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TAXING THE VICTIMS: COMPENSATORY DAMAGE AWARDS AND ATTORNEYS' FEES IN SEXUAL HARASSMENT LAWSUITS

*Marisa J. Mead**

INTRODUCTION

The prospect of recovering damages in sexual harassment lawsuits should be encouraging to potential claimants.¹ Prior to 1996, the federal income tax code furthered this goal by allowing victims winning or settling lawsuits based on non-physical personal injuries to exclude compensatory damage awards from

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¹ Civil Rights Act of 1964, 42 U.S.C. § 2000e (2003); Civil Rights Act of 1991, 42 U.S.C. § 1981(a) (2003). Plaintiffs may sue and recover damages for sexual harassment pursuant to Title VII of the Civil Rights Act of 1964 (the 1964 Act). 42 U.S.C. § 2000e (prohibiting sex discrimination in employment); *see also infra* notes 19-21 and accompanying text (discussing the application of the Civil Rights Acts to sexual harassment law); *infra* Part I.B (noting the types of damages that victims may recover in sexual harassment lawsuits). Both men and women are presently entitled to sue for sexual harassment. 42 U.S.C. § 2000e. The number of women who are affected by and prosecute for sexual harassment, however, is substantially greater than the number of men. U.S. Equal Employment Opportunity Commission, *Sexual Harassment Charges EEOC & FEPAs Combined: FY 1992-FY 2002*, at <http://www.eeoc.gov/stats/harass.html> (last visited Mar. 6, 2003). In 2001, women filed 86.3% of sexual harassment charges with the Equal Employment Opportunity Commission (EEOC). *Id.* Because sexual harassment law is predominantly targeted toward the concerns of women, this note specifically focuses on how women are influenced by the interaction between sexual harassment law and federal tax policy.

their gross income.² In 1996, however, Congress added a provision to the Small Business Job Protection Act³ making all punitive and compensatory damages awarded for non-physical injuries taxable income.⁴ Therefore, federal income tax may significantly reduce or completely dissolve damages awarded to non-physical injury victims.⁵ In extreme cases, these plaintiffs may owe the government more money than they were originally awarded to compensate for their injuries.⁶

Nevertheless, plaintiffs who receive compensatory damages on account of physical personal injuries are not taxed on their damage awards.⁷ Section 104(a) of the United States tax code provides that victims receiving damages for non-physical injuries,

² See Kristin Loiacono, *Where There's a Will, There's a Way and Means*, TRIAL, Sept. 1, 2000, at 11 (reporting on the tax treatment of damage awards received for physical and non-physical injuries). Section 61(a) of the Internal Revenue Code defines gross income as "all income from whatever source derived." 26 U.S.C. § 61(a) (2003). Section 104(a) of the Internal Revenue Code provided an exception to this for income derived from personal injury damage awards received in settlements or lawsuits. 26 U.S.C. § 104(a)(2) (1995). Prior to 1996, § 104(a) did not distinguish between types of personal injuries but, rather, excluded damages from any type of personal injury or sickness. *Id.*

³ Pub. L. No. 104-188, 110 Stat. 1775 (1996).

⁴ 26 U.S.C. § 104(a) (2003). See Loiacono, *supra* note 2, for discussion of the implications of this provision.

⁵ Loiacono, *supra* note 2.

⁶ See Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, at A18 (discussing the case of Cynthia C. Spina, who won her sex discrimination case but was required to pay taxes in excess of her damage award); *infra* Part III.B (illustrating the specifics of Ms. Spina's case). The tax consequences vary among plaintiffs, depending on a number of factors such as the plaintiff's gross income before the damage award, the amount the plaintiff may be claiming as income tax deductions and the amount of damages awarded to the plaintiff in the lawsuit. See *infra* Parts II.D and III.B (discussing the different factors that determine the tax consequences for different plaintiffs).

⁷ § 104(a)(2). This is because the Internal Revenue Code still allows victims of physical personal injuries to exclude their damage awards from the calculation of gross income. *Id.*; see also Loiacono, *supra* note 2 (noting that victims of personal physical injuries are treated preferentially, as opposed to victims of non-physical injuries by the tax code). § 104(a)(2).

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including sexual harassment, must always pay income tax on their awards while claimants recovering compensatory damages for physical injuries are not required to do so.⁸ Because § 104(a) creates expensive tax consequences for plaintiffs receiving damage awards in non-physical injury cases,⁹ many sexual harassment victims are being deterred from commencing lawsuits against their employers.¹⁰

This note argues that the unreasonable distinction between damages flowing from physical personal injuries and those from non-physical personal injuries is not simply a monetary burden—it also hinders the progress the United States has made in recognizing sexual harassment as a serious problem.¹¹ Part I of this note provides background information about the development of sexual harassment law and how sexual harassment became a compensable injury as a form of employment discrimination. Part II explains the history and current status of the taxation of damage awards in the United States pursuant to 26 U.S.C. § 104(a). Part III examines the economical, social and legal consequences of § 104(a)'s system of “taxing the victims.”

⁸ § 104(a)(2). All damages relating to physical injuries, except for punitive damages, are exempt from income taxation, while all damages relating to non-physical injuries, both compensatory and punitive, are not exempt from taxation. *Id.*; see Marcia Coyle, *Bill to Remove Tax on Awards May See Action*, 228 N.Y. L.J. 33 (2002) (arguing that the tax treatment of physical and non-physical injuries is a distinction without reason).

⁹ Loiacono, *supra* note 2. See also Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447 (1998) (criticizing the distinction between lost wages in physical injury cases and back pay awarded in employment discrimination cases).

¹⁰ See Liptak, *supra* note 6 (reporting that there is less of an incentive to commence a lawsuit based on employment discrimination because of the tax burdens created by § 104(a)). Section 104(a) applies to all non-physical injuries and, thus, to all forms of employment discrimination. § 104(a)(2). This note focuses on sexual harassment claims to provide a specific example of the effect current tax policy has on a particular area of anti-discrimination law.

¹¹ See *infra* Part I.A (discussing the development of the law in recognizing sexual harassment as a compensable injury).

Specifically, the tax code deters victims of sexual harassment from reporting their claims, insinuates that their injuries are not “real” and creates a contradictory legal policy.¹² Finally, Part IV discusses conceivable future improvements to the tax code that would correct the negative effects of this tax policy.

I. BACKGROUND OF SEXUAL HARASSMENT LAW

The significance of taxing non-physical injury damage awards in sexual harassment lawsuits is best appreciated by understanding the foundations of sexual harassment law.¹³ Today, through the provisions of Title VII of the Civil Rights Act,¹⁴ the law “recognizes that unwanted, demeaning, or threatening sexual conduct can limit women’s opportunities, ambitions, and rewards in workplaces and schools.”¹⁵ The legislature, however, did not always provide victims of sexual harassment adequate remedies.¹⁶ In fact, it was not until the Civil Rights Act was amended in 1991 that sexual harassment plaintiffs were entitled to the full range of damages available today in all employment discrimination

¹² See Karen B. Brown, *Not Color or Gender Neutral: New Tax Treatment of Employment Discrimination Damages*, 7 S. CAL. REV. L. & WOMEN’S STUD. 223, 256-58 (1998) (arguing that § 104(a) was enacted partly because of Congress’s intention to discount the importance of job bias injuries); Sager & Cohen, *supra* note 9, at 502 (arguing that heightened sympathy for victims of physical injuries does not justify a tax exclusion favoring physical injury victims over non-physical injury victims); Mark J. Wolff, *Sex, Race, and Age: Double Discrimination in Torts and Taxes*, 78 WASH. U.L.Q. 1341, 1485 (2000) (stating that employment discrimination victims suffer substantial injuries and are entitled to the § 104(a) tax exclusion just as much as victims of physical injuries).

¹³ 42 U.S.C. § 2000e (2003).

¹⁴ *Id.*

¹⁵ GWENDOLYN MINK, *HOSTILE ENVIRONMENT: THE POLITICAL BETRAYAL OF SEXUALLY HARASSED WOMEN* 3 (2000) (arguing that although there is currently a statutory basis for relief for sexual harassment victims, those victims are still socially and politically demeaned).

¹⁶ *Id.* at 24. See *infra* Part I.A (discussing the development of sexual harassment law and available remedies).

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cases.¹⁷

A. Development of Sexual Harassment Law

By prohibiting sex discrimination in employment, Title VII of the Civil Rights Act of 1964 was the first statute to provide relief to women who experienced sexual harassment.¹⁸ Title VII states that it is an “unlawful employment practice for an employer . . . to fail or refuse to hire or to discharge any individual, or otherwise 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.”¹⁹ The text of Title VII does not specifically mention “sexual harassment,” and victims first had to persuade courts that sexual harassment constituted discrimination on the basis of sex.²⁰ Initially, courts were not receptive.²¹ In 1974, the first claim of

¹⁷ 42 U.S.C. § 1981(a) (2003).

¹⁸ 42 U.S.C. § 2000e (2003); *see also* MINK, *supra* note 15, at 24. Prior to the 1964 Act, victims of sex discrimination, and therefore sexual harassment, had no federal statutory recourse. *Id.*

¹⁹ 42 U.S.C. § 2000e. The 1964 Act only prohibited racial discrimination in employment when it was first introduced to Congress. 110 CONG. REC. H2577-84 (1964). The prohibition of sex discrimination in employment was added during the congressional debates on the bill. *Id.* In fact, it is believed that members of Congress opposed to the passage of the Civil Rights Act actually included the prohibition on sex discrimination in employment to help defeat the passage of the bill. Stephanie Schaeffer, *Sexual Harassment Damages and Remedies*, 73 AM. JUR. TRIALS 1 § 6 (1999).

²⁰ MINK, *supra* note 15, at 24; Schaeffer, *supra* note 19, at § 6. Plaintiffs asked the courts to recognize that sexual harassment was an “unlawful employment practice . . . because of . . . sex,” as prohibited by Title VII. 42 U.S.C. § 2000e (2003).

²¹ MINK, *supra* note 15, at 24; *see* *Corne v. Bausch & Lomb, Inc.*, 390 F. Supp. 161 (D. Ariz. 1975) (holding that plaintiffs subjected to sexual advances by their supervisor had not been discriminated on the basis of their sex); *Barnes v. Train*, 13 Fair Empl. Prac. Cas. (BNA) 123 (D.D.C. 1974), *available at* 1974 WL 10528 (ruling that plaintiff’s assertion of sexual harassment was not discrimination on account of sex), *rev’d sub nom.* *Barnes v. Costle*, 561 F.2d 983 (D.C. Cir. 1977).

sex discrimination based on sexual harassment was dismissed.²² The court explained that the woman had been discriminated against not because she was a woman, but because of her refusal to engage in a sexual affair with her supervisor.²³ The following year, another court denied two women relief under Title VII, finding it was “ludicrous” to hold that the activity involved constituted sex discrimination in employment.²⁴ The court reasoned that the alleged sexual advances made by the supervisor were merely attributed to his “personal urge,” without any relation to a discriminatory policy of the employer.²⁵ Therefore, the court found that his actions could not constitute sex discrimination in employment.²⁶

It was not until 1976, in *Williams v. Saxbe*, that a court ruled

²² *Barnes*, 13 Fair Empl. Prac. Cas. (BNA) at 123.

²³ *Id.* Paulette Barnes alleged that her supervisor at the Environmental Protection Agency had asked her to begin an affair and told her that doing so would improve her employment position. *Id.* She declined, and was eventually fired. *Id.* The court found against her, maintaining that this was a “personal controversy underpinned by the subtleties of an inharmonious personal relationship.” *Id.*

²⁴ *Corne v. Bausch & Lomb, Inc.*, 390 F. Supp. 161 (D. Ariz. 1975). In *Corne*, two plaintiffs, Jane Corne and Geneva DeVane, alleged that they had been repeatedly subjected to verbal and physical advances from their supervisor, Leon Price. *Id.* They also stated that because they did not want to cooperate with Mr. Price, they resigned from their positions as clerical workers. *Id.* Therefore, they argued that they had been subjected to a sex discriminatory condition of employment. *Id.* See MINK, *supra* note 15, at 25 (discussing *Corne*).

²⁵ *Corne*, 390 F. Supp. at 162. The court stated:

Mr. Price’s conduct appears to be nothing more than a personal proclivity, peculiarity, or mannerism. By his alleged sexual advances, Mr. Price was satisfying a personal urge. Certainly no employer policy is here involved; rather than the company being benefited in any way by the conduct of Price, it is obvious that it can only be damaged by the very nature of the acts complained of. Nothing in the complaint alleges nor can it be construed that the conduct complained of was company directed policy which deprived women of employment opportunities.

Id. at 163.

²⁶ *Id.*

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in favor of a sexual harassment plaintiff.²⁷ The claimant, Diane Williams, alleged that she was humiliated and fired after rejecting sexual advances from her supervisor.²⁸ The District Court for the District of Columbia ruled that she had demonstrated discrimination based on her sex pursuant to Title VII.²⁹ The defendant argued that sex discrimination was not demonstrated because there had been no gender stereotyping but, rather, the plaintiff was fired for refusing to accept her supervisor's sexual advances.³⁰ The court stated that this argument was "an erroneous analysis of the concept of sex discrimination as found in Title VII"³¹ To the contrary, the court found that Congress intended broad construction of Title VII to include a discrimination claim based on a "rule, regulation, practice or policy . . . applied on the basis of gender," even if it did not arise out of an employer's "well-recognized sex stereotype."³² After *Williams*, courts commonly accepted Title VII sexual harassment claims,³³ making Title VII the main basis of relief for

²⁷ *Williams v. Saxbe*, 413 F. Supp. 654 (D. D.C. 1976).

²⁸ *Id.* at 655. Ms. Williams alleged that after she refused the sexual advance of her supervisor, Mr. Brinson, he continued to harass and humiliate her by, among other things, giving her unwarranted reprimands for her job performance. *Id.* at 655-56. After investigating her allegations, the EEOC informed Ms. Williams that a "finding of no discrimination was proposed." *Id.* at 656. At an administrative hearing, the complaints examiner found no discrimination on the basis of sex because "the evidence did not establish 'any causal relationship' between her rejection of Mr. Brinson and his subsequent treatment of her and her ultimate termination." *Id.* Ms. Williams then sued in the District Court for the District of Columbia to recover damages under Title VII. *Id.* at 655.

²⁹ *Id.* at 657-58.

³⁰ *Id.* at 657.

³¹ *Id.* at 658.

³² *Id.*

³³ MINK, *supra* note 15, at 48. Both *Barnes* and *Corne* were eventually overturned so that the plaintiffs were allowed to pursue their sexual harassment claims under Title VII. *Barnes v. Costle*, 561 F.2d 983 (D.C. Cir. 1977), *rev'g Barnes v. Train*, 13 Fair Empl. Prac. Cas. (BNA) 123 (D.D.C. 1974), *available at* 1974 WL 10528; *Corne v. Bausch & Lomb, Inc.*, 19 Empl. Prac. Dec. P9181 (D. Ariz. 1978), *available at* 1978 WL 205, *rev'g* 390 F. Supp. 161 (D. Ariz. 1975). There is still some debate over whether

victims of sexual harassment.³⁴

In 1980, the United States Equal Employment Opportunity Commission (EEOC), a federal agency created pursuant to § 705 of Title VII, published guidelines for employers to demonstrate preventive measures employers should take to eliminate sexual harassment in the workplace.³⁵ In addition, the EEOC guidelines

same-gender sexual harassment qualifies as discrimination on the basis of sex. *See Oncale v. Sundowner Offshore Serv., Inc.*, 523 U.S. 75 (1998) (ruling that same sex harassment is actionable); Debra L. Raskin, *Sexual Harassment in Employment*, SG 083 A.L.I.-A.B.A. 691, 729 (2000) (providing a general discussion about the development of same-gender sexual harassment case law).

³⁴ Schaeffer, *supra* note 19, at § 6. Plaintiffs may also sue for sexual harassment under several other federal statutes. Debra L. Raskin, *Sexual Harassment in Employment*, Employment Discrimination and Civil Rights Actions in Federal and State Courts, SG083 A.L.R.-A.B.A. 691, 799 (2002). For instance, plaintiffs may sue pursuant to 42 U.S.C. §§ 1985(3), 1986 for conspiracy to deprive them of their legal rights. 42 U.S.C. §§ 1985, 1986 (2003); *see Lyes v. City of Riviera Beach*, 166 F.3d 1332 (11th Cir. 1999) (holding that women are protected by § 1985 from conspiracies of sex discrimination); *Palace v. Deaver*, 838 F. Supp. 1016 (E.D. Pa. 1993) (allowing assertion of conspiracy to sexually harass plaintiff in order to deny her equal protection rights). Plaintiffs may also sue under Title IX of the Education Amendments of 1972. 20 U.S.C. § 1681 (2003); *see Franklin v. Gwinnett County Pub. Sch.*, 503 U.S. 60 (1992) (ruling in favor of a plaintiff asserting a Title IX sexual harassment case against a public school).

