education and Human Capital*, *supra* note 44, at 826-82 (discussing the difficulties posed by trying to achieve "proper" taxation of human capital through various surrogates for up-front taxation of human capital accumulations).

49. See Treas. Reg. § 1.162-5 (1993). Theoretically, costs associated with education having a useful life extending substantially beyond the taxable year should be capitalized. However, the regulations permit educational expenses to be currently deductible as ordinary and necessary business expenses under certain narrow circumstances: (1) when the education "[m]aintains or improves skills required by the individual in employment," or (2) when the education meets certain requirements "imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation." *Id.* § 1.162-5(a). Educational expenses necessary to meet the minimum educational requirements for employment (such as high school or college tuition), or to qualify for a new trade or business (vocational school tuition) are viewed as "personal expenditures" or as "an inseparable aggregate of personal and capital expenditures," and thus are "not deductible as ordinary and necessary business expenses." *Id.* § 1.162-5(b)(1). *But cf.* Sharon v. Commissioner, 66 T.C. 515 (1976), *aff'd per curiam*, 591 F.2d 1273-74 (9th Cir. 1978) (holding fees to state attorney licensing authority and fee for admission to practice before the U.S. Supreme Court to be capital expenditures amortizable over taxpayer's working life expectancy), *cert. denied*, 442 U.S. 941 (1979).

contrast, other investment assets have been described as being taxed twice: once when the investment is made (because the purchase price is nondeductible), and again when income (in the form of periodic dividends or interest) or gain from the asset is received at the sale or exchange of the asset, less a basis offset.⁵⁰

The difference in treatment between investment capital and human capital can be illustrated with an example comparing the treatment of Joe and Jane, two high school graduates. Joe immediately goes to work as a fast-food worker, lives at home with his parents, and invests his after-tax earnings during the next three years in stocks and zero coupon bonds (with all interest payable three years hence at maturity). Jane, on the other hand, goes to a three-year vocational school to become a mechanic.

Joe, the investor, purchases assets, the prices of which reflect the present value of their future income stream. Because no deduction from his wage income is allowed for their purchase, he is taxed up front on the investment expenditure. In addition, he is taxed currently on any dividends received on his stock⁵¹ and on the imputed daily interest income earned by the bonds over the three-year period, under concepts consistent with the economic accrual of interest as applied through the original issue discount rules.⁵² If interest rates go down, and the value of the bond goes up, Joe is not taxed on the appreciation in value of the bond until a sale or exchange. If he then sells the bond, however, he will recognize gain equal to the amount realized from the sale minus his adjusted basis in the bond.⁵³ Similarly, he will not be taxed on the appreciation in value of his shares of stock. When there is a realization event such as a sale or exchange, he will recognize gain equal to the amount realized from the sale over his adjusted basis in the shares.

In contrast, Jane, the student, is not taxed up front on a substantial portion of her investment in vocational school, even though she is allowed no deduction for her schooling costs. That is so because she is partly acquiring her increased human capital through foregone earnings. Instead of earning money as a fast-food worker over the next three years and investing

50. As explained in Dodge, *supra* note 44, at 162 n.100 (citation omitted):

Investments are normally made with after-tax dollars because capital expenditures creating or purchasing investments are not deductible. . . . This nondeductible cost of the investment is, in financial terms, the present discounted value of all future receipts, the net income portion of which will be taxed again when accrued or received. Human capital is not systematically taxed twice in the same manner: Accretions to human capital may or may not be taxed, but wage income is taxed on a gross basis, not on a "net" basis after amortizing human capital, which is nonexistent.

51. I.R.C. § 61(a)(7) (West Supp. 1993).

52. *Id.* §§ 1272-1273. See generally, e.g., Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1 (1986) (describing the original issue discount rules).

53. I.R.C. §§ 1001, 1272(d)(2) (West Supp. 1993).

in stocks and bonds like Joe, she invests in a vocational education. Although her tuition fees are paid with after-tax dollars, she is not taxed on what she could have earned for three years as a fast-food worker or on any income from investing such earnings. Those foregone earnings constitute a major portion of the "cost" of her educational investment, and the failure to tax those foregone earnings is equivalent to allowing her an immediate deduction for that portion of the cost of her education.⁵⁴ Thus, her initial human capital investment is at least partially tax free.

Like Joe, she is not taxed on any unrealized appreciation in the value of her capital investment. The increase in her human capital represented by her training is taxed when she actually receives her increased income stream, that is, when she begins to receive wages as a newly employed mechanic three years later. Unlike Joe, she gets no basis offset against wages for that portion of her investment that was made from after-tax dollars, her tuition costs, for example.

In reality, the tax consequences of acquiring investment and human capital are much more complex due to the Code's treatment of borrowing, accelerated depreciation for certain types of assets, qualified retirement accounts, the effects of inflation, and offsets and adjustments under the Code for various ways of financing education.⁵⁵ In greatly simplified form, however, the double tax on investment capital contrasts with the single tax on investments in human capital.⁵⁶

B. *The Exclusion for Personal Injury Damages: The Policy Debate*

Prompted in part by a more expansive judicial interpretation of the personal injury exclusion over the past decade,⁵⁷ commentators have been reexamining § 104(a)(2) on tax policy grounds. Some have concluded that

54. See, e.g., THEODORE W. SCHULTZ, INVESTMENT IN HUMAN CAPITAL: THE ROLE OF EDUCATION AND RESEARCH 167-68 (1971) (stating that earnings foregone by students constitute more than half of the real costs of human capital formation by higher education); Michael J. Boskin, *Notes on the Tax Treatment of Human Capital in OFFICE OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY, CONFERENCE ON TAX RESEARCH* 185, 187, 189 (1975) (observing that (1) studies support the conclusion that "well over half of human capital investment costs consist of foregone earnings," (2) "[t]he failure to tax foregone earnings is equivalent to an immediate write-off of the investment cost," and (3) "[t]he lack of an educational expenditure depreciation allowance probably biases investments away from education to job training"); cf. BECKER, *supra* note 3, at 18-29 (noting that unless on-the-job training produces firm-specific training, the employee effectively bears the cost of generalized job training in the form of lower current wages).

55. Stephan, *supra* note 3, at 1368-75; see also Joseph Isenbergh, *The End of Income Taxation*, 45 TAX L. REV. 283, 310-12, 319-28 (1990) (discussing the adverse effects of income taxation on capital formation and describing various investment incentives "grafted on" the income tax system).

56. See JOSEPH M. DODGE, THE LOGIC OF TAX 112, 221 (1989); Klein, *supra* note 46, at 476-78, 481.

57. See *infra* text accompanying notes 159-212.

the exclusion cannot be justified as a matter of tax policy⁵⁸ because personal injury recoveries are "income," and therefore, their exclusion from gross income constitutes a tax preference.⁵⁹ Some explain its continued presence in the Code as a holdover from now outmoded views of the constitutional limits of an income tax,⁶⁰ or as a humanitarian (or politically expedient) gesture by Congress not to tax those who have received compensation for personal injuries.⁶¹ Many have called for legislative action,⁶² including the repeal of the section in its entirety,⁶³ to respond to judicial developments.

A few dissenters, at least with regard to the broader question of the policy justification for § 104(a)(2), rely on the compensatory nature of personal injury recoveries and view the exclusion as proper because such recoveries are not "income." Under this view, the exclusion for personal injury recoveries (at least to the extent such recoveries are compensatory) makes sense if the amounts can be seen as a tax-free recovery of human

58. E.g., J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits*, 50 MONT. L. REV. 13, 46 (1989).

59. Allaire U. Karzon, *Tax Expenditures and Tax Reform*, 38 VAND. L. REV. 1397, 1407-08 (1985) (reviewing STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985)) ("[U]ntil the Code Section 104(a)(2) exclusion appears in the formal tax expenditure budget, it may continue to elude the attention of the legislators and the public and permit some persons to realize enormous amounts of wealth tax-free."). Section 104(a)(2)'s exclusion is not currently listed as a tax expenditure, although exclusions for workers' compensation benefits and certain disability benefits for coal miners are so listed under income security functions. See JOINT COMMITTEE ON TAXATION, *ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1994-1998* (JCS-6-93) (Apr. 22, 1993), reprinted in *Daily Tax Rep.* (BNA) No. 77, at L-1 (Apr. 23, 1993).

The tax expenditure model divides the income tax into two elements: (1) provisions needed to implement the "normal tax structure," and (2) "special preferences." STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 3 (1985). The structural provisions include the rate structure, personal exemptions, accounting period, and the taxable unit and those provisions necessary to define the tax base. *Id.* Departures from the normal tax are tax expenditures or special preferences, "designed to favor a particular industry, activity, or class of persons" and are viewed as equivalent to direct government outlays. *Id.* Beneficiaries of a tax preference are viewed as having received a government grant or appropriation equal to the amount of the tax reduction due to the preference. Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 706 (1970). For a discussion of the impact of the tax expenditure model on tax policy formation, see Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 349-52 (1989).

60. 1 BITTKER & LOKKEN, *supra* note 43, ¶¶ 5.6, 13.1.1, 13.1.4; Burke & Friel, *supra* note 58, at 20-21.

61. See Burke & Friel, *supra* note 58, at 43.

62. E.g., Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform*, 56 TENN. L. REV. 661, 689-91 (1989); Burke & Friel, *supra* note 58, at 46-47; Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 LA. L. REV. 875, 930 (1988).

63. E.g., Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 64-65 (1987); see also Lawrence A. Frolik, *Personal Injury Compensation as a Tax Preference*, 37 MAINE L. REV. 1, 35-39 (1985) (advocating repeal of § 104(a)(2)).

capital.⁶⁴ This view assumes, however, that each taxpayer has a substantial basis in her human capital (represented by expenditures for food, medical care, education, and so forth).⁶⁵ In addition, it presumes that the amounts of court-ordered personal injury awards or settlements do not exceed the victims' bases in their human capital.⁶⁶ More fundamentally, however, this view has been faulted as being at odds with the tax system's general refusal to treat human capital as a conventional asset with basis, as illustrated by the lack of a deduction for uncompensated personal injury losses and the lack of depreciation deductions to offset wages.⁶⁷

Personal injury recoveries for lost earning capacity or lost past wages raise difficult questions because the wages they supposedly replace otherwise would be subject to tax. Hence, some have argued that the exclusion for personal injury damages should not reach such recoveries even if an exclusion for medical expenses or for pain and suffering damages could be justified.⁶⁸ That approach, if adopted, would necessitate a change from current law, which excludes lost past or future wages received as part of a

64. *E.g.*, Stephan, *supra* note 3, at 1400. The exclusion for amounts received for pain and suffering has been justified as consistent with the nontaxation of imputed income from human capital. *See* Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759 *passim* (1988). *But see* Dodge, *supra* note 44, at 182-87 (disagreeing with Brooks's argument that damages for pain and suffering should not be taxed because they are a substitute for goods of a nontaxable nature, such as pleasure, pain, or normalcy).

In addition, the exclusion for amounts received to compensate for personal injury medical expenses has been justified as comports with the deduction for medical expenses. *See* Stephan, *supra* note 3, at 1402-03 (observing that the medical expense deduction puts the self-compensator on the same footing as the person who excludes personal injury compensation).

65. *See* Stephan, *supra* note 3, at 1392-93 (presuming that taxpayers have a substantial basis in their human capital and applying a basis-recovery-first rule to partial liquidations of human capital to support the exclusion of most, if not all, individual injury compensation awards); *see supra* note 44 for a discussion of basis.

66. *See, e.g.*, Edward Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 CORNELL L. REV. 701, 712 (1977) (criticizing such a presumption and advocating repeal of exclusion from gross income for lost earning recoveries in personal injury cases).

67. Dodge, *supra* note 44, at 152-53.

68. *E.g.*, Douglas K. Chapman, *No Pain—No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L.J. 407 (1986-87) (arguing that Congress should amend § 104(a)(2) to limit the exclusion to personal injury damages for actual expenses, pain and suffering, and mental anguish, and that damages for lost earnings and punitive damages should be includable in income); Yorio, *supra* note 66, at 733-36; *see also* Thomas D. Griffith, *Should "Tax Norms" Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115 *passim* (challenging traditional tax norms and suggesting an alternative normative analysis under which it would be desirable to tax recoveries for lost earnings and pain and suffering and to exempt recoveries for medical expenses); Malcolm L. Morris, *Taxing Economic Loss Recovered in Personal Injury Actions: Towards a Capital Idea*, 38 U. FLA. L. REV. 735 (1986) (suggesting that economic loss recoveries awarded in personal injury actions be incorporated into the tax base but in a preferential manner). *See generally* Susan K. Matlow, Comment, *Exclusion of Personal Injury Damages: Have the Courts Gone Too Far?*, 44 VAND. L. REV. 369, 392-94 (1991).

recovery for a physical injury.⁶⁹ Personal injury recoveries presumably would be bifurcated, instead, into taxable and nontaxable portions.

Another quite different type of analysis focuses on whether the receipt of damages should be treated as an income realization or recognition event regardless of the theoretical status of such damages as "income." If personal injury recoveries for lost earnings replace increases in human capital (increased earning capacity), these recoveries are theoretically "income."⁷⁰ However, the exclusion from gross income provided by § 104(a)(2) can be rationalized because the current Code does not treat an increase in human capital as realized income. Section 104(a)(2) ensures that when human capital is involuntarily converted into investment capital through a personal injury damage award, it is taxed only once, just as if it were income from human capital.⁷¹

This analysis, developed by Professor Joseph Dodge, asserts that the "exclusion-inclusion dichotomy" incorrectly frames the issue.⁷² He argues that any resolution of the issue "should be sensitive to both federal tax policy and state tort policies" by ensuring that plaintiffs are put "in the same post-tax economic position after receiving the recovery as they would have been in if the injury had not occurred,"⁷³ regardless of how damages are computed under state tort law. He proposes a federal tax rule that would permit states to adapt their compensation rules to their own notions about the efficient regulation of defendants' conduct.⁷⁴ Accordingly, Dodge sug-

69. See *supra* note 10 and accompanying text.

70. If they merely replace human capital, as opposed to replacing increases in human capital, there remains the theoretical issue regarding the status of such recoveries as "income." See *supra* notes 64-67 and accompanying text. An analysis that focuses on whether personal injury recoveries should be treated as an income realization or recognition event, regardless of whether they are "income," does not depend for its theoretical validity upon resolving the question of whether the personal injury results in the loss of existing human capital or the loss of future increases in human capital, or both.

71. DODGE, *supra* note 56, at 112. This view of § 104(a)(2) recognizes it as a mechanism for ensuring that personal injury damages are taxed in a manner consistent with what would have occurred under the current Code if there had been no injury to the person's human capital. There is no need, therefore, to pursue the illusory goal of determining a cost basis in the individual's body (for physical injuries) or in their social, genetic, or educational endowment to determine how much of the personal injury recovery ought to be viewed as basis recovery and how much should be viewed as gain or "profit." That would be irrelevant under the Code's treatment of human capital, which as described above, ignores basis in this context. See *supra* text accompanying note 44. The § 104(a)(2) exclusion treats the victim of a personal injury as a wage earner rather than an investor and generally ensures the result of taxing the human capital income once rather than twice.

72. Dodge, *supra* note 44, at 145.

73. *Id.*

74. *Id.*

gests a set of rules that would treat lost earnings variably, according to the method used to compute damages under state law.⁷⁵

Under his analysis, at least four basic combinations of state tort damage computation regimes and federal tax treatments are compatible with the § 104 exclusion and leave the injured "taxpayer in the same economic position as if the personal injury had never occurred,"⁷⁶ and two additional combinations that are consistent with the repeal of § 104 but satisfy the compensatory goal.⁷⁷ He summarizes the results as follows:

- (1) For periodic-payment recoveries . . . , the payments should be fully excluded if the recovery is computed after taxes,⁷⁸ otherwise it should be fully included⁷⁹
- (2) For lump-sum recoveries invested in annuities⁸⁰ . . .

75. *Id.* at 155-67. For lost past earnings, Dodge concludes that the proper federal tax treatment is "easily discerned," and depends on "whether the recovery for lost wages is computed, under state law, on a before- or after-tax basis." *Id.* at 165. For example, if the recovery is computed on an after-tax basis (\$100,000 in wages reduced to an after-tax amount of \$70,000, assuming a 30% tax rate), the recovery (of \$70,000) should not be taxable. If the recovery is computed on a before-tax basis (\$100,000 in wages, with no reduction for implicit taxes of \$30,000), the recovery (of \$100,000) should be taxable for federal income tax purposes. Thus, the government would receive taxes (of \$30,000, assuming a 30% tax rate). In either case, the claimant would receive the same amount (\$70,000).

Recoveries for lost future earnings require a more complex analysis. Applying concepts of financial analysis, Dodge asks "what tax treatment for lost earning capacity recovery would best replicate what" the injured party would have received from future earnings if there had been no personal injury. *Id.* at 155. The injured party would have received wages over some specified period, which could be as long as her life expectancy or as short as the duration of a less serious injury. The appropriate amount of any lump sum recovery is the present discounted value of such wages. *Id.*

The present value of a future amount is computed under the discount formula

$$PV = \frac{FV}{(1 + i)^n}$$

where *FV* is the amount of money to be paid at some date in the future, *i* is the daily, monthly, semiannual, or annual discount rate, expressed as a decimal, and *n* is the number of (days, months, half-years or years) periods between the present and the date that the amount is received in the future. *Id.* at 155 n.72. The present value of an income stream is the sum of the present values of all future receipts of income. *Id.*

76. *Id.* at 155-56.

77. *Id.* at 158.

78. See Dodge's first scenario, in which the recovery is in the form of periodic payments. *Id.* at 156. Each payment equals the amount the wage earner would have earned after taxes. *Id.* Accordingly, the payments should be fully excluded from tax. *Id.* at 159.

79. See Dodge's sixth scenario, in which payments of before-tax amounts are received periodically. *Id.* at 158. The payments should be taxed in full. *Id.* at 159. After taxes, the net amount received by the injured party would be the same bottom-line result as in his first scenario. *Id.* at 158.

80. Any lump-sum recovery for lost future earnings "would be required to be reinvested in a wage-mimicking annuity." *Id.* at 188; see also *infra* note 88.

(a) the lump-sum recovery should be excluded if the recovery is figured on an after-tax basis;⁸¹ otherwise it should be fully included;⁸² and

(b) the annuity payments should be fully excluded if the recovery is calculated using a before-tax discount rate;⁸³ otherwise they should be treated as payments upon a debt obligation.⁸⁴

He concludes that the § 104 exclusion is justified when the recovery is calculated on an after-tax basis because the "taxpayer already bears an implicit tax on the wage-stream substitute."⁸⁵

81. As Dodge points out, if the lump sum recovery is computed on an after-tax basis, the *FV* "in the present value formula is reduced" by the amount of future taxes. Dodge, *supra* note 44, at 155 n.73. For example, if a payment of \$100,000 is to be received at the end of year one and the tax rate is 30%, the after-tax *FV* is \$70,000 ($\$100,000 - (.30 \times \$100,000)$). *Id.*

82. In a variation of Dodge's second scenario, the lump-sum recovery, which is computed on a before-tax basis, is fully taxed. *Id.* at 158.

83. "The before-tax discount rate is the rate of return (before taxes) on readily available nonrisky assets." *Id.* at 155 n.74.

For example, assuming a discount rate of 10% compounded annually, the present value of an after-tax amount of \$70,000, which is to be received at the end of year one, is

$$PV = \frac{\$70,000}{(1 + .10)^1}$$

or \$63,636.36. The present value of a three-year after-tax income stream of \$70,000 each year, assuming a before-tax discount rate of 10%, would be $\$63,636.36 + \$57,851.24 + \$52,592.04 = \$174,079.60$. In other words, \$174,079.60 "is the present value, at 10%, of an annuity consisting of three annual payments of \$70,000." *Id.* at 157 n.78.

Under Dodge's third scenario, in which the lump-sum recovery is computed on an after-tax basis, using a before-tax discount rate, the annuity payments should be exempted from taxable income. *Id.* at 156.

84. *Id.* at 159. In Dodge's fourth scenario, "the lump-sum recovery is computed on an after-tax basis, . . . using an after-tax discount rate, and the annuity payments are taxed subject to a basis offset." *Id.* at 156. Rather than taxing the annuity payments under I.R.C. § 72, however, Dodge would tax the annuity payments similarly to receipt of payments under a level payment mortgage. *Id.* at 156 n.77. For example, when a loan is repaid, each payment is treated as if comprised of an amount of interest, computed by multiplying the applicable interest rate times the remaining principal balance. The remainder of the payment is treated as a return of principal. Thus, the income portion of each payment declines over time as the principal is paid down. *Id.*

The after-tax discount rate is the before-tax discount rate reduced by the marginal tax rate. If the before-tax discount rate is 10%, and the tax rate is 30%, the after-tax discount rate would be 7%. In the example above, the present value of a three-year after-tax wage stream of \$70,000 at the end of each year, assuming a tax rate of 30% and an after-tax discount rate of 7% compounded annually, would be $\$65,420.56 + \$61,140.71 + \$57,140.85 = \$183,702.12$.

Under the fourth scenario, an annuity could be purchased for \$183,702, assuming a 10% before-tax rate of return and equal annuity payments at the end of each year of \$73,869, leaving an after-tax amount of \$68,358 in year one, \$70,023 in year two, and \$71,855 in year three. *Id.* at 157.

85. *Id.* at 159. As explained by Professor Dodge, an "implicit tax is not actually transferred to the government . . . [but is an] amount that reduces the taxpayer's net return." *Id.* at 159 n.87. Whether that rationalized result under § 104(a)(2) is consistent with tort policies concerning deterrence, of course, is another matter. *Id.* at 161-62.

