TAXATION OF DAMAGE AWARDS: CURRENT LAW AND IMPLICATIONS

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Introduction

Congress, as part of the Small Business Job Protection Act of 1996,[1] has apparently settled the ambiguous issue of when damages are excludible from gross income by amending section 104(a)(2) of the Internal Revenue Code. Previously, this section stated that an exclusion from gross income was allowed for "the amount of any damages received (whether by suit or agreement and whether as a lump sum or as periodic payments) on account of personal injury or sickness." The *Small Business Job Protection Act* amends this section by allowing an exclusion for "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." Hence, this law, which became effective with the President's signature on August 20, 1996, does not allow an exclusion for punitive damages or for compensatory damages not connected with a physical injury. Heretofore, in some instances, punitive damages and compensatory damages associated with nonphysical injuries (e.g., emotional distress, sexual harassment, discrimination) were excludible.

Forensic economists need to be familiar with the taxation of damages in personal injury and employment cases to appropriately calculate the amount of compensatory damages needed to make the person whole, to write reports that explain the tax implications implicit in these calculations, and to converse intelligently with attorneys regarding the strategy of a case. To understand the current law and its intent, a discussion of previous law is necessary.

Previous Law

Historically, damages received under nontort and noncontract claims have presented ambiguous tax-treatment[2]—namely amounts received based on one or more of the discrimination acts: *Civil Rights Act of 1964*, *Civil Rights Act of 1991*, *Age Discrimination in Employment Act*, *Fair Labor Students Act*, and *Americans with Disabilities Act*. In *U.S. v. Burke*,[3] the Supreme Court first made an attempt to clarify the applicability of IRC Sec. 104(a)(2) to the discrimination acts. This ruling indicated that compensatory damages[4] received from claims based on a statute that allowed for a broad range of remedies (similar to the remedies available under tort law) would be excludible under Sec. 104(a)(2) (see Wells

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[1] Public Law No. 104-188, Sec. 1605.

[2] Compensatory damages arising from the tort claims of personal injury or wrongful death have been clearly excludible under IRC Sec. 104(a)(2). Conversely, compensatory damages from a contract claim have clearly fallen outside the scope of this section.

[3] *U S v Burke*, 69 AFTR 2d 92-1293.

[4] The *Revenue Reconciliation Act of 1989* (Public Law No. 101-239) had made punitive damages received after July 10, 1989 excludible only when received in connection with cases involving physical injury or sickness.

[1996]). Subsequent to this ruling, the Internal Revenue Service issued Revenue Ruling 93-88, that provided that amounts received under post-1991 Civil Rights actions for intentional discrimination are excludible under Sec. 104(a)(2).

Apparently not satisfied with its first attempt to solve the problem, the Supreme Court heard another discrimination case, *CIR v. Schleier*.[5] Here the court ruled that compensatory damages received under the *Age Discrimination in Employment Act* were not made excludible by Sec. 104(a)(2). This decision, and the subsequent suspension of Rev. Ruling 93-88 by the IRS, left the damage award taxation issue confused. Now, Congress has stepped in and imposed what appears to be rather unambiguous guidance.

Current Law

The *Small Business Job Protection Act* makes punitive damages not resulting from a personal physical injury subject to federal income taxes.[6] Apparently to help define what is a personal physical injury, this law also adds the following new sentence to IRC Sec. 104(a)(2): "For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness."[7] The intent of this law appears to be clear: an exclusion will not be allowed for damages received under any of the discrimination acts or torts involving nonphysical injuries such as emotional distress and injury to personal or business reputation.

Implications for Damage Calculations

If the legal framework allows,[8] the economist needs to calculate an amount that will leave the person whole. Most economists are familiar with the appropriate model applied to calculating lost wages in personal injury suits: an award is needed that will provide for an immediate withdrawal to replace past lost wages, future withdrawals to replace future after-tax lost wages, and future withdrawals to pay the income taxes imposed on interest earnings of the award. This procedure appropriately focuses on replacing after-tax lost wages since, in personal injury cases, the award itself (not the interest it subsequently generates) is nontaxable. Given the new tax law imposing taxes on awards in discrimination cases, it would appear appropriate to calculate damages as in personal injury cases with the only change being a shift of focus away from replacing after-tax wages to replacing gross wages. This approach, however, would be incorrect as shown below.

Since the income tax liability on a series of future periodic payments is different than the tax liability on a lump sum equal to the present value of that series of payments, the focus

[5] *Commissioner v. Schleier*, 75 AFTR 2d 95-2675.