In addition, most states now have anti-discrimination statutes that entitle women to sue for sexual harassment as a form of sex discrimination. *See* Debra S. Katz & Alan R. Kabat, *Sexual Harassment in the Workplace*, SH039 A.L.I.-A.B.A. 1111 (2002) (giving an overview of current sexual harassment law). Alabama is the only state that does not have a race or sex discrimination law. *Id.* at 1235. *See, e.g.*, California Fair Employment and Housing Act, CAL. GOV'T CODE §§ 12900-96 (2003); New York Human Rights Law, N.Y. EXEC. LAW §§ 290-301 (2001); *see* Katz & Kabat, *supra* at 1235 (providing a complete list of all state anti-discrimination law citations).

³⁵ JOEL WM. FRIEDMAN & GEORGE M. STRICKLER, JR., *THE LAW OF EMPLOYMENT DISCRIMINATION: CASES AND MATERIALS* 17, 409 (5th ed. 2001) (discussing the creation and purposes of the EEOC); MINK, *supra* note 15, at 24 (discussing the role of the EEOC in the development of sexual harassment law). The guidelines were first published on November 10, 1980. ALBA CONTE, *SEXUAL HARASSMENT IN THE WORKPLACE: LAW AND PRACTICE* § 2.8 (2d ed. 1994) (describing the use of EEOC guidelines in the law of sexual harassment).

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included definitions of sexual harassment to help victims recognize and pursue their claims.³⁶ The EEOC guidelines define sexual harassment as:

Unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature when (1) submission to such conduct is made either explicitly or implicitly a term or condition of an individual's employment, (2) submission to or rejection of such conduct by an individual is used as the basis for employment decisions affecting such individual, or (3) such conduct has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile, or offensive working environment.³⁷

The EEOC is authorized to enforce federal anti-

³⁶ FRIEDMAN & STRICKLER, *supra* note 35, at 409. Although these guidelines are not binding on the courts, they are a guide for what constitutes actionable sexual harassment, and many courts still refer to them in making rulings on sexual harassment claims. Schaeffer, *supra* note 19, at § 14 (1999) (providing an overview of the EEOC guidelines stating what is actionable sexual harassment); *see, e.g.*, Meritor Sav. Bank v. Vinson, 477 U.S. 57, 65-66 (1986) (approving and relying on the EEOC guidelines in making its decision). "The Commission has applied the Guidelines in its enforcement litigation, and many lower courts have relied on the Guidelines." U.S. Equal Employment Opportunity Commission, *EEOC Enforcement Activities*, Dec. 4, 2002 [hereinafter EEOC Enforcement Activities], at <http://www.eeoc.gov/enforce.html>.

³⁷ 29 C.F.R. § 1604.11 (2003). Employers are held liable for acts of sexual harassment committed by their employees. § 1604.11(d). The EEOC guidelines state, "With respect to conduct between fellow employees, an employer is responsible for acts of sexual harassment in the workplace where the employer (or its agents or supervisory employees) knows or should have known of the conduct, unless it can show that it took immediate and appropriate corrective action." *Id.* In addition, an employee may hold an employer liable for harassment caused by a non-employee if the employer (or its agents or supervisory employees) knew or "should have known of the conduct and fail[ed] to take immediate and appropriate corrective action." § 1604.11(e). These policies provide an incentive for employers to implement programs encouraging sexual harassment prevention. FRIEDMAN & STRICKLER, *supra* note 35, at 409.

discrimination laws by receiving complaints from employees who believe they have suffered employment discrimination.³⁸ Before suing in federal court for a violation of employment discrimination laws, potential plaintiffs must first file a complaint with the EEOC.³⁹ If the EEOC finds reasonable cause to believe that the discrimination has occurred, it attempts to reach a resolution between the individual filing the charge and the responding employer.⁴⁰ The EEOC may also file lawsuits in federal court on behalf of employees who believe they have been discriminated against or allow the charging party to file an action in court without further EEOC involvement.⁴¹

The Supreme Court decided its first sexual harassment case, *Meritor Savings Bank v. Vinson*, in accordance with the EEOC guidelines.⁴² The Court explicitly acknowledged the EEOC definition of sexual harassment, ruling that employers can be liable for two types of harassment: quid pro quo harassment and harassment that creates a hostile work environment.⁴³ Quid pro

³⁸ FRIEDMAN & STRICKLER, *supra* note 35, at 409. *See also* EEOC Enforcement Activities, *supra* note 36.

³⁹ FRIEDMAN & STRICKLER, *supra* note 35, at 409.

⁴⁰ EEOC Enforcement Activities, *supra* note 36. All charges the EEOC receives are classified into three categories: "Category A" includes charges that are given priority in investigation efforts and settlement efforts "due to the early recognition that discrimination has likely occurred; "Category B" includes charges that require further investigation to determine whether discrimination has occurred; "Category C" includes charges that are unsupported or non-jurisdictional and are closed immediately. *Id.*

⁴¹ *Id.* In 1972, the federal government authorized the EEOC to file lawsuits on behalf of workers. KAREN J. MASCHKE, LITIGATION, COURTS, AND WOMEN WORKERS 3 (1989) (providing the history of sex discrimination in employment and the judicial response to such claims). Parties may voluntarily participate in the EEOC's alternative dispute resolution program, where a neutral mediator assists in confidentially resolving discrimination issues between parties. EEOC Enforcement Activities, *supra* note 36. The EEOC may also file lawsuits on behalf of employees in "egregious" discrimination cases or file amicus curiae briefs to support EEOC positions. *Id.*

⁴² 477 U.S. 57 (1986); *see* Schaeffer, *supra* note 19, at § 7 (discussing the impact of *Meritor* on the law of sexual harassment).

⁴³ Schaeffer, *supra* note 19, at § 14. If liability is proven, the same types

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quo harassment occurs when an employment benefit has been conditioned, implicitly or explicitly, on an employee's compliance with an unwelcome sexual activity.⁴⁴ On the other hand, hostile environment sexual harassment involves unwelcome sexual advances, requests for sexual favors or other verbal or physical conduct of a sexual nature in the workplace.⁴⁵ According to *Meritor*, hostile work environment sexual harassment is actionable when it is "sufficiently severe or pervasive 'to alter

of remedies are usually available for both types of sexual harassment cases, depending on the circumstances of each individual case. 42 U.S.C. §2000e-5(g) (2003). "If the court finds that the respondent has intentionally engaged in . . . an unlawful employment practice . . . , the court may . . . order such affirmative action as may be appropriate . . . or any other equitable relief as the court deems appropriate." *Id.* "In an action brought by a complaining party under [42 U.S.C. 2000e-5] against a respondent who engaged in unlawful intentional discrimination . . . the complaining party may recover compensatory and punitive damages . . ." 42 U.S.C. § 1981a (2003). Federal district courts have discretion over which remedies will be available to plaintiffs on a case by case basis. *Id.*; Schaeffer, *supra* note 19, at §14.

⁴⁴ MINK, *supra* note 15, at 50. *See* Miller v. Bank of Am., 600 F.2d 211 (9th Cir. 1979) (finding quid pro quo harassment where the plaintiff was fired after refusing supervisor's sexual advances); Williams v. Saxbe, 413 F. Supp. 654 (D.D.C. 1976) (finding sexual harassment where the plaintiff was discharged after refusing her supervisor's sexual advances).

⁴⁵ LITIGATING THE SEXUAL HARASSMENT CASE 3 (Matthew B. Schiff & Linda C. Kramer eds., 2d ed. 2000) (providing an overview of sexual harassment litigation tactics and information for claimants). *See e.g.*, Meritor Sav. Bank v. Vinson, 477 U.S. 57, 57 (1986) (holding that sexual harassment occurred where the plaintiff was subject to many unwelcome sexual advances and was even raped on several occasions); Katz v. Doyle, 709 F.2d 251 (4th Cir. 1983) (finding sexual harassment where the plaintiff endured sexual slurs, insults and other offensive verbal harassment in the workplace); Henson v. City of Dundee, 682 F.2d 897 (11th Cir. 1982) (holding that sexual harassment occurred where an employee was subjected to demands for sexual relations from her supervisor and sexual language on numerous occasions). Catherine MacKinnon originally asserted the idea that hostile environment should be a recognizable form of sexual harassment. *See generally*, CATHERINE MACKINNON, SEXUAL HARASSMENT OF THE WORKING WOMAN: A CASE OF SEX DISCRIMINATION (1979). MacKinnon declared that quid pro quo harassment was not the only type of harassment that could violate Title VII. *Id.* at 2, 40.

the conditions of [the victim's] employment and create an abusive working environment.’”⁴⁶

B. Damages Under Sexual Harassment Law

Under the Civil Rights Act of 1964, only back pay, injunctions and other forms of equitable relief were available to prevailing sexual harassment plaintiffs under Title VII.⁴⁷ The Civil Rights Act of 1991 (the 1991 Act) changed this result—presently, a plaintiff can be awarded many types of damages: reinstatement, back pay, front pay, compensatory and punitive damages, attorneys' fees and costs and pre-judgment interest.⁴⁸ The 1991 Act defines compensatory damages as including “future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other non-pecuniary losses.”⁴⁹ The 1991 Act's expansion of available

⁴⁶ *Meritor*, 477 U.S. at 67 (quoting *Henson v. City of Dundee*, 682 F.2d 897, 904 (11th Cir. 1982)). This severity requirement was satisfied in *Meritor*. *Id.* Vinson described a situation where her supervisor made repeated requests for sexual favors while at work, fondled her in front of other employees, followed her into the women's restroom and exposed himself to her and raped her on several occasions. *Id.* at 60.

⁴⁷ 42 U.S.C. § 2000e-5(g) (2003). See Deborah F. Buckman, *Award of Compensatory Damages Under 42 U.S.C.A. §1981A for Violation of Title VII of Civil Rights Act of 1964*, 154 A.L.R. FED. 347, § 2 (1999) (discussing the expansion of available remedies under Title VII throughout the years).

⁴⁸ 42 U.S.C. § 1981(a) (2003). See Buckman, *supra* note 47, at § 2; Schaeffer, *supra* note 19, at §§ 16-17. Pre-judgment interest is normally awarded on back pay and compensatory damages and accrues from the date the plaintiff was terminated until the date the plaintiff receives a judgment in a lawsuit for sexual harassment. Schaeffer, *supra* note 19, at § 26. An award of pre-judgment interest ensures that the plaintiff is fully compensated for her economic losses. *Id.* The 1991 Act states that “[a] complaining party may recover punitive damages . . . if the complaining party demonstrates that the respondent engaged in a discriminatory practice or discriminatory practices with malice or with reckless indifference to the federally protected rights of an aggrieved individual.” 42 U.S.C. § 1981a(b) (2003).

⁴⁹ § 1981a(b)(3). Compensable pecuniary losses may include, but are not limited to, back pay and front pay. LITIGATING THE SEXUAL HARASSMENT CASE, *supra* note 45, at 24. Back pay compensates plaintiffs for the wages

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damages evidenced congressional recognition that victims of sex discrimination deserve compensation for all of their resultant harms.⁵⁰

According to the 1991 Act, employers may be liable for compensatory and punitive damages up to \$300,000 per plaintiff, depending upon the size of the employer's work force.⁵¹

they would have earned had they not been discriminated against, while front-pay awards for future lost earnings. *EEOC v. Joe's Stone Crab, Inc.*, 15 F. Supp. 2d 1364, 1380 (S.D. Fla. 1998). Basically, front pay compensates the victim for wages she loses while she is looking for employment comparable to the employment she would hold but for the discrimination. *Id.* Therefore, front pay is usually only awarded when it would be impracticable for the court to require the reinstatement or re-hiring of the victim. *Id.* at 1378-80. In addition, plaintiffs may also seek compensatory damages for other pecuniary losses such as moving expenses, job search expenses, medical expenses, physical therapy and other expenses reasonably incurred as a result of the discriminatory conduct. LITIGATING THE SEXUAL HARASSMENT CASE, *supra* note 45, at 447.

⁵⁰ *See, e.g.*, *Williams v. Pharmacia Ophthalmics, Inc.*, 926 F. Supp. 791, 794 (N.D. Ind. 1996), *aff'd*, 137 F.3d 944 (7th Cir. 1998) (ruling that a sex discrimination plaintiff's award of \$1,250,000 in compensatory and punitive damages be reduced only as far as the statutory maximum of \$300,000 because "compensation is the primary purpose of the new remedies provided by the 1991 Act"); *see infra* Part III.C and note 221 (describing the types of harms caused by sexual harassment). The plaintiff, Evelyn Williams, won her lawsuit based on the allegations that she had not been considered for a promotion and was later terminated because of her sex. *Williams*, 926 F. Supp. at 794. The court of appeals, struck down her punitive damage award but upheld her compensatory damage award. *Id.*

⁵¹ 42 U.S.C. § 1981(b)(3) (2003). Under the 1991 law, damages are capped according to the number of employees working for the employer found liable for the harassment: an employer with between 15 and 100 employees can be liable for no more than \$50,000; for an employer with 101 to 200 employees, damages are capped at \$100,000; for an employer with 201 to 500 employees, the cap is \$200,000; for an employer with more than 500 employees, the cap is \$300,000. *Id.* Because the cap applies to the amount of damages each plaintiff may recover from an employer, however, an employer might have to pay \$300,000 to each plaintiff suing that employer for the same sexual harassment claim. 42 U.S.C. § 1981(a) (stating "damages awarded under this section, shall not exceed, for each complaining party . . . \$300,000"). On the other hand, just because a single plaintiff brings several different sex discrimination claims does not mean the plaintiff may recover

Therefore, when a jury awards more than \$300,000 to a sexual harassment plaintiff, the judge must reduce the award to what she deems an appropriate amount pursuant to the damage cap provision.⁵² After compensatory and punitive damage awards are granted, the court may also award attorneys' fees and costs to compensate a successful plaintiff for the expense of bringing the action.⁵³ There are two general reasons why attorneys' fees are

\$300,000 in damages for each one of her claims. *Hudson v. Reno*, 130 F.3d 1193 (6th Cir. 1997), *cert. denied* 119 S. Ct. 64, L. Ed. 2d 50 (U.S. 1998) (holding that sex discrimination and retaliation plaintiff could not recover the statutory maximum on each of her asserted claims but, rather, could only recover the statutory maximum once to compensate for all her claims combined). When plaintiffs request punitive or compensatory damages the court is not to inform the jury of the statutory caps put on damage awards. 42 U.S.C. § 1981a(c) (2003). This requirement enables the jury to make its own determination of appropriate damages based on the facts of the case without any influence from the monetary limits of the statute. *See Buckman, supra* note 47, at § 5 (discussing the expansion of available damages under Title VII and the statutory cap on those damages).

⁵² 42 U.S.C. § 1981(b)(3) (2003). When a jury award is excessive, the trial judge has discretion on how far to reduce the award below the damage cap. *Schaeffer, supra* note 19, at § 31. Therefore, courts differ on whether to reduce excessive awards to the statutory maximum or below the statutory maximum. *See, e.g., Luciano v. Olsten Corp.*, 110 F.3d 210 (2d Cir. 1997) (upholding the trial judge's reduction of an award to no lower than the statutory maximum of \$300,000, where the plaintiff was awarded more than \$5 million in punitive and compensatory damages). *But see Hennessy v. Penril Datacomm Networks*, 69 F.2d 1344 (7th Cir. 1995) (holding that when the jury awards punitive damages in excess of the statutory cap, under certain circumstances, the award may be reduced to an amount below the statutory maximum).

⁵³ 42 U.S.C. § 2000e-5(k) (2003). *See also Schaeffer, supra* note 19, at § 35; *CONTE, supra* note 35, at §6.55. Title VII states that "the court, in its discretion, may allow the prevailing party, other than the Commission or the United States, a reasonable attorney's fee (including expert fees) as part of the costs, and the Commission and the United States shall be liable for costs the same as a private person." § 2000e-5(k). The use of "the Commission" refers to the Equal Employment Opportunity Commission. *See supra* text accompanying notes 35-41 (describing the purposes of the EEOC). If the plaintiff loses her lawsuit and the employer prevails, the prevailing employer may only recover attorneys' fees if the court finds that the "plaintiff's action was frivolous, unreasonable, or without foundation, even though not brought

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recoverable pursuant to Title VII. First, compensation for litigation expenses is the last step in restoring the plaintiff to the position she would have been in if the harassment had not taken place.⁵⁴ Second, there would be less of an incentive to file sexual harassment lawsuits if plaintiffs had to bear the costs of hiring attorneys and pursuing their claims.⁵⁵ Courts have broadly construed the provision of Title VII allowing recovery of attorneys' fees to fully compensate victims for their injuries and encourage victims to vindicate their civil rights.⁵⁶

II. TAXATION OF DAMAGE AWARDS

Historically, the United States tax code excluded personal injury damage awards from income taxation.⁵⁷ Through the Small Business Job Protection Act, however, Congress significantly narrowed this exclusion.⁵⁸ Just five years after expanding damages available under the Civil Rights Act of 1991, Congress amended the tax code to limit the exclusion to damages received on account of physical personal injuries.⁵⁹ In addition, the

in subjective bad faith." *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412, 421 (1978).