Professor Dodge's analysis provides one of the most persuasive theoretical rationales for § 104(a)(2), as long as personal injury damages are computed "correctly" for tax purposes under state law. Dodge chooses neither to force states to conform to a federal model of tort damage computation, nor to be content with a tax rule resulting in either overcompensation⁸⁶ or undercompensation⁸⁷ of plaintiffs. Instead, he proposes that the federal tax rule adjust to the states' own policy determinations concerning tort damages.⁸⁸ Alternatively, he argues that if § 104(a)(2) is retained in its current form, states can adapt without undermining the deterrence and punishment functions of tort law because both of these functions can be achieved by punitive damages and damages from noneconomic harms, such as for pain and suffering.⁸⁹ He concludes that regardless of how economic recoveries, such as lost earnings, are taxed, both punitive damages and damages for noneconomic harms should be included in income.⁹⁰

Dodge's insight that § 104(a)(2) "is neither categorically right nor wrong" as applied to recoveries for lost earnings seems correct.⁹¹ Whether § 104(a)(2) results in the right answer depends on how the personal injury damages are computed. His suggestion of a variable approach to federal taxation depending on how states have decided to compute tort recoveries is grounded in tax logic and sensitivity to notions of federalism. Nevertheless, his legislative proposal for variable federal tax results is unlikely to be adopted by Congress; neither is the repeal of § 104(a)(2) likely to occur in the near future. In the meantime, § 104(a)(2) remains in the Code and pro-

86. Overcompensation of plaintiffs would result if the personal injury damages received by the plaintiff were computed on a before-tax basis (no reduction for the tax liability for lost future wages, for example) and if the damages were nontaxable under § 104(a)(2).

87. Undercompensation would result if the lost future wages were computed on an after-tax basis and if the amounts received by the plaintiff were taxable due to the repeal or inapplicability of § 104(a)(2).

88. Professor Dodge offers the following statutory language with respect to lost earning capacity and lost earnings to replace § 104(a):

(a) In General-. . . [G]ross income shall not include, under regulations prescribed by the Secretary, such amounts received as damages (whether by suit or agreement and whether as lump sums or periodic payments), . . . on account of personal injuries or sickness as are necessary to restore the injured or sick person, with respect to lost earning capacity and lost earnings, to the same economic position as would have occurred had the personal injury not occurred, but in the case of any lump-sum recovery only to the extent that it be invested in an annuity that provides level (or increasing) payments for a period which is to end no earlier than the earlier to occur of (i) 20 years, (ii) the attainment by the injured party of age 70, or (iii) the death of the injured party.

Dodge, *supra* note 44, at 166. The regulations referenced in the statute would incorporate the results outlined *supra* in the text accompanying notes 78-84.

89. *Id.* at 188.

90. *Id.* at 180-88.

91. *See id.* at 188.

duces correct results only when lost earnings are computed on an after-tax basis.

Professor Dodge's analysis provides a useful framework for understanding the proper taxation of lost earnings under federal employment discrimination statutes.⁹² If employment discrimination results in a loss of human capital, and thus constitutes a "personal" injury, excluding employment discrimination recoveries from gross income may be appropriate, depending on how that loss is compensated under the statutory relief provisions. Section 104(a)(2) may be applied with more uniformity in the employment discrimination context than would be possible under Dodge's approach for state tort recoveries. Congress has imposed its will in the area of civil rights by providing federal causes of action and federal remedies for their violation, and thus, federalism considerations do not constrain the application of a uniform tax rule and method of computing damages in federal civil rights cases.⁹³ Given the possibility of more uniformity in this context, the alternative approach suggested in Part IV of this Article may be implemented without the repeal or amendment of § 104(a)(2). Although the alternative approach comports with Dodge's conclusions regarding lost earnings and punitive damages, it parts company with him on the taxation of damages for pain and suffering.⁹⁴

92. Professor Dodge does not discuss issues raised by employment discrimination cases in any detail, but does comment that "[e]mployment discrimination and civil rights deprivation cases are apparently more complex, because it is often difficult to determine whether the plaintiff has really lost human capital." *Id.* at 179 (discussing what is a "personal injury" under the current § 104). His uncertainty is based on the unexplained observation that the plaintiff in such cases "can recover for lost past and future wages even if she ends up with a higher-paying job." *Id.* However, back pay recoveries are significantly more restricted under various federal antidiscrimination statutes than Professor Dodge's statement might suggest. *See infra* note 117.

The question of whether employment discrimination results in injury to human capital may be easier to answer than the question of how the recoveries permitted by federal civil rights statutes redress such loss. Federal civil rights laws were enacted to accomplish systemic change as well as to afford private compensation for discrimination. This Article attempts to explore some of the complexities of applying a human capital approach to employment discrimination recoveries and benefits from Professor Dodge's application of such an approach to state tort recoveries.

93. Uniform federal application could result from judicial decisions adopting the approach suggested here. State law employment discrimination recoveries may raise issues similar to those of state tort recoveries in considering how the federal tax rule should be applied in light of states' potentially varying conclusions as to the "correct" approach to damage computation. Those issues are beyond the scope of this Article, however, which focuses on the taxation of recoveries under federal employment discrimination laws.

94. *See infra* notes 305-37 and accompanying text. As discussed more completely in Part IV of the Article, the taxation of employment discrimination recoveries should be consistent with the taxation of personal injury awards. Employment discrimination pain and suffering awards should therefore be excluded from gross income, unless § 104(a)(2) is amended or repealed. *See infra* notes 330-34 and accompanying text.

C. *Theoretical and Pragmatic Issues Concerning Employment Discrimination Recoveries*

As applied to employment-related civil rights awards and settlements, the § 104(a)(2) exclusion for damages “on account of personal injuries” requires a determination of whether recoveries measured by lost past or future wages and, in some cases, damages for medical expenses, emotional distress, or punitive damages, qualify for the exclusion. Much of the controversy surrounding the recent cases centers on whether recoveries such as back pay ought to be excluded from gross income when wages received by the same person would not be excluded. Exclusion of back pay awards appears to treat similarly situated persons (wage earners) differently for tax purposes, and thus is criticized as contrary to tax policy.⁹⁵

Whether the § 104(a)(2) exclusion ought also to apply to employment discrimination recoveries requires closer examination of the economic and noneconomic injuries suffered by victims of employment discrimination. Does employment discrimination result in loss of human capital, which by its very nature constitutes a “personal” injury?⁹⁶ Are back pay or front pay awards an attempt to compensate for any such injury to human capital? If so, depending on how the awards are calculated, they may be appropriately excluded from income under § 104(a)(2).⁹⁷ Instead, are back pay or front pay awards merely a remedy of specific relief for wages withheld? If so, they arguably do not compensate for human capital loss and ought to be taxed as ordinary wages. Answers to these questions may be suggested by considering the effect of employment discrimination on human capital accumulation and the approaches adopted by federal employment discrimination statutes to remedy any such effects. This Article concludes that employment discrimination results in loss of human capital for the victims of discrimination and that statutory remedies provide limited compensation for such loss.

95. See *supra* notes 58, 68. However, as discussed *supra* in notes 70-90 and accompanying text, the § 104(a)(2) exclusion can be rationalized as a means of allowing those who involuntarily have been injured in some aspect of their wage-earning capacity to be compensated without being taxed on the monetary recovery for that loss. The recovery replaces human capital, which would produce earnings in the form of wages. If the recovery is taxed like human capital rather than investment capital, any wages generated by the nontaxable increased human capital would be taxed. Thus, a nontaxable recovery based upon a putative wage stream should be calculated on the basis of an after-tax wage stream. Otherwise, the recovery, or some portion of it, should be includable in income.

96. See *supra* text accompanying note 43.

97. See *infra* notes 305-29 and accompanying text.

1. The Effect of Employment Discrimination on Human Capital Accumulation

Employment opportunities affect the accumulation of human capital.⁹⁸ Economists have explored the effect of inequality of employment opportunity on earnings and investment and have observed that race or sex discrimination results in reduced earnings and reduced human capital investment.⁹⁹ No consensus exists among economists and legal theorists, however, regarding the relationship of such effects, their causes, or their amelioration. Economic models of race and sex discrimination have been applied and criticized in the ongoing legal debate concerning the efficacy and efficiency of federal employment discrimination statutes such as Title VII.¹⁰⁰ The legal debate has focused on whether the antidiscrimination laws effectively address discrimination in employment and how best to evaluate their effectiveness.¹⁰¹

98. See *supra* note 3.

99. See, e.g., GARY S. BECKER, *THE ECONOMICS OF DISCRIMINATION* 31-46 (2d ed. 1971); BECKER, *supra* note 3, at 123-30; LESTER THUROW, *INVESTMENT IN HUMAN CAPITAL* 38-43 (1970) (discussing the lowering effect of race discrimination on the price of human capital); Theodore W. Schultz, *Investment in Human Capital*, 51 *AM. ECON. REV.* 1, 3-4 (1961); see also JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* bk. II, ch. XIV, §§ 5-6, at 400-03 (W.J. Ashley ed., A.M. Kelly 1965) (1909).

100. See, e.g., RICHARD A. EPSTEIN, *FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS* 145-266 (1992) (applying models of statistical discrimination and individual preferences and arguing that competitive markets with free entry offer better and more certain protection against discrimination than antidiscrimination laws); Mary E. Becker, *Needed in the Nineties: Improved Individual and Structural Remedies for Racial and Sexual Disadvantages in Employment*, 79 *GEO. L.J.* 1659, 1663-74 (1991) (criticizing economic models of discrimination for their assumptions of rationality and exogenous preferences, their failure to recognize the desire to subordinate, and their expectation that markets will eliminate discriminatory desires); John J. Donohue III & James J. Heckman, *Re-evaluating Federal Civil Rights Policy*, 79 *GEO. L.J.* 1713 *passim* (1991) (criticizing Gary Becker's model of discrimination as based on individualistic preferences and suggesting a model based on systematic social beliefs and coercive social norms); Richard H. McAdams, *The Law and Economics of Racial Discrimination: Relative Preferences*, 102 *YALE L.J.* 1, 91-103 (1992) (criticizing Gary Becker's descriptive model of race discrimination—based on a taste for nonassociation—as inconsistent with his later-developed household production theory, with its reduced emphasis on “tastes” in interpreting behavior; suggesting instead a status competition model for evaluating the efficiency of antidiscrimination laws); David A. Strauss, *The Law and Economics of Racial Discrimination in Employment: The Case for Numerical Standards*, 79 *GEO. L.J.* 1619 *passim* (1991) (outlining legal and economic models of discrimination and suggesting that the principal focus of employment discrimination law should be to induce employers to hire minorities in numbers roughly proportionate to their representation in the relevant population).

101. See, e.g., John J. Donohue III, *Prohibiting Sex Discrimination in the Workplace: An Economic Perspective*, 56 *U. CH. L. REV.* 1337, 1367-68 (1989); John J. Donohue III, *Further Thoughts on Employment Discrimination Legislation: A Reply to Judge Posner*, 136 *U. PA. L. REV.* 523, 538-40 (1987); John J. Donohue III, *Is Title VII Efficient?*, 134 *U. PA. L. REV.* 1411 *passim* (1986); Richard A. Posner, *An Economic Analysis of Sex Discrimination Laws*, 56 *U. CH. L. REV.* 1311, 1325-34 (1989); Richard A. Posner, *The Efficiency and Efficacy of Title VII*, 136 *U. PA. L. REV.* 513, 516-21 (1987).

Without relying on any particular conclusion as to the theoretical relationship between employment opportunities, discrimination, earnings, and human capital investment, we can view federal antidiscrimination statutes as recognizing a practical relationship between discrimination and reduced opportunity (or loss in human capital) for members of certain groups. Federal civil rights laws mandate an egalitarian approach toward workplace opportunities and benefits; that is, employers cannot lawfully discriminate in their employment decisions based on certain invidious classifications such as race, sex, religion, or national origin, and sometimes, age or disability.¹⁰²

If any of the antidiscrimination prohibitions are violated, the statutes permit various types of remedial relief.¹⁰³ For purposes of analyzing the tax implications of such recoveries, the form and content of employment discrimination statutes as enacted by Congress must be our starting point.

2. The Changing Nature of Discrimination Claims: The Political Response

The tax issues raised by employment discrimination recoveries surfaced during a period of intensive reexamination of federal civil rights statutes. Political activity focused on proposals leading to the Civil Rights Act of 1991.¹⁰⁴ The legislation was proposed in response to a series of Supreme Court decisions that significantly limited prior judicial interpretations of the statutes' reach.¹⁰⁵ It was passed by Congress and signed into law shortly

102. See *supra* notes 2, 19; see also *infra* notes 104, 174-75, 182, 197.

103. This Article does not attempt to address whether the combination of a public law and private law remedial scheme as it currently exists (with increasing emphasis on private individual enforcement), and as it existed prior to the recent statutory amendments to employment-related civil rights statutes, reflects the proper approach to civil rights enforcement.

104. The Civil Rights Act of 1990, vetoed by President Bush after passing both houses of Congress, was reintroduced early in 1991. H.R. 1, 102d Cong., 1st Sess. (1991).

During this period Congress also passed, and President Bush signed, the Americans With Disabilities Act (ADA), which prohibits discrimination against employees with disabilities. Pub. L. No. 101-336, 104 Stat. 327-378 (1990) (codified at scattered sections of 42 U.S.C.A.) Perhaps in part due to the phase-in of the effective date of the Act (July 26, 1992, for employers with 25 or more employees, and July 26, 1994, for employers with 15 or more employees), there have been no reported cases involving the tax treatment of ADA recoveries. Because the enforcement and remedial provisions of the ADA employment prohibitions track those of Title VII, 42 U.S.C. § 12117(a) (Supp. III 1991), the tax treatment of ADA recoveries may simply track the tax treatment of Title VII recoveries. See H.R. REP. NO. 485 (II), 101st Cong. 2d Sess., 23 (1990), reprinted in 1990 U.S.C.C.A.N. 303, 304; see also *infra* discussion of the post-Burke ADA issues in text accompanying notes 265-85.

105. The proposed legislation was aimed at overturning several 1989 Supreme Court decisions and extending the scope of protections and remedies for employment discrimination. See H.R. REP. NO. 40(I), 102d Cong. 1st Sess., at 14-15 (1991); H.R. REP. NO. 40(II), 102d Cong. 1st Sess., 2-4 (1991); see also *Patterson v. McLean Credit Union*, 491 U.S. 164, 164-71 (1989) (limiting 42 U.S.C. § 1981 to formation and enforcement of contracts, and holding that it cannot be used to

after the bitter Senate confirmation hearings on the nomination of Justice Clarence Thomas to the United States Supreme Court.¹⁰⁶ The legislative proposals ignited discussion concerning the nation's civil rights policy and raised issues about the statutes' coverage and remedial structure, particularly that of Title VII of the Civil Rights Act of 1964, as amended.

The legislative debate occurred in the context of a gradual change in the form and content of employment discrimination claims. Employment discrimination litigation formerly emphasized a public law model of systemic class action suits calling for affirmative injunctive relief and aggregated class monetary awards. During the last decade, the litigation was measurably transformed into a more private-law norm of individual disputes between employers and employees, which frequently involved claims of discriminatory discharge.¹⁰⁷

This change in employment discrimination law troubled many civil rights advocates, not only because of the difficulty of institutionalizing sweeping changes through the vehicle of many separate individual enforcement actions but also because of the inadequate remedies available for victims of such individualized discrimination.¹⁰⁸ The traditional statutory remedies for individual claims, reinstatement and back pay, were sharply

challenge conditions of employment such as racial harassment); *Lorance v. AT&T Technologies*, 490 U.S. 900, 906-13 (1989) (holding that the statute of limitations on discriminatory seniority plan begins to run at the time the plan is instituted, not at the time concrete harm occurs); *Martin v. Wilks*, 490 U.S. 755, 761 (1989) (holding that white firefighters could bring suit to challenge an affirmative action plan although they had failed to intervene during court proceedings authorizing the plan); *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642, 655-60 (1989) (holding that the burden of proving a violation of Title VII under the disparate impact theory remains with the plaintiff, and the employer can prevail if there is merely a reasoned basis, not necessarily a business necessity, for the challenged practice); *Price Waterhouse v. Hopkins*, 490 U.S. 228, 258 (1989) (holding that an employment decision motivated in part by prejudice does not violate Title VII if the employer can show it would have taken the same action in the absence of any prejudicial motives). In addition, several other decisions involving procedural issues, expert witness fees, and attorneys fees were overruled or clarified. See H.R. REP. No. 40(II), 102d Cong. 1st Sess., at 3-4 (1991).

106. The Civil Rights Act of 1991 was signed into law on November 21, 1991. See Statement on Signing the Civil Rights Act of 1991, 27 WEEK. COMP. PRES. DOC. 1701 (November 21, 1991). See generally, e.g., Symposium, *Gender, Race and the Politics of Supreme Court Appointments: The Import of the Anita Hill/Clarence Thomas Hearings*, 65 S. CAL. L. REV. 1279 (1992) (discussing the effects of the hearings).

107. See, e.g., John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 STAN. L. REV. 983, 1019-28 (1991); Minna J. Kotkin, *Public Remedies for Private Wrongs: Rethinking the Title VII Back Pay Remedy*, 41 HAST. L. J. 1301, 1338-47 (1990). See generally Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1288-1304 (1976) (discussing how certain federal litigation requires courts to manage more complex situations).

108. For a discussion of this aspect of civil rights policy, see Constance B. Motley, *The Supreme Court, Civil Rights Litigation, and Debra Vu*, 76 CORNELL L. REV. 643, 646-55 (1991); Symposium, *Civil Rights Legislation in the 1990s*, 79 CAL. L. REV. 591 *passim* (1991).

criticized as insufficient incentive for victims of discrimination to litigate their claims or for employers to evaluate their subjective decisionmaking for signs of bias.¹⁰⁹ The shift to a more private-law model of employment discrimination litigation also accentuated the limitations of the statute's public-law remedial scheme as applied to individual actions. This led civil rights advocates to push for the enactment of provisions permitting compensatory and punitive damages under Title VII.¹¹⁰

3. Title VII Back Pay and Front Pay Awards: Compensation for Economic Losses Rather Than Specific Relief for Wages Withheld

The Supreme Court has long emphasized that monetary recoveries under Title VII serve a dual function: to eradicate discriminatory practices throughout the economy and to "make whole" the victims of discrimination.¹¹¹ Although back pay¹¹² has been categorized as a form of equitable relief, this classification constitutes something of a departure from traditional notions of equity.¹¹³ Traditionally, equitable restitution "restores" to the plaintiff either the property wrongfully withheld or the gains resulting from the withholding and focuses on the "unjust enrichment" of the defendant.¹¹⁴ Restitution typically depends on the defendant's good faith and the degree of hardship imposed by the specific relief ordered.¹¹⁵

In contrast, back pay focuses on compensating the economic losses to the plaintiff rather than requiring the defendant to disgorge unjust gains. It

109. *E.g.*, Kotkin, *supra* note 107, at 1378 (arguing that additional remedies should be developed to buttress Title VII's private enforcement scheme).

110. As discussed in greater detail *infra* at notes 138-43, the legislation amended Title VII to allow employment discrimination victims to recover compensatory and punitive damages from their employers under certain circumstances. 42 U.S.C. § 1981a(a)(1) (Supp. III 1991). In addition, it amended the Civil Rights Act of 1866, 42 U.S.C. § 1981, to provide that the right to make and enforce contracts would include "the making, performance, modification, and termination of contracts, and the enjoyment of all benefits, privileges, terms, and conditions of the contractual relationship." *Id.* § 1981(b).

111. *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 421 (1975). In this case, the Court addressed the intent and scope of Title VII monetary relief provisions, observing that "back pay should be denied only for reasons which, if applied generally, would not frustrate the central statutory purposes of eradicating discrimination throughout the economy and making persons whole for injuries suffered through past discrimination." *Id.*

112. Back pay is authorized under the remedial provision of Title VII, which permits the court to enjoin unlawful employment practices and to "order such affirmative action as may be appropriate, which may include, but is not limited to, reinstatement or hiring of employees, with or without back pay . . . or any other equitable relief as the court deems appropriate." 42 U.S.C. § 2000e-5(g)(1) (1988).

113. Kotkin, *supra* note 107, at 1370-77. Although the lower courts have held back pay to be equitable in nature and thus have held that Title VII plaintiffs are not entitled to a jury trial, the Supreme Court has never expressly ruled that jury trials are unavailable under the pre-amended version of Title VII. *See infra* note 238 and accompanying text.

114. Kotkin, *supra* note 107, at 1372.

115. *See Dobbs, supra* note 9, at 222-26.

is available regardless of the amount of defendant's gain, if any, or the existence of defendant's good faith.¹¹⁶ In essence, back pay compensates for the lost opportunity to earn higher wages, either as an applicant for employment, a candidate for promotion, or as a discharged employee. It is available regardless of the existence of an actual employment relationship between the plaintiff and defendant, such as in discriminatory failure-to-hire cases. The amount of back pay awarded is reduced by any amount the victim earned or could have earned in another job.¹¹⁷ All of these characteristics of a back pay award suggest that it is more compensatory in nature than specific relief for wages withheld from a wronged employee.¹¹⁸ Back pay is thus conceptually closer to compensatory legal relief than to equitable restitution, and its categorization as an equitable remedy has been criticized as "quasi-fictional."¹¹⁹

Front pay also is available under Title VII, in circumstances in which reinstatement or reinstatement of the plaintiff would not be feasible and the plaintiff has not found comparable work.¹²⁰ It requires an estimate of fu-

116. *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 422-23 (1975).

117. The back pay award is reduced by "[i]nterim earnings or amounts earnable with reasonable diligence by the person or persons discriminated against." 42 U.S.C. § 2000e-5(g)(1) (Supp. III 1991). The back pay period thus terminates when the plaintiff obtains a comparable or better paying position. *Id.* It may also be terminated if the plaintiff fails to look for alternative employment or fails to make reasonable attempts to mitigate her loss. *See, e.g.*, BARBARA LINDEMANN SCHLEI & PAUL GROSSMAN, *EMPLOYMENT DISCRIMINATION LAW* 1432-34 (2d ed. 1983) & *FIVE-YEAR CUMULATIVE SUPPLEMENT* 531 (David A. Cathcart & R. Lawrence Ashe, Jr. eds., 2d ed. 1989). In addition, back pay does "not accrue from a date more than two years prior to the filing of a charge" with the Equal Employment Opportunity Commission (EEOC). 42 U.S.C. § 2000e-5(g)(1).