[6] A remaining ambiguity is what portion, if any, of compensatory damages in discrimination suits is subject to the FICA tax.

[7] See Public Law No. 104-188, Sec 1605.

[8] Federal law and IRS regulations notwithstanding, forensic economists remain constrained by judicial practices and guidelines. For example, state courts in Utah have essentially directed that damages in tort actions be computed without considering tax implications even though the actual tax effects could be significant. See Lewis and Bowles (1996).

ought to be on replacing after-tax wages. In discrimination suits, an amount is needed that will provide for the following: (1) an immediate withdrawal to replace past lost wages; (2) an immediate withdrawal to pay the income tax imposed on the award; (3) future withdrawals to replace future after-tax lost wages; and (4) future withdrawals to pay the income taxes imposed on the interest earnings of the award.

The following example will illustrate. Assume that in a violation of the *Americans with Disabilities Act*, a person is terminated who would have earned $40,000 annually for the next five years, and that the appropriate discount rate is 6 percent. Further, assume that there is an average tax rate of 10 percent on income of $40,000 and 20 percent on income of $140,000 or more.[9] A simple (but incorrect) approach would be to assume that since the award is taxable, and future wages would have been taxable, that taxes can be ignored and, hence, the loss is simply the present value of the future gross wages. Using this approach, the award intended to make the person whole is $178,605. However, this amount would leave the person under compensated as Table 1 illustrates. Had the person not been terminated, they would have had $36,000 of after-tax income available in each of the future five years. An award that equals the present value of future lost gross wages is inadequate in that it only provides $13,452 of after-tax income in year five.

The correct approach is to first calculate the present value of future after-tax lost wages, which, in this instance, is $160,743 (i.e., the present value of five future payments of $36,000 discounted at 6 percent), and then "gross-up" this amount to pay the initial tax imposed on the award. This "gross-up" procedure is complicated by the fact that every time the award is increased to account for taxes, the tax liability also is increased. Fortunately, there is a simple mathematical solution to this problem. The appropriate award, A, can be calculated as:

$$A = w/(1 - t),$$

where w is the present value of future after-tax wages, and t is the average tax rate on a lump sum equal to w. Here, A would equal $200,928. As illustrated in Table 2, the award now fully compensates the victim of discrimination.[10]

[9] We are ignoring past lost benefits, tax on interest earnings, and other issues in order to concentrate on the effect of a progressive tax system on calculating damages in a discrimination suit.

[10] No further damage calculations are necessary where an amount is awarded for punitive damages. While such an award is taxable, it essentially is a windfall to the recipient and is unrelated to the actual losses suffered.

Conclusion

The *Small Business Job Protection Act of 1996*, that became law on August 20, 1996, effectively limits the exclusion from gross income available under IRC Sec 104(a)(2) to compensatory damages received on account of personal physical injuries or sickness In discrimination suits, therefore, the forensic economist needs to focus on calculating an amount that will not only fund past and future lost after-tax wages and taxes on interest income, but also will pay the tax on the award itself

Table 1. Annual Withdrawals Available from an Award Based on Future Gross Wages

Period	Beginning Balance of Award Fund	Interest Earnings	Withdrawal	Ending Balance of Award Fund
1	$178,605	—	$71,721[a]	$106,884
2	106,884	6,413	36,000	77,297
3	77,297	4,638	36,000	45,935
4	45,935	2,756	36,000	12,691
5	12,691	761	13,452	—

[a] This amount equals the sum of a withdrawal to pay income taxes on the award ($35,721 = 0 2 x 178,605) and a withdrawal to replace the after-tax lost wages of period one ($36,000 = $40,000 - 0 1 x $40,000)

Table 2. Annual Withdrawals Available from an Award Based on Future After-Tax Wages and "Grossed-Up" for the Tax on the Award

Period	Beginning Balance of Award Fund	Interest Earnings	Withdrawal	Ending Balance of Award Fund
1	$200,928	—	$76,186[a]	$124,742
2	124,742	$7,485	36,000	96 227
3	92,227	5,774	36,000	66,001
4	66,000	3,960	36,000	33,962
5	33,962	2,038	36,000	—

[a] This amount equals the sum of a withdrawal to pay income taxes on the award ($40,186 = 0 2 x $200,928) and a withdrawal to replace after-tax lost wages of period one of $36,000)

References

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