⁵⁴ LITIGATING THE SEXUAL HARASSMENT CASE, *supra* note 45, at 496.

⁵⁵ *Id.*

⁵⁶ *Id.* at 496; *see Brandau v. Kansas*, 168 F.3d 1179 (10th Cir. 1999), *cert. denied*, 119 S. Ct. 1808, 143 L. Ed. 2d 1012 (U.S. 1999) (holding that an award of nominal damages in a hostile work environment case entitled the plaintiff to recover attorneys' fees from defendant); *see also CONTE*, *supra* note 35, at § 6.55.

⁵⁷ 26 U.S.C. § 104(a) (1995); F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725, 726 (1997).

⁵⁸ Small Business Job Protection Act, Pub. L. No. 104-188, 110 Stat. 1755 (1996); *see infra* Part I.C (discussing the implications of the Small Business Job Protection Act's amendment to the tax code).

⁵⁹ 26 U.S.C. § 104(a)(2) (2003); Civil Rights Act of 1991, 42 U.S.C. § 1981(a) (2003). *See supra* Part I.B (discussing the expansion of remedies pursuant to the Civil Rights Act of 1991); *see also infra* text accompanying notes 102-04 (discussing the taxation of non-physical injury damage awards in light of the expansion of remedies).

distinction between physical and non-physical injuries generated disagreement among circuit courts about the tax treatment of attorneys' fees awarded in non-physical injury cases.⁶⁰

A. Personal Injury Taxation

The taxation of damages has undergone many changes since the federal income taxation program was first adopted in 1913.⁶¹ As early as 1918, damage recoveries for personal injuries were excluded from the calculation of gross income, regardless of the type of injury.⁶² Two major theories developed on why Congress excluded all personal injury damage recoveries.⁶³ The first notion is that damage awards for personal injuries are not "income" per se; therefore, they should not be taxed as "income."⁶⁴ This theory derives from the historically accepted common law definition of "income."⁶⁵ For taxation purposes, income is "a gain that adds to the capital already owned by the person."⁶⁶ If damage awards compensate individuals for losses caused by personal injuries, they cannot constitute "gains" in capital

⁶⁰ See *infra* Part II.D and text accompanying notes 140-42 (discussing the split among circuits on how to treat contingent attorneys' fee awards).

⁶¹ U.S. Const. Amend. XVI. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived . . ." *Id.*; Hubbard, *supra* note 57, at 732.

⁶² Revenue Act of 1918, Pub. L. No. 65-254 § 213(b)(6), 20 Stat. 1057, 1066 (1919); Hubbard, *supra* note 57, at 741. Thus, at that time, damage awards based on non-physical personal injuries received the same tax treatment as those for physical personal injuries. 26 U.S.C. § 104 (1995). The relevant section of the tax code provided, "In General . . . gross income does not include . . . the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." *Id.*

⁶³ Hubbard, *supra* note 57, at 738 (providing theories for the exclusion since Congress did not provide an explanation).

⁶⁴ *Id.* at 739.

⁶⁵ *Id.* at 736.

⁶⁶ *Id.*; see *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913) (stating that "[i]ncome may be defined as the gain derived from capital, from labor, or from both combined").

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because they are actually “returns” of capital.⁶⁷ If recoveries for personal injuries are merely returns of capital, they are outside the tax code’s definition of taxable “income.”⁶⁸ A second possible explanation for the exclusion is that Congress made a humanitarian policy decision benefiting tort victims by refusing to tax their damage awards.⁶⁹ Congress might have been suggesting that victims of personal injuries deserve compensation without an additional tax burden.⁷⁰

To determine which damage awards should be excludable from income taxation, courts first had to clarify what constituted “personal injuries” within the meaning of the original exclusion provision.⁷¹ During the 1920s, both the Bureau of Internal Revenue and the Board of Tax Appeals ruled that alienation of affection and defamation constituted personal injuries, excluding damage awards from taxation.⁷² The Board of Tax Appeals stated that the damages “[made] the plaintiff whole as before the injury” and did not constitute a gain in income.⁷³ Therefore, the

⁶⁷ Hubbard, *supra* note 57, at 739. For example, in *O’Gilvie v. United States*, the Court stated that the exclusion of personal injury damages from taxation has been based on the decision not to tax damages that are making up for a loss to the victim. 519 U.S. 79, 80 (1996). *See also* *Comm’r v. Glenshaw Glass Co.* 348 U.S. 426, 432 n.8 (1955). “The long history of departmental rulings holding personal injury recoveries nontaxable [is based] on the theory that they roughly correspond to a return of capital” *Id.*

⁶⁸ Hubbard, *supra* note 57, at 739. *See also* *Stratton’s Independence*, 231 U.S. at 415 (stating the historically accepted definition of “income” to be a “gain”).

⁶⁹ Hubbard, *supra* note 57, at 738-39.

⁷⁰ *Id.* at 739.

⁷¹ Revenue Act of 1918, Pub. L. No. 65-254 § 213(b)(6), 20 Stat. 1057, 1066 (1919); *see supra* note 62 (providing the language of the tax code’s original exclusion of personal injuries from gross income).

⁷² Sol. Op. 132, 1922-1 C.B. 92 (1922) (ruling that damages awarded for alienation of affection, defamation and surrender of a minor’s custody did not constitute income); *Hawkins v. Comm’r*, 6 B.T.A. 1023 (1927) (excluding damages awarded for defamation suit brought against former employer for publishing defamatory statements). *See* Wolff, *supra* note 12, at 1356 (describing the implications of the Solicitor General’s opinion in 1992 on the definition of income).

⁷³ *Hawkins*, 6 B.T.A. at 1025.

damages were excluded from taxation.⁷⁴ Consistent with this principle, during the 1950s several Internal Revenue rulings held that the personal injury tax exclusion applied to compensation payments for inhumane treatment by enemy governments to former prisoners of war.⁷⁵ In 1960, the Treasury ruled that damages paid pursuant to a lawsuit or settlement based on “tort or tort-type rights,” as opposed to contract rights, would be excludable from income taxation.⁷⁶

The passage of the federal civil rights acts required courts to apply the personal injury tax exclusion to damages awarded in the newly created employment discrimination causes of action.⁷⁷ The tax court first addressed the taxation of damages awarded in employment discrimination cases in 1975 in *Hodge v.*

⁷⁴ *Id.*

⁷⁵ See Rev. Rul. 58-370, 1958-2 C.B. 14 (1958) (ruling that payments made by Austria to victims of Nazi persecution were excludable); Rev. Rul. 56-462 1956-2 C.B. 20 (1956) (ruling that payments to prisoners of war in the Korean War were excludable); Rev. Rul. 56-518, 1956-2 C.B. 25 (1956) (ruling that payments to victims of Nazi persecution were excludable); Rev. Rul. 55-132, 1955-1 C.B. 213 (1955) (ruling that payments to prisoners of war in World War II for violation of the Geneva Convention were excludable); Sager & Cohen, *supra* note 9, at 454, n.48 (indicating IRS rulings affirming the position that damages received from personal injuries were not taxable).

⁷⁶ Treas. Reg. § 1.104-1(c) (1960); see Sager & Cohen, *supra* note 9, at 454.

⁷⁷ F. Philip Manns, Jr., *Restoring Tortiously Damaged Human Capital Tax-Free Under Internal Revenue Code Section 104(a)(2)'s New Physical Injury Requirement*, 46 BUFF. L. REV. 347, 356-57 (1998). This is because, for the first time, tax courts were required to determine whether injuries caused by employment discrimination should be taxable income. *Id.* Courts differed on whether it was appropriate to look toward the nature of the injuries caused by violations of the Civil Rights Act or the nature of the damages provided to successful plaintiffs in determining the taxability of damage awards. *Id.* See *Hodge v. Comm'r*, 64 T.C. 616, 619 (1975) (requiring taxation of a back-pay award granted in a racial discrimination case because of the nature of the damage award). *But see* *Roemer v. Comm'r*, 716 F.2d 692, 697 (9th Cir. 1983) (ruling that a damage award from a defamation action was excludable because of the nature of the claim).

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Commissioner.⁷⁸ The court concluded that back pay awarded in a Title VII employment case was taxable income because it was not based on a personal injury.⁷⁹ The court further reasoned that since wages are ordinarily taxable income, an award for lost wages should be taxable as well.⁸⁰

Most circuit courts disagreed with the tax court's approach in *Hodge*.⁸¹ During the 1980s, the Sixth and Ninth circuits changed the direction of the interpretation of the personal injury exclusion.⁸² These courts looked toward the nature of the claim rather than the nature of the damages awarded to determine whether the damages should be subject to income taxation.⁸³

⁷⁸ *Hodge*, 64 T.C. 616. The plaintiff, a former truck driver, alleged that he had been denied a job transfer from "city driver" to "line driver" because of his race. *Id.* at 617. He was awarded the difference between his salary in his current job and the job to which he had been denied a promotion. *Id.* He and his wife then attempted to exclude half of the damages awarded on the basis that he was being compensated for a personal injury. *Id.* at 618. The court ruled that the back-pay award was taxable income. *Id.* at 619.

⁷⁹ *Id.* The court did not rule on the taxability of a compensatory damage award because the 1991 Act had not yet been passed, so compensatory damages were not recoverable for Title VII claims. 42 U.S.C. § 2000e-5g (2003); 42 U.S.C. § 1981a (2003).

⁸⁰ *Hodge*, 64 T.C. at 619. Therefore, it was the nature of the award that determined its taxability. Manns, *supra* note 77, at 359.

⁸¹ Manns, *supra* note 77, at 359. See *Rickel v. Comm'r*, 900 F.2d 655, 661-64 (3d Cir. 1990) (reversing the tax court's determination that the nature of damages rather than the nature of the claim should be determinative of the taxability of damages); *Threlkeld v. Comm'r*, 848 F.2d 81, 84 (6th Cir. 1988) (ruling that damages in a malicious prosecution and injury to reputation case were excludable because of the nature of the claims); *Roemer*, 716 F.2d at 697. But see *Thompson v. Comm'r*, 866 F.2d 709, 712 (4th Cir. 1989) (ruling consistent with *Hodge* that the claim for back pay was not excludable because it was essentially a contractual claim for unpaid wages, and therefore was not a tort-type award). On the other hand, the *Thompson* court ruled that liquidated damages were excludable from taxation because they had been awarded for a tort-type injury. *Id.*

⁸² *Threlkeld*, 848 F.2d 81; *Roemer*, 716 F.2d 692; see also Manns, *supra* note 77, at 359.

⁸³ Manns, *supra* note 77, at 359. Although these cases did not deal with sexual harassment claims, they decided the tax treatment of damages received in connection with other non-physical injuries and therefore are influential in

First, in *Roemer v. Commissioner* the Ninth Circuit ruled that an award for defamation should be excludable because of the nature of the tort of defamation.⁸⁴ The court determined that a defamation claim was a personal injury within the purview of § 104(a)(2)'s exclusion.⁸⁵ Ruling the damages excludable, the court stated that "the relevant distinction that should be made is between personal and non personal injuries, not between physical and nonphysical injuries."⁸⁶

In 1986, the Sixth Circuit made a similar decision in *Threlkeld v. Commissioner*.⁸⁷ The plaintiff sought to exclude his recovery for an injury to his reputation caused by a malicious prosecution.⁸⁸ The Sixth Circuit adopted the tax court's holding that any compensatory damages "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" were excludable from income tax.⁸⁹ The court further explained that to determine whether an injury was personal, "we must look to the origin and character of the claim . . . and not to the consequences that result from the injury."⁹⁰ Therefore, the nature of the actual injury, not the nature of the damages received from the lawsuit, was the dispositive factor in determining the tax treatment of the damages

deciding the tax treatment of damages received from sexual harassment lawsuits. See *Threlkeld*, 848 F.2d at 84 ("We must look to the nature of the underlying injury to determine excludability under [S]ection 104(a)(2)."); *Roemer*, 716 F.2d at 697 ("We must look to the nature of the tort . . . to determine whether the award should have been reported as gross income.").

⁸⁴ *Roemer*, 716 F.2d at 694 (ruling that Roemer, who won a lawsuit for defamation created by a false credit report, was entitled to exclude his damage awards from his gross income for tax purposes).

⁸⁵ *Id.* at 697-98.

⁸⁶ *Id.* at 697.

⁸⁷ *Threlkeld v. Comm'r*, 848 F.2d 81, 84 (6th Cir. 1988) (holding that damages won by Threlkeld in a malicious prosecution suit resulting from his endurance of a series of false lawsuits were excludable from taxation).

⁸⁸ *Id.* at 81-82.

⁸⁹ *Threlkeld v. Comm'r*, 87 T.C. 1294, 1308 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

⁹⁰ *Threlkeld*, 87 T.C. at 1299. This analysis is termed the "nature of the claim" test. Manns, *supra* note 77, at 359-60.

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awarded.⁹¹ The plaintiff's recovery was excludable from income tax because the nature of the injury was "personal."⁹² The court stated, "A personal injury has long been understood to include non-physical as well as physical injuries. Therefore, 'personal' must be defined more broadly than 'bodily' injury."⁹³ In addition, both the *Roemer* and *Threlkeld* courts held that lost earnings received on account of both physical and non-physical injuries were excludable from taxation.⁹⁴ These rulings were made despite the fact that wages are ordinarily taxable as income.⁹⁵

B. The History of the Taxation of Employment Discrimination Recoveries

During the years following *Threlkeld*, however, courts struggled to apply the nature of the claim test to different types of damage awards won in employment discrimination cases.⁹⁶ In 1992, the Supreme Court in *United States v. Burke* held that a back-pay award for a Title VII sex discrimination claim was

⁹¹ *Threlkeld*, 848 F.2d at 84; Douglas A. Kahn, *Taxation of Damages After Schleier—Where Are We and Where Do We Go From Here?*, 15 QUINNIPIAC L. REV. 305, 308-09 (1995) (examining past court rulings about the taxation of personal injury damage awards).

⁹² *Threlkeld*, 87 T.C. at 1299.

⁹³ *Id.* at 1305. The types of non-physical injuries denied tax exclusion by § 104(a)(2) include employment discrimination, slander, libel, defamation and wrongful death. Loiacono, *supra* note 2; *see also* Philip Buchan, *New Hope on NonPhysical Injury Taxes*, TRIAL, Jan. 1998, at 11.

⁹⁴ *Threlkeld*, 87 T.C. at 1300; *Roemer v. Comm'r*, 716 F.2d 692, 697 (9th Cir. 1983).

⁹⁵ *Hodge v. Comm'r*, 64 T.C. 616, 619 (1975); *see Threlkeld*, 848 F.2d at 81 (ruling that lost wages award is excludable); *Roemer*, 716 F.2d at 693 (ruling award for lost earnings to be excludable).

⁹⁶ *Downey v. Comm'r*, 97 T.C. 150, 161 (1991), *rev'd*, 33 F.3d 836 (7th Cir. 1994) (ruling that damages received for age discrimination in employment were excludable from gross income); *Comm'r v. Burke*, 929 F.2d 1119 (6th Cir. 1991), *rev'd*, 504 U.S. 229 (1992) (ruling that a damage award for sex discrimination was excludable from gross income). The tax court in *Downey* stated, "Some confusion has arisen . . . when the focus has shifted from the source and character of the injury . . . to its consequences." *Downey*, 97 T.C. at 161.

taxable.⁹⁷ The Court found the equitable remedies available for Title VII claims distinguishable from the typical compensatory damages available for the tort-type personal injuries aimed at in the § 104(a) tax exclusion.⁹⁸ Using its own version of the nature of the claim approach, the Court held that a claim could not be considered tort-like unless it provided remedies similar to traditional tort claims.⁹⁹ For instance, the Court compared the damages available under Title VII, which only provided back pay, with Title VIII of the Civil Rights Act of 1968, which provided for both compensatory and punitive damages.¹⁰⁰ The

⁹⁷ 504 U.S. 229 (1992). This case was based on the pre-1991 amendment Civil Rights Act pursuant to which compensatory damages were not recoverable. 42 U.S.C. § 2000e-5(g) (2003); *Burke*, 504 U.S. at 231; see Brent B. Nicholson, *Recent Developments Concerning the Taxation of Damages Under Section 104(A)(2) of the Internal Revenue Code*, 61 ALB. L. REV. 215, 218 (1997) (exploring the taxability of personal injury damage awards and the Supreme Court's decision in *Burke*). The original plaintiff in *Burke* was Judy A. Hutcheson, who brought a Title VII claim in the Eastern District of Tennessee. *Burke*, 504 U.S. at 231. Other employees, including Therese A. Burke, joined, alleging that their employer had discriminated against them by denying salary increases on the basis of their sex. *Id.* They reached a settlement agreement with the employer and later petitioned the district court for a determination that the settlement payments were excludable from their gross income. *Id.* at 232. The district court ruled that the settlement payments were not excludable, and the Sixth Circuit reversed. *Id.* at 232.