118. For a post-*Burke* discussion of back pay as compensatory rather than as specific relief for wages withheld, see *Hubbard v. Administrator, Env'tl. Protection Agency*, 982 F.2d 531, 539 (D.C. Cir. 1992) (en banc) (holding that the waiver of sovereign immunity under 5 U.S.C. § 702 for "relief other than money damages" does not encompass back pay ordered along with reinstatement in suit against EPA for failure to hire in violation of First Amendment rights). As discussed in the concurring opinion in *Hubbard*, the "suffered loss . . . is not wages, but the chance to earn them," and "[b]ack pay makes up for that lost opportunity." *Id.* at 539 (Randolph, J., concurring). *See also* DOBBS, *supra* note 9, at 69 n.18, 135-38, 528-34, 924-27 (viewing back pay as a type of compensatory relief akin to damages); *cf.* *Mertens v. Hewitt Assocs.*, 113 S. Ct. 2063, 2068 (1993) (referring to *Burke* as interpreting the terms "any other equitable relief" in Title VII's remedial provision as precluding awards for compensatory or punitive damages). *But see* Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 *TAX LAW* 755, 770-71 (1993) (suggesting that when the discrimination results in underpayment of wages, back pay is based upon quasi-contract or implied-in-law contract under which the employee in effect is seeking restitution, but acknowledging that the restitution theory does not work well when no wages have been earned by the victim of discrimination).

119. Kotkin, *supra* note 107, at 1373.

120. Front pay rather than reinstatement or reinstatement may be ordered where the court finds it unlikely that the parties will be able to reestablish an effective employment relationship or if an innocent incumbent would have to be displaced. *See, e.g.*, SCHLEI & GROSSMAN, *supra* note 117, at 1398 & *FIVE-YEAR CUMULATIVE SUPPLEMENT*, *supra* note 117, at 516-17 (collecting cases).

ture lost earnings. Although front pay is not specifically authorized by Title VII, courts have granted it under the "make whole" approach to monetary recoveries of Title VII.¹²¹ Front pay represents a less restrictive approach to monetary relief under Title VII than does back pay.¹²² It attempts to compensate for the denial of employment opportunities when prospective relief is unavailable or would be significantly delayed.

Both front pay and back pay are essentially a limited way of compensating for the loss in human capital resulting from employment discrimination.¹²³ The limits of pre-amendment Title VII monetary awards and a more detailed description of the 1991 amendments are illustrated by the following example. Readers familiar with Title VII claims and remedies may wish to skip to Part III.

4. Example: Title VII's Remedial Scheme and Its Impact on Human Capital Loss Resulting from Discrimination

Consider Jane, who wishes to become an airplane mechanic. She graduates from vocational school and enters the job market. She applies for a job with an airline but is not hired because of her failure to satisfy some facially neutral employment requirement or test, such as a height or weight-lifting requirement imposed by the airline.¹²⁴ Disappointed, but in

121. SCHLEI & GROSSMAN, *supra* note 117, at 1434-36.

122. Kotkin, *supra* note 107, at 1377.

123. Back pay received under the Americans With Disabilities Act (ADA) should be analyzed in the same way. See *supra* note 104. Back pay received under the Age Discrimination in Employment Act (ADEA) and the Equal Pay Act may also be viewed as compensation for the loss of human capital resulting from employment discrimination. The analysis is somewhat different, however. There is no need to reach the question of whether back pay constitutes equitable restitution for specific wages earned but withheld from the employee by the employer because ADEA and Equal Pay Act awards have been treated as legal damages. See generally *Lorillard v. Pons*, 434 U.S. 575, 583 (1978) (interpreting 29 U.S.C. § 626(b) and holding that trial by jury is available in private actions under ADEA). Nevertheless, it is especially difficult to distinguish between wages withheld and the lost opportunity to earn higher wages in the Equal Pay Act context because the violation being remedied is wage discrimination. That is also why the facts in *Burke*, involving Title VII sex-based wage discrimination, see *infra* text accompanying note 225, presented the most difficult factual setting. Unlike a contract or implied-in-contract type claim, however, the employee has no right to the higher nondiscriminatory wage apart from the rights established by statute. Thus, the employer is not restoring wages "due" the employee. Instead, the employee is being compensated for economic losses suffered as a result of the discrimination, the measure of loss being the difference between the higher wages paid male employees and those paid female employees performing substantially equal work. See *infra* notes 197, 208.

124. If the airline instead had an explicit policy against hiring women, Jane would prevail against her employer in a per se disparate treatment case unless the airline could establish that sex is a bona fide occupational qualification (BFOQ) reasonably necessary to the normal operation of that particular business. 42 U.S.C. § 2000e-2(e)(1) (1988). The BFOQ defense has been construed narrowly and cannot be based upon "stereotyped characterizations." *Dothard v. Rawlinson*, 433 U.S. 321, 333 (1977); see also, e.g., *Diaz v. Pan Am. World Airways, Inc.*, 442 F.2d 385, 387 (5th Cir.) (holding that employer's requirement that flight attendants be female was not a valid

need of income, she takes a job as a fast-food clerk while continuing to search for a job as a mechanic. Another disappointed applicant brings a Title VII disparate impact class action suit against the airline for unlawful sex discrimination; Jane is a member of the certified class. The class wins by showing that the airline's hiring policies have a disparate impact on women; the airline is unable to demonstrate the job-relatedness or business necessity of its policies.¹²⁵ The court orders the airline to revise its hiring policies and to implement an affirmative action plan that sets goals and timetables for hiring. The court also awards back pay to the class. Jane receives a portion of the back pay award (perhaps after receiving notice and an opportunity to prove her claim before a special master) measured by the difference between what she would have made as an entry-level mechanic and the amount she actually made as a fast-food clerk for the period between the time she applied for the job and the time she was eventually hired

BFOQ when the essence of the airline's business—providing safe transportation—would not be undermined by hiring male flight attendants), *cert. denied*, 404 U.S. 950 (1971); *Weeks v. Southern Bell Tel. & Tel. Co.*, 408 F.2d 228, 235-36 (5th Cir. 1969) (holding that there must be a factual basis for believing that all, or substantially all, persons in the excluded class could not perform the essential job duties and thus concluding that the BFOQ defense did not apply when the company had precluded women from holding jobs that required lifting more than 30 pounds).

Alternatively, if the airline had neither an explicitly stated policy against hiring women nor a neutral policy with a disparate impact, but instead had an unstated bias against hiring women as mechanics, Jane could bring an individual disparate treatment claim. Jane would have the burden of proving intentional discrimination by the airline. *United States Postal Serv. Bd. of Governors v. Aikens*, 460 U.S. 711, 715 (1983). If she had no direct evidence of such intent to discriminate, she could present a *prima facie* case based upon circumstantial evidence. *Id.* However, the employer could defend by articulating a legitimate nondiscriminatory reason for its action, and thus prevail, unless Jane could establish that the articulated reason was a pretext for discrimination. *See Texas Dep't of Community Affairs v. Burdine*, 450 U.S. 248, 254-56 (1981); *McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 802-04 (1973). *But cf. St. Mary's Honor Center v. Hicks*, 113 S. Ct. 2742, 2749 (holding that "the Title VII plaintiff at all times 'bears the ultimate burden of persuasion'")

125. The Civil Rights Act of 1991 legislatively overruled *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642 (1989), and reestablished much of pre-1989 law concerning disparate impact discrimination. Section 105(a) of the Act adds new § 703(k)(1)(A) to Title VII, 42 U.S.C. § 2000e-2(k)(1)(A) (Supp. III 1991), which states:

An unlawful employment practice based on disparate impact is established under this subchapter only if—

- (i) a complaining party demonstrates that a respondent uses a particular employment practice that causes a disparate impact on the basis of race, color, religion, sex, or national origin and the respondent fails to demonstrate that the challenged practice is job related for the position in question and consistent with business necessity. . . .

The terms "job related" and "business necessity" are to be interpreted by reference to pre-*Wards Cove* Supreme Court decisions such as *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). See interpretive memorandum, 137 CONG. REC. S15276 (daily ed. Oct. 25, 1991), which was expressly incorporated as legislative history on this issue. 42 U.S.C. § 1981 (Supp. III 1991) (note on Legislative History).

as an airplane mechanic.¹²⁶ If Jane and others like her cannot be hired because there are no openings or because laid-off workers stand in line in front of them, the court may order front pay for the class.¹²⁷ Jane and other class members would not be eligible for compensatory or punitive damages under the 1991 amendments because such remedies are not available for disparate impact claims.¹²⁸

If Jane is denied the opportunity to develop her skills as a mechanic through on-the-job training and experience, she will experience a loss in the human capital she otherwise would have accumulated. The remedies available under Title VII stem the loss but do not provide complete relief. Affirmative injunctive relief is provided; the airline is ordered to change its policies, and perhaps Jane and others like her will be hired. The order may also require the airline to give reapplicants retroactive seniority and benefit credits.¹²⁹ The back pay award received by Jane and other claimants may make up for the wage differential they suffered in the meantime. Nevertheless, Jane can never reclaim her lost time in her craft, which may permanently affect her job prospects, as compared to her male counterpart who graduated from vocational school at the same time and who has been on the job since then.¹³⁰ The implementation of an affirmative action plan and the deterrent effect of an aggregated back pay award may, however, affect the prospective human capital accumulation of past and future female applicants in an across-the-board fashion.

In contrast to class-based cases, individual disparate treatment cases provide a much more limited means of eliminating employment discrimination. These cases focus on individual private relief. For example, if Jane later is discriminatorily discharged from her job, she could assert an individual claim of disparate treatment under Title VII. To prevail on her claim, she would be required to prove that, when it terminated her employment, the airline intentionally discriminated against her based upon her sex.¹³¹ Unless she were in the unusual position of having direct evidence of

126. See *supra* note 117.

127. See *supra* note 120. Awards of front pay raise difficult computational issues, particularly in the context of an aggregate class award. See *infra* note 326 and accompanying text.

128. 42 U.S.C. § 1981a(a)(1) (Supp. III 1991).

129. In *Ford Motor Co. v. EEOC*, 458 U.S. 219, 241 (1982), the Court held that "absent special circumstances," the rejection of an employer's unqualified job offer, supplemented by the right to continue to pursue full court-ordered compensation, terminates the back pay period even though the offer does not include either retroactive seniority or accrued back pay.

130. Jane's male counterpart, let's call him John, who began his working life as a mechanic rather than as a fast-food worker, may always remain a step ahead of Jane as a mechanic. Although it has been suggested that Title VII could support a monetary award for the loss of employment opportunity as a supplement to a back pay award, the courts have not recognized such a remedy. Kotkin, *supra* note 107, at 1377.

131. See *supra* note 124 for a discussion of individual disparate treatment cases.

discriminatory motive, she might have difficulty proving her case.¹³² In addition, if she succeeded, any effect on the airline would be limited to her individual case or to the more limited deterrent effect provided by the potential for separate individual enforcement actions.¹³³ If she were successful in proving her case, she could be reinstated with back pay. She might also be able to recover compensatory and punitive damages, provided that the 1991 amendments apply to her case.¹³⁴

Suppose instead that the following scenario occurs. As one of a handful of newly hired women coming on the job under the court-ordered affirmative action plan, Jane is constantly harassed on the job. Jane files a Title VII individual disparate treatment action against her employer. She asserts sexual harassment¹³⁵ by her supervisor and fellow employees so reg-

132. In mixed-motive cases, the Supreme Court held in 1989 that a plaintiff showing the presence of a prohibited factor such as gender could carry her burden of persuasion. *Price Waterhouse v. Hopkins*, 490 U.S. 228, 240 (1989). However, the employer could avoid liability by showing that the same decision would have been reached even if the illegitimate considerations had not been present. *Id.* at 242. The Civil Rights Act of 1991 modifies that approach. Section 703(m) provides that a Title VII violation is established "when the complaining party demonstrates that race, color, religion, sex, or national origin was a motivating factor for any employment practice, even though other factors also motivated the practice." 42 U.S.C. § 2000e-2(m) (Supp. III 1991). However, the employer may demonstrate that it "would have taken the same action in the absence of the impermissible motivating factor." *Id.* § 2000e-5(g)(2)(B). If the employer makes such a showing, the court may grant declaratory relief, some injunctive relief, and attorneys' fees and costs directly attributable to the § 703(m) claim. *Id.* The court may "not award damages or issue an order requiring any admission, reinstatement, hiring, promotion, or payment [of back pay]." *Id.*

133. It is possible to assert classwide disparate treatment. *See, e.g., International Bhd. of Teamsters v. United States*, 431 U.S. 334 (1977). In such a case, plaintiffs challenge an employer's pattern and practice of discriminatory treatment. A pattern and practice case may more likely involve a challenge to hiring rather than firing practices because of the statistical showing required in classwide disparate treatment cases. For example, in a hiring case, plaintiffs introduce statistical evidence of significant disparities between men and women in the employer's work force compared to the general labor force and other relevant labor pool data and couple this statistical showing with evidence of individual instances of discrimination. *See id.* at 334-40 n.20, 357-62. However, "[w]here gross statistical disparities can be shown, they alone may in a proper case constitute prima facie proof of a pattern or practice of discrimination." *Hazelwood Sch. Dist. v. United States*, 433 U.S. 299, 307-08 (1977). The focus at the prima facie case stage is not on individual employment decisions but on a pattern of discriminatory decisionmaking. To rebut a prima facie showing of classwide disparate treatment, the employer must demonstrate that the statistics used by the plaintiffs are either inaccurate or insignificant and provide a nondiscriminatory explanation for the apparently discriminatory result. *International Bhd. of Teamsters*, 431 U.S. at 360 n.46.

134. *See infra* note 139.

135. Sexual harassment constitutes a violation of Title VII if the employer bases employment benefits on a quid pro quo exchange of sexual favors, or if the harassment is "sufficiently severe or pervasive to 'alter the conditions of [the victim's] employment and create an abusive working environment.'" *Meritor Sav. Bank, FSB v. Vinson*, 477 U.S. 57, 66-67 (1986) (quoting *Henson v. Dundee*, 682 F.2d 897, 902 (11th Cir. 1982)). Liability may be established without economic losses resulting from the discrimination, and agency principles are considered in determining whether an employer is liable for the actions of the employee's supervisor. *Id.* at 72.

ular and severe that she suffers emotional distress and physical stress symptoms.¹³⁶ In addition, she claims that the hostile working environment has resulted in discriminatory job assignments; that is, she has been assigned to routine maintenance tasks rather than more challenging repair jobs given to male mechanics at her level of skill and experience. She decides to file a disparate treatment claim against her employer. Prior to filing suit, she leaves the airline for another job as a mechanic with a new employer at the same pay level.

Before the 1991 amendments to Title VII, even if she won her case (unless she prevailed under state statutory or tort law), she could recover no punitive damages, no compensatory damages to cover her medical expenses, and no damages for pain and suffering. She could claim the moral victory of a judgment against the airline for unlawful discrimination and possibly some back pay if there were a gap between her old and new job. If there were no gap in time or in pay, she would receive no monetary recovery.¹³⁷ Thus, she would have no compensation for the loss in human capital resulting from a stagnation in job skills or for the psychic or physical symptoms caused by the harassment.

Under the Civil Rights Act of 1991, she would be able to receive some monetary recovery,¹³⁸ provided that she could prove intentional discrimination.¹³⁹ Punitive damages are available (other than against a governmental

136. Jane must show that the harassment was "severe or pervasive enough to create an objectively hostile or abusive work environment—an environment that a reasonable person would find hostile or abusive." *Harris v. Forklift Systems, Inc.*, — U.S. —, 1993 WL 453611 (November 9, 1993). In addition, as long as she establishes that she subjectively perceived the environment to be abusive, she need not show that it was "psychologically injurious." *Id.*

137. If she were the prevailing party, she would be entitled to reasonable attorneys' fees. 42 U.S.C. § 2000e-5(k) (Supp. III 1991). *But see Swanson v. Elmhurst Chrysler Plymouth, Inc.*, 882 F.2d 1235, 1236-37 (7th Cir. 1989) (reversing district court's order of attorneys' fees and nominal damages of one dollar in pre-amendment Title VII case in which the district court found that there had been sexual harassment but that the harassment had not caused plaintiff's discharge), *cert. denied*, 493 U.S. 1036 (1990).

138. In addition, unlike claims brought under the pre-amended version of Title VII, which were tried before a judge, not a jury, she would have the right to a jury trial if she sought compensatory or punitive damages. *See* 42 U.S.C. § 1981a(c)(1) (Supp. III 1991).

139. Compensatory and punitive damages are limited to disparate treatment claims. They are expressly unavailable as remedies for claims of disparate impact. 42 U.S.C. § 1981a(a)(1). In addition, the claimant must not be eligible for recovery under 42 U.S.C. § 1981. *Id.* For the text of § 1981, *see infra* note 175. The Civil Rights Act of 1991 overruled the Supreme Court's decision in *Patterson v. McLean Credit Union*, 491 U.S. 164, 164-71 (1989), *see supra* note 105, by providing that § 1981 applies to the "making, performance, modification, and termination of contracts, and the enjoyment of all benefits, privileges, terms, and conditions of the contractual relationship." 42 U.S.C. § 1981(b). Prior to the Supreme Court's decision in *Patterson*, § 1981 had also been applied to prohibit racial discrimination (including racial harassment) on the job. *See, e.g., Nazaire v. Trans World Airlines*, 807 F.2d 1372, 1380 (7th Cir. 1986), *cert. denied*, 481 U.S. 1039 (1987) (citing racial harassment cases); *Goff v. Continental Oil Co.*, 678 F.2d 593, 597-99 (5th Cir. 1982) (holding a retaliation claim actionable under § 1981). The proviso in

defendant) if the defendant acted "with malice or with reckless indifference" to an individual's federally protected rights.¹⁴⁰ Compensatory damages awarded under the Act do not include back pay or interest on back pay or any other equitable relief authorized under the pre-amended version of Title VII.¹⁴¹ They include "future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses."¹⁴² The recoverable compensatory and punitive damages are limited, however, to a combined total of specified amounts ranging from \$50,000 to \$300,000, depending upon the number of the defendant's employees.¹⁴³

III. SECTION 104(a)(2) HISTORY AND LEGAL DEVELOPMENTS: ADOPTION OF THE "NATURE OF THE CLAIM" TEST AND ITS APPLICATION BY REFERENCE TO THE "TORT OR TORT-LIKE" STANDARD

Many of the issues the Supreme Court faced in *Burke* echo those considered by the courts and the government when the predecessor of § 104(a)(2) was adopted, shortly after Congress first enacted the personal income tax.¹⁴⁴ The legislative history provides little insight into the reasons for adoption of the exclusion and suggests that it was merely a clarification of existing law.¹⁴⁵ Although the then-existing law was based upon what is

amended Title VII, 42 U.S.C. § 1981a(a), that compensatory and punitive damages are available in cases of intentional discrimination only if the complaining party cannot recover under § 1981, prevents overlap of remedies for race discrimination (compensatory and punitive damages are available under § 1981).

140. 42 U.S.C. § 1981a(b)(1).

141. *Id.* § 1981a(b)(2). Back pay would be recoverable under another provision of Title VII, 42 U.S.C. § 2000e-5(g).

142. *Id.* § 1981a(b)(3).

143. The lowest cap of \$50,000 applies to employers of 15-100 employees. For employers with 101-200 employees, the cap is \$100,000. For employers with 201-500 employees, the cap is \$200,000. For employers with more than 500 employees, the cap is \$300,000. 42 U.S.C. § 1981a(b)(3) (Supp. III 1991). The statute provides that the court is not to inform the jury of such limitations. *Id.* § 1981a(c)(2).

144. The first modern income tax was adopted in 1913. Pub. L. No. 16, ch. 16, 38 Stat. 166 (1913). The predecessor of § 104(a)(2) was § 213(b)(6) of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1066 (1919), which provided that gross income does not include "[a]mounts received . . . as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness."

For a more complete description of the origins of § 104(a)(2) and the history of its administrative interpretations, see Paul C. Feinberg, *Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions*, 42 CASE W. RES. L. REV. 339, 356-69 (1992) and Burke & Friel, *supra* note 58, at 14-23.

145. H.R. REP. NO. 767, 65th Cong., 2d Sess. (1918), *reprinted in* 1939-1 C.B. (Part (2) 86, 92 ("Under the present law it is doubtful whether . . . damages received on account of . . . injuries or sickness . . . are required to be included in gross income."); *see also* H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4039 (discussing the treatment of injury payments under insured and noninsured employer benefit plans); S. REP. NO. 1622, 83d

now viewed as a flawed notion of "income," it nevertheless manifested a more sophisticated understanding of human capital than has generally been credited. That history is briefly set forth below, along with a description of the initial administrative interpretation of the exclusion as applied to recoveries for nonphysical injuries, and then, more specifically, to employment discrimination recoveries.

After describing the major legal developments of the last decade, including the judicial adoption of the "nature of the claim" test and its impact on cases applying the § 104(a)(2) exclusion to employment discrimination recoveries, Part III analyzes the Supreme Court's decision in *Burke*. The Part closes with a preview of post-*Burke* problems concerning application of the tort-like standard and the recommendation that the standard be discarded.

A. *Early Administrative Interpretations of the Exclusion for Personal Injury Damages*

Before enactment of the exclusion for personal injury damages, the law was subject to changing administrative interpretation. Just prior to enactment, the Treasury department concluded that an amount received for personal injuries sustained "through accident" was not taxable and revoked a prior regulation to the contrary.¹⁴⁶ Treasury based its change in position on a 1918 Attorney General's opinion which concluded that the proceeds of an accident insurance policy did not constitute "income" as defined by the Supreme Court.¹⁴⁷

The Attorney General's opinion has been described as based on the notion of the human body as a kind of capital, with recoveries for injuries

Cong., 2d Sess. (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4817 (discussing the committee's amendment to proposed § 104(a)(4) and the otherwise identical House and Senate versions of § 104).

146. T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918), reprinted in 20 Treas. Dec. Int. Rev. 127, 130 (1918) (revoking Treas. Reg. No. 33, Revised, Part I, Ruling 25 (1918)).