⁹⁸ *Burke*, 504 U.S. at 237-38. Compensatory damages are typically granted for pain, suffering, emotional distress, or injury to reputation. Nicholson, *supra* note 97, at 218. The court looked back to the 1960 treasury regulation which stated that any case arising under a tort or tort-type right would be considered a personal injury and any damages flowing from such injury would be excludable. *Burke*, 504 U.S. at 234; Treas. Reg. § 1.104-1(c) (1960); see *supra* text accompanying note 76. This type of analysis is termed the "tort-type" or "tort-like" analysis. See Manns, *supra* note 77, at 361.

⁹⁹ *Burke*, 504 U.S. at 237; Manns, *supra* note 77, at 360; see cases cited *supra* note 83 (discussing the nature of the claim approach).

¹⁰⁰ *Burke*, 504 U.S. at 240. At the time of the plaintiff's claim, Title VII allowed courts to award "such affirmative relief as may be appropriate," including back pay and reinstatement, as well as "any other equitable relief." 42 U.S.C. § 2000e-5(g) (2003); Buckman, *supra* note 47, at § 2. Title VIII, however, allowed plaintiffs to recover "actual damages" and "injunctive or other equitable relief." 42 U.S.C. § 3612(g)(3) (1995). In addition, Title VIII

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Court suggested that were compensatory damages recoverable under Title VII, a compensatory damage award would be excludable because the injury would be within the same category as tort-type injuries.¹⁰¹

After the 1991 Act expanded the types of damages recoverable for discrimination suits, the Internal Revenue Service (IRS) ruled that those damages were based on personal injuries.¹⁰² Therefore, “compensatory damages, including back pay, received in satisfaction of a claim of disparate treatment gender discrimination under Title VII . . . are excludable from gross income as damages for personal injury under Section 104(a) of the Code.”¹⁰³ The ruling also held that this applied even if the compensatory damages were comprised only of back pay.¹⁰⁴

In *Commissioner v. Schleier*, however, the Supreme Court ruled that the back pay and liquidated damages received in settlement of an Age Discrimination in Employment Act (ADEA) claim were not excludable from taxation.¹⁰⁵ The Supreme Court

provides that the court may assess a “civil penalty” against the respondent. *Id.*

¹⁰¹ *Burke*, 504 U.S. at 237. The court stated:

Notwithstanding a common-law tradition of broad tort damages and the existence of other federal antidiscrimination statutes offering similarly broad remedies, 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. Thus, we cannot say that a statute such as Title VII, whose sole remedial focus is the award of back wages, redresses a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations.

Id. at 241.

¹⁰² Rev. Rul. 93-88, 1993-2 CB 61 (1993); 42 U.S.C. § 1981(a) (2003); *see infra* Part I.B (describing the expansion of available remedies for sex discrimination in employment plaintiffs).

¹⁰³ Rev. Rul. 93-88, 1993-2 CB 61. The ruling also applied to disparate treatment racial discrimination under Title VII as well as amounts received under the Americans with Disabilities Act. *Id.*

¹⁰⁴ *Id.* The ruling was short-lived, however, as it was suspended. Rev. Rul. 95-45, 1995-1 C.B. 53 (1995). *See infra* text accompanying notes 117-19 (discussing the IRS’s position after Rev. Rul. 93-88 was suspended).

¹⁰⁵ 515 U.S. 323, 327 (1995) (holding that a member of an age

granted certiorari to resolve the appellate court conflict about the tax exclusion of damages.¹⁰⁶ At the time *Schleier* was decided, the ADEA provided only punitive damages and back pay as remedies.¹⁰⁷ Therefore, the Court followed *Burke*'s "tort-type" reasoning to decide the available remedies were not sufficient to render the recovery excludable from income tax under § 104(a).¹⁰⁸ The Court found that the victim in *Schleier* suffered several different injuries when he was fired in contravention of the ADEA.¹⁰⁹ Although emotional distress was a personal injury,

discrimination class action suit against United Airlines was required to pay income taxes on his entire \$145,629 settlement, which included both back pay and liquidated damages). Pursuant to the ADEA, an individual proving she has been discriminated against on the basis of age can sue to recover lost wages. If the discrimination is willful, the individual may recover liquidated damages in the amount equal to lost wages. 29 U.S.C. § 621 (2000). See *Schleier*, 515 U.S. at 325-26.

¹⁰⁶ *Id.* at 327. David B. Jennings, *The Supreme Court Gets Tough with I.R.C. S 104(A)(2) Exclusions: Taxpayer Discrimination Awards Suffer Injury as a Result of Commissioner v. Schleier*, 40 ST. LOUIS U. L.J. 865, 866 (1996) (reporting on the status of the taxation of damage awards prior to 1996). The case was specifically taken to resolve a split among the Ninth, Seventh and Fifth circuits, which had conflicted over whether back pay and liquidated damages received in age discrimination suits were excludable. *Schmitz v. Comm'r*, 34 F.3d 790 (9th Cir. 1994); *Downey v. Comm'r*, 33 F.3d 836 (7th Cir. 1994); *Schleier v. Comm'r*, 26 F.3d 1119 (5th Cir. 1994).

¹⁰⁷ 29 U.S.C. §§ 621, 626 (1994). "Amounts owing to a person as a result of a violation of this chapter shall be deemed to be unpaid minimum wages or unpaid overtime compensation . . . provided that liquidated damages shall be payable only in cases of willful violations of this chapter." 29 U.S.C. § 626(b). The Supreme Court in *Trans World Airlines, Inc. v. Thurston* ruled that liquidated damages received pursuant to the ADEA are considered punitive damages. 469 U.S. 111 (1985).

¹⁰⁸ *Schleier*, 515 U.S. 323; Jennings, *supra* note 106, at 866.

¹⁰⁹ *Schleier*, 515 U.S. at 330; Kahn, *supra* note 91, at 329. One injury he may have suffered was emotional distress. *Schleier*, 515 U.S. at 330. The plaintiff was fired from his position at United Airlines at the age of sixty, according to the company's policy at that time. *Id.* at 325. He and other employees sued the employer in a class action seeking lost earnings, liquidated damages, injunctive relief and other relief. *Id.* at 326. The emotional distress he suffered could have stemmed from the emotional pain and humiliation from being fired from his job. *Id.* at 329. Another injury he suffered was the

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he was not compensated for it through his lawsuit.¹¹⁰ He was compensated for the loss of his job through back pay, but this was an economic injury and not a personal injury.¹¹¹ Therefore, it did not satisfy the tort-type *Burke* test, and could not be excluded from income tax.¹¹²

Even though the Court found that ADEA damages were not consistent with tort-type rights to satisfy *Burke*, the Court further stated that the *Burke* test was not the final analysis.¹¹³ Instead, the Court articulated a two-part test to determine whether the tax exclusion applied.¹¹⁴ The Court stated that the exclusion applied only when the damages “(i) [were] received through prosecution or settlement of an action based upon tort or tort-type rights . . . and (ii) [were] received on account of personal injuries or sickness.”¹¹⁵ Therefore, because the plaintiff’s settlement award was not based on a personal injury, he could not exclude the award from his gross income.¹¹⁶

Following *Schleier*, on December 30, 1996, the IRS issued another ruling on the subject.¹¹⁷ The ruling stated that in employment discrimination cases, lost wages must be included in the calculation of gross income, but emotional distress awards could be excluded.¹¹⁸ This ruling superseded the ruling issued prior to *Schleier*, and conformed the IRS’s position to the Supreme Court’s holding in *Schleier*.¹¹⁹

economic loss from having his job taken away. *Id.* at 330-31.

¹¹⁰ Kahn, *supra* note 91, at 329. The plaintiff had won a set of “liquidated damages,” but the Court considered those to be punitive damages, and therefore not received on account of a personal injury. *Schleier*, 515 U.S. at 323. Thus, they could not be excluded. Kahn, *supra* note 91, at 329.

¹¹¹ Kahn, *supra* note 91, at 329-30.

¹¹² *Schleier*, 515 U.S. at 334.

¹¹³ *Id.* at 333-34; Jennings, *supra* note 106, at 883.

¹¹⁴ *Schleier*, 515 U.S. at 333-34.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 337.

¹¹⁷ Rev. Rul. 96-65, 1996-2 C.B. 6 (1996).

¹¹⁸ *Id.*

¹¹⁹ *Id.* See *supra* note 104 (citing the suspension of the ruling in effect prior to *Schleier*); *supra* text accompanying notes 102-04 (explaining the IRS

In the same month, the Supreme Court held that punitive damages for physical injuries were not excludable under § 104(a).¹²⁰ Although the case involved punitive damages awarded for a physical injury, the opinion included an important discussion of the policy supporting § 104(a)'s historical tax exclusion of certain damage awards.¹²¹ The Court questioned § 104(a)'s exclusion of lost wages from taxation, stating that exclusion for that type of damages goes "beyond what one might expect a purely tax-policy related 'human capital' rationale to justify."¹²² The Court observed that exclusion of lost wages entitled the victim to a windfall because she would not have to pay taxes on wages that she would ordinarily have paid if not for the personal injury.¹²³ The Court was suggesting that just as punitive damages, which serve to punish wrongdoing, did not restore "human capital," neither did an award for lost wages; therefore, neither should be excludable from gross income.¹²⁴

C. Taxation of Compensatory Damage Awards After the Small Business Job Protection Act of 1996

In 1996, through a provision in the Small Business Job

ruling in effect prior to the Supreme Court decision in *Schleier*).

¹²⁰ *O'Gilvie v. U.S.*, 519 U.S. 79 (1996) (holding that the surviving spouse of a tort victim was required to pay taxes on punitive damages won in the victim's suit for personal injuries). This case was decided after § 104(a) was amended in 1996, but the decision was based on the pre-amendment statute. *Id.* In 1995, the relevant section of the tax code provided that "gross income does not include . . . the amount of any damages received . . . on account of personal injuries or sickness." 26 U.S.C. § 104 (1995). The plaintiffs in the case were the husband and children of a woman who died of toxic shock syndrome in 1983. *O'Gilvie*, 519 U.S. at 81. The plaintiffs sued the manufacturer of the product that had caused her death and were awarded \$1,525,000 in actual damages and \$10 million in punitive damages. *Id.* The plaintiffs paid income tax on the punitive damages but argued that they should be refunded. *Id.*

¹²¹ *O'Gilvie*, 519 U.S. at 82-90.

¹²² *Id.* at 86.

¹²³ *Id.*

¹²⁴ *Id.*

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Protection Act (SBJPA),¹²⁵ Congress created a bright line rule to determine which damage awards would be taxable in the future.¹²⁶ Although the SBJPA was best known for its increase of the minimum wage and tax cuts to small businesses,¹²⁷ it also contained a provision amending § 104(a) to state that only non-punitive damages paid on account of physical injuries or physical sickness may be excluded from gross income.¹²⁸

The amended statute also explicitly states that, with one

¹²⁵ Pub. L. No. 104-188, 110 Stat. 1755 (1996).

¹²⁶ 26 U.S.C. § 104(a)(2) (2003). The SBJPA was codified throughout several provisions of the Internal Revenue Code, but the damage award amendment is specifically codified in 26 U.S.C. § 104(a)(2). *Id.*

¹²⁷ Pub. L. No. 104-188. The Conference report on the Act stated its purposes were to:

[P]rovide tax relief for small businesses, to protect jobs, to create opportunities, to increase the take home pay of workers, to amend the Portal-to-Portal Act of 1947 relating to the payment of wages to employees who use employer owned vehicles, and to amend the Fair Labor Standards Act of 1938 to increase the minimum wage rate and to prevent job loss by providing flexibility to employers in complying with minimum wage and overtime requirements under that Act.

H.R. REP. NO. 104-737 (1996).

¹²⁸ Small Business Job Protection Act, Pub. L. No. 104-88, 110 Stat. 1755 (1996). The relevant post-amendment sections read:

(a) In General. Except in the case of amounts attributable to (and not in excess of) deductions allowed under Section 213 (relating to medical to medical, etc. expenses) for any prior taxable year, gross income does not include—

...

(2) 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.

...

For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.

26 U.S.C. § 104(a) (2003). See *supra* note 62 for the pre-amendment code sections.

notable exception,¹²⁹ emotional distress is not within the definition of physical injuries or sickness.¹³⁰ This means that a lawsuit based on emotional distress alone will not trigger the § 104(a)(2) exclusion for damage awards.¹³¹ On the other hand, if a claim for emotional distress is attached to a physical personal injury, compensatory damages received for emotional distress can be excluded from the individual's gross income.¹³² To clarify, if an individual receives a compensatory damage award or settlement stemming from a physical personal injury, the entire award would be excludable from taxation.¹³³ In contrast, if an

¹²⁹ The portion of a compensatory damage awards allotted to the reimbursement of medical expenses relating to emotional distress stemming from any personal injury (physical or non-physical) may be excluded from gross income. § 104(a); A. Van Lanckton & Joseph A. Brear, Jr., *Federal Tax Treatment of Personal Injury Damages*, 44 PRACTICAL LAWYER No. 3, 59, at 60 (1998).

¹³⁰ 26 U.S.C. § 104; *see supra* note 128 (providing the exact language of the statute's emotional distress reference). Compensatory damages received on account of wrongful death actions or loss of consortium claims are excludable from gross income pursuant to § 104(a)(2). Internal Revenue Service, *Lawsuit Awards and Settlements*, DIGITAL DAILY, at <http://www.irs.gov/businesses/page/0,,id=7050,00.html> [hereinafter *Lawsuit Awards and Settlements*] (last visited April 18, 2003). The House Committee Report for the 1996 amendment states:

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income.

H.R. REP. NO. 104-737, at 88 (1996).

¹³¹ 26 U.S.C. § 104(a) (2003).

¹³² *See* Patrick E. Hobbs, *The Personal Injury Exclusion: Congress Gets Physical But Leaves the Exclusion Emotionally Distressed*, 76 NEB. L. REV. 51, 87 (1997) (explaining the different interpretations of the emotional distress provision in § 104(a)(2)); *see also* Coyle, *supra* note 8 (stating, "If a plaintiff received damages for pain and suffering attendant to a physical injury, the plaintiff could still deduct those damages from gross income.").

¹³³ § 104(a)(2); Robert Margolis, *Personal Injuries—Physical and*

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individual were to recover compensatory damages stemming from a non-physical personal injury, the entire award would be taxable.¹³⁴

According to the 1996 House Ways and Means Committee Report on the SBJPA, one reason for the amendment was to end confusion about the tax treatment of damages in non-physical injury cases, in light of decisions such as *Schleier*.¹³⁵ Although the full reasoning for Congress's distinction between physical and non-physical injuries remains speculative, the origin of the amendment is easily traceable to the federal government's continuing search for revenue.¹³⁶ To increase federal funds,

NonPhysical, 1 MERTENS LAW OF FED. INCOME TAX'N § 7.91 (2002). This exclusion applies to a lost wages award a plaintiff recovers in a physical injury lawsuit. § 104(a)(2). Any punitive damages, however, would not be excludable for any type of injury pursuant to § 104(a)(2). *See id.* This could theoretically cause a problem in a situation where a plaintiff in a physical injury case is awarded a lump sum settlement including both punitive and compensatory damages. Lanckton & Brear, *supra* note 129, at 63. If the award comes from a trial by jury, the jury will state which part of the award was attributed to the compensatory damages as opposed to punitive damages. *Id.* If the award comes from a settlement, however, the person who prepares the tax payer's tax return must determine which portion of the award is attributable to punitive damages or compensatory damages. *Id.* There is a good faith requirement for this, and the preparer must look at all the evidence as well as the initial complaint requesting certain amounts for damages. *Id.* This also sends a message to potential plaintiffs in physical injury lawsuits to consider the tax consequences of their categorization of damages when they prepare their initial complaints. *Id.*

¹³⁴ § 104(a)(2); *see* Lanckton & Brear, *supra* note 129, at 60 (giving an example of tax consequences to plaintiff who wins damages for a non-physical injury).

¹³⁵ H.R. CONF. REP. NO. 104-737 (1996).

The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income The House bill provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness.

Id.; *see also* Comm'r v. *Schleier*, 515 U.S. 323 (1995).

¹³⁶ Marcia Coyle, *U.S. Tax on Damages Under Fire: Bill to Repeal '96 Levy Has Backing of Both Business, Plaintiff Bar*, 21 NAT. L.J. 50, Aug. 9, 1999, at A1. When Congress gave tax breaks to small businesses, it needed to

Congress made all punitive damage awards as well as all damages received on account of non-physical personal injuries taxable income.¹³⁷

D. Taxation of Attorneys' Fees

A separate but related issue to the taxation of compensatory damage awards is the taxation of contingent attorneys' fees and costs. Contingent attorneys' fees often make up a significant portion of the monetary damages successful plaintiffs in sex discrimination cases receive in their judgments or settlements.¹³⁸ It is settled that, similar to compensatory damage awards, attorneys' fees and costs awarded to plaintiffs in cases based on physical injuries are excluded from income tax.¹³⁹ On the other hand, confusion remains about how attorneys' fees and costs awarded for claims of non-physical injuries should be taxed.¹⁴⁰ The Fifth, Sixth, and Eleventh circuits have held contingency fees excludable from gross income for federal income tax

recover the resultant loss in federal income. *Id.*

¹³⁷ 26 U.S.C. § 104(a) (2003); *see also* Coyle, *supra* note 136. This rule has not been changed since § 104(a) was amended in 1996. The changes in the amendment apply to awards received after August 20, 1996, unless received under a "binding written agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995. *Lawsuit Awards and Settlements*, *supra* note 130. The estimated revenue return from the date of this amendment through the year 2000 was \$230 million. Coyle, *supra* note 136.

¹³⁸ Paul M. Jones, *NonPhysical Personal Injury Settlements and Judgments: Amending the Internal Revenue Code to Exclude Attorney Fees*, 35 IND. L. REV. 245 (2001). The court may award a prevailing party a "reasonable attorney's fee as part of costs" in cases under Title VII. 42 U.S.C. § 1988(b) (2003); *supra* note 53.

¹³⁹ § 104(a); Jones, *supra* note 138, at 246 (citing Priv. Ltr. Rul. 99-52-080 (Sept. 30, 1999), which held that damages awarded in a physical injury case were excludable from gross income).

¹⁴⁰ Jones, *supra* note 138, at 246 (commenting on the "crucial shift" taking place "with respect to the income tax treatment of attorney fees awarded in non-physical personal injury settlements and judgments").

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purposes.¹⁴¹ On the other hand, the First, Ninth, and Federal circuits have held that contingent attorneys' fees must be included in gross income and then may be declared as a miscellaneous itemized deduction.¹⁴²

The Seventh Circuit, in *Kenseth v. Commissioner*, tried to resolve the dispute between a divided tax court's decision.¹⁴³ The court ruled that a portion of the plaintiff's settlement award used to pay a contingent attorney's fee had to be included in his calculation of gross income.¹⁴⁴ The court held that when a taxpayer pays a lawyer pursuant to a contingency fee agreement, the taxpayer receives the benefit of the funds because the court allows the taxpayer to recover the full amount of the fee through the lawsuit.¹⁴⁵ Since the taxpayer benefits from the use of the fee, the award must be included in the calculation of gross income,

¹⁴¹ *Id.* at 247. These courts have explained that because state law in these jurisdictions gives attorneys ownership rights in the income received in the settlements or judgment awards, the plaintiff may exclude that portion of the award from his or her own gross income. *Id.* at 247. See *Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) (applying the holding in *Cotnam* and declining to follow the assignment of income approach); *Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000) (allowing plaintiff to exclude portion of damage award paid to plaintiff's attorneys); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959) (allowing exclusion of the award from gross income because of Alabama law granting attorneys rights to the fees).

¹⁴² See *Fredrickson v. Comm'r*, 166 F.3d 342 (9th Cir. 1998) (requiring attorneys' fees awarded to be included in plaintiff's calculation of his gross income); *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995) (requiring plaintiff to declare fees as deduction on income tax return); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995) (ruling that a portion of plaintiff's award paid to attorneys should be included in taxpayer's gross income); *Jones*, *supra* note 138, at 247. These courts take the "assignment of income" approach, reasoning that since plaintiffs "earn" the income from attorneys' fees awards, they cannot assign that income and avoid paying taxes on it. *Jones*, *supra* note 138, at 249.

¹⁴³ 114 T.C. 399 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001) (holding that contingent attorney's fee awarded in settlement was not excludable from plaintiff's gross income).

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 413. The court was using the "assignment of income" approach, as described *infra* note 158.

even though the attorney actually receives that portion of the award.¹⁴⁶ The court stated, however, that the plaintiff would be allowed to declare his legal fees as a miscellaneous itemized deduction.¹⁴⁷

Unfortunately, the ability to declare an attorneys' fee award as a miscellaneous itemized deduction can create further negative tax consequences for some plaintiffs.¹⁴⁸ The limitations already placed by the tax code on miscellaneous itemized deductions can create situations where plaintiffs are taxed on their entire awards, including the portions paid to their attorneys.¹⁴⁹ Usually, the most severe limitation on miscellaneous itemized deductions is the "alternative minimum tax."¹⁵⁰ This rule entirely disallows

¹⁴⁶ Kristina Maynard, *The Fruit Does Not Fall Far from the Tree: The Unresolved Tax Treatment of Contingent Attorney's Fees*, 33 LOY. U. CHI. L.J. 991, 1016 (2002) (arguing that courts should require plaintiffs to include attorneys' fees awards in their gross income).

¹⁴⁷ *Kenseth*, 114 T.C. at 413.

¹⁴⁸ Jones, *supra* note 138, at 256.

¹⁴⁹ *Id.* One limitation put on miscellaneous itemized deductions is that miscellaneous itemized deductions are only deductible to the extent that the aggregate amount of those deductions exceeds two percent of adjusted gross income (AGI). 26 U.S.C. § 67(a) (2003); Maynard, *supra* note 146, at 1010. If the deductions do not amount to more than two percent of a person's AGI, they cannot be deducted at all. Aaron C. Charrier, *Taxing Contingency Fees: Examining the Alternative Minimum Tax and Common Law Tax Principles*, 50 DRAKE L. REV. 315, 325 (2002) (examining the circuit split on the tax treatment of contingent attorneys' fees and arguing that the current tax doctrine contradicts the purpose of contingency fee agreements). For example, assume that an individual wins \$300,000 in a sex discrimination lawsuit in addition to a \$150,000 attorneys' fees award. Her AGI will be \$300,000. *See* 26 U.S.C. § 62 (2003) (providing a list of items that must be deducted from an individual's gross income to arrive at the amount of AGI); Maynard, *supra* note 146, at 1010 n.120 (illustrating calculation of AGI). If she tries to deduct the \$150,000 fee award, 26 U.S.C. § 67(a) requires that she only be allowed to deduct the amount of the attorneys' fee award that exceeds two percent of her AGI (\$300,000). 26 U.S.C. § 67(a). Two percent of her AGI is \$6,000. Therefore, she would still be required to pay tax on \$6,000 of her award. *See* Jones, *supra* note 138, at 255 (providing a hypothetical illustration of the two percent requirement for miscellaneous itemized deductions).

¹⁵⁰ 26 U.S.C. §§ 55-58 (2003). Maynard, *supra* note 146, at 1011 ("Even more onerous than the limitations on deductions for legal fees for regular tax

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miscellaneous itemized deductions by people with significant miscellaneous itemized deductions.¹⁵¹ The amount intended for deduction is added back into the income tax base, and taxes are then paid on the deduction.¹⁵² Moreover, the attorneys' fees will be subject to double taxation—the plaintiff's attorney will also pay his or her own income tax on the attorneys' fee award, despite the fact that the plaintiff is already paying taxes on the award.¹⁵³

An example of the negative effects of the double taxation of attorneys' fees is illustrated by the case of an Iowa citizen named Don Lyons.¹⁵⁴ Mr. Lyons won a sex discrimination lawsuit and

purposes is the treatment of such expenses under the Alternative Minimum Tax.”). The alternative minimum tax is in place to prevent taxpayers with “substantial economic income” from avoiding “significant tax liability by using exclusions, deductions, and credits.” Charrier, *supra* note 149, at 331 (quoting the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 432 (1986)).

¹⁵¹ Charrier, *supra* note 149, at 324-26; Jones, *supra* note 138, at 255. The alternative minimum tax rule is triggered when an individual's tentative minimum tax exceeds the amount the individual would normally pay in taxes on his AGI. 26 U.S.C. § 51(a)(1)-(2) (2003); Charrier, *supra* note 149, at 326. Tentative minimum tax is found by calculating the individual's alternative minimum taxable income, which is usually the individual's gross income before making any itemized deductions. *Id.* at 326. If the amount of tax an individual would pay on the alternative minimum taxable income exceeds the amount she would pay on her AGI with the deduction, the individual will owe the alternative minimum tax. *Id.* at 326. The alternative minimum tax is the difference between the amount the individual owes in taxes on her AGI and the amount the individual would owe on her alternative minimum taxable income. *Id.* at 326-27. Thus, in effect, the alternative minimum tax provision requires individuals to pay taxes on both their regular income and the income listed as a miscellaneous itemized deduction. *Id.*

¹⁵² Jones, *supra* note 138, at 255; *see also* Charrier, *supra* note 149, at 326-28 (providing an illustration of how the alternative minimum tax works).

¹⁵³ *See* Jones, *supra* note 138, at 256 (arguing that the double taxation of attorneys' fees should be abolished).

¹⁵⁴ 146 CONG. REC. S7160-03, S7163 (July 18, 2000) (statement by Sen. Grassley of Iowa, in introducing H.R. 1997 and 4570, quoting a letter sent by Don Lyons, a citizen of Iowa, regarding the current consequences of the taxation of attorneys' fees).

received \$15,000 in damages.¹⁵⁵ After being taxed on this award, Mr. Lyons was left with \$9,533.¹⁵⁶ In a letter to Congress requesting statutory revision to eliminate the tax consequences to Mr. Lyons, his attorney, Victoria L. Herring, stated that she would be requesting a fee reimbursement in the amount of \$150,000.¹⁵⁷ Ms. Herring illustrated that if this request was granted by the court, Mr. Lyons would be required to pay \$67,791 in taxes on the entire award.¹⁵⁸ In Mr. Lyons's jurisdiction, plaintiffs are required to pay tax on attorneys' fee awards.¹⁵⁹ Therefore, after applying his net damage award, \$9,533, to the tax payments he was required to make on his attorneys' fees, he would still owe the government \$58,236 altogether.¹⁶⁰ This was more than two-thirds his normal annual salary and was required despite the fact that his attorney would also be paying income tax on the award of attorneys' fees.¹⁶¹ Even though he would be able to deduct the fee award as a miscellaneous itemized deduction, the triggering of the alternative minimum tax would require him to pay tax on the award anyway.¹⁶²

According to his letter, Mr. Lyons would be required to pay \$5,467 in taxes on his adjusted gross income (AGI).¹⁶³ Mr.

¹⁵⁵ *Id.* at S7163. Don Lyons sued under Title VII alleging that he was retaliated against by his employer because he had "helped" his coworker in filing a sex discrimination complaint against the employer. *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at S7164. Mr. Lyons' attorney stated in her letter to Congress that her fee request was based on her "hourly rate of \$180.00 an hour (a rate much less than that of lawyers in other cities, and probably less than the two defense lawyers from Chicago who tried the case)." *Id.* She further stated, "The fees and expenses amount may seem high, but is the result of a fair amount of contentiousness and the need to take depositions in Kansas and Arizona." *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.* Ms. Herring stated, "Not only will I pay taxes on this figure (gladly so), but my client will also and without the ability to deduct the sum due to the pernicious effect of the alternative minimum tax!" *Id.*

¹⁶³ *Id.* His AGI would be equal to his gross income less any itemized

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Lyons's alternative minimum taxable income (AMTI) would be his regular taxable income, subject to the provisions of sections 56 and 58 of the Internal Revenue Code.¹⁶⁴ Section 56(b)(1)(A)(i) prohibits miscellaneous itemized deductions.¹⁶⁵ Therefore, Mr. Lyon's AMTI would be \$165,000 because it would include his attorney's fee award (which he would list as a miscellaneous itemized deduction) and his other income (\$15,000 in damages from his lawsuit).¹⁶⁶ Assuming Mr. Lyons's tentative minimum tax would exceed the tax owed on his AGI (\$15,000), the alternative minimum tax rule would require that Mr. Lyons's entire AMTI be taxed as if it had not been reported as a deduction at all.¹⁶⁷ Instead, he would owe the difference between his tentative minimum tax and his regular tax on his regular taxable income, in addition to his regular tax.¹⁶⁸ Therefore, he would essentially have to pay taxes on his AGI of \$15,000 in addition to taxes owed on his deduction of \$150,000.¹⁶⁹ In effect, he would be taxed as if he had made no deduction whatsoever.¹⁷⁰

deductions he makes. 26 U.S.C. § 62 (2003). For example, if Mr. Lyons had not earned any other income besides his damages and attorneys' fee award, his AGI would be \$15,000 (\$165,000 gross income less than \$150,000 attorneys' fee deduction equals \$15,000). *Id.* Mr. Lyons's actual gross income for that year is unavailable.

¹⁶⁴ 26 U.S.C. § 55(b)(2)(A) (2003); Charrier, *supra* note 149, at 326.

¹⁶⁵ 26 U.S.C. § 56(b)(1)(A)(i) (2003); Charrier, *supra* note 149, at 327. "In determining the amount of the alternative minimum taxable income of any taxpayer . . . no deduction shall be allowed . . . for any miscellaneous itemized deduction." § 56(b)(1)(A)(i).

¹⁶⁶ See *supra* note 164.

¹⁶⁷ See Charrier, *supra* note 149, at 326-27 (providing a hypothetical illustration of how the alternative minimum tax provision works); Jones, *supra* note 138, at 254-56 (illustrating how to calculate tentative minimum tax rates).

¹⁶⁸ 26 U.S.C. § 55(a)(1)-(2) (2003); Charrier, *supra* note 149, at 327. Mr. Lyons would owe the difference between his tentative minimum tax and the \$5,647 that he would owe in regular tax. *Id.*; see text accompanying note 164.

¹⁶⁹ Charrier, *supra* note 149, at 327.

¹⁷⁰ *Id.*

III. EFFECTS OF SECTION 104(A)(2) ON VICTIMS OF SEXUAL HARASSMENT

Section 104(a) adds to the negative effects that victims of sexual harassment already endure, such as the emotional harms and social stigmas associated with sexual harassment.¹⁷¹ Section 104(a) creates economic disincentives for coming forth with sexual harassment lawsuits because it requires successful plaintiffs to pay taxes on their compensation.¹⁷² In addition, the taxation of damages based on non-physical injuries insinuates that sexual harassment is not a serious injury because damages based on physical injuries are excludable from income tax.¹⁷³

A. Social Stigma and Emotional Harms of Sexual Harassment

In the interests of justice and equality for men and women, Congress recognized the need to compensate victims for the suffering associated with sexual harassment.¹⁷⁴ Unfortunately, although this type of discrimination is a compensable injury, many women still have trouble coming forward with allegations against their employers when they have been sexually harassed.¹⁷⁵ One major explanation is that sexual harassment involves

¹⁷¹ See *infra* Part III.A (discussing the implications § 104(a) has on victims of sexual harassment); see generally MINK, *supra* note 15 (discussing the harms and stigmas created by sexual harassment).

¹⁷² 26 U.S.C. § 104(a)(2) (2003); see *infra* Part III.B (discussing the financial consequences imposed by the tax code upon successful plaintiffs in employment discrimination cases).

¹⁷³ See *supra* note 12; *infra* Part III.C (discussing the social and political consequences of § 104(a)); see also *infra* note 221 (discussing various injuries caused by sexual harassment).

¹⁷⁴ 42 U.S.C. § 1981a (2003); see *supra* Part I (discussing the Civil Rights Act of 1991 and the types of compensatory damages available to victims of sexual harassment).

¹⁷⁵ MINK, *supra* note 15, at 7.

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discussing personal, private subjects.¹⁷⁶ In addition, bringing a complaint of sexual harassment often requires the victim to endure personal attacks on her character as well as suggestions that she may have provoked the harassment, exaggerated it or even lied about it.¹⁷⁷ For exposing their harassers, women can be stigmatized, blacklisted on the job market or ostracized by colleagues and friends.¹⁷⁸

The highly publicized cases of Paula Jones, who sued former President Bill Clinton on allegations of sexual harassment,¹⁷⁹ and

¹⁷⁶ *Id.* at 7.