147. See 31 Op. Att'y Gen. 304, 308 (1918). At the time, the Supreme Court defined "income" as "the gain derived from capital, from labor, or from both combined." *Id.* at 306 (quoting *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913)); accord *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (defining income as "'gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets" (citations omitted)). The *Eisner* formulation was reconsidered and abandoned by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430-31 (1955), which held that punitive damages received in an antitrust action are includable in gross income. The Court in *Glenshaw Glass* adopted a more expansive view of income, as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 431.

viewed as a tax-free recovery of such capital.¹⁴⁸ The opinion explains the basis for its conclusion more precisely as follows:

Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of *future* periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore "capital" as distinguished from "income" receipts.¹⁴⁹

The Attorney General's analysis of accident insurance recoveries suggests that the insurance proceeds substitute for the "capital in human ability," which is the source of future income in the form of wages. This analysis constitutes an essential part of the policy justification for the personal injury exclusion discussed above, as applied to recoveries for lost future earnings.¹⁵⁰ It falls short of that justification, however, by failing to distinguish between the taxation of human capital and investment capital. In addition, at its inception, the administrative justification for the exclusion rested on the notion that personal injury recoveries were simply not "income," but instead constituted a recovery of capital.¹⁵¹

The income exclusion was for a short period administratively interpreted as applying only to damages received on account of physical inju-

148. See Burke & Friel, *supra* note 58, at 14 (quoting 31 Op. Att'y Gen. 304 (1918)) ("An Attorney General's opinion held that accident insurance proceeds were not taxable, based on the theory that the human body is a kind of capital and the insurance proceeds represented a conversion of the capital lost through the injury."); Stephan, *supra* note 3, at 1388 (citing T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918)) ("Characterization of the human body as a 'kind of capital,' albeit based more on analogies to physical goods than on any abstract notion of future income flows, thus led to exclusion of proceeds from the conversion of any part of this asset.").

149. 31 Op. Att'y Gen. at 308.

150. See *supra* text accompanying notes 71-93.

151. Later developments in the Supreme Court's view of "income," most notably in *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), see *supra* note 147, did not lead to a reevaluation of the tax administrators' view that personal injury damages did not constitute "income." The failure to revisit the issue may be explained in part by the Court's footnote in *Glenshaw Glass* distinguishing the taxation of punitive damages from the longstanding treatment of compensatory personal injury recoveries as a tax-free recovery of capital. 348 U.S. at 432 n.8. Instead of receiving a fresh look in light of the *Glenshaw Glass* Court's broader view of "income," the early authority merged with the administrative and judicial statutory interpretation of the § 104(a)(2) exclusion. See, e.g., Rev. Rul. 74-77, 1974-1 C.B. 33 (superseding Sol. Op. 132, I-1 C.B. 92 (1922) by restating its conclusion under current statute and regulations); BITTKER & LOKKEN, *supra* note 43, ¶¶ 5.6, 13.1.4. See generally Burke & Friel, *supra* note 58, at 21 ("It is curious that a line of authority based on a discredited theory of gross income which does not rely on or purport to interpret (and in most cases does not even acknowledge) an existing statutory exclusion should later be viewed as defining the scope of the statutory exclusion.").

ries.¹⁵² Tax administrators and the courts soon rejected that view, however, and held that damages for nonphysical injuries, such as alienation of affections or defamation of personal character, did not constitute income.¹⁵³ The Service later developed a different reason for denying application of the exclusion to certain "nonphysical" injuries, such as damage to reputation. That analysis turned on whether recoveries for such injuries were "personal" as opposed to "business" injuries. If a business receives compensation for loss of business profits, the recovery is taxable because the damages are received by the injured party "in lieu of" or as a substitute for the lost profits. This approach, long applied to damages received in the "commercial" setting,¹⁵⁴ was used by the Service in this more personal setting. For physical injuries, the Service applied essentially a per se approach, which assumed their nature as "personal" injuries. No such assumption was made for "nonphysical" injuries.

For example, for nonphysical torts such as libel or defamation, the Service distinguished between damages for injury to personal reputation and those for professional or business reputation. Under this approach, damages for an injury to the taxpayer's business or professional reputation are not treated as excludable damages on account of personal injuries.¹⁵⁵ Instead, such damages measured by lost income are treated as income substitutes, which are includable in gross income.

Applying the above analysis, the Service treated employment discrimination recoveries as gross income because they constituted replacement of lost business income rather than damages on account of personal injury.¹⁵⁶ The Tax Court ratified the Service's approach,¹⁵⁷ and until the mid-1980's,

152. S. 1384, 2 C.B. 71 (1920) (holding damages received on account of alienation of affections not within the exclusion); S. 957, 1 C.B. 65 (1919) (holding that damages received for libel are taxable).

153. *E.g.*, *Hawkins v. Commissioner*, 6 B.T.A. 1023 (1927), *acq.*, VII-1 C.B. 14 (1928) (relating to damages received for libel and slander); Sol. Op. 132, I-1 C.B. 92 (1922) (holding that damages received for alienation of affection are not income).

154. Similarly, if a business receives damages for loss of "good will," the recovery represents a return of capital, which may be nontaxable if the business can present evidence to establish the basis in its lost good will. *E.g.*, *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.) ("The test is not whether the action was one in tort or contract but rather the question to be asked is 'In lieu of what were the damages awarded?')", *cert. denied*, 323 U.S. 779 (1944).

155. Rev. Rul. 85-143, 1985-2 C.B. 55 (refusing to follow the Ninth Circuit's ruling in *Rocmer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982), and instead adopting the Tax Court's position that defamation damages to business reputation are includable in gross income).

156. *E.g.*, Rev. Rul. 72-341, 1972-2 C.B. 32 (holding recovery under Title VII of the Civil Rights Act of 1964 includable in gross income).

157. *Hodge v. Commissioner*, 64 T.C. 616, 619 (1975) (Title VII settlement).

employment discrimination back pay recoveries were generally viewed as includable in gross income.¹⁵⁸

B. Cases Setting the Stage: The "Nature of the Claim" Test

Several key federal appellate decisions, decided in the early 1980s, tested the nature of the claim for relief to determine the tax status of an award or settlement amount. Those decisions held that the § 104(a)(2) exclusion applies to damages awarded for "nonphysical" personal injuries such as libel and defamation,¹⁵⁹ malicious prosecution,¹⁶⁰ and constitutional torts.¹⁶¹ They rejected the Service's position that the exclusion encompasses damages in the nature of lost wages only when the claim involves "physical" (for example, loss of life or limb) or other "nonbusiness" damages (for example, damage to personal rather than to business reputation). Instead the courts increasingly looked to the nature of the claim for relief to determine the tax status of the award, rather than focusing on the specific type of damages recovered (amounts compensating for lost wages, medical expenses, or pain and suffering).

In determining whether the underlying claim for relief constituted a "personal injury" instead of injury to business interests, the courts, at times, turned to state tort law for guidance. For example, in *Roemer v. Commissioner*, the Ninth Circuit found that damages for an insurance agent's loss of income from a false credit report constituted excludable damages on account of a personal injury.¹⁶² The court relied in part on the fact that the plaintiff had filed a libel suit—a personal injury action under California law—rather than an action for disparagement or trade libel, which would remedy an attack on the quality of the plaintiff's products or services.¹⁶³ Having determined that the underlying claim involved injury to the person, the Ninth Circuit emphasized that the nature of the claim should not be confused with the derivative consequences, such as loss of reputation in the

158. See *infra* text accompanying notes 159-72 for a discussion of the changes occurring in the 1980s.

159. *Roemer v. Commissioner*, 716 F.2d 693, 700-01 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982).

160. *Threlkeld v. Commissioner*, 848 F.2d 81, 84 (6th Cir. 1988), *aff'g* 87 T.C. 1294 (1986) (adopting the Ninth Circuit's reasoning in *Roemer*).

161. *Wulf v. City of Wichita*, 883 F.2d 842, 873 (10th Cir. 1989) (holding nontaxable an award of back-pay damages in civil rights action for wrongful discharge in violation of First Amendment); *Bent v. Commissioner*, 835 F.2d 67, 70 (3d Cir. 1987) (addressing claim under 42 U.S.C. § 1983 for deprivation of First Amendment rights).

162. *Roemer*, 716 F.2d at 700.

163. *Id.* at 699; see also *Threlkeld*, 848 F.2d at 82 (noting that the Tax Court had concluded that an action for malicious prosecution is a personal injury action under Tennessee law); *infra* note 172.

community and any resulting income loss.¹⁶⁴ The court explained that the consequences of a personal injury, such as loss of future professional income, are often the most persuasive means of proving the extent of the injury. The court thus refused to distinguish between damage to personal reputation and damage to professional reputation for purposes of § 104(a)(2).¹⁶⁵

In another case rejecting the distinction between business and personal damages, *Threlkeld v. Commissioner*,¹⁶⁶ the Sixth Circuit excluded from gross income the settlement proceeds of a malicious prosecution suit in which a portion of the settlement had been allocated to injury to the taxpayer's professional reputation. The court affirmed the Tax Court's decision to abide by the Ninth Circuit's approach in *Roemer*.¹⁶⁷ The Tax Court applied a broad definition of a "personal injury," stating that "[e]xclusion under section 104 will be appropriate if compensatory damages are received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."¹⁶⁸

C. *Employment Discrimination Cases*

Utilizing this "nature of the claim" analysis, taxpayers receiving awards or settlements for various types of employment discrimination began to assert eligibility for exclusion under § 104(a)(2). They argued that a claim for discrimination in the workplace based on race, age, sex, religion or national origin was by its very nature an injury to the person. The Service rejected such claims, relying on its position that such recoveries constituted gross income as replacement of lost business income, not damages on account of personal injuries.¹⁶⁹ Although the Tax Court initially approved

164. *Roemer*, 716 F.2d at 699 ("The personal nature of an injury should not be defined by its effect.").

165. In Rev. Rul. 85-143, 1985-2 C.B. 55, the Service announced that it would not follow the Ninth Circuit's decision in *Roemer* in cases where the court's decision was not controlling.

166. 848 F.2d 81, 84 (6th Cir. 1988).

167. *Id.*

168. *Threlkeld v. Commissioner*, 87 T.C. 1294, 1308 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

169. *See supra* text accompanying note 156.

the Service's position,¹⁷⁰ taxpayers began to succeed with their § 104(a)(2) arguments in the courts of appeals.¹⁷¹

The analysis applied by the Tax Court and the various courts of appeals differed somewhat, depending on the particular statutory basis for the underlying discrimination claim. For the most part, employment discrimination claims were asserted under federal antidiscrimination statutes, eliminating the question of whether state or federal law controlled when deciding if such claims were for "personal injuries" within the meaning of § 104(a)(2).¹⁷²

1. Claims Under Sections 1981 and 1983

Settlements or awards for violation of the post-Civil War civil rights acts have been held excludable under § 104(a)(2).¹⁷³ The Civil Rights Act of 1871, codified at 42 U.S.C. § 1983, prohibits violation of constitutional or statutory rights under color of state law.¹⁷⁴ The Civil Rights Act of 1866, codified at 42 U.S.C. § 1981, prohibits racial discrimination in the making or enforcing of contracts.¹⁷⁵ Unlike § 1983, which requires a show-

170. See *supra* note 157; see also *Rickel v. Commissioner*, 92 T.C. 510, 522 (1989) (age discrimination recovery), *aff'd in part and rev'd in part*, 900 F.2d 655 (3d Cir. 1990). Other courts came to apparently conflicting conclusions with regard to this issue. Compare *Sweet v. General Tire & Rubber Co.*, 28 Empl. Prac. Dec. (CCH) ¶ 32,644 (N.D. Ohio 1982) (concluding that a Title VII settlement award was not includable in gross income) with *Sears v. The Atchison, Topeka & Santa Fe Ry.*, 31 Empl. Prac. Dec. (CCH) ¶ 33,388 (D. Kan. 1982) (finding Title VII settlement amounts subject to federal income tax, and therefore approving plaintiffs' tax component as part of the back pay formula to offset the adverse tax impact of receipt of the back pay awards in a single year).

171. See *infra* text accompanying notes 173-212.

172. See generally William A. Stahr, Comment, *What Effect Should State Law Have in Defining "Personal Injury" Damages for Purposes of I.R.C. Section 104(a)(2) Exclusion?*, 29 SAN DIEGO L. REV. 299, 332-33 (1992) (criticizing reliance on state tort law to define what is meant by "personal" injury for federal tax purposes).

173. E.g., *Wulf v. City of Wichita*, 883 F.2d 842, 873 (10th Cir. 1989) (awarding damages pursuant to 42 U.S.C. § 1983); *Bent v. Commissioner*, 835 F.2d 67, 70 (3d Cir. 1987) (addressing settlement under § 1983); *Metzger v. Commissioner*, 88 T.C. 834, 858 (1987) (§§ 1981, 1983, 1985(3), 1986, and Title VII), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988).

174. 42 U.S.C. § 1983 (1988) (originally enacted as § 1 of the Civil Rights Act of 1871, ch. 22, § 1, 17 Stat. 13, 13) (also known as the Ku Klux Klan Act). The text of § 1983 provides as follows:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

175. 42 U.S.C. § 1981 (Supp. III 1991) (originally enacted as § 1 of the Civil Rights Act of 1866, ch. 31, § 1, 14 Stat. 27, 27). The original Act was passed under the authority of the Thirteenth Amendment. After the ratification of the Fourteenth Amendment in 1868, however, the statute was reenacted as the Civil Rights Act of 1870 to remove any doubt of its constitutional

ing of state action, § 1981 affords a federal remedy against purely private acts of discrimination.¹⁷⁶ Successful claimants under §§ 1981 and 1983 are entitled to both equitable and legal relief, including compensatory and, in certain circumstances, punitive damages.¹⁷⁷ Relief may include amounts measured by lost wages, and such an award is not limited by the time period specified for back pay recovery under Title VII.¹⁷⁸

The tax issues focus on whether the § 1981 or § 1983 recoveries are received on account of "personal injuries" within the meaning of § 104(a)(2).¹⁷⁹ In the leading case, *Bent v. Commissioner*, the Tax Court relied on Supreme Court precedent, holding that § 1983 claims are analogous to personal injury suits for statute of limitations purposes.¹⁸⁰ *Bent* involved a teacher whose contract was not renewed following his public criticism of school programs. The teacher filed a § 1983 action for violation of his right of free speech. The Third Circuit, affirming the Tax Court's ruling in favor of the teacher, held that he was entitled to exclude from gross income settlement amounts received in lieu of damages for mental pain and suffering, emotional distress, and lost wages.¹⁸¹

2. Age Discrimination Claims

The Tax Court initially held that recoveries under the Age Discrimination in Employment Act ("ADEA") of 1967¹⁸² are partially excludable from

authority. See Civil Rights Act of 1870, ch. 114, §§ 16, 18, 16 Stat. 140, 144. The current version of § 1981(a) provides as follows:

All persons within the jurisdiction of the United States shall have the same right . . . to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and exactions of every kind, and to no other.

As discussed earlier, see *supra* note 139, § 1981 has been amended to clarify its application to race discrimination on the job as well as in hiring, and that such rights are protected against impairment by both private and state action. See 42 U.S.C. § 1981(b)-(c) (Supp. III 1991).

176. *Johnson v. Railway Express Agency, Inc.*, 421 U.S. 454, 459-60 (1975); see *supra* note 175.

177. *Johnson*, 421 U.S. at 460 (§ 1981). See generally *Carey v. Phipps*, 435 U.S. 247, 253-59 (1978) (discussing § 1983 damages).

178. *Johnson*, 421 U.S. at 460. An award of back pay under § 1981 instead is subject to the relevant state statute of limitations. See 2 CHARLES A. SULLIVAN ET AL., EMPLOYMENT DISCRIMINATION § 23.1.1 (2d ed. 1988). For a description of the limitations on back pay awards under Title VII, see *supra* note 117 (stating that back pay does not accrue from a date more than two years prior to the filing of an EEOC charge).

179. See *infra* note 265 for discussion of post-*Burke* application of the tort-like standard.

180. 87 T.C. 236, 247 (1986) (citing *Wilson v. Garcia*, 471 U.S. 261 (1985)), *aff'd*, 835 F.2d 67 (3d Cir. 1987). A similar analysis would be applicable to § 1981 claims. See *Metzger v. Commissioner*, 88 T.C. 834, 852-56 (1987).

181. *Bent v. Commissioner*, 835 F.2d 67, 70 (3d Cir. 1987).

182. Pub. L. No. 90-202, 81 Stat. 602 (codified as amended at 29 U.S.C. §§ 621-634 (1988)). The ADEA is closely modeled on Title VII with regard to its substantive provisions and enforce-

income.¹⁸³ Later it held that such awards are fully excludable, however, after appellate courts rejected the distinction between ADEA liquidated and nonliquidated damages for purposes of § 104(a)(2).¹⁸⁴

In *Rickel v. Commissioner*,¹⁸⁵ for example, the Service argued that the ADEA action was in the nature of an action for breach of an employment contract, rather than a tort action. In the Tax Court's view, ADEA actions had elements of each.¹⁸⁶ It concluded that, although ADEA liquidated damages are intended as compensation for a tort or tort-like injury, ADEA back pay awards are in the nature of a breach of contract recovery and thus are includable in income.¹⁸⁷ The Third Circuit rejected the Tax Court's approach, relying on an earlier decision in *Byrne v. Commissioner*¹⁸⁸ involving the settlement of claims of retaliatory discharge under the Fair Labor Standards Act as well as wrongful discharge under state law.¹⁸⁹ In *Byrne*, the court held that all such claims involve the assertion of a personal injury, a tort or tort-type right, rather than an economic right arising out of a contract.¹⁹⁰ The *Byrne* court rejected the Service's argument that compensatory damages for nonphysical injuries are taxable unless the taxpayer can

ment structure. Compare 29 U.S.C. § 623(a)(1) (1988) ("It shall be unlawful for an employer . . . to fail or refuse to hire or to discharge any individual . . . because of such individual's age . . ." (emphasis added)) with 42 U.S.C. § 2000e-2(a)(1) (1988) ("It shall be an unlawful employment practice for an employer . . . to fail or refuse to hire or to discharge any individual . . . because of such individual's race, color, religion, sex, or national origin . . ." (emphasis added)). The ADEA, however, incorporates the remedies available under § 16 of the Fair Labor Standards Act, 29 U.S.C. § 216 (1988), providing liquidated damages that require the doubling of back pay awards in the case of "willful violations." *Id.* § 626(b). An exception to mandatory liquidated damages applies if the employer establishes that its actions were made in good faith and it had reasonable grounds for believing that it was not violating the act. *Id.* § 260.

183. See *Rickel v. Commissioner*, 92 T.C. 510, 522 (1989), *aff'd in part and rev'd in part*, 900 F.2d 655 (3d Cir. 1990).

184. As described in note 182, the ADEA incorporates certain remedial provisions of the Fair Labor Standards Act (FLSA). 29 U.S.C. § 626(b) (1988). The FLSA permits aggrieved employees to recover "unpaid minimum wages" or "unpaid overtime compensation," as well as an equal amount of mandatory "liquidated damages" for employer violations of minimum wage and maximum hour laws. *Id.* § 216(b). Although the FLSA makes liquidated damages mandatory, *id.*, the ADEA provides such double damages only in cases of willful violations of the ADEA. *Id.* § 626(b). In addition, the ADEA permits the courts "to grant such legal or 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." *Id.*

185. *Rickel*, 92 T.C. 510.

186. *Id.* at 521.

187. *Id.*

188. 883 F.2d 211 (3d Cir. 1989).

189. *Rickel*, 900 F.2d at 660-61.

190. *Byrne*, 883 F.2d at 215. In *Rickel*, the Third Circuit extended its analysis in *Byrne* to ADEA claims, observing that "we do not believe that the ADEA, and federal employment discrimination statutes in general, are usefully viewed as a Congressional attempt to rewrite the terms of employment contracts." *Rickel*, 900 F.2d at 662.

show that the injuries are personal in nature and not related to business.¹⁹¹ In the court's view, the nonpersonal consequences of discrimination—the loss of wages—did not transform discrimination into a nonpersonal injury.¹⁹² Thus, the entire amount of the settlement was held excludable under § 104(a)(2).¹⁹³ A similar result was reached by the Sixth Circuit in *Pistillo v. Commissioner*.¹⁹⁴ The Tax Court later overruled its prior decisions with regard to the nonliquidated portion of ADEA recoveries and concluded that nonliquidated damages based on back pay received under the ADEA are also excludable under § 104(a)(2).¹⁹⁵

3. Title VII and Equal Pay Act Claims

The tax treatment of recoveries under Title VII of the Civil Rights Act of 1964¹⁹⁶ and the Equal Pay Act of 1963¹⁹⁷ underwent similar reevaluation by the courts. As stated earlier, the Tax Court initially held that back pay awards under Title VII¹⁹⁸ are includable in gross income.¹⁹⁹ After the appellate decisions in *Roemer*²⁰⁰ and *Threlkeld*,²⁰¹ however, the Tax Court suggested that discrimination claims based on sex or national origin under Title VII, and later, claims based on age or race, are in the nature of tort or tort-like claims, and thus recoveries for such claims may be excludable

191. *Byrne*, 883 F.2d at 214.

192. *Id.*

193. *Id.* at 216.

194. 912 F.2d 145, 149 (6th Cir. 1990), *rev'g* 57 T.C.M. (CCH) 874 (1989).

195. *Downey v. Commissioner*, 97 T.C. 150, 168-170, 173 (1991). Because the Tax Court's decision in *Downey* was appealable to the Seventh Circuit, a circuit that had not yet decided the issue, the Tax Court was not bound by the appellate decisions in *Rickel* and *Pistillo*. See *Golsen v. Commissioner*, 445 F.2d 985, 988 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971). Nevertheless, the Tax Court disavowed its earlier analysis and decided to follow the lead of the Third and Sixth Circuits. *Downey*, 97 T.C. at 168. See *infra* text accompanying notes 289-90 for discussion of the Tax Court's post-*Burke* reaffirmance of *Downey*.

196. 42 U.S.C. § 2000e (1988); see also *supra* note 19.