¹⁷⁷ *Id.* at 27. *See, e.g.*, CLARA BINGHAM & LAURA LEEDY GANSLER, CLASS ACTION: THE STORY OF LOIS JENSON AND THE LANDMARK CASE THAT CHANGED SEXUAL HARASSMENT LAW 349 (2002) (describing the first sexual harassment class action, initiated by Lois Jenson and her fellow female mine workers, who had endured years of hostile environment sexual harassment). In the case of Lois Jenson, opposing attorneys pointed to the fact that she had been raped and had not reported the crime at the time of the incident. *Id.* at 348-49. They argued that since she did not report it, she must have been lying about the rape as well as her sexual harassment claim. *Id.* at 349. Furthermore, despite an agreement between the parties to keep her rape testimony private, the judge deciding the case included details about the rape in his opinion, which then became public information. *Id.* at 349. Other potential members of the class action lawsuit refused to join because they did not want to have to answer painful questions about their families. *Id.* at 286.

¹⁷⁸ MINK, *supra* note 15, at 101. A woman who complains of sexual harassment in the workplace runs the risk of being “branded a troublemaker—or worse, a feminist.” MINK, *supra* note 15, at 81; *see also* BINGHAM & GANSLER, *supra* note 177, at 105 (describing the personal attacks Lois Jenson endured after filing a sexual harassment complaint with her employer). Lois Jenson started working for Eveleth Mines during the late 1970s. BINGHAM & GANSLER, *supra* note 177, at 3. After enduring years of pervasive sexual harassment, she came forward and filed a grievance with the mine worker’s union. *Id.* at 100. After word of her complaint spread around the mine, she found all four of her car tires slashed. *Id.* at 111. When she filed a complaint with the state attorney general, her coworkers immediately shunned her. *Id.* at 126. “People stood together in groups giving her dirty looks, people avoided her.” *Id.* at 126.

¹⁷⁹ MINK, *supra* note 15, at 30. In 1998, Paula Jones’ lawsuit was dismissed by the Eighth Circuit on a motion for summary judgment. *Id.*; Dan Fruomkin, *Case Closed*, WASH. POST, Dec. 3, 1998, *available at* <http://www.washingtonpost.com/wp-srv/politics/special/pjones/pjones.htm>.

Anita Hill, who publicly accused Justice Clarence Thomas of sexual harassment,¹⁸⁰ are poignant examples of the obstacles women face when alleging sexual harassment.¹⁸¹ Both Anita Hill and Paula Jones endured severe criticism and even public outrage for coming forth with allegations against their male supervisors.¹⁸² In particular, the public seemed to find it important that Paula Jones had waited a number of years before speaking publicly about her alleged harassment.¹⁸³ The delay was

Her lawsuit alleged that former Governor of Arkansas and United States President William Jefferson Clinton sexually harassed her while she was employed with the State of Arkansas. *Text of Paula Jones' Complaint*, All Politics, Jan. 13, 1997, available at <http://www.cnn.com/ALLPOLITICS/1997/01/13/jones.supremecourt/suit.shtml>. Ms. Jones alleged that he had made unwelcome sexual advances toward her and that she had felt her employment would be threatened if she were to report the incident. *Id.* She further alleged that she was later terminated because she had rejected the sexual advances made by Mr. Clinton. *Id.*

¹⁸⁰ MINK, *supra* note 15, at 99-100. Anita Hill never actually filed a lawsuit against Justice Clarence Thomas, but during his Supreme Court appointment hearings in 1991, she accused him of having made sexual advances and harassing remarks towards her during their employment at the EEOC. *Id.*; Florence George Graves, *The Complete Anita Hill*, B. GLOBE MAG., Jan. 19, 2003, available at <http://www.boston.com/globe/magazine/2003/0119/coverstory.htm>.

¹⁸¹ Graves, *supra* note 180 (reporting that even after her testimony had ended, Ms. Hill faced media stakeouts at her home); *Paula Jones' Day In Court Draws Nearer*, All Politics, Jan. 8, 1997, available at <http://www.cnn.com/ALLPOLITICS/1997/01/08/jones.morton/index.shtml> (reporting that "everybody in America knows who [Paula Jones] is," but recognizing the public's "dismissive attitude" towards her).

¹⁸² MINK, *supra* note 15, at 2. "The vicious personal attacks weathered by Anita Hill and Paula Jones are no different from those endured by many women who bring sexual harassment claims, although the attacks against Hill and Jones were far louder and more visible than most." *Id.* After testifying at Justice Thomas's appointment hearings, Anita Hill faced "death threats, strangers condemning her to hell, hostile stares" and was accused of "flat-out perjury." Graves, *supra*, note 180. "The GOP had tried to portray Hill as a spurned woman who had fantasized a sexual relationship with Thomas." *Id.* Paula Jones was portrayed as a "trailer park bimbo" in the public eye. *Paula Jones' Day in Court Draws Nearer*, *supra* note 181.

¹⁸³ MINK, *supra* note 15, at 2, 117. Paula Jones was characterized as a

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used against her as a way for society to judge the credibility of her claim.¹⁸⁴ One possible reason she did not immediately come forward, though, is that she, like most victims of sexual harassment, first tried to cope with the harassment privately instead.¹⁸⁵

The fact that so many women over the years have had very little choice but to quietly endure the effects of sexual harassment is one reason the right to sue under Title VII exists—it legitimizes women’s experiences and encourages them to report incidences of sexual harassment.¹⁸⁶ The Supreme Court has stated that the

“gold digger” for attempting to pursue her claim once Mr. Clinton had become president. *Id.* at 2. Mrs. Clinton stated on the *Today Show*, on January 27, 1998, that Ms. Jones’ claim against the president was part of a right-wing conspiracy against him. *Id.* at 117; *Hillary Clinton: ‘This is a Battle,’* All Politics, Jan. 27, 1998, available at <http://www.cnn.com/ALLPOLITICS/1998/01/27/hillary.today>.

¹⁸⁴ MINK, *supra* note 15, at 4-5. The public questioned Ms. Jones’s motives for coming forward with allegations of sexual harassment. *Id.* at 5. Some stated that Hill was more credible than Jones because Hill had been forced to come forward while Jones did so voluntarily. Anna Quindlen, *A Tale of Two Women*, N.Y. TIMES, May 11, 1994, at A1.

¹⁸⁵ MINK, *supra* note 15, at 81; *see supra* notes 184-86 (discussing the various disincentives for coming forth with sexual harassment lawsuits). Women are particularly susceptible to struggling privately with sexual discrimination in “hostile work environments,” where the complaint process is long and tedious. MINK, *supra* note 15, at 81. Lois Jenson, before commencing the first class action sexual harassment lawsuit in America, stated in her diary:

It amazes me that through the years women have kept so silent, but think it should not amaze me, for I have done the same. Since it is against the law. In fact this is not an isolated case but merely that we do not go public. One thought comes to mind. How many violent crimes have emanated from women trying to handle harassment themselves? After all, companies have no set policy until it becomes a necessity and that means that a woman has tried everything she could first and then went to the company

BINGHAM & GANSLER, *supra* note 177, at 105.

¹⁸⁶ BINGHAM & GANSLER, *supra* note 177, at 101. In referring to Title VII, in *Mardell v. Harleysville Life Ins. Co.*, the third circuit stated:

Throughout this nation’s history, persons have far too often been judged not by their individual merit, but by the fortuity of their race,

purpose of the Civil Rights Act was “to achieve equality of employment opportunities and remove barriers that have operated in the past to favor an identifiable group of . . . employees over other employees.”¹⁸⁷ With so many personal, social and political consequences of speaking out about harassment, Title VII recognizes that there should be incentives to persuade women to expose incidences of harassment and encourage people to take steps to eliminate sexual harassment.¹⁸⁸ The federal taxation scheme should be used to support this notion, not contradict it.

the color of their skin, the sex or year of their birth, the nation of their origin, or the religion of their conscientious choosing. Congress has responded to these pernicious misconceptions and ignoble hatreds with humanitarian laws formulated to wipe out the iniquity of discrimination in employment, not merely to recompense the individuals so harmed, but principally to deter future violations A plaintiff in an employment discrimination case accordingly acts not only to vindicate his or her personal interests in being made whole, but also as a ‘private attorney general’ to enforce the paramount public interests in eradicating invidious discrimination.

31 F.3d 1221, 1234 (3d Cir. 1994), *vacated by* 514 U.S. 1034, 115 S. Ct. 1397, 131 L. Ed. 2d 286 (1995), *reinstated by* 65 F.3d 1974 (3d Cir. 1995) (ruling in favor of the plaintiff, who alleged sex and age discrimination in employment). *Mardell* was placed on probation and eventually discharged from her position as a manager for the Harleysville Life Insurance Company. *Id.* at 1222-23. She alleged that she was discharged on the basis of her sex and age, and that she had specifically been told that she “couldn’t be a good old boy” and that the insurance agents would think of her as a “wife.” *Id.* at 1223. The employer tried to counter these arguments by revealing evidence that Ms. *Mardell* had made false representations on her employment application and resume, and that, therefore, the employer could not be found liable for the employment discrimination. *Id.* at 1223. The court found for Ms. *Mardell*, stating that this type of “after-acquired evidence” did not absolve the employer from liability. *Id.* at 1237.

¹⁸⁷ *Albermale Paper Co. v. Moody*, 422 U.S. 405, 417-18 (1975).

¹⁸⁸ One way the government has done this is to create the EEOC. *See supra* Part I (discussing the purposes of the EEOC).

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B. Section 104(a) as an Economic Disincentive to Commencing Sexual Harassment Lawsuits

Section 104(a) creates yet another disincentive for victims of sexual harassment to speak out because it taxes any compensatory damages they might receive through lawsuits.¹⁸⁹ A recent example is the case of Cynthia C. Spina, who was awarded \$3 million by a jury in her sex discrimination and harassment suit against her employer, the Forest Preserve District of Cook County.¹⁹⁰ After winning \$950,000 in attorneys' fees, in addition to \$3 million in punitive and compensatory damages, she still owed an additional \$99,000 to the IRS.¹⁹¹ Therefore, after winning her lawsuit for one of the most egregious violations of Title VII ever seen, she owed more to the IRS than she was actually awarded.¹⁹²

The tax consequences for Ms. Spina were so burdensome that she asked the court to consider the taxation of her award when deciding by how much her jury verdict award should be reduced.¹⁹³ In denying her argument, the magistrate judge stated that he was aware of the tax consequences and was not unsympathetic, but "Congress, not this Court, must correct any

¹⁸⁹ See *supra* Part II (explaining the tax treatment of compensatory damages).

¹⁹⁰ *Spina v. Forest Pres. Dist. of Cook County*, 207 F. Supp. 2d 764 (2002). Ms. Spina won her sexual discrimination, harassment and retaliation claims against her employer. *Id.* at 767. She alleged that she had been berated, belittled and isolated by her male colleagues because of her sex. *Id.* at 767. She complained to her supervisors about her treatment, but the harassment only escalated. *Id.* at 767. Finally, she filed a complaint with the EEOC and filed suit shortly thereafter. *Id.* at 768.

¹⁹¹ Liptak, *supra* note 6. There are no reports on Ms. Spina's exact tax returns. See *infra* notes 196-200.

¹⁹² Liptak, *supra* note 6. The magistrate judge presiding over Ms. Spina's case stated that he did not know of another case in which a plaintiff had "endured such continuous harassment at the hands of so many different officers and superiors for such an extended period of time." *Spina*, 207 F. Supp. 2d at 774.

¹⁹³ *Spina*, 207 F. Supp. 2d at 777.

shortcomings in the tax code's application."¹⁹⁴ Although Ms. Spina sought an equitable exception in her circumstances, the court declined "[p]laintiff's invitation to venture down a slippery slope and wage into this legal morass under a guise of equitable relief."¹⁹⁵

There are several reasons why Ms. Spina's award of approximately \$4 million ended up costing her almost \$100,000 more than what she received.¹⁹⁶ First, the judge was required to reduce Ms. Spina's jury award from \$3 million to \$300,000.¹⁹⁷ The double taxation of attorneys' fees and costs also caused negative tax consequences for Ms. Spina.¹⁹⁸ When Ms. Spina was awarded approximately one million dollars in attorneys' fees in addition to her compensatory and punitive damages, she had to pay income tax on the fees.¹⁹⁹ Although she was in a jurisdiction where she could deduct the portion of the award allotted to the payment of attorneys' fees, the large deduction triggered the alternative minimum tax and required her to pay tax on almost her entire award anyway.²⁰⁰

¹⁹⁴ *Id.* (quoting *Hukkanen Campbell v. Comm'r*, 274 F.3d 1312, 1314 (10th Cir. 2001)).

¹⁹⁵ *Id.*

¹⁹⁶ *Spina v. Forest Pres. Dist. of Cook County*, 207 F. Supp. 2d 764, 777 (2002).

¹⁹⁷ *Id.* at 776. The judge did this in compliance with the cap put on compensatory damages in the Civil Rights Act of 1991. 42 U.S.C. § 1981(b)(3) (2003). *See supra* note 51 (discussing the damage cap provision of the Civil Rights Act of 1991); *see also* Buckman, *supra* note 47, at § 5.

¹⁹⁸ Coyle, *supra* note 8. In certain districts, taxpayers are required to pay taxes on the attorneys' fees and costs they receive when their lawsuits are based on non-physical injuries. *See supra* note 142 (listing districts that require taxation of attorneys' fees). Illinois, the state in which Ms. Spina brought her lawsuit, requires that plaintiffs pay tax on their awards according to the "assignment of income" approach. Liptak, *supra* note 6; *see supra* note 142 (explaining the "assignment of income" approach).

¹⁹⁹ Coyle, *supra* note 8; Liptak, *supra* note 6.

²⁰⁰ 26 U.S.C. §§ 55-58 (2003). *See supra* Part II.D (illustrating the alternative minimum tax). Assuming that Ms. Spina made no additional itemized deductions and earned no additional income in the tax year, her alternative minimum taxable income amounted to \$1,250,000. §§ 55-58. This

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In addition, negative tax consequences can also arise when plaintiffs win lump sum back-pay awards in employment discrimination cases.²⁰¹ The IRS requires the taxation of back-pay awards in the year received, even though the awards usually reflect several years' of lost pay.²⁰² As a result, those who win lump sum back-pay awards are often placed into higher income tax brackets (with higher assigned tax rates) than they would have been in had they received their wages on a regular basis.²⁰³ Meanwhile, if back pay or lost wages are awarded in a physical injury case, they are not taxed at all.²⁰⁴ Thus, the tax code entitles

is because AMTI is equal to her AGI in addition to all miscellaneous itemized deductions. *See supra* text accompanying notes 164-65 (explaining alternative minimum taxable income). Her regular AGI would be equal to \$300,000 because she would be listing the \$950,000 attorneys' fee award as a deduction. 26 U.S.C. § 62 (2003). The tentative minimum tax would then be established using her AMTI. Jones, *supra* note 138, at 255. She would be required to pay the difference between her tentative minimum tax and the regular tax she would owe on her regular AGI (\$300,000). *Id.* Altogether, by operation of these rules in her particular situation, she owed approximately \$99,000 in taxes. Liptak, *supra* note 6.

²⁰¹ 26 U.S.C. §§ 3121, 3402 (2003). Spina's case does not mention whether Ms. Spina was awarded back pay. *Spina*, 207 F. Supp. 2d at 776. The court attributed \$200,000 of her award to emotional distress while \$100,000 was to compensate her for damage to her reputation. *Id.* at 776.

²⁰² 26 U.S.C. § 104(a). The Internal Revenue Code does not include any provision allowing a lump sum award for back pay to be taxed over a number of years. 146 CONG. REC. S1760-03, S1763 (July 18, 2000). Instead, it is taxed as a lump sum in the year that it was awarded by a jury or in a settlement. *Id.*; *Successful Plaintiff Gets Extra Money to Cover Extra Tax, Says P.A. Court*, 6 ANDREWS SEX. HARASSMENT LIT. REP. No. 8, at 12 (Oct. 2000) (discussing the case of O'Neill v. Sears, Roebuck & Co., 108 F. Supp. 2d 443 (E.D. Penn. 2000), where the court awarded the plaintiff money to cover the negative tax consequences of receiving a lump sum back-pay award).

²⁰³ 146 CONG. REC. S1760-03, S1763 (July 18, 2000).

²⁰⁴ *Id.* The Supreme Court in *O'Gilvie* pointed out that an exclusion for lost wages actually entitles victims to a windfall in that they would ordinarily be required to pay income tax on those wages had they earned them through employment. *O'Gilvie*, 519 U.S. at 86. After the 1996 amendment to § 104(a), however, only victims of physical injuries are entitled to this preferential treatment. 26 U.S.C. § 104(a)(2) (2003).

victims of physical injuries to another inequitable tax benefit.²⁰⁵

All of this leads to the conclusion that when potential plaintiffs approach a lawyer about initiating sexual harassment litigation, they face another consideration—the possibility that, if they win, they may be in a worse financial position than when they started.²⁰⁶ Women who decide to bring sexual harassment claims already have to consider the risk of job loss, injury to their reputations and the economic consequences of losing their lawsuits.²⁰⁷ Now, they also must take into account the fact that, even if they establish liability, they may have to pay the IRS

²⁰⁵ See 26 U.S.C. § 104(a)(2); see also Sager & Cohen, *supra* note 9, at 448-49 (criticizing the distinction made between the exclusion of back pay in physical injury cases and the taxation of back pay in non-physical injury cases). Sager and Cohen argue that in all personal injury cases, damages for lost earnings should be taxable and damages received for pain and suffering should be excludable because damages should be taxed only if they compensate the taxpayer for money that would have been taxable if received under usual circumstances. *Id.* at 449-50.

²⁰⁶ Liptak, *supra* note 6 (reporting that attorneys must now instruct clients on the potential effects of § 104(a) on their damage recoveries). As a general rule, in cases based on federal statutes, evidence and arguments about the tax consequences of verdict amounts may be introduced to the jury. See Kenneth G. Zaleski, *Jury Instructions as to Tax Consequences*, 5 MERTENS LAW OF FED. INCOME TAX'N § 24A:12 (2002). State laws vary on this issue, though. *Id.* The majority rule is that juries may not be told of the tax status of personal injury awards in state actions. *Id.* This principle was articulated in the leading case on the subject, *Norfolk & Western Ry. Co. v. Liepelt*, where the Supreme Court ruled that it was error not to instruct the jury as to the tax-free status of damages awarded in a Federal Employers' Liability Act (FELA) wrongful death action. 444 U.S. 490 (1980); Federal Employers' Liability Act, 45 U.S.C. § 51 (2003). In *Norfolk*, the plaintiff suffered fatal injuries during his employment as a fireman. *Norfolk*, 444 U.S. at 491. His estate sued under FELA and was awarded \$750,000 of non-taxable damages by a jury. *Id.* The appellate court ruled that it was not error for the court to have not instructed the jury that the plaintiffs would not be required to pay tax on the award. *Id.* The Supreme Court reversed. *Id.* at 498. Nevertheless, the Supreme Court's ruling has often been limited to actions arising under FELA and, unfortunately for victims like Ms. Spina, is not always followed in cases arising under federal laws. See Zaleski, *supra* note 206.

²⁰⁷ See *supra* Part III.A (discussing the harms of sexual harassment).

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more than they recover in damages.²⁰⁸ Women are much less likely to take their chances suing employers for harassment if they think they may have to exhaust their financial resources litigating with no reward in the end.²⁰⁹ Instead, they are left to endure the personal effects of sexual harassment quietly, while those guilty of harassment escape any consequences.²¹⁰

The financial disincentives created by § 104(a)(2) may decrease the number of Title VII sexual harassment claims prosecuted by victims.²¹¹ Because meritorious lawsuits are burdened by § 104(a), this provision undermines the Title VII goals of enabling and encouraging victims to bring sex discrimination claims.²¹² If victims no longer have a reason to pursue lawsuits against those guilty of harassment, there will be no consequences in place for employers who violate Title VII and

²⁰⁸ See *Spina v. Forest Pres. Dist. of Cook County*, 207 F. Supp. 764, 777 (2002).

²⁰⁹ Liptak, *supra* note 6 (citing Cynthia Spina's lawyer, Monica McFadden, who said that the "tax laws will result in fewer civil rights cases"). Ms. McFadden went on to state, "It has an enormously chilling effect. I have to advise a person coming to me that it is entirely possible not only that any award they achieve will go to the Internal Revenue Service but that they will owe the Internal Revenue Service money." *Id.* "It's had a chilling effect on employment discrimination cases and dire consequences for some people. If people can't afford to win, why would they go to the trouble of even pursuing the case, no matter how important or meritorious." Coyle, *supra* note 8 (quoting Carlton Carl of the Association of Trial Lawyers of America (ATLA)).

²¹⁰ MINK, *supra* note 15, at 3.

²¹¹ See *supra* note 209 (quoting an attorney on the resultant loss of lawsuits caused by the taxation of non-physical injury damage awards).

²¹² Coyle, *supra* note 136. The Supreme Court in *Meritor* stated that Title VII "affords employees the right to work in an environment free from discriminatory intimidation, ridicule, and insult." *Meritor Sav. Bank v. Vinson*, 477 U.S. 57, 65 (1986). The EEOC furthers this goal by asking employers to implement reporting systems that encourage victims of sexual harassment to come forward with claims. U.S. Equal Employment Opportunity Commission, *Policy Guidance on Current Issues of Sexual Harassment*, at <http://www.eeoc.gov/docs/currentissues.html> (last visited March 21, 2003).

the EEOC guidelines.²¹³

Additionally, § 104(a)(2) discourages settlements because settlement payments are susceptible to the same tax treatment as trial awards.²¹⁴ Furthermore, settlements often pose a financial problem for employers, just as they pose a problem for plaintiffs.²¹⁵ Now that lawyers advise victims about the tax consequences of settlement awards,²¹⁶ victims often seek increased monetary damages to compensate for the negative financial burdens they face regarding income taxes.²¹⁷ Employers are discovering that they have to pay more than the plaintiffs would have sought if § 104(a)(2) did not make the award taxable.²¹⁸ Businesses are further economically burdened by this because Title VII provides that only employers may be liable for sexual harassment, even when an individual employee committed

²¹³ H.R. REP. NO. 102-40 pt. 1 (1991). In his report to Congress on the Civil Rights Act of 1991, Congressman Ford of Michigan stated:

America is a better country because we as a people have moved forward toward the goal of eradicating discrimination. Nowhere is that more important than in the workplace. Of almost any sector of American life, the progress toward equality has been greatest in the workplace precisely because of strong federal equal employment opportunity laws.

Id. By discouraging victims from utilizing the laws and guidelines put in place by the federal government, Congress is contradicting the very purposes for which those laws were enacted—to protect from evils of sex discrimination that occur in the workplace. 146 CONG. REC. S1760-03, S1763 (July 18, 2000); see Wolff, *supra* note 13, at 1409 (examining the taxation of non physical injuries against the backdrop of the progress of the civil rights movement in the United States).

²¹⁴ 26 U.S.C. § 104(a)(2) (2003) (stating, “gross income does not include . . . the amount of any damages . . . (whether by suit or agreement) . . . on account of personal physical injuries or physical sickness”); Coyle, *supra* note 136.

²¹⁵ Coyle, *supra* note 136 (explaining that businesses are paying plaintiffs for the negative tax burdens of their settlement awards).

²¹⁶ See *supra* note 209 (quoting a lawyer advising client of tax burdens).

²¹⁷ Coyle, *supra* note 136.

²¹⁸ *Id.* (quoting attorneys David Chashdan and Frederick M. Gittes, who stated that businesses have been paying more to individuals to cover tax consequences).

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the harassment.²¹⁹ Therefore, although the SBJPA was designed to give tax breaks to small businesses, it may in fact create an additional tax burden for businesses attempting to settle employment discrimination cases.²²⁰

C. Section 104(a)(2) Denies the Reality of the Harms Caused by Sexual Harassment

Victims of sexual harassment suffer a number of harms.²²¹ As a result, the scope of harm for which recovery is permitted in sexual harassment cases is very broad.²²² A victim may recover for more than just emotional distress—she may also sue for damages to reputation and career, loss of pride or self-respect, loss of enjoyment in life or career, impact on family or close friends and loss of community or social standing.²²³ The availability of damages in sexual harassment cases “demonstrates congressional recognition that discriminatory employment practices inflict injuries beyond mere loss of paycheck or

²¹⁹ 42 U.S.C. § 1981(a) (2003); Coyle, *supra* note 136.

²²⁰ Small Business Job Protection Act, Pub. L. No. 104-188, 110 Stat. 1755 (1996); *see infra* Part II.C (discussing the SBJPA).

²²¹ *See* LITIGATING THE SEXUAL HARASSMENT CASE, *supra* note 45, at 447. Victims of sexual harassment may suffer from “stress, uncontrolled anger, alienation, helplessness, fright, tension, nervousness, distress, irritability, depression, persistent sadness, guilt, lability, anergia, hyperenergia, mood swings, impulsivity, emotional flooding, anxiety, fear or loss of control, escape fantasies, compulsive thoughts, rage episodes, obsessional fears, crying spells, vulnerability, diminished self confidence, and decreased self esteem and concentration.” Wolff, *supra* note 12, at 1457. Victims may also experience psychiatric disorders such as depression or post traumatic stress. *Id.* at 1458. In addition, these harms may lead to physical conditions, such as heart disease, ulcers, headaches, insomnia, stomach problems, weight loss, eating disorders and other chronic illnesses. *Id.* Sexual harassment may also strain the victim’s relationships with friends and family. *Id.*

²²² LITIGATING THE SEXUAL HARASSMENT CASE, *supra* note 45, at 447.

²²³ *Id.* at 447; H.R. REP. NO. 102-40, pt. 1, at 15 (1991). “Victims of intentional discrimination often endure terrible humiliation, pain and suffering while on the job. This distress often manifests itself in emotional disorders and medical problems.” *Id.*

reduction in wage and benefits, and congressional intent that victims of employment discrimination should be compensated for those non-pecuniary injuries.”²²⁴

In light of the myriad harms caused by employment discrimination and sexual harassment, it is difficult to understand why Congress distinguished between those harms and others caused by physical injuries.²²⁵ It appears that the government is using the policy of disparate tax treatment of physical and non-physical injury damage awards to insinuate that sex discrimination is not as legitimate or serious an injury as a physical assault.²²⁶ “A victim of discrimination suffers a dehumanizing injury as real as, and often far more severe and lasting harm than, a blow to the jaw.”²²⁷ Yet, the federal tax code contradicts this statement by discriminating against those who are already victims of sex discrimination and taxing them differently

²²⁴ Williams v. Pharmacia Ophthalmics, Inc., 926 F. Supp. 791, 794 (N.D. Ind. 1996), *aff'd*, 137 F.3d 944 (7th Cir. 1998) (ruling that a sex discrimination plaintiff’s compensatory damage award should be set at the statutory maximum cap); *see infra* text accompanying note 50 (providing the facts of the case); *see also supra* note 51 (discussing damage award caps pursuant to Title VII).

²²⁵ *See supra* note 221 (explaining harms of sexual harassment). “It is beyond question that discrimination in employment on the basis of sex . . . is, as . . . this Court consistently has held, an invidious practice that causes grave harm to its victims.” United States v. Burke, 504 U.S. 229, 238 (1992). “[T]he harms women and religious and racial minorities may suffer as a consequence of the various types of intentional discrimination are the same.” H.R. REP. NO. 102-40, pt. 1 (1991). *See also* Wolff, *supra* note 12, at 1464 (investigating the possibility of unconscious discrimination playing a part in the taxation of employment discrimination damage awards).

²²⁶ *See* Brown, *supra* note 12, at 256-68 (highlighting the insinuation § 104(a) makes regarding the importance of job discrimination injuries); Wolff, *supra* note 12, at 1485 (arguing that hidden prejudice is to blame for the unreasonable distinction § 104(a) makes between physical and non-physical injuries).

²²⁷ Mardell v. Harleysville Life Ins. Co., 31 F.3d at 1221, 1232 (3d Cir. 1994). *See also* H.R. REP. NO. 102-40, pt. 1, (1991). (arguing for the expansion of available remedies to victims of sex and race discrimination). “[T]he principle of anti-discrimination is as important as the principle that prohibits assaults, batteries and other intentional injuries to people.” *Id.*

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than victims of other damaging actions.²²⁸

Most importantly, the policy of § 104(a)(2) is not justifiable in light of the progress this country has made since the Civil Rights Act was first enacted in 1964.²²⁹ After years of hard work and rallying against sex discrimination, victims of sexual harassment and other forms of discrimination won the right to go to court, prove that they have been victimized and receive relief.²³⁰ Yet, by taxing the victims of sexual harassment, the federal government invalidates the reality of those victims' injuries.²³¹

In addition, § 104(a)(2) penalizes women for falling victim to sexual harassment in the first place.²³² If the government seeks to use the tax code as a social tool, making policy decisions about the treatment of different societal injuries, it should conform its tax provisions to the political goal of eliminating discrimination in society.²³³ Yet, by forcing women to pay for pursuing sexual

²²⁸ 26 U.S.C. § 104(a)(2) (2003). The exception allowing medical expenses for emotional distress to be excluded from income tax does not overcome the insinuation that non-physical injuries are less personally harmful than physical injuries. *See Wolff, supra* note 12, at 1480. Instead, it supports that perception because it suggests that unless a victim seeks medical help for his or her injuries, those injuries will not be regarded as "real." *Id.*

²²⁹ *See Wolff, supra* note 12, at 1480 (concluding that victims of non-physical injuries endure harms as severe as physical injuries and should therefore receive the same tax treatment as victims of physical injuries); *see also Sager & Cohen, supra* note 9 (stating that "the national commitment to end unlawful discrimination is undermined when damages for the non-physical injury of discrimination are taxed more heavily than damages for physical harm").

²³⁰ 42 U.S.C. § 2000e (2003); 42 U.S.C. § 1981a (2003); *see supra* Part I.A (showing authority for victims to sue for sexual harassment in court); *see also Wolff, supra* note 12, at 1484 (arguing that the progress of civil rights in the U.S. led to a backlash causing the double discrimination of non-physical injury victims).

²³¹ 26 U.S.C. § 104(a)(2).

²³² 146 CONG. REC. S1760-03, S1763 (July 18, 2000). "The result of the [Small Business Protection Act of 1996] was to discriminate against people in civil rights cases." *Id.*

²³³ *See Wolff, supra* note 12, at 1486 n.1 (providing the history of Congress using the Internal Revenue Code to make social policy decisions);

harassment claims, the tax code re-victimizes the victims of sexual harassment. Rather than compensating them for their injuries at the expense of those liable for the harassment, § 104(a)(2) adds to the misfortune victims of sexual harassment suffer.²³⁴

IV. CONGRESSIONAL INVOLVEMENT AND A SUGGESTION FOR THE FUTURE

The negative consequences created by taxing sexual harassment damage awards must be remedied in the legislature.²³⁵ Several solutions have been proposed, including one that Congress is currently considering.²³⁶ This note suggests that the solution best suited to address the negative tax treatment of employment discrimination cases involves taxing defendants rather than victims.

A. *Civil Rights Tax Relief Act*

A simple solution to the troubles of § 104(a) is for Congress to reverse its 1996 amendment and eliminate the disparate tax treatment of non-physical and physical injury damage awards.²³⁷ Congress is currently considering the Civil Rights Tax Relief Act (CRTRA),²³⁸ which proposes to amend the tax code so that damage awards for unlawful discrimination would not be considered part of an individual's gross income for tax

see also, 26 U.S.C. § 170 (2003) (providing for the ability to make tax deductible charitable contributions).

²³⁴ 146 CONG. REC. S1760-03, S1763 (July 18, 2000). "The result of this taxation is that the attorneys and government make out better than the victims who had their rights violated." *Id.* See *supra* note 221 (describing harms caused by sexual harassment).

²³⁵ 146 CONG. REC. S7160-03, (July 18, 2000).

²³⁶ Civil Rights Tax Relief Act, H.R. 840, 107th Cong. (2001). The Civil Rights Tax Relief Act was first introduced in 1998. Coyle, *supra* note 136. The bill is supported by the House Way and Means Committee. *Id.*

²³⁷ 26 U.S.C. § 104(a)(2) (2003).

²³⁸ H.R. 840.

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purposes.²³⁹ Therefore, damages received on account of sexual harassment would receive the same treatment as physical injury damage awards.²⁴⁰ In addition, although the amendment would not allow exclusion of punitive damages or back-pay awards, it would allow income averaging of back-pay awards so they would no longer be taxed in lump sums.²⁴¹ Pursuant to the amendment,

²³⁹ *Id.* The proposal would amend the tax code to state:

(a) In General.

(1) Exclusion. Gross income does not include amounts received by a claimant (whether by suit or agreement and whether as lump sums or periodic payments) on account of a claim of unlawful discrimination.

(2) Amounts covered. For purposes of paragraph (1), the term 'amounts' does not include—

(A) backpay or frontpay (as defined in section 1302(b)), or

(B) punitive damages.