197. Pub. L. No. 88-38, 77 Stat. 56 (codified as amended at 29 U.S.C. § 206(d) (1988)). The Equal Pay Act prohibits certain gender-based wage discrimination when it can be shown that the wage disparity occurs in situations where men and women perform substantially equal work. *Id.* § 206(d)(1). The Equal Pay Act permits such wage disparities, however, if paid pursuant to a seniority system, a merit system, any system that measures earnings by quantity or quality of production, or a differential based on any other factor other than sex. *Id.* An employer may not attain compliance with the Act by reducing the wage rate of any employee. *Id.* The Equal Pay Act provides for liquidated damages unless a good faith defense is established. *Id.* §§ 206(b)(3), 216(b).

198. See *supra* notes 111-23 and accompanying text for description of back pay and front pay under Title VII.

199. See *supra* note 157.

200. *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983), *rev'g* 79 T.C. 398 (1982); see *supra* notes 159-65 and accompanying text.

201. *Threlkeld v. Commissioner*, 848 F.2d 81, 84 (6th Cir. 1988), *aff'g* 87 T.C. 1294 (1986); see *supra* notes 166-68 and accompanying text.

under § 104(a)(2).²⁰² The Sixth Circuit explicitly adopted that approach *Burke v. United States*.²⁰³

The Court of Appeals for the District of Columbia took a different approach in *Sparrow v. Commissioner*.²⁰⁴ In *Sparrow*, the court focused on the remedial structure of Title VII and concluded that § 104(a)(2) did not apply to Title VII recoveries because Title VII provided only equitable relief, not legal “damages” as contemplated by § 104(a)(2).²⁰⁵ Thus, the court’s decision turned on its construction of the term “damages” rather than “personal injuries.”²⁰⁶

With regard to claims brought under both the Equal Pay Act²⁰⁷ and Title VII,²⁰⁸ the Tax Court applied an analysis similar to the one it had

202. See *Metzger v. Commissioner*, 88 T.C. 834, 851 (1987), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988); cf. *Stocks v. Commissioner*, 98 T.C. 1, 18 (1992) (holding settlement amounts allocated to race discrimination excludable); *Downey v. Commissioner*, 97 T.C. 150, 164-65 (1991) (applying the rationale in *Metzger* to an age discrimination claim under the ADEA in holding that such claims, like those based on sex or national origin, are in the nature of tort or tort-like claims).

203. 929 F.2d 1119, 1123 (6th Cir. 1991), *rev'd*, 112 S. Ct. 1867 (1992).

204. 949 F.2d 434 (D.C. Cir. 1991), *cert. denied*, 112 S. Ct. 3009 (1992).

205. *Id.* at 438. In *Sparrow*, the court relied on the distinction between suits in equity and actions at law. *Id.* at 436-37. When the predecessor of § 104(a)(2) was enacted by Congress, the distinction may have had more vitality than it does currently. Because Congress used the term “damages” with regard to personal injuries, the court concluded that the § 104(a)(2) exclusion does not apply to Title VII back pay. The court reasoned that the exclusion was not meant to encompass recoveries under suits in equity, such as Title VII actions. *Id.* at 436-38. See *supra* notes 111-17 and accompanying text (discussing back pay as a remedy closer in concept to legal damages than to equitable restitution).

The *Sparrow* opinion was issued by the Court of Appeals for the District of Columbia after the petition for certiorari was filed by the government in *Burke*, but before the briefs on the merits were due. The taxpayers in *Burke* argued that the *Sparrow* court’s conclusion not only was based on an archaic distinction, but also misstated the law at the time the exclusion was enacted. Brief for Respondents at 12-13, *Burke*, 112 S. Ct. 1867 (1992) (No. 91-42). They argued that although a party seeking only monetary relief had to bring a suit “at law,” in a case properly in equity, the court could dispense compensatory damages when necessary to give complete relief. *Id.* at 13.

206. *Sparrow*, 949 F.2d at 437.

207. 29 U.S.C. § 206(d) (1988).

208. 42 U.S.C. § 2000e (1988). Sex-based wage discrimination claims are often brought under both Title VII and the Equal Pay Act due to different procedural and remedial provisions available under those two different statutes. See, e.g., *Thompson v. Sawyer*, 678 F.2d 257, 293 (D.C. Cir. 1982) (applying overlapping remedies under Title VII and the Equal Pay Act). For example, Equal Pay Act plaintiffs may file suit without exhaustion of administrative remedies, 29 U.S.C. § 216(b), and are entitled to a jury trial. *Hodgin v. Jefferson*, 447 F. Supp. 804 (D. Md. 1978); see also *Lorillard v. Pons*, 434 U.S. 575, 581 n.7 (1978) (construing the FLSA). Title VII plaintiffs are now entitled to a jury trial only in limited circumstances. 42 U.S.C. § 1981a(c)(1) (Supp. III 1991). Unlike Title VII actions, only representative actions, not ordinary class actions pursuant to Rule 23 of the Federal Rules of Civil Procedure, are available under the Equal Pay Act. 29 U.S.C. § 216(b). Similarly situated employees may be joined as plaintiffs, but they must “opt in” or they will not participate in or be bound by the judgment. *Id.* This makes class-type wage discrimination claims much more cumbersome under the Equal Pay Act. Notice of settlement is correspondingly less burdensome, however.

initially applied to ADEA claims. It bifurcated the nonliquidated (or back pay) portion of Equal Pay Act awards, which it treated as a taxable contract-type recovery,²⁰⁹ from the liquidated damages portion, which it treated as a personal injury recovery and thus excludable under § 104(a)(2).²¹⁰ The Title VII back pay recovery was also treated as taxable income.²¹¹ That approach was subsequently affirmed by the Fourth Circuit,²¹² setting the stage for Supreme Court review of the Sixth's Circuit's decision in *Burke*, based on an apparent conflict among the circuit courts of appeals.

D. Congressional Response to Developing Case Law

Meanwhile, in response to the case law developments outlined above, Congress considered limiting the exclusion under § 104(a)(2) to damages received on account of "physical injuries."²¹³ Congress did not enact this

Remedies under the Equal Pay Act are set forth in sections 16 and 17 of the Fair Labor Standards Act. *Id.* §§ 216-17. Unlike Title VII, which provides for no liquidated damages, 42 U.S.C. § 2000e (1988), the Equal Pay Act provides for liquidated damages, with an exception if a good faith defense is established. 29 U.S.C. § 216(b) (1988). Under the Equal Pay Act, lost wages are generally limited to two years before the date the lawsuit is filed, 29 U.S.C. § 255(a) (1988) (three years for willful violations), compared to Title VII, in which back pay is computed with reference to the date the EEOC charge is filed. 42 U.S.C. § 2000e-5(g)(1) (back pay does "not accrue from a date more than two years prior to the filing of a charge"). *See generally* SCHLEI & GROSSMAN, *supra* note 117, at 439-42 (discussing remedies); Clyde Summers, *Effective Remedies for Employment Rights: Preliminary Guidelines and Proposals*, 141 U. PA. L. REV. 457, 479-500 (1992) (same).

209. *Thompson v. Commissioner*, 89 T.C. 632, 646 (1987), *aff'd*, 866 F.2d 709 (4th Cir. 1989).

210. *Id.* at 650.

211. *Id.* at 648. Subsequent to its decision in *Thompson*, the Tax Court held that ADEA lost wages and liquidated damages, also based on Fair Labor Standards Act remedial provisions, are excludable under § 104(a)(2). *See supra* note 195. The Tax Court at that time specifically refused to opine whether its conclusions in the ADEA context would apply to the Equal Pay Act. *Downey v. Commissioner*, 97 T.C. 150, 169 (1991).

212. *Thompson*, 866 F.2d at 712.

213. In 1989, the House proposed that § 104(a)(2) be amended to read as follows:

[G]ross income does not include . . . the amount of any damages received . . . on account of personal injuries or sickness *in a case involving physical injury or physical sickness*. . . .

H.R. 3299, 101st Cong., 1st Sess., pt. 2 § 11641 (1989) (emphasis added). The House Report states that courts have interpreted the § 104(a)(2) exclusion "broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving employment discrimination and injury to reputation where there is no physical injury or sickness." H.R. REP. No. 247, 101st Cong., 1st Sess., at 1354-55, *reprinted in* 1989 U.S.C.C.A.N. 1906, 2824-25. It gives as the reasons for the proposed change the following explanation: "Amounts received as damages for personal injury or sickness receive favorable tax treatment in that they are excludable from gross income. The committee believes that such treatment is inappropriate where no physical injury or sickness is involved." *Id.* at 1355, *reprinted in* 1989 U.S.C.C.A.N. at 2825. There was no corresponding Senate amendment, and the conference committee did not adopt the House proposal. *See infra* note 214.

proposed limitation. Instead, in 1989, Congress amended § 104(a)(2) to provide that the exclusion does not apply to punitive damages for nonphysical injuries.²¹⁴ Although the amendment clarified that punitive damages are taxable in cases involving nonphysical injuries, it left the tax status of other punitive damages in doubt.²¹⁵

Prior to adoption of the amendment, the Service took the position that the exclusion under § 104(a)(2) did not encompass punitive damages of any kind.²¹⁶ That position was generally supported by the case law and the view that, although the exclusion could perhaps be justified to the extent that personal injury recoveries are compensatory in nature, punitive damages could not be similarly justified.²¹⁷ Nevertheless, the amendment suggests by negative implication that, contrary to the assumption under prior law, the exclusion may apply to punitive damages for physical injuries.²¹⁸

As described in greater detail below, *Burke* promised resolution of many of the legal issues raised by various employment discrimination cases. Despite the government's invitation to issue a broad decision precluding application of the § 104(a)(2) exclusion for age, sex, and race-based

214. With no explanation of its action, the conference committee declined to adopt the House proposal as described *supra* note 213 and instead adopted an entirely different amendment limiting the exclusion for certain punitive damages. The 1989 Act inserted at the end of § 104(a)(2) the sentence "[p]aragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (amending I.R.C. § 104(a)(2) (1988)). The amendment applies to amounts received after July 10, 1989, in tax years ending after that date. However, it does not apply to any amount received (1) under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) July 10, 1989, or (2) pursuant to any suit filed on or before July 10, 1989. *Id.* § 7641(b), 103 Stat. at 2379.

215. See Paul C. Feinberg, *Federal Income Taxation of Punitive Damages Awarded in Personal Injury Actions*, 42 CASE W. RES. L. REV. 339, 346-49 (1992); David G. Jaeger, *Taxation of Punitive Damage Awards: The Continuing Controversy*, 57 TAX NOTES 109 *passim* (1992); Craig Day, Comment, *Taxation of Punitive Damages: Interpreting Section 104(a)(2) After the Revenue Reconciliation Act of 1989*, 66 WASH. L. REV. 1019 *passim* (1991).

216. See Rev. Rul. 84-108, 1984-2 C.B. 32, *revoking* Rev. Rul. 75-45, 1975-1 C.B. 47. *But see* Roemer v. Commissioner, 716 F.2d 693, 700 (9th Cir. 1983) (relying on Rev. Rul. 75-45).

217. In 1989, the Tax Court held punitive damages to be excludable in a defamation case. *Commissioner v. Miller*, 93 T.C. 330, 332 (1989). However, the Fourth Circuit later reversed the Tax Court's decision, holding that punitive damages are not excludable under the pre-1989 version of § 104(a)(2). *Commissioner v. Miller*, 914 F.2d 586, 590-91 (4th Cir. 1990), *rev'g* 93 T.C. 330 (1989); *accord* Reese v. United States, 28 Cl. Ct. 702, 710 (1993) (holding pre-1989 punitive damages to be includable in gross income); *Rice v. United States*, 93-2 U.S.T.C. (CCH) ¶ 50,488 (E.D. Cal. 1993) (same); *Kemp v. Commissioner*, 771 F.Supp. 357, 359 (N.D. Ga. 1991) (holding that punitive damages received from settlement of a § 1983 action are not excludable under § 104(a)(2)). See *infra* text accompanying notes 277-85 for post-*Burke* developments.

218. See Mark W. Cochran, *1989 Tax Act Compounds Confusion Over Tax Status of Personal Injury Damages*, 49 TAX NOTES 1565, 1567 (1990).

discrimination recoveries,²¹⁹ the Supreme Court issued a very narrow decision that left many issues unresolved.

E. The Supreme Court's Decision in Burke: "Tort-Like" Standard Applied to Determine Nature of the Claim

In *United States v. Burke*,²²⁰ the Supreme Court held, by a vote of seven to two, that a back pay award in settlement of a Title VII sex-based wage discrimination claim is not excludable from gross income under § 104(a)(2).²²¹ The majority held that Title VII did not redress a tort-like personal injury because it did not permit recovery for traditional harms associated with personal injury such as pain and suffering, emotional distress, harm to reputation, and other consequential damages. In its then applicable form, Title VII permitted only the award of back pay, injunctions, and other equitable relief.²²²

Three female employees of the Tennessee Valley Authority (TVA) filed the *Burke* case as a tax refund suit. They received distributions under the settlement of a Title VII action brought against the TVA by an individual plaintiff and the Office and Professional Employees International Union (the "Union"). The women asserted that the § 104(a)(2) exclusion was applicable to a Title VII settlement award. The Title VII complaint, filed in 1984, claimed that the TVA intentionally discriminated against female employees when it (1) increased the salaries for employees in certain male-dominated pay schedules, while not increasing the salaries of employees in certain female-dominated pay schedules and (2) lowered the salaries in certain female-dominated pay schedules. In addition, the complaint alleged that the pay schedules had a disparate impact on female employees.²²³ The plaintiffs sought injunctive relief and back pay for all the affected employees.²²⁴

219. Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit at 17, *United States v. Burke*, 112 S. Ct. 1867 (1992) (No. 91-42):

The question presented in this case has substantial recurring administrative importance because it affects the thousands of individuals who have received or will receive back pay under Title VII or under other federal employment discrimination statutes, such as the Age Discrimination in Employment Act and the Equal Pay Act.

220. 112 S. Ct. 1867 (1992).

221. *Id.* at 1874. Justice Blackmun wrote the opinion of the Court, in which Chief Justice Rehnquist and Justices White, Stevens, and Kennedy joined. Justices Scalia and Souter filed concurring opinions, taking issue for different reasons with the majority's analysis. Justice O'Connor filed a dissenting opinion, in which Justice Thomas joined.

222. *Id.* at 1872-73.

223. *Burke v. United States*, 90-1 U.S. Tax Cas. (CCH) ¶ 50,203, at 83,745 (E.D. Tenn. Mar. 20, 1990).

224. *Id.*

The TVA filed a counterclaim against the Union. After the district court denied cross-motions for summary judgment, the parties settled.²²⁵ Under the settlement agreement, the TVA agreed to pay \$4,200 to the original individual plaintiff and a total of \$5 million to the other affected employees.²²⁶ The TVA withheld federal income taxes and social security taxes from amounts distributed to claimants receiving an allocated portion of the \$5 million settlement award.²²⁷ Several of the claimants then filed for refund of the withheld taxes.

The district court denied the refund claim, ruling that, because the women had sought and obtained back pay rather than compensatory or other damages, the amounts were not excludable as "damages received . . . on account of personal injuries."²²⁸ The Sixth Circuit reversed, holding that the exclusion under § 104(a)(2) depends upon whether the injury and the claim are "personal and tort-like in nature,"²²⁹ and concluding that Title VII provides a tort-like cause of action for injury to the dignity of the person.²³⁰ The Sixth Circuit observed that "[a]t no point do we inquire into the nature of the damages involved," but "the narrow scope of our gaze is properly

225. The survival of a motion for summary judgment on the disparate impact claim was a significant legal breakthrough for the plaintiffs, given the uncertainty regarding the status of such disparate impact wage discrimination claims when the jobs performed could not meet the equal work requirements of the Equal Pay Act. *See American Fed'n of State, County, and Municipal Employees v. Washington*, 770 F.2d 1401, 1405-06 (9th Cir. 1985) (holding that the disparate impact analysis is inapplicable to such a wage discrimination claim). *See generally* *County of Washington v. Gunther*, 452 U.S. 161 (1981) (recognizing such a wage discrimination claim brought as a Title VII disparate treatment case).

226. The original settlement agreement provided that the Union would distribute the \$5 million lump sum amount to the individual claimants. Under an amended settlement agreement, the TVA agreed to distribute the lump sum settlement amount directly to individuals under a formula developed by the Union based on length of service and rates of pay. *See Burke v. United States*, 929 F.2d 1119, 1120 (6th Cir. 1991). In addition, the TVA agreed to conduct a new regional salary survey, and the bargaining agreement between the TVA and the Union was amended to provide a method of salary arbitration for the future. *Id.*

227. Although the TVA did not withhold taxes from the amount paid to the original individual plaintiff, it insisted on withholding from amounts distributed as part of the \$5 million settlement. For example, Therese Burke was entitled to \$764.94 of the settlement proceeds. The TVA withheld \$152.99 in federal income tax and \$54.69 in FICA tax from Burke's check, leaving her with \$557.26 net of taxes. *Burke*, 90-1 U.S. Tax Cas. (CCH) at 83,747.

228. *Id.* at 83,749. The district court's opinion relied on the fact that the underlying Title VII claim involved wage discrimination, which would entitle a prevailing plaintiff to equitable relief (possibly entailing back pay, front pay, and fringe benefits), but not compensatory or punitive damages. The court emphasized that the settlement agreement provided for allocation based on pay rates and length of service, and that when "coupled with the fact that the complaint refers only to wage discrimination, it is more apparent that the payments dispersed by the TVA to the various plaintiffs . . . were not merely 'measured by' back wages . . . , but were payments 'in lieu of' wages not paid under schedules derived from allegedly sexually-based regional studies." *Id.* at 83,748 (citations omitted).

229. *Burke*, 929 F.2d at 1121.

230. *Id.* at 1123.

limited to the 'origin and character of the claim, . . . and not to the consequences that result from the injury.'²³¹ The Supreme Court reversed the judgment of the court of appeals, relying on Title VII's remedial scheme in holding that the injury and claim were not tort-like in nature.²³²

In reaching this result, the majority opinion first noted that neither § 104(a)(2) nor the legislative history provided any explanation of the term "personal injuries." Relying on a Treasury regulation issued in 1960, however, the Court stated that the regulations "formally have linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles."²³³ After reviewing common-law tort concepts, the Court observed that "[r]emedial principles . . . figure prominently in the definition and conceptualization of torts," and that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff."²³⁴ Thus, in the Court's view, the concept of a "tort" is "inextricably bound up with remedies—specifically damages actions."²³⁵

The Court then examined the remedial scheme of Title VII. By examining the remedial scheme to answer the question of whether the claimants suffered a tort-like "personal injury" for purposes of federal income tax law, the Court defined the nature of the claim by reference to the remedies permissible under the statute.²³⁶ The Court emphasized that, in contrast to tort remedies for physical injuries or for a "dignitary" or nonphysical tort, such as defamation, "Title VII does not allow awards for compensatory or punitive damages; instead, it limits available remedies to back pay, injunctions, and other equitable relief."²³⁷ In addition, the Court observed, somewhat cryptically, that the courts of appeals have held that, unlike ordinary tort plaintiffs, Title VII plaintiffs are not entitled to a jury trial.²³⁸

231. *Id.* (quoting *Threlkeld v. Commissioner*, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)).

232. *United States v. Burke*, 112 S. Ct. 1867, 1873-74 (1992). The Court expressly confined its analysis to the federal income tax question. It did not address the question whether back pay received under Title VII constitutes "wages" subject to taxation for FICA purposes. *Id.* at 1869 n.1.

233. *Id.* at 1870 (citing 25 Fed. Reg. 11,490 (1960)). For the text of § 1.104-1(c) of the regulations, promulgated at 25 Fed. Reg. 11,490 (1960), see *supra* note 1.

234. *Burke*, 112 S. Ct. at 1871 (citation omitted).

235. *Id.* at 1872 n.7.

236. *Id.*

237. *Id.* at 1873.

238. *Id.* at 1872. The reference to the lack of jury trials in Title VII actions (regardless of the fact that the Court itself had never so ruled) is puzzling because the availability of a jury trial is most relevant to the issue of whether Title VII recoveries are "damages" on account of personal injuries. The D.C. Circuit held that this issue was dispositive in *Sparrow v. Commissioner*, 949 F.2d 434, 439 (D.C. Cir. 1991) (holding Title VII relief to be equitable in nature and thus not "damages" within the meaning of § 104(a)(2)), *cert. denied*, 112 S. Ct. 3009 (1992). The *Burke* Court did not explicitly reach the issue.

Significantly, the Court acknowledged that discrimination could constitute a "personal injury" for purposes of federal tax law if the relevant cause of action "evidenced a tort-like conception of injury and remedy."²³⁹ The majority then distinguished Title VII from other federal antidiscrimination statutes.²⁴⁰ The Court focused on the back pay remedy, stating that "Congress declined to recompense Title VII plaintiffs for anything beyond the wages properly due them—wages that, if paid in the ordinary course, would have been fully taxable."²⁴¹ Accordingly, the Court held that Title VII does not redress a tort-like personal injury within the meaning of § 104(a)(2) and applicable regulations.²⁴²

In a footnote, the Court left open the possibility that it might reach a different result under the amended version of Title VII.²⁴³ Under the

In her dissent, Justice O'Connor challenged the majority's reference to the apparent unavailability of a jury trial for Title VII claims. *Burke*, 112 S. Ct. at 1880 (O'Connor, J., dissenting). After pointing out that the Supreme Court has on a number of occasions expressly declined to address that question, Justice O'Connor observed that the majority had failed to explain the relevance of the availability of a jury trial to the excludability question. *Id.* (O'Connor, J., dissenting). She also criticized the majority's analysis, suggesting that the Court may have rejected excludability because Title VII suits are equitable rather than legal in nature. *Id.* (O'Connor, J., dissenting). The applicable Treasury regulation, however, does not define "damages received" in terms of remedies available in actions at law, but instead defines it in terms of amounts recovered through prosecution or settlement of a "legal suit or action based upon tort or tort-type rights." *Id.* at 1880-81 (O'Connor, J., dissenting) (quoting Treas. Reg. § 1.104-1(c)). Thus, in Justice O'Connor's view, the regulation "renders the historical incidents of 'actions at law' and 'suits in equity' irrelevant to the proper interpretation of § 104(a)(2)." *Id.* at 1881 (O'Connor, J., dissenting) (citation and emphasis omitted).

239. *Id.* at 1873.

240. The Court distinguished Title VII from 42 U.S.C. § 1981 and fair housing actions under Title VIII of the Civil Rights Act of 1968, which both allow for jury trials and for compensatory and punitive damages. *Id.* at 1873-74.

Justice O'Connor's dissent took issue with the majority's attempt to distinguish Title VII from other antidiscrimination statutes that have been found analogous to tort suits for other purposes. *Id.* at 1879 (O'Connor, J., dissenting). For example, in deciding that claims under 42 U.S.C. § 1983 are most appropriately subject to the statute of limitations applicable to state tort claims for personal injury Justice O'Connor argued that the Court failed to look to the remedies afforded under § 1983, but instead looked to the "essence of the claim" and the "elements of the cause of action." *Id.* at 1879 (O'Connor, J., dissenting) (quoting *Wilson v. Garcia*, 471 U.S. 261, 268 (1985)). Similarly, in deciding the appropriate state analogue to suit under § 1981, the Court considered the rights protected by the law, racial discrimination being a "fundamental injury to the individual rights of a person," rather than the remedies permitted under the statute. *Id.* at 1880 (O'Connor, J., dissenting) (quoting *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987)). Justice O'Connor argued that when such actions have been found to be tort-like, the Court has relied on the nature of the rights protected, rather than on the remedies provided. *Id.* (O'Connor, J., dissenting). See generally William Wroblewski, Note, *Application of the Personal Injury Exclusion to Awards for Sex Discrimination under Title VII: U.S. v. Burke*, 112 S. Ct. 1867 (1992), 71 NEB. L. REV. 1272, 1276-82 (1992) (criticizing the majority opinion in *Burke* and arguing that the dissent's analysis on this issue is more persuasive).

241. *Burke*, 112 S. Ct. at 1874 (citation omitted).

242. *Id.*

243. *Id.* at 1874 n.12.

amendments provided in the Civil Rights Act of 1991, claims of intentional discrimination may be tried before a jury and remedied with compensatory and punitive damages.²⁴⁴ The taxpayers in *Burke* argued that the expanded scope of Title VII, as amended, provided additional support for their contention that Title VII claims are inherently “tort-like” in nature.²⁴⁵ The Court rejected that argument, but suggested that it might reach a different result under the amended version of the statute, noting that “Congress’ decision to permit jury trials and compensatory and punitive damages under the amended act signals a marked change in its conception of the injury redressable by Title VII.”²⁴⁶ The Court concluded, however, that the amendments could not “be imported back into analysis of the statute as it existed at the time of [the taxpayers’] lawsuit” against their employer.²⁴⁷

Writing separate concurring opinions, Justices Souter and Scalia agreed with the majority that the settlement amounts were taxable, but each employed sharply different reasoning in reaching that result. Justice Scalia argued that a more “common sense” construction of the terms “personal injuries or sickness” in § 104(a)(2) would limit application of the exclusion to injuries to the recipients’ physical or mental health; thus, the exclusion ought not apply to nonphysical injuries such as defamation.²⁴⁸ Regardless of whether a Title VII discrimination victim suffers psychological harm as a result of the discrimination, he concluded that “[t]he only harm that Title VII dignifies with the status of redressable *legal* injury is the antecedent economic deprivation that produced the Title VII violation in the first place.”²⁴⁹ Justice Scalia’s analysis resembles the position of the Service, which maintains that employment discrimination constitutes an economic or business injury rather than a “personal” injury. He acknowledged, how-

244. *Id.*

245. *Id.*

246. *Id.* In contrast to the majority’s view that the Civil Rights Act of 1991 fundamentally changed Title VII actions, Justice O’Connor viewed the amendments to Title VII as simply a recognition on the part of Congress that “existing penalties [were] insufficient to effectuate the law’s settled purposes.” *Id.* at 1881 (O’Connor, J., dissenting). Even before the amendments to Title VII, Justice O’Connor pointed out, the statute reached not only economic inequality, but also racially hostile working environments and sexual harassment in the workplace. *Id.* (O’Connor, J., dissenting). Relying on Congress’s stated reason for the new remedies—that additional remedies “are needed to deter unlawful harassment and intentional discrimination in the workplace,” *id.* (O’Connor, J., dissenting) (quoting Civil Rights Act of 1991, Pub. L. No. 102-166, § 2(1), 105 Stat. 1071, 1071 (1991))—Justice O’Connor concluded that the new remedies more completely serve the established goals of Title VII, which had always offered a “tort-like” cause of action for the injury of employment discrimination. *Id.* (O’Connor, J., dissenting).

247. *Id.* at 1874 n.12.

248. *Id.* at 1876 (Scalia, J., concurring).

249. *Id.* (Scalia, J., concurring) (citation omitted). As Justice O’Connor pointed out, this view of Title VII is difficult to square with its application to claims involving racially hostile working conditions or sexual harassment. *Id.* at 1881 (O’Connor, J., dissenting).

ever, that his “common sense” reading of the statute was inconsistent with the “tort or tort-like” standard adopted by Treasury in § 1.104-1(c).²⁵⁰ Under his statutory analysis, the settlement payments are not “on account of personal injuries” within the meaning of § 104(a)(2).²⁵¹

Justice Souter, in contrast, accepted the view that the exclusion applied if the Title VII action was based on “tort or tort-type rights.”²⁵² He then reviewed the arguments in favor of placing Title VII on either side of the line dividing contract and tort actions, acknowledging good reasons for either conclusion.²⁵³ He disagreed with the majority’s view that the “tort-like” character of the claim should turn on whether the plaintiff can recover for “intangible elements of injury.” However, he agreed that back pay is “quintessentially a contractual measure of damages”²⁵⁴ and acknowledged the resemblance of rights guaranteed under Title VII to those “commonly arising under the terms and conditions of an employment contract.”²⁵⁵ Turning then to the “default rule” of statutory interpretation—that exclusions from income must be construed narrowly—he concluded that he need not decide whether the action was more “tort-like” or more “contract-like.”²⁵⁶ In his view, when application of the exclusion was not clear, the exclusion of income should be denied.²⁵⁷

Writing in dissent, Justice O’Connor, joined by Justice Thomas, disagreed with the majority’s premise that the remedies available under Title VII fix the character of the rights they seek to enforce. Justice O’Connor instead focused on the purposes and operation of Title VII, which are “closely analogous to those of tort law.”²⁵⁸ Thus, although the focus of her analysis was quite different, Justice O’Connor, like the majority, accepted the “tort or tort-like” standard adopted in the regulations.

In examining the nature of the statute, Justice O’Connor pointed out that employment discrimination is actionable under Title VII without regard to the contractual arrangements between the parties; “courts award compensation for [the] right to be free from certain [types of injury] in the workplace.”²⁵⁹ In addition, “monetary relief . . . serves a public purpose beyond offsetting specific losses” by providing an incentive for employers and unions to examine their employment practices for possible violations or ques-

250. *Id.* (Scalia, J., concurring).

251. *Id.* (Scalia, J., concurring).

252. *Id.* at 1877 (Souter, J., concurring).

253. *Id.* at 1878 (Souter, J., concurring).

254. *Id.* at 1877 (Souter, J., concurring).

255. *Id.* at 1878 (Souter, J., concurring).

256. *Id.* (Souter, J., concurring).

257. *Id.* (Souter, J., concurring).

258. *Id.* (O’Connor, J., dissenting).

259. *Id.* at 1879 (O’Connor, J., dissenting).

tionable practices.²⁶⁰ Thus, she maintained that the purpose of Title VII is not only to compensate the victim for injuries suffered,²⁶¹ but also to eliminate discrimination throughout the economy.²⁶² Justice O'Connor concluded, therefore, that Title VII operates functionally in the traditional manner of torts; it provides compensation for invasions of a right to be free from certain injuries, and at the same time, it provides a public deterrent purpose beyond offsetting specific losses.²⁶³

F. *The Post-Burke Landscape: Applying the "Tort-Like" Standard*

Numerous post-*Burke* issues confront the lower courts. Cases involving back pay awards under the pre-amended version of Title VII fall within the narrow holding of *Burke*.²⁶⁴ However, many issues, including the taxability of post-amendment Title VII or Americans with Disabilities Act (ADA) recoveries, and the treatment of amounts received under ADEA or the Equal Pay Act, await future resolution.²⁶⁵ Courts must closely examine the remedies provided under the various employment discrimination statutes to determine whether the claims are sufficiently "tort-like" for statutory recoveries to constitute personal injury damages.

260. *Id.* (O'Connor, J., dissenting).

261. Turning her attention to the back pay remedy itself, Justice O'Connor challenged the majority's assertion that not taxing back pay would give victims of discrimination a "windfall" because the wages they would have received but for the discrimination would have been taxed. *Id.* at 1880 (O'Connor, J., dissenting). She pointed out that making back pay awards nontaxable would simply treat Title VII litigants like other personal injury victims. *Id.* (O'Connor, J., dissenting). Victims of a physical injury are able to exclude the entire amount of any recovery, "even if all or a part of the recovery is determined with reference to the income lost because of the injury." *Id.* at 1880 (O'Connor, J., dissenting) (quoting *Threlkeld v. Commissioner*, 87 T.C. 1294, 1300 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)).

262. *Id.* (O'Connor, J. dissenting) (quoting *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 421 (1975)).

263. *Id.* (O'Connor, J., dissenting).

264. *E.g.*, *Harris v. Commissioner*, 64 T.C.M. (CCH) 518, 519 (1992) (applying *Burke* to pre-amendment settlement of race discrimination case challenging General Accounting Office promotion procedures); *Fogle v. Commissioner*, 64 T.C.M. (CCH) 242, 243 (1992) (same). In addition, some cases may require post-*Burke* resolution of factual issues regarding the extent to which payment might be allocated to back pay. *E.g.*, *Leib v. Commissioner*, 63 T.C.M. (CCH) 3166, 3168 (1992).

265. Based on the distinction drawn by the *Burke* Court between Title VII's remedial scheme and that of § 1981, which permits recoveries for both compensatory and punitive damages (as does § 1983), the Service has held that recoveries for § 1981 violations are nontaxable. Rev. Rul. 93-88, 1993-41 I.R.B. 4 (Dec. 20, 1993); *see also Stender v. Lucky Stores, Inc.*, No. C-88-1467MHP, 1993 U.S. Dist. LEXIS 18271, at *5 (N.D. Cal. Dec. 15, 1993) (holding that § 1981 consent decree payments are excludable from gross income under § 104(a)(2)); *Johnson-Waters v. Commissioner*, 66 T.C.M. (CCH) 252 (1993) (where the Service apparently conceded that the portion of a settlement award allocated to plaintiff's § 1981 claim was excludable as tort-like damages under § 104(a)(2)). The same result should apply to § 1983, although the Service has not yet so ruled.

1. Recoveries Under Title VII and the ADA

The Title VII and ADA tax-related issues will require interpretation of the new remedial provisions adopted by the Civil Rights Act of 1991.²⁶⁶ The major issue to be resolved is how broadly the "nature of the claim" test and the "tort or tort-like" standard will be applied to the new remedial scheme: that is, whether the tests adopted in *Burke* will be applied to the entire range of remedies available under Title VII or the ADA or more narrowly to the specific remedies available for the types of claims asserted in any given case.

The 1991 amendments, which make "tort-like" compensatory and punitive damages available under certain circumstances,²⁶⁷ arguably have the effect of making any post-amendment Title VII or ADA violation a "personal injury" because the change in the scope of remedies available under Title VII or the ADA may make the remedial scheme sufficiently "tort-like" as a whole. If so, the § 104(a)(2) exclusion would apply generally to any post-amendment recovery, including any back pay received pursuant to disparate impact or disparate treatment claims. Thus, any Title VII or ADA recovery would be excludable regardless of whether compensatory and punitive damages are in fact available for the type of claim asserted or whether such damages were sought by the plaintiff. Courts would apply the "nature of the claim" test by examining the range of remedies available under the statute as a whole rather than focusing on the particular theory asserted to establish liability. Such a broad approach offers the most uniform tax results—all post-amendment recoveries would be excludable.

On the other hand, taxability may depend more particularly upon the type of Title VII or ADA claim asserted and the scope of relief available for that type of claim.²⁶⁸ It may depend, for example, on whether the claimant asserts intentional discrimination under a disparate treatment theory,²⁶⁹ for

266. ADA's employment discrimination remedial provisions track those of Title VII. Compare 42 U.S.C. §§ 1981a(a)(2) and 12117 (ADA) with 42 U.S.C. §§ 1981a(a)(1) (Supp. III 1993) and 2000e-5(g) (Supp. III 1993) (Title VII); see also *supra* note 104.

267. See *supra* notes 138-43 and accompanying text.

268. See *supra* notes 124-43 and accompanying text for discussion of disparate impact and disparate treatment claims; see also Andrews, *supra* note 118, at 768-69 (arguing that taxation will depend upon the type of Title VII claim asserted). But see *Stender*, 1993 U.S. Dist. LEXIS 18271, at *7 (suggesting that the remedies added to Title VII in 1991 make it sufficiently tort-like to exempt Title VII awards generally).

269. The General Counsel's Office of the Equal Employment Opportunity Commission (EEOC), the agency charged with enforcing Title VII, has limited its guidance to disparate treatment cases in a recently issued litigation guidance memorandum to regional attorneys on the taxability of damages and the *Burke* decision. The memorandum states that "it is the position of OGC that monetary relief awarded in EEOC disparate treatment actions under Title VII as amended by the Civil Rights Act of 1991 . . . is excludable from gross income under section 104(a)(2)." *EEOC General Counsel Memorandum on Civil Rights Act of 1991*, DAILY LAB. REP.

which compensatory and punitive damages are available, or challenges a facially neutral policy with disparate impact on a protected group,²⁷⁰ for which such damages are unavailable. If this narrower view of the "nature of the claim" test is adopted, Title VII and ADA settlements or recoveries involving both disparate impact and disparate treatment claims would have to be apportioned into taxable and nontaxable amounts. Back pay recoveries would be taxable if received as part of the recovery for a disparate impact claim, but would be nontaxable if received under a disparate treatment claim.²⁷¹

The Service recently applied *Burke* in such a claim-specific manner in Revenue Ruling 93-88.²⁷² The Service held that compensatory damages and back pay received for disparate treatment sex discrimination are excludable under § 104(a)(2). The Service explained that the same result would apply even if the recovery in the case were limited to back pay. Back pay received for disparate impact sex discrimination, however, would not be excludable. In addition, the Service held that compensatory damages and

(BNA), No. 34, Feb. 23, 1993, at E-1. Without discussing disparate impact claims, the memorandum expressly restricts its conclusions to disparate treatment claims:

All of the considerations which led the Court to conclude that Title VII claims were not "personal injury" claims within the meaning of section 104(a)(2) were removed by the Civil Rights Act of 1991. Under the amended Title VII plaintiffs are entitled to jury trials and may recover compensatory and punitive damages where appropriate. Title VII disparate treatment claims are now indistinguishable from claims under 42 U.S.C. § 1981 and Title VIII of the Civil Rights Act of 1968, which the *Burke* Court used as paradigms of claims covered by section 104(a)(2). Therefore, we will take the position that Title VII claims as to which the new remedies are available are "personal injury" claims, and, therefore, money recovered by individuals need not be included in taxable income.

Id.; see also *Tax Litigation, Damages Under Age Bias Act Are Taxable, EEOC Counsel Says in Revised Memorandum*, DAILY TAX REP. (BNA), No. 41, Mar. 4, 1993, at G-11 (referring to revised memorandum dated March 1, 1993, in which OGC reiterated its conclusion and stated that monetary relief in disparate treatment actions is "likely" to be nontaxable).

270. See *Andrews*, *supra* note 118, at 768-69 (arguing that back pay received pursuant to post-amendment disparate impact claims are taxable).

271. Conceivably, it could be argued that back pay awards should be taxable even if received pursuant to a disparate treatment claim. See *Andrews*, *supra* note 118, at 769-70. That argument, however, makes the "nature of the claim" test adopted in *Burke* meaningless. It is also inconsistent with the treatment of lost past and future wages for physical personal injuries. See Carolyn F. Kolks, Note, *United States v. Burke—Does It Definitely Resolve the Analytical Confusion Created by the Section 104(a)(2) Personal Injury Exclusion?*, 46 ARK. L. REV. 656, 674-78 (1993) (suggesting and rejecting various arguments in favor of including back pay awards for intentional discrimination in gross income after *Burke*).

272. 1993-41 I.R.B. 4 (Dec. 20, 1993). The ruling discusses two factual situations: first, a sex discrimination case in which an individual received back pay and compensatory damages in satisfaction of a disparate treatment claim under Title VII; and second, a race discrimination case in which an individual received back pay and compensatory damages under Title VII and § 1981. Both situations involved wrongfully denied promotions. Although the cases raised no disability claims, the Service noted that a similar analysis would be applied to amounts received under the ADA.

back pay received in satisfaction of a claim for racial discrimination under § 1981²⁷³ and Title VII are excludable under § 104(a)(2). Here, too, the Service specified that the same result would be reached even if the recovery were limited to back pay. Under the reasoning of the ruling, recoveries in cases with both disparate treatment and disparate impact claims (as in *Burke*) would be partially excludable and partially taxable, raising potentially difficult allocation issues.

The ruling does not address the issue of punitive damages. As suggested by the express limitation contained in § 104(a)(2), taxability may vary depending on whether the relief granted is compensatory or punitive. The 1989 amendment to § 104(a)(2) provides that the exclusion does not apply to "any punitive damages in connection with a case not involving physical injury or physical sickness."²⁷⁴ Accordingly, punitive damages received in connection with a nonphysical injury are taxable. The tax treatment of punitive damages received pursuant to Title VII and the ADA thus depends on whether there is some physical manifestation of the injury caused by the discrimination. That may be quite possible, particularly in cases where punitive damages are available; that is, those involving actions taken "with malice or with reckless indifference" to the plaintiff's rights.²⁷⁵ For example, discrimination could result in actual physical injury in a sexual harassment case, or more frequently, in emotional distress leading to medical treatment for physical symptoms.²⁷⁶ This possibility raises the broader issue of whether punitive damages for physical injuries should be nontaxable after *Burke*.

Although that issue was not before the Court in *Burke*, the Court stated in dictum that, in 1989, "Congress amended [§] 104(a) to allow the exclusion of punitive damages only in cases involving 'physical injury or physical sickness.'"²⁷⁷ Contrary to the Court's characterization of the 1989 amendment, however, Congress did not make a positive statement about the excludability of punitive damages for physical injuries. Congress merely stated that punitive damages for nonphysical injuries were not excludable.²⁷⁸ In the same breath, the *Burke* Court also pointed out Congress' assumption in 1989 that compensatory damages in both physical and nonphysical injury cases would be excludable.²⁷⁹ The distinction between compensatory damages, which compensate for loss of human capital, and

273. See *supra* note 265.

274. I.R.C. § 104(a) (West Supp. 1993).

275. 42 U.S.C. § 1981a(b)(1) (Supp. III 1991).

276. See *Andrews, supra* note 118, at 775-76.

277. *United States v. Burke*, 112 S. Ct. 1867, 1871 n.6 (quoting I.R.C. § 104(a) (1989)).

278. See *supra* text accompanying note 274.

279. *Burke*, 112 S. Ct. at 1871 n.6.

punitive damages, which serve other purposes, may justify different tax treatment for compensatory and punitive damages.²⁸⁰

Nevertheless, the Tax Court and several district courts have held in post-*Burke* decisions that punitive damages for physical injuries are excludable, relying on the "nature of the claim" analysis in *Burke*.²⁸¹ In *Horton v. Commissioner*,²⁸² the Tax Court held that if the claim involves a "personal injury," any type of damages received, including punitive damages, are excludable.²⁸³ The dissent in *Horton* emphasized that punitive damages are not generally received "on account" of the injury, but are instead designed to punish or discourage certain behavior of tortfeasors; thus, they should be included in income.²⁸⁴ The view that tort-like punitive damages must satisfy the additional requirement of being received "on account" of personal injuries has recently been adopted by the United States Court of Federal Claims.²⁸⁵ Presumably the Service will continue to litigate this issue, requiring further consideration by appellate courts.

2. ADEA and Equal Pay Act Recoveries

Determining the tax treatment of ADEA and Equal Pay Act recoveries also requires application of the tort-like standard applied in *Burke*.²⁸⁶ Many of the pre-*Burke* issues remain because *Burke* offers little guidance concerning how they should be resolved. The major issue to be resolved for both ADEA and EPA cases is similar to that discussed above for post-amendment Title VII cases: How broadly or narrowly should the "nature of the claim" test and the "tort-like" standard be applied to the statutes' remedial scheme? Upon closer examination of the remedial scheme, will it

280. Courts had so held prior to *Burke*. See *supra* notes 215-17 and accompanying text.

281. *Horton v. Commissioner*, 100 T.C. 93, 100-01 (1993) (holding nontaxable a punitive damage award for personal injuries caused by gas explosion and fire in home, which resulted from utility's gross negligence); accord *Hawkins v. United States*, 93-1 U.S. Tax Cas. (CCH) ¶ 50,208 (D. Ariz. 1993) (citing *Burke* and holding punitive damage award excludable under § 104(a)(2)); *O'Gilvie v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567 (D. Kan. 1992) (holding excludable punitive damage award of \$2.48 million paid to husband in wrongful death of wife who died of toxic shock syndrome, and modifying pre-*Burke* ruling of taxability on motion for reconsideration in light of Supreme Court's decision in *Burke*); see also *Estate of Moore v. Commissioner*, 1994 Tax Ct. MEMO LEXIS 1 (Jan. 5, 1994) (applying *Horton* and holding pre-1989 punitive damages for malicious prosecution and invasion of privacy excludable from gross income).

282. 100 T.C. 93.

283. *Id.* at 100-01.

284. *Id.* at 108-12 (Whalen, J., dissenting) (considering state law and general tort principles concerning the nature of punitive damages and concluding that *Burke* does not require nontaxability of punitive damages because of the § 104(a)(2) requirement that the damages be received "on account" of the personal injury).