Id. Many are advocating for the equal tax treatment of physical injury and employment discrimination damage awards. See Brown, *supra* note 12, at 223 (arguing for the exclusion of damages for job bias recoveries); Coyle, *supra* note 8; Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries under Federal Civil Rights Statutes: Income from Human Capital, Realization, and NonRecognition*, 72 N.C. L. REV. 549 (1994) (arguing that based on the human capital approach, damage awards for employment discrimination cases as well as physical injuries should be excludable from income tax); Loiacono, *supra* note 2.

²⁴⁰ *Supra* note 239 (providing text of the proposed amendment).

²⁴¹ H.R. 840; see also 146 CONG. REC. S1760-03, S1763 (July 18, 2000).

The tax code would be amended to read:

General Rule. If employment discrimination backpay or frontpay is received by a taxpayer during a taxable year, the tax imposed by this chapter for such taxable year shall not exceed the sum of—

(1) the tax which would be so imposed if—

(A) no amount of such backpay or frontpay were included in gross income for such year, and

(B) no deduction were allowed for such year for expenses (otherwise allowable as a deduction to the taxpayer for such year) in connection with making or prosecuting any claim of unlawful employment discrimination by or on behalf of the taxpayer, plus

(2) the product of—

back-pay awards would be taxed at the same rate as if the individual were still employed.²⁴² Finally, the bill attempts to address the double taxation of attorneys' fees by eliminating the requirement that victims pay taxes on attorneys' fees recovered in successful lawsuits.²⁴³

The CRTRA is a good solution—it would ensure that the tax treatment of damage awards in sexual harassment cases coincides with the policy goals of Title VII's ban on sex discrimination.²⁴⁴

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- (A) the number of years in the backpay period and frontpay period, and
 - (B) the amount by which the tax determined under paragraph (1) would increase if the amount on which such tax is determined were increased by the average annual net backpay and frontpay amount.

H.R. 840.

²⁴² Civil Rights Tax Relief Act, H.R. 840, 107th Cong. (2001); 146 CONG. REC. S1760-03, S1763 (July 18, 2000). "The act provides for income averaging of back-pay awards, making it possible for the award to be taxed over the same number of years it was meant to compensate." *Id.*

²⁴³ H.R. 840. *See* 146 CONG. REC. S1760-03, S1763 (July 18, 2000) (stating that "this legislation ends the double taxation on attorney's fees that are awarded to a victim in a discrimination case"). In addition, on August 5, 2002, the mayor of Washington D.C. signed the nation's first Civil Rights Tax Fairness Act, which mirrors the bill currently pending in Congress. *NELA Applauds District's Adoption of Nation's First Civil Rights Tax Fairness Act; Asks Congress to Follow*, U.S. NEWSWIRE, Aug. 2, 2002, available at 2002 WL 22070164. Specifically, the new law amends the District of Columbia Official Code to exclude from gross income amounts received on account of unlawful discrimination and adds a new section to the tax code to allow the income averaging of back-pay and front-pay awards received from employment discrimination cases. *Id.* Although the local legislation does not address the problem on a national level, it does offer hope of increasing support for the passage of federal legislation. *Id.*; *see* National Employment Lawyers Association, *HR 840/S 917, The Civil Rights Tax Relief Act: Tax Equity for Targets of Discrimination*, at <http://www.nela.org/news/hr840/endorsing.htm> (last visited March 20, 2003) (providing a list of the current endorsing organizations of the Civil Rights Tax Relief Act, including such organizations as the American Civil Liberties Union, the U.S. Chamber of Commerce, ABA Labor and Employment Section, and the American Small Business Alliance).

²⁴⁴ H.R. 840. *See generally* Wolff, *supra* note 12, at 1343 (arguing that

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The equal tax treatment of physical injury and employment discrimination damage awards would remove the suggestion that the harms created by sexual harassment are less important than the harms of physical injuries.²⁴⁵ Unlike an amendment that would tax all damage awards flowing from all injuries, the CRTRA ensures that victims are not re-victimized by the IRS.²⁴⁶

Nevertheless, there are several problems with the CRTRA. First, in passing the bill, the federal government will lose the revenue that it gained through the taxation of all non-physical injury damage awards since the 1996 amendment.²⁴⁷ More importantly, though, the CRTRA misses an important opportunity to increase the negative consequences to employers

the equal treatment of physical and non-physical injuries would be more in line with the recognition that non-physical injuries can be as harmful to victims as physical injuries).

²⁴⁵ See *supra* Part III.C (arguing that the tax distinction between physical and non-physical injuries insinuates that victims of non-physical injuries, such as sexual harassment, do not suffer real injuries).

²⁴⁶ See Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 51-52 (1987) (arguing that a tax exclusion for personal injury damage awards is inconsistent with the fundamentals of the tax code); Lawrence A. Frolick, *Personal Injury Compensation as a Tax Preference*, 37 ME. L. REV. 1, 39-40 (1985) (asserting that the exclusion from gross income for personal injury awards should be eliminated in order to increase tax revenue).

²⁴⁷ See *supra* note 137 (stating that the government has already received millions in revenue from the creation of the § 104(a)(2) amendment). Some have advocated for an amendment that would make all damage awards, for both physical and non-physical injuries, excludable. See, e.g., H.R. 2802, 105th Cong. (1997); see Buchan, *supra* note 93, at 11 (discussing the bill as a means to restore the tax exclusion for non-physical injuries). Although this type of solution would ensure against any unreasonable distinctions made between different types of physical and non-physical injuries, this solution would result in a substantial loss in revenue. In this way, the Civil Rights Tax Relief Act has been viewed by some as the “middle road” because rather than providing for the equal treatment of all physical and non-physical injuries, the Civil Rights Tax Relief Act would provide for the equal treatment of physical injury and employment discrimination damages. See Buchan, *supra* note 93, at 11 (describing the bill suggested by Rep. Gerald Solomon, who proposed that the damage exclusion be applied to employment discrimination awards, but not all non-physical injury damage awards).

found liable for sexual harassment.²⁴⁸ This is especially true because many tortfeasors are already allowed to declare payments to plaintiffs in employment discrimination cases as income tax deductions.²⁴⁹ Therefore, although the CRTRA would entitle discrimination victims to equal tax treatment, Congress would still be allowing employers to deduct employment discrimination damage payments for income tax purposes.²⁵⁰

B. A Solution for the Future: Taxing the Defendants, Not the Victims

A better solution would be one that uses the tax code as a social policy tool to support the goals of Title VII and the EEOC guidelines to eliminate employment discrimination, while still providing the revenue that the taxation of non-physical injury damage awards currently provide through § 104(a).²⁵¹ A statutory requirement that defendant employers compensate plaintiffs for the negative tax consequences they suffer when they are awarded compensatory damage awards or attorneys' fees would satisfy both the victims and the government.²⁵² This solution would keep § 104(a) as it stands, requiring the taxation of damage awards in employment discrimination cases.²⁵³ Instead of changing § 104(a), Congress should adopt a law stating that employers found liable for harassment are required to pay successful plaintiffs for

²⁴⁸ 42 U.S.C. § 1981(a) (2003); *see infra* Part I.B (discussing the types of liability employers are exposed to for sexual harassment).

²⁴⁹ *See* Wolff, *supra* note 12, at 1486 (arguing that the income tax deduction allowed for payments made by the tortfeasor should be eliminated in order to eliminate the inequalities of § 104(a)(2) while still providing financial revenue for the government).

²⁵⁰ *Id.* *See* Wolff, *supra* note 12, at 1486 (calling for the elimination of the business expense allowance for payments to victims of employment discrimination).

²⁵¹ *See supra* note 137 (stating the estimated revenue from this tax provision).

²⁵² 26 U.S.C. § 104(a) (2003); *See supra* note 137 (stating the government's revenue return on § 104(a)); *supra* Part III.B (discussing negative financial effects of § 104(a) on successful plaintiffs).

²⁵³ 26 U.S.C. § 104(a)(2).

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the negative tax consequences posed by § 104(a)(2).²⁵⁴ Imposing such a requirement would use § 104(a) to burden parties responsible for perpetuating harassment rather than victims who are already harmed.²⁵⁵

Some courts have attempted to implement this solution by requiring defendant's to pay plaintiffs for the negative tax consequences of damage awards.²⁵⁶ For instance, the Eastern District of Pennsylvania attempted to do so in a recent age discrimination case.²⁵⁷ In *O'Neill v. Sears, Roebuck & Co.*, the

²⁵⁴ See *infra* Part III.B (discussing negative tax consequences of § 104(a)); see also Wolff, *supra* note 12, at 1486 (advocating the equal treatment of physical and non-physical injuries). Wolff advocates eliminating the taxation of non-physical injuries as well as eliminating the business expense allowance for payments to victims of employment discrimination. *Id.* This note's proposal differs because it would keep § 104(a) the way it is—it would maintain the distinction between physical and non-physical injury damages. However, this note suggests adding a federal law that requires that the tax consequences posed to employment discrimination plaintiffs by § 104(a)(2) be paid by the employers found liable. Employers should have to reimburse the plaintiffs the negative consequences without declaring the tax payments as business expenses.

²⁵⁵ See *Mardell v. Harleysville Life Ins. Co.*, 31 F.3d 1221, 1234-35 (3d Cir. 1994) (stating that one purpose of anti-discrimination laws is to increase the burdens on employers held liable for the discrimination, so as to deter employment discrimination).

²⁵⁶ *O'Neill v. Sears, Roebuck & Co.*, 108 F. Supp. 2d 443 (E.D. Pa. 2000) (awarding plaintiff additional damages for tax consequences of lump sum back-pay award); *Blaney v. Int'l Ass'n of Machinists and Aerospace Workers*, 55 P.3d 1208 (Wash. Ct. App. 2002) (awarding plaintiff supplemental award to compensate for negative tax consequences caused by attorneys' fee and back-pay award in sex discrimination case). See also *EEOC v. Joe's Stone Crab Inc.*, 15 F. Supp. 2d 1364, 1380 (S.D. Fla. 1998) (ruling that a district court may award an additional damage award for negative tax consequences posed by a lump sum back-pay award, but declining to do so in that particular case because there was insufficient evidence to make appropriate tax calculations).

²⁵⁷ *O'Neill*, 108 F. Supp. 2d at 446. The plaintiff had sued his former employer for the premature termination of his job, alleging that he had been terminated in willful contravention of the ADEA. *Id.* at 443. The plaintiff was awarded both back pay and front pay in a lump sum, rather than over a period of years, equal to what the plaintiff would have worked if he had not been

district court found the plaintiff entitled to receive money to cover the negative tax burdens in relation to his back pay and front pay because had he kept his employment, he would have received his salary over a number of years.²⁵⁸ The court reasoned that an award for the negative tax consequences, endured as a result of bringing an employment discrimination suit, was necessary to meet the goal of making the plaintiff "whole."²⁵⁹ Therefore, the court awarded him the difference between his tax liability for the back-pay and front-pay awards received in the lawsuit and the amount he would have owed in taxes had he received the money as wages.²⁶⁰

A Washington court of appeals has also recently taken the initiative to allow a plaintiff to receive a supplemental damage award for negative tax consequences.²⁶¹ The plaintiff, Ms. Blaney, was awarded \$638,764 in damages and \$235,625.38 in attorneys' fees for winning her sex discrimination case based on a Washington state anti-discrimination statute.²⁶² At trial, Ms.

terminated. *Id.* at 444. The plaintiff requested that the court add an award for the negative tax consequences posed by these awards. *Id.* at 446.

²⁵⁸ *Id.*

²⁵⁹ *Id.*; Susan Kalinka, O'Neil v. Sears, Roebuck and Co: *Award of Damages for Increased Tax Liability*, 79 TAXES 45, Jan 1. 2001, available at 2001 WL8812786. The court also thought it was particularly important to award the plaintiff recovery for the negative tax consequences of his lump sum front-pay award because his front-pay award had already been reduced to present value. *O'Neill*, 108 F. Supp. 2d at 447. Therefore, the presumption was that he would invest the money and receive a return equal to his lost wages; however, the negative tax consequences of his award would leave him with less money to invest. *Id.* at 447.

²⁶⁰ *Id.* at 449. Mr. O'Neill's tax liability after the lawsuit was \$67,164.96. *Id.* at 448. This was \$38,780.05 more than what he would have owed had he been paid wages. *Id.* Therefore, the court awarded him \$38,780.05 in addition to his back-pay and front-pay award of \$237,332. *Id.* The court did not consider the negative tax consequences posed by the compensatory and liquidated damages the plaintiff had been awarded, in the amount of \$281,736. *Id.* at 448. It only compensated the plaintiff for the consequences posed by the lump sum wages award. *Id.*

²⁶¹ *Blaney v. Int'l Ass'n of Machinists and Aerospace Workers*, 55 P.3d 1208 (Wash. Ct. App. 2002).

²⁶² *Id.* at 1210; Washington Law Against Discrimination, WASH. REV.

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Blaney presented the testimony of a certified public accountant who stated that she would owe \$244,753 in taxes as a result of her damage awards.²⁶³ To determine whether Ms. Blaney was entitled to compensation for the negative tax consequences, the court of appeals interpreted the anti-discrimination statute's provision allowing the award of "actual damages."²⁶⁴ The court construed "actual damages" to include a supplemental payment to "offset the adverse federal tax consequences to her from the . . . lump sum payment of the judgments on the damages award and attorney fees against it."²⁶⁵ Therefore, the court remanded the case to determine the amount Ms. Blaney should be awarded for the negative tax consequences.²⁶⁶

Similarly, parties negotiating settlement agreements have also tried to implement this type of solution by agreeing that the employers make increased settlement payments to cover the negative tax consequences posed to the victims.²⁶⁷ During many recent sexual harassment settlement discussions, employers have discovered that they have to pay extra money to compensate plaintiffs for the taxes that will have to be paid on the settlement payments.²⁶⁸ Employers who normally want to settle cases are instead finding that they are in a better position if they go to trial where plaintiffs cannot request compensation for negative tax consequences.²⁶⁹ If there were a statutory requirement that employers compensate plaintiffs for negative tax consequences

CODE 49.60.030(2) (2003).

²⁶³ *Blaney*, 55 P.3d at 1210.

²⁶⁴ WASH. REV. CODE 49.60.030(2); *see Blaney*, 55 P.3d at 1215 (quoting the Washington statute).

²⁶⁵ *Blaney*, 55 P. 3d at 1214. The court further stated that its ruling made practical sense because forcing plaintiffs to pay the taxes would "threaten to thwart meritorious suits because a highly successful plaintiff runs the risk of having the entire benefit of a judgment eliminated plus incurring a substantial tax liability to the Internal Revenue Service." *Id.* at 1217.

²⁶⁶ *Id.* at 1218. The court stated that on remand, the burden would be on Ms. Blaney to demonstrate the negative tax consequences. *Id.*

²⁶⁷ *Coyle*, *supra* note 136.

²⁶⁸ *Id.*

²⁶⁹ *See id.*

both in court and through out of court settlements, however, employers would no longer be able to use trial to avoid the tax payments.²⁷⁰ This would decrease the burden on the courts by allowing more cases to settle.²⁷¹

This type of solution is particularly productive because victims of sexual harassment would no longer bear the financial burden of being successful in court.²⁷² Compensating successful plaintiffs for negative tax consequences caused by § 104(a) will reduce the disincentives in place for victims of harassment to bring lawsuits to vindicate their civil rights.²⁷³ Women would no longer face the uncertainty of the tax consequences of their lawsuits. Instead, they would know that if they win, their employers would reimburse them for whatever taxes they may have to pay on their monetary damages.²⁷⁴

Moreover, this solution is unique in that it creates an added incentive for employers to take measures to prevent sexual harassment in their workplaces.²⁷⁵ Requiring employers to pay

²⁷⁰ Coyle, *supra* note 136. "Because of the tax bite, businesses have to pay more or individuals have to take less to get settlements, or there are no settlements. A lot of cases are on the docket longer, and there are more trials." *Id.* (quoting lawyer Frederick M. Gittes, partner at Spater, Gittes, Schulte & Kolman, of Columbus Ohio).

²⁷¹ *Id.* Advocates of the Civil Rights Tax Relief Act also state that its passage would reduce the burden on courts. Coyle, *supra* note 8. "If the IRS takes less in taxes from civil rights plaintiffs' settlements, it will be easier for both civil rights plaintiffs and defendant businesses to reach just settlements without the need for protracted trials requiring significant investment of resources." *Id.* (quoting Rep. Deborah Pryce, who supported the Civil Rights Tax Relief Act).

²⁷² 26 U.S.C. § 104(a)(2) (2003).

²⁷³ *Id.*; Blaney v. Int'l Ass'n of Machinists and Aerospace Workers, 55 P.3d 1208, 1217 (Wash. Ct. App. 2002) (stating that forcing plaintiffs to pay the negative tax consequences will "thwart" meritorious claims from coming forward); *see supra* Part III (discussing the disincentives to bringing lawsuits for sexual harassment).