285. *Reese v. United States*, 93-2 U.S. Tax Cas. (CCH) ¶ 50,447 (Cl. Ct. 1993).

286. As described above, ADEA and Equal Pay Act actions share certain remedial provisions because they both incorporate remedial aspects of the Fair Labor Standards Act. See *supra* notes 182, 208.

be held sufficiently "tort-like?" If so, will back pay and liquidated damages both be excludable or will back pay and liquidated damages be treated differently?

As discussed earlier,²⁸⁷ there is pre-*Burke* authority for bifurcating the ADEA and Equal Pay Act recoveries; that is, treating back pay amounts as taxable and liquidated damages as excludable. Bifurcation appears questionable under the "nature of the claim" analysis applied by the Supreme Court in *Burke*. Nevertheless, post-*Burke* decisions have split on the taxability of ADEA recoveries.

The Tax Court recently reaffirmed its pre-*Burke* holding²⁸⁸ that an ADEA settlement award containing a fifty-fifty allocation to back pay and liquidated damages is entirely excludable.²⁸⁹ Applying a broad interpretation of the "nature of the claim" test, the court held that the ADEA remedial scheme evidences a tort-like conception of injury and remedy, and therefore, all damages received on account of the ADEA claim are excludable from income.²⁹⁰ In contrast, a district court held that ADEA settlement amounts are taxable, based upon the conclusion that the ADEA remedial scheme is not sufficiently "tort-like" to come within the § 104(a)(2) exclusion.²⁹¹ The settlement award received by the claimant did not include any amount allocated to liquidated damages. The court observed that availability of liquidated damages under the ADEA did not "convert every ADEA award into 'personal injury' damages for tax purposes."²⁹² The court's conclusion is based in part on the restrictive and somewhat questionable view that ADEA liquidated damages merely substitute for a criminal penalty. A

287. See *supra* text accompanying notes 182-95.

288. See *supra* note 195.

289. *Downey v. Commissioner*, 100 T.C. No. 40, 1993 U.S. Tax Ct. LEXIS 40 (June 29, 1993) [hereinafter *Downey II*]; accord *Rice v. United States*, 93-2 U.S. Tax. Cas. (CCH) ¶ 50,488 (E.D. Cal. 1993) (holding ADEA back pay and liquidated damages excludable from income under § 104(a)(2)); see also *Purcell v. Seguin State Bank & Trust Co.*, 999 F.2d 950, 960 (5th Cir. 1993) (applying *Downey II*).

290. *Downey II*, 1993 U.S. Tax Ct. LEXIS at *9 (LEXIS pagination). The three separate concurring and dissenting opinions in *Downey II* illustrate the range of other possible results: (1) When the cause of action is for nonwillful age discrimination, for which liquidated damages are not available, the back pay award is includable in income; however, when it is for willful discrimination, a "tort-like" conception of injury and remedy is present and thus both back pay and liquidated damages are excludable, *id.* (Halpern, J., concurring, joined by Whalen and Beghe, JJ.). (2) Bifurcating the claim for willful violation of the ADEA into tort and contract claims, and concluding that liquidated damages are excludable tort damages and that back pay is includable as damages for breach of contract. *Id.* at *22 (Laro, J., concurring in part and dissenting in part, joined by Jacobs, J.). (3) Agreeing with Judge Laro's conclusion, but deferring to the majority's result because *Burke* does not provide a "clear-cut reason for changing the result in *Downey I*" and because all other authorities support petitioners' position of excluding such damages. *Id.* at *9 (Cohen, J., concurring in the result).

291. *Maleszewski v. United States*, 827 F. Supp. 1553, 1556-57 (N.D. Fla. 1993).

292. *Id.* at 1557.

more expansive view of liquidated damages leads to results contrary to the district court's decision. For example, some courts understand liquidated damages to serve as compensation for intangible elements of injury caused by discrimination, as well as a deterrent to and punishment for violations.²⁹³

If courts instead look to the specific type of ADEA claim asserted by the plaintiff, the tax results may depend upon the theory of the case. Thus, for example, taxability of ADEA recoveries may depend upon whether the recovery is obtained pursuant to a disparate impact²⁹⁴ or disparate treatment theory, and back pay awards may have to be allocated based upon the theory of recovery. The EEOC, the agency charged with enforcement of the ADEA, initially took the position that all disparate treatment awards under the ADEA are nontaxable.²⁹⁵ It took no position on disparate impact claims.²⁹⁶ It reversed itself on disparate treatment claims, however, after consultation with the Service. The EEOC then stated that both back pay and liquidated damages are taxable.²⁹⁷

293. See *Bennett v. United States*, Nos. 92-216T, 92-213T, 92-214T, 92-218T, 1994 U.S. Claims LEXIS *5 (Cl. Ct. Jan. 5, 1994, as amended Feb. 4, 1994) (criticizing *Maleszewski* and holding that both liquidated damages and back pay received in settlement of ADEA claims are excludable from income under § 104(a)(2)); see, e.g., *Downey II*, 100 T.C. at *7 (discussing the nature of ADEA liquidated damages); *Downey v. Commissioner*, 97 T.C. 150, 172 (1991).

294. The Supreme Court has never decided whether a disparate impact theory of liability is available under the ADEA. See *Hazen Paper Co. v. Biggins*, 113 S. Ct. 1701, 1706 (1993); *Markham v. Geller*, 451 U.S. 945, 948 (1981) (Rehnquist, J., dissenting from denial of certiorari). Although there is some debate as to whether the disparate impact theory developed in the context of Title VII applies to the ADEA, most appellate courts have either assumed its applicability or expressly applied it. E.g., *EEOC v. Borden's, Inc.*, 724 F.2d 1390, 1394-95 (9th Cir. 1984); *Geller v. Markham*, 635 F.2d 1027, 1032 (2d Cir. 1980), cert. denied, 451 U.S. 945 (1981). See generally SCHLEI & GROSSMAN, *supra* note 117, at 503-04 & FIVE-YEAR CUMULATIVE SUPPLEMENT, *supra* note 117, at 198-200 (collecting cases); .

295. The EEOC Office of General Counsel reversed its position on the taxability of ADEA relief. It first decided that monetary relief for disparate treatment actions under the ADEA is excludable under § 104(a)(2):

ADEA claims fall somewhere between claims under the unamended Title VII and claims under section 1981. OGC will take the view, however, that under the *Burke* analysis, an ADEA claim is [a] "personal injury" claim. First, unlike Title VII plaintiffs before the amendments, ADEA plaintiffs are entitled to jury trials. Secondly, although the ADEA does not provide the full range of compensatory and punitive damages available under section 1981, plaintiffs may recover liquidated damages in addition to the back pay available under Title VII. Thus the ADEA comes much closer than Title VII does to compensating plaintiffs for "other traditional harms associated with personal injury."

EEOC General Counsel Memorandum, *supra* note 269, at E-1 (quoting *Burke*, 112 S. Ct. at 1873).

296. *Id.*

297. After receiving advice from the Internal Revenue Commissioner, the EEOC issued a revised position, rescinding the earlier guidance and concluding that back pay and liquidated damage awards under the ADEA are to be regarded as taxable income:

OGC will take the position that backpay and liquidated damages under the ADEA are not awards based upon tort or tort-like rights and are not excludable from income under section 104(a)(2)

G. *Conclusion: The "Tort-Like" Standard Should Be Discarded*

The foregoing sampling of post-*Burke* issues illustrates the potential for extremely technical and seemingly inconsistent results depending upon the statutory claim, the theory of relief asserted, and the type of damages received.²⁹⁸

Some of these issues are unavoidable because they are relevant to the issue of whether the recovery constitutes damages on account of a "personal" injury under the "nature of the claim" analysis. Nevertheless, the "tort-like" standard applied by the Court in *Burke* necessitates the resolution of issues which appear quite divorced from the underlying policies and design of the anti-discrimination statutes. The civil rights statutes provide protections and obligations apart from and independent of state tort law and of the parties' contractual relationships, if any. The "tort-like" standard forces lower courts to decide whether a particular federal civil rights claim is more tort-like or contract-like based upon that particular statute's remedial scheme, when neither a contract nor a tort label fits.

Justice Souter's opinion in *Burke*²⁹⁹ illustrates the dilemma. He acknowledged good reasons for placing Title VII on either side of the line dividing tort and contract actions.³⁰⁰ He then removed himself from the dilemma by concluding that when application of the exclusion is unclear, the exclusion should be denied.³⁰¹ Relying on the tort-like standard thus leads either to doubtful and conflicting results or to an artificial consistency mandated by the presumption of taxability when application of the exclusion is unclear.

Justice Scalia was the only member of the Court to reject the standard itself.³⁰² His alternative approach to the problem of defining a "personal" injury—applying a physical injury standard—leads to its own set of problems and technicalities, however. First, his "common sense" statutory construction is difficult to reconcile with the historical treatment of recoveries for nonphysical injuries during a period contemporaneous with the earliest version of § 104(a)(2).³⁰³ Second, although the government had at

Damages Under Age Bias Act are Taxable, *supra* note 269, at G-11 (quoting from revised EEOC memorandum dated March 1, 1993).

298. See generally ROBERT W. WOOD, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS ¶¶ 3.1-3.47 (1991 & Supp. 1992) (discussing the tax treatment of discrimination and other employee recoveries); Andrews, *supra* note 118 (discussing the effects of *Burke* on excludability under § 104(a)(2)); 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, 84-85 (1992) (discussing post-*Burke* tax planning issues).

299. *United States v. Burke*, 112 S. Ct. 1867, 1877 (1989) (Souter, J., concurring).

300. *Id.* at 1877-78 (Souter, J., concurring).

301. *Id.* at 1878 (Souter, J., concurring).

302. *Id.* at 1875-76 (Souter, J., concurring).

303. See *supra* text accompanying notes 152-53.

one time asserted the distinction between physical and nonphysical injuries for purposes of § 104(a)(2), it had abandoned that argument by the time the *Burke* case reached the Court.³⁰⁴ Finally, the physical injury standard is bound to create artificial distinctions between employment discrimination recoveries when the claimant can show some physical manifestation and those when there is no record of medical treatment for stress-related symptoms. Like the category of punitive damages for nonphysical injuries, which are expressly excepted from the application of § 104(a)(2), taxability would turn on how much of a physical manifestation suffices to be treated as physical injuries. Well-informed plaintiffs' attorneys would likely advise their clients to seek medical treatment for stress caused by discrimination, putting a premium on good, early legal advice and penalizing those who suffer without medical evidence of their symptoms.

In sum, both the "tort-like" standard and the physical injury standard should be rejected. Not only are they fraught with practical problems in application, but they also apply § 104(a)(2) too restrictively given its theoretical justification. The "tort-like" standard should be replaced by a rule that recognizes the effect of discrimination on human capital accumulation. Part IV of this Article develops that alternative approach.

IV. AN ALTERNATIVE APPROACH

The "tort-like" standard should be replaced with an alternative human capital approach. Under this approach, employment discrimination, whether actionable under Title VII, the ADA, the ADEA, the Equal Pay Act, or under § 1981 or § 1983, would qualify per se as a "personal" injury, and recoveries under such statutes would be excludable under § 104(a)(2) to the extent they compensate for such injury. As discussed above, the loss of human capital suffered by victims of employment discrimination and the "nature of the claims" asserted are by their very nature "personal."³⁰⁵ There is no "business" asset at issue for victims of discrimination apart from their person and their status as an employee. They cannot transfer their human capital apart from providing their services to an employer. As compensation for human capital loss, employment discrimination recoveries should be excluded under § 104(a)(2) as damages received "on account" of personal injuries. This approach offers two key advantages: (1) it is consistent with the theoretical justification for § 104(a)(2), and (2) it is

304. Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit, *supra* note 219, at 10 n.7 ("[The Service] no longer contends that only physical injuries are encompassed within Section 104. Instead, the focus of the inquiry is whether the nature of the recovery for a claim of nonphysical injury compensates for a personal loss or represents an economic gain.").

305. See *supra* text accompanying note 43.

administratively much easier to apply because it provides a bright-line rule that is consistent with the tax treatment of personal tort recoveries.

As discussed in Part II, § 104(a)(2) can be understood as generally comporting with the Code's treatment of human capital, which is quite different from its treatment of investment capital.³⁰⁶ Under such a view of § 104(a)(2), personal injury recoveries for lost past earnings are treated as compensation for loss of human capital. If the injury had never occurred, the earnings would have been subject to tax when realized in the form of wages. If personal injury recoveries for past earnings are excluded from income, as they are under current application of § 104(a)(2), the amount of any such recovery should be computed on an after-tax basis, compensating the victim for an amount net of the taxes that otherwise would have been due on the wages received. Conversely, if § 104(a)(2) were repealed, such recoveries should be computed on a before-tax basis and then made subject to tax. Under either approach, the bottom-line results to the claimant are the same, except in the context of settlement.³⁰⁷

Personal injury recoveries for future earnings are more complicated because they may be paid on a periodic basis to replace putative future earnings, or alternatively, paid as a lump sum equal to the present value of the future earnings stream.³⁰⁸ Section 104(a)(2) should ensure in either

306. See *supra* text accompanying notes 36-56, 71-93.

307. If the recoveries are nontaxable, more will be received by the claimant in settlement. As a result, the *Burke* case will probably have its most direct effect in the context of settlement. Characterized as wages rather than as a personal injury recovery, see *supra* note 232, any settlement amounts would be included in the claimant's gross income and subject to both the withholding of the employee's portion of tax and the additional liability for the employer's employment taxes. See generally *Redfield v. Insurance Co. of North Am.*, 940 F.2d 542, 547 (9th Cir. 1991) (holding, in pre-*Burke* decision, that age discrimination settlement amounts are excludable from gross income and thus not subject to federal, state, or FICA withholding taxes). Taxes can reduce the amount available for settlement and payable to the claimant by one-third or more, making settlement less likely. It is therefore very much in both parties' interest to characterize the payment, to the extent possible, as a recovery for nontaxable compensatory damages under the amended civil rights statute or for personal injuries under traditional tort claims. See, e.g., *Andrews*, *supra* note 118, at 776-83; Richard T. Helleloid & Joanne H. Turner, *Tax Status of Employment Discrimination Awards and Settlements*, 15 REV. TAX'N OF INDIVIDUALS, 127, 142-48 (1991); Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 TAX LAW. 783, 804 (1992); Robert W. Wood, *Taxing Discrimination Recoveries: Bucking Burke*, 56 TAX NOTES 363, 366-67 (1992).

308. Unless special circumstances apply, the investment income on the personal injury recovery itself will be taxed. Thus, for example, interest income on a lump sum personal injury award is generally includable in income. E.g., *Kovacs v. Commissioner*, 100 T.C. 124, 130 (1993) (concluding that interest on wrongful death damages is not excludable under § 104(a)(2)).

The Code recognizes a limited exception for a narrow class of "structured settlements" under § 130. In a typical structured settlement, a plaintiff's personal injury claim is settled under an agreement in which the defendant agrees to make a series of periodic payments to the plaintiff for a fixed period or for the life of the plaintiff. In the settlement agreement, the defendant may agree to purchase a nonassignable, noncancelable annuity from a life insurance company, the income

case that the amounts received replace the after-tax earning stream that the victim would have received if the injury had not occurred.³⁰⁹ If § 104(a)(2) were repealed, the amounts might instead be taxed like investment capital: once when the lump sum is received and again when the earnings are received.³¹⁰ Under such a regime, a personal injury victim would receive less than an equivalent earnings stream because the human capital that the lump sum replaces ordinarily would not be subject to taxation until realized in the form of earnings produced by such capital.

Reasonable policymakers could disagree about whether personal injury recoveries should be treated as an income realization and recognition event. Arguably, some personal injury recoveries represent a conversion of human capital into investment capital, and thus, they should be taxed like investment capital. Congress long ago determined, however, that personal injury recoveries are not includable in income, perhaps in part due to the involuntariness of the injury and the understanding that such recoveries compensate for human capital loss. That result can be defended today, even under our more developed ideas of what constitutes "income."³¹¹

Given such a judgment (or simply the continued existence of § 104(a)(2) through inaction), the exclusion ought to apply to employment

from which is used to make the periodic payments. Alternatively, the defendant may make a payment to a third party, a "qualified assignee," who agrees to assume the payment liability in a "qualified assignment" under § 130.

A qualified assignment under § 130 "means any assignment of liability to make periodic payments as damages" on account of personal injury in cases involving physical injury or physical sickness, provided the terms of the assignment satisfy four requirements, including: (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the person assigning the liability; and (4) the payments are excludable to the recipient as damages under § 104(a)(2). I.R.C. § 130 (West Supp. 1993).

The limitation on the application of § 130 structured settlements to physical injuries or sickness was added by Congress in 1986. Pub. L. No. 99-514, § 1002(a), 100 Stat. 2388 (1986). Because the insurer or defendant owns the annuity, the claimant in a structured settlement does not actually or constructively receive the amount used to fund the settlement by the insurance company and therefore is not taxed on the income generated by the annuity. The periodic payments are excluded from the income of the claimant under § 104(a)(2).

Not taxing the investment income in structured settlements under § 130 has been criticized as inconsistent with the proper taxation of economically accrued interest. *E.g.*, Blackburn, *supra* note 62, at 690. On the other hand, not taxing the interest has been defended on the theory that such amounts represent imputed income (the benefit of physical wholeness) from a replacement of bodily human capital, and as such, should be excluded. *See* Brooks, *supra* note 64, at 773. Professor Dodge has criticized that imputed income rationale. *See* Dodge, *supra* note 64, at 152-53. Nevertheless, he justifies the § 130 result as appropriate, provided that a before-tax discount rate is used to compute the putative lump sum recovery (the annuity purchase price). By reducing the recovery (or the amount available to purchase an annuity), the before-tax discount rate implicitly taxes the income portion of the annuity. Dodge, *supra* note 44, at 159.

309. *See supra* notes 78-84 and accompanying text.

310. Dodge, *supra* note 44, at 177.

311. *Id.* at 155-67.

discrimination awards because they are recoveries for injury to human capital, which is at the very core of the § 104(a)(2) exclusion. In the employment context, such a claim is by definition "personal" in nature.

Assuming the § 104(a)(2) exclusion continues, employment discrimination recoveries should be treated the way other personal injury recoveries are treated: they should be excluded from income to the extent they compensate for human capital loss. Accordingly, recoveries measured by lost past or future income (economic recoveries) should be computed on an after-tax basis; that is, reflecting what the claimant would have otherwise earned but for the discrimination, minus taxes. Such a result would comport with the compensatory remedial policy of federal antidiscrimination statutes. In addition, it would make the amount of compensatory relief, which is appropriately determined in the context of the civil rights case itself, a matter for the court considering the substantive claim.

Recoveries other than lost earnings raise different issues. Whatever the correct result from a theoretical point of view for damages such as pain and suffering, they should be treated consistently with their treatment in the tort context. Although an argument can be made for including damages for pain and suffering in the tort victim's income, they are currently excludable under § 104(a)(2). For administrative reasons, employment discrimination recoveries should be treated no differently. Punitive damages, which are noncompensatory, should be includable in income regardless of how they are treated in the tort context due to the lack of comparable administrative considerations.

A. *Ensuring the "Correct" Computation of Recoveries for Lost Earnings: Economic Recoveries*

If the purpose of § 104(a)(2) is to leave the taxpayer in the same economic position as if the personal injury had never occurred, that is, taxing any income from the victim's human capital only once, then the correct result for tax purposes depends in part on how the damages are computed.³¹² An examination of the computation of damages under substantive

312. For example, suppose Jane, who wanted to become an airplane mechanic, makes \$12,000 a year as a fast-food worker. *See supra* Joe and Jane example in text accompanying notes 51-56. Jane's male counterpart, John, *see supra* note 130, who graduated with her from vocational school, makes \$25,000 a year as an airplane mechanic. Under Title VII, Jane may be entitled to recover the difference between what she could have made as an airplane mechanic (\$25,000) and what she made as a fast-food worker (\$12,000), or \$13,000. Theoretically, the recovery of \$13,000 for back pay should be taxed once, just as the \$12,000 she made as a fast-food worker was taxed once. Given § 104(a)(2), the Title VII recovery should be computed net of taxes. If § 104(a)(2) were repealed, the recovery should be computed on a gross basis, that is, before taxes. Jane should be indifferent as to whether § 104(a)(2) is repealed.

If she then is hired as a result of the Title VII action, her future salary should reflect her earnings as a mechanic. Thus, prospective injunctive relief can eliminate the need for future pay

tort law reveals conflicting views concerning the role of taxes in the computation of lost earnings. After summarizing those views, the Article turns to a more detailed consideration of how employment discrimination back pay and front pay awards ought to be computed, and whether after-tax computation of employment discrimination recoveries is feasible.

1. Background: Computation of Tort Recoveries

For most garden-variety personal injury claims, the role that taxability plays in the computation of tort damages depends upon vagaries of state law. States are divided on the issue of whether the defendant may introduce evidence concerning the taxes that would have been due on lost past or future earnings and whether the jury may be instructed that any award for lost earnings would be excluded from the gross income of the recipient.³¹³ Those states that refuse to reduce a recovery for taxes sometimes base that rule on the speculative nature of computing taxes on future income in situations where the determination of future income is already complex and inexact. Regardless of whether the state tort damages are computed on a before or after-tax basis, the lost past or future earnings remain nontaxable

adjustments. If, on the other hand, instatement is not ordered, front pay may be awarded. Front pay awards require a more complex analysis because of the need to discount a future income stream to its present value. See *supra* note 75. To avoid taxing such amounts twice, the proper discount rate must be applied to the properly computed wages to determine the present value of the future wage stream. See *supra* notes 83-84.

In contrast, Joe, the investor in the original example, makes investments with after-tax dollars and is also subject to tax on the income from his investment.

313. See, e.g., John E. Theuman, Annotation, *Propriety of Taking Income Tax Into Consideration in Fixing Damages in Personal Injury or Death Action*, 16 A.L.R. 4th 589 (1982 & Supp. 1992). See also RESTATEMENT (SECOND) OF TORTS § 914A (1977) (ignoring taxes generally). For example, in California, it is permissible for a trial judge not to instruct the jury as to the tax consequences of damage awards arising from personal injury. See *Henninger v. Southern Pacific Co.*, 250 Cal. App. 2d 872, 879 (1967); *accord Mackey v. Campbell Constr. Co.*, 101 Cal. App. 3d 774, 789 (1980). In addition, it has been held that the introduction of evidence of future tax consequences affecting the amount of an award in a personal injury action would "open the door to intense speculation about the future on part of the jury," and thus, damages for loss of future income are computed on a gross income rather than an after-tax net income basis. *Rodriquez v. McDonnell Douglas Corp.*, 87 Cal. App. 3d 626, 667 (1978). In New York, the highest court has held that the better practice in all cases in which jury awards are excluded from taxation is for the jury to be instructed that such awards, if any, are not subject to income taxes. *Lanzano v. City of New York*, 519 N.E.2d 331, 332 (N.Y. 1988). The jury should be further instructed not to add or subtract from the award on account of taxes, but to follow ordinary specific instructions for measuring damages. *Id.* at 331. Under these instructions, "taxes are treated for what they are in this area—a speculative and irrelevant nonfactor." *Id.* at 332. Some other states permit damages to be computed on an after-tax basis. See *Beaulieu v. Elliott*, 434 P.2d 665, 673 (Alaska 1967) (holding that deduction for taxes should be made for award of lost earnings); *Floyd v. Fruit Indus. Inc.*, 136 A.2d 918, 925-26 (Conn. 1957) (requiring award of lost future earnings to be computed on a net after-tax basis).

for federal income tax purposes. State variations in the computation of recoveries thus are not reflected in application of the federal exclusion.³¹⁴

In contrast, federal law has been applied in a more uniform manner. In what has been characterized as a "federal common law rule," in actions for wrongful death arising under the Federal Employer's Liability Act (FELA) and certain other federal law claims when the measure of damages is a question of federal law, the Supreme Court has held that federal income tax should be considered in determining a claimant's lost earnings and, upon request, the jury must be instructed on the tax-exempt nature of the award under § 104(a)(2) of the Code.³¹⁵ In so holding, the Court implicitly rejected arguments, which were well articulated by the dissent, that the probable purpose of the § 104(a)(2) exclusion was (1) to create a federal rule, similar to the rule adopted by some states, that income taxes should not be taken into account in computing a personal injury award because of the complexities and uncertainties involved; or (2) to confer a humanitarian benefit on the victim or victims of the tort, not to confer a tax benefit on the tortfeasor.³¹⁶

The federal approach to the computation of damages on an after-tax basis is based upon the compensatory purpose of personal injury or wrong-

314. For the suggestion that federal tax law should instead respond to the state's method of computing tort damages, see discussion of Dodge proposal *supra* in text accompanying notes 72-88. Arguably, claimants in states that do not compute damages for lost income on an after-tax basis get an extra benefit when the § 104(a)(2) exclusion is applied for income tax purposes. See Dodge, *supra* note 44, at 165. On the other hand, the exclusion perhaps ought to apply when personal injury damages are computed in a much more approximate way; i.e., when the tax consequences are viewed either as relatively inconsequential or as otherwise subsumed in the overall methodology applied to compute damages. Such states may be viewed as computing damages without considering taxes at all rather than expressly deciding to make the computation on a before-tax basis.

315. *Norfolk & W. Ry. v. Liepelt*, 444 U.S. 490, 493-94 (1980) (holding that in wrongful death action under FELA when the measure of recovery is the damages flowing from the "deprivation of the pecuniary benefits which the beneficiaries might have reasonably received," the wage earner's after-tax income is the proper measure of monetary loss suffered by his dependents when he dies); see *Gulf Offshore Co. v. Mobile Oil Corp.*, 453 U.S. 473, 488 (1981) (remanding for consideration of whether state law requires jury instruction that damage awards are not subject to federal income tax, and if it does, whether "federal common-law rule generally applicable to federal damages actions" established in *Liepelt* for FELA cases displaces state rule in action under the Outer Continental Shelf Lands Act); see also *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523, 533-38 (1983) (computing lump-sum damages for lost income in personal injury action under Longshoremen's and Harbor Workers' Compensation Act on the basis of after-tax wages and benefits, and proposing that the discount rate used to compute the present value of the future stream of lost income should "represent the after-tax rate of return to the injured worker"). *But cf.* Dodge, *supra* note 44, at 156-60, 160 n.92 (arguing that an after-tax discount rate should be used only if the annuity income on the lump sum would be taxed).

316. *Liepelt*, 444 U.S. at 500-02 (Blackmun, J., dissenting) (stating that the computation of personal injury damages on an after-tax basis transfers the tax benefit to the tortfeasor, making the tortfeasor better off by paying the damages rather than paying the wages directly).

ful death damages and the applicability of the exclusion under § 104(a)(2). Recoveries for personal injury actions calculated under federal law thus view compensation for injury as computed on an after-tax basis, subtracting the taxes from the amounts the victim would otherwise have earned, thereby lessening the amounts the tortfeasor otherwise would have paid.³¹⁷ Because the injured party has already been subject to an implicit tax, requiring an explicit tax upon payment by the tortfeasor would undercompensate the victim. In this context, therefore, the § 104(a)(2) exclusion results in the correct answer.

2. Computation of Back Pay Awards

Recovery for economic injuries resulting from employment discrimination generally means an award of back pay, and sometimes, front pay (in lieu of promotion or reinstatement).³¹⁸ Courts awarding lost pay in employment discrimination cases have generally been responsive to the applicable federal tax rule.³¹⁹ Until the 1980s, back pay was generally viewed as taxable; that is, subject to employment taxes as wages and includable in the recipient's income. For the most part, therefore, back pay was computed on a before-tax or gross basis.³²⁰ When the appellate courts began applying

317. When the government is the tortfeasor, the fisc suffers no real loss. When a private employer pays damages minus the taxes, however, the government suffers a revenue loss from the after-tax computation method.

318. See *supra* notes 112-17 and accompanying text. Economic recoveries could also include compensatory damages for medical expenses and other out-of-pocket costs incurred as a result of the discrimination. Generally speaking, back pay or front pay is awarded as a lump sum, rather than as periodic payments.

319. After *United States v. Burke*, 112 S. Ct. 1867 (1992), presumably courts will compute any pre-amendment lost earnings on a before-tax or gross basis. Much uncertainty remains, however, regarding the taxation of post-amendment back pay awards. For example, if post-*Burke* tax decisions treat back pay received under a disparate impact claim as taxable, and back pay received under a disparate treatment claim as nontaxable, the correct back pay computation would be to award disparate impact back pay on a before-tax basis, and disparate treatment back pay on an after-tax basis. On the other hand, if all back pay awards are held nontaxable, they should be computed on an after-tax basis.

Where the tax treatment of post-amendment back pay awards is uncertain, back pay should be computed on a before-tax basis. Otherwise, the victims of discrimination could be subject to a double tax: once in the form of an implicit tax when lost earnings are computed on an after-tax or net basis, and again in the form of an explicit tax if § 104(a)(2) is held to be inapplicable. That result would conflict with the "make whole" purpose of back pay awards. Until there is a clear tax rule (or one that is responsive to the computation of the damage award, as has been suggested in the state tort context), the correct computation of most employment discrimination recoveries remains unclear. Until the issues under § 104(a)(2) are resolved, courts should resolve any uncertainty in favor of the victim of discrimination when computing awards.

320. *E.g.*, *Johnston v. Harris County Flood Control Dist.*, 869 F.2d 1565, 1579-80 (5th Cir. 1989) (allowing the trial court to account for the plaintiff's tax liability in a nontaxable personal injury award but refusing to require such accounting in a taxable back pay award), *cert. denied*, 493 U.S. 1019 (1990); see also *United States v. City and County of San Francisco*, 747 F. Supp.

the "nature of the claim" test to employment discrimination recoveries, and finding them excludable from income under § 104(a)(2), some courts responded by taking taxes into account in the computation of back pay awards in employment discrimination cases and computing back pay on an after-tax basis (net of taxes).³²¹

Under the alternative proposal suggested above, employment discrimination awards would be excluded from income under § 104(a)(2). Given excludability from income, awards for lost earnings should be computed on an after-tax basis. The responsiveness of courts to the federal income tax treatment of back pay awards suggests that the proposal could be implemented without legislative changes. However, the correct result depends upon judicial adoption of the approach urged here.

Although courts generally have responded to the tax status of back pay awards in computing the amount of the award, some courts granting relief in employment discrimination cases have resisted making adjustments to back pay awards. Faced with other types of adjustments, they have referred to case law in which back pay awards have not been reduced to take account of unemployment compensation benefits received during the back pay period, for example,³²² or relied on the notion that back pay need not be computed with unrealistic exactitude.³²³ Those concerns may affect the af-

1370, 1372 (N.D. Cal. 1990) (calculating interest on back pay award based on gross back pay owed rather than on an after-tax amount).

321. *E.g.*, *Purcell v. Seguin State Bank & Trust Co.*, 999 F.2d 950, 960 (5th Cir. 1993) (holding in an ADEA case, after applying *Downey II*, 100 T.C. No. 40, that the lost earnings award was properly computed net of taxes); *Robinson v. Southeastern Penn. Transp. Auth.*, No. 87-5114, 1991 WL 78257 (E.D. Pa. May 7, 1991) (reducing Title VII gross back pay award by the amount of federal income taxes that would have been withheld if received as wages, relying on the Third Circuit's opinion in *Rickel v. Commissioner*, 900 F.2d 655, 663-64 (3d Cir. 1990), that back pay awards for age discrimination are excludable from gross income under § 104(a)(2)), *rev'd*, 982 F.2d 892, 898 (3d Cir. 1993) (explaining that, in light of the Supreme Court's intervening decision in *Burke*, the effect of the trial judge's ruling was to tax Robinson twice); *Beilan v. Sun Co., Inc.*, No. 88-3085, 1990 WL 106581, at *2 (E.D. Pa. July 25, 1990) (rejecting plaintiff's argument that the victim of age discrimination, and not the perpetrator, should receive the windfall that results from non-taxability of ADEA back pay awards: "The defendant, far from receiving a windfall, is required to pay plaintiff an amount equal to after tax wages without ever receiving the benefit of any services from plaintiff.").

322. Courts are split on whether unemployment compensation should be deducted from a recovery of back pay under Title VII or the ADEA. It is sometimes left to the discretion of the trier of fact. Where courts have denied the offset, the result has often been justified on the basis of the collateral source rule—that benefits received by an injured party from a source independent of the wrongdoer should not be deducted from the damages paid the injured party. *See, e.g.*, Glenn A. Guarino, Annotation, *Offsetting Unemployment Benefits Received Against Award for Backpay in Employment Discrimination Actions*, 66 A.L.R. Fed. 880 (1984 & Supp. 1993) (collecting cases).

323. *Rasimas v. Michigan Dep't of Mental Health*, 714 F.2d 614, 627 (6th Cir. 1983) (concluding that "backpay awards should not be reduced by the amount of income and social security taxes which would have been deducted from the wages the claimant would have received but for the discrimination"), *cert. denied*, 466 U.S. 950 (1984).

ter-tax computation of back pay when the computation is itself an inexact process.

The degree of exactitude achievable in the computation of back pay awards varies with the type of discrimination claim asserted. For individual claims involving back pay and no front pay, the after-tax amount could be computed by the trier of fact with a relatively high degree of accuracy. If the trier of fact does not compute the award on an after-tax basis, my proposal results in overcompensation of the victim of discrimination, an incorrect result. That result is more tolerable, however, than the undercompensation that could occur under *Burke*,³²⁴ particularly given the goals of Title VII and the limited way in which back pay compensates for human capital loss.

For class action claims involving aggregate back pay awards or aggregate front pay,³²⁵ determining the appropriate amount of any remedial award is more difficult. The computation of class relief may involve the use of various assumptions and statistical models, in which taxes would be another variable in a process necessarily dependent upon approximations.³²⁶ Deciding how to take taxes into account for purposes of fashioning relief in the aggregate claim context should arguably be within the discretion of the court.³²⁷ Consistent with the compensatory purposes of Title VII, any doubt regarding the appropriate reduction for taxes should be resolved in favor of the victim of discrimination.³²⁸

324. Undercompensation of the victim of discrimination could occur under *United States v. Burke*, 112 S. Ct. 1867 (1992), if the trier of fact computes the back pay award on an after-tax basis, and the award is included in income. See *supra* note 321.

325. The computation of front pay requires a present value computation—applying an appropriate discount rate to a future stream of income. See *supra* notes 81-83 and accompanying text for a description of tax considerations applying to such a computation.

326. Title VII back pay awards have been approved on the basis of average damages for a class of claimants. *E.g.*, *Pettway v. American Cast Iron Pipe Co.*, 494 F.2d 211, 260-63 (5th Cir. 1974). Two principles are sometimes applied: (1) “unrealistic exactitude is not required,” and (2) uncertainties “should be resolved against the discriminating employer.” *Id.* at 260-61. The combination of a large class, ambiguity of employment practices or policies, or multiple effects of discriminatory practices may result in the necessity of applying a class-wide approach to measuring back pay, a process involving a “quagmire of hypothetical judgments.” *Id.* at 260; see also, *e.g.*, *Pitre v. Western Elec. Co.*, 843 F.2d 1262, 1275-79 (10th Cir. 1988) (ordering district court to devise a new remedy, but affirming the use of a class-wide remedy); *Bowe v. Colgate, Palmolive Co.*, 489 F.2d 896 (7th Cir. 1973) (affirming the use of a test period for computation of class-wide back pay awards in sex discrimination case).

327. *Cf.* *Sears v. Atchison, Topeka, & Santa Fe Ry.*, 749 F.2d 1451, 1451 (10th Cir. 1984) (holding that district court did not abuse discretion by including a “tax component in back pay award to compensate class members for their additional tax liability as a result of receiving over 17 years of back pay in one lump sum”), *cert. denied*, 471 U.S. 1099 (1985).

328. Assuming that an accurate amount of front pay could be computed, the present value calculation should be informed by the principles set forth *supra* in notes 57-94 and accompanying text. Front pay awards ordinarily would be received as a lump sum amount. Such an award may be viewed as a nontaxable replacement of future earnings under § 104(a)(2). Thus, the amount should be calculated on an after-tax basis and the lump sum excluded from income.

The excludability of employment discrimination recoveries under § 104(a)(2) results in certain administrative advantages. Uniform tax treatment of tort and employment discrimination recoveries would make tax planning less important for employment discrimination litigators and would make allocation of damages for settlement purposes less subject to manipulation.³²⁹

In sum, once the judgment has been made to treat personal injury awards as nonrealization or nonrecognition events, employment discrimination recoveries for lost earnings should be treated consistently with tort recoveries for lost earnings. Employment discrimination also injures human capital; back pay and front pay compensate for the opportunities and benefits lost as a result of such discrimination. If such recoveries are excluded from gross income, they should be computed on an after-tax basis when the relief is provided for the substantive violation. How the adjustment for taxes is made is best determined at the time relief is fashioned by trier of fact in its effort to make the victim "whole." On the other hand, if § 104(a)(2) were repealed, then employment discrimination recoveries for lost earnings must be computed on a before-tax basis and included in the gross income of the recipient.

B. Noneconomic Injuries: Policy Choices and Practicalities

1. Emotional and Dignitary Harms

Employment discrimination also results in personal emotional and dignitary harms, which can be labeled as noneconomic injury. The label is not entirely apt, given the ability of factfinders to assign an economic value to such injury. Nevertheless, the term "noneconomic" reflects a distinction between "economic" recoveries, such as back pay awards and compensation for certain out-of-pocket expenses, and those recoveries for which there is no market analog. Noneconomic recoveries in the employment discrimination context include: (1) awards for pain and suffering and emotional distress under §§ 1981 and 1983, and (2) certain compensatory damages under the amended remedial provisions applicable to claims of intentional discrimination under Title VII and the ADA. Noneconomic recoveries may also include liquidated damage awards under the ADEA and the Equal Pay Act.³³⁰

329. See *supra* note 307.

330. Generally speaking, courts have viewed liquidated damages under the ADEA and the Equal Pay Act as compensatory in nature, although they have been viewed as combining aspects of compensatory and punitive functions. *E.g.*, *Downey v. Commissioner*, 97 T.C. No. 10 (1991) (*Downey I*) (discussing case law and concluding that liquidated damages compensate the victim of age discrimination for certain nonpecuniary losses).

Recoveries for dignitary harm (that is, for being treated not as an individual but as a member of a subordinated or stigmatized group) compensate the victim for loss of imputed income from human capital. Imputed income (the pleasure or satisfaction derived from one's job or leisure time) is simply not accounted for in our current tax system.³³¹ When the victim of discrimination receives an award for emotional distress, however, what would otherwise be imputed income has been transformed into cash, a market transaction (analogous to leisure time being used to earn money), which ought to be taxed. Theoretically, therefore, an argument can be made for taxing monetary recoveries for such noneconomic recoveries as a kind of windfall to the recipient.³³² On the other hand, the recovery could be thought of as a substitute for emotional or dignitary well-being, an element of one's human capital that ought never be taxed, particularly when it has been lost involuntarily.³³³

Recoveries for pain and suffering are excludable from gross income under § 104(a)(2).³³⁴ Unless the rule is changed in the tort context, noneconomic awards for employment discrimination should remain excludable because of allocation and manipulation problems caused by an inconsistent rule applicable to tort and employment discrimination recoveries. Furthermore, because this Article proposes that recoveries for lost earnings also be excludable from income, no allocation between employment discrimination economic (back pay) and compensatory noneconomic (emotional distress) damages need be made by the trier of fact or by the parties to a settlement agreement.

2. Punitive Damages

Punitive damages are both noneconomic and noncompensatory. The theoretical justification for exclusion of personal injury awards from gross income under § 104(a)(2) does not apply to punitive damages. Rather than compensate for human capital loss, punitive damages serve the quite different policy goals of retribution and deterrence.³³⁵

Punitive damages may be awarded under limited circumstances pursuant to successful claims brought under §§ 1981 and 1983, and for claims of intentional discrimination under Title VII and the ADA. They ordinarily

331. See *supra* text accompanying notes 38-48.

332. Dodge, *supra* note 44, at 182-87; Griffith, *supra* note 68, at 1130-35, 1153 (under a utilitarian tax base, recoveries for pain and suffering are included in the base because they increase the taxpayer's income without increased offsetting expenses).

333. See *supra* note 64.

334. See *supra* notes 1, 10.

335. See *supra* text accompanying notes 214-18, 274-85 for a discussion of the pre-*Burke* and post-*Burke* tax treatment of punitive damages.

would be included in the recipient's gross income under § 104(a)(2) as punitive damages for nonphysical injuries.

Even if there were no such limit on the exclusion provided by § 104(a)(2), or if the injuries caused by employment discrimination had some physical manifestation, the correct result would be inclusion in income.³³⁶ Few problems of allocation in the settlement context would arise from inclusion for punitive damages (when other categories of damages are excludable) because defendants ordinarily would resist any allocation of settlement amounts to punitive damages.³³⁷ It would not be in the plaintiffs' interest to allocate a portion of the award to an includable amount, and defendants would be loathe to admit the kind of behavior justifying a punitive award. Therefore, few would be making an allocation to punitive damages in the settlement context. Any jury award for punitive damages would be separately specified, and thus, the different tax treatment of punitive damages would not pose administrative difficulties.

V. CONCLUSION

The "tort-like" standard applied by the Supreme Court in *United States v. Burke*³³⁸ should be discarded in favor of an alternative human capital approach, which is more consistent with the policy justification for § 104(a)(2) and the purposes of equal employment opportunity laws. The *Burke* decision leaves many issues unresolved and applies a framework of analysis bound to create more litigation concerning the tax treatment of employment discrimination recoveries.

Post-*Burke* litigation is characterized by hypertechnical analysis of statutory relief provisions to determine whether they are more tort-like or contract-like in nature, an undertaking quite divorced from the policies served by federal antidiscrimination statutes, which provide rights apart from the tort or contract theories otherwise available to victims of discrimination. Post-*Burke* issues illustrate the difficulty of applying the tort-like standard in this context. Unless the "nature of the claim" test is applied quite broadly, application of the "tort-like" standard will result in some back pay awards being treated as taxable and others as nontaxable. That result conflicts with the compensatory purposes served by back pay awards. Application of the standard also results in uncertainty. The lower courts have already split on application of § 104(a)(2) to age discrimination recov-

336. See, e.g., Dodge, *supra* note 44, at 180-81 ("As a matter of policy, there is little doubt that punitive damages should be included in gross income."); Feinberg, *supra* note 215 *passim* (arguing that Congress did not intend to exclude punitive damages for personal injuries from income).

337. Wood, *supra* note 298, ¶ 2.61, at 2-10 (Supp. 1992).

338. 112 S. Ct. 1867 (1992).

eries. Uncertainty regarding the tax rule creates corresponding uncertainty regarding the correct computation of back pay awards.

Application of the human capital approach leads to a different analysis than that applied in *Burke*. Although the bottom-line results to victims of discrimination may differ in the context of settlement, the analysis proposed here may not significantly affect the after-tax amount of back pay in most cases reaching judgment, except when *Burke* results in double taxation.³³⁹ Nevertheless, the alternative approach treats various employment discrimination recoveries more uniformly and is more consistent with the tax treatment of tort recoveries. That consistency has certain administrative advantages as well as theoretical appeal.

Injuries suffered by victims of employment discrimination and by victims of personal torts affect an individual's human capital, and are thus "personal" injuries. Section 104(a)(2) generally comports with the Code's approach to the taxation of human capital. Under that approach, economic recoveries for lost earnings are correctly excluded from income if computed based on an after-tax wage stream. Recoveries for emotional distress and pain and suffering are excluded from income under § 104(a)(2) and should be treated no differently in the employment discrimination context. Punitive damages, which do not compensate for human capital loss, should be included in income. In addition to consistency and administrative advantages, the human capital approach offers a theory more compatible with the purposes of civil rights statutes and with tax policy.

339. See *supra* notes 319, 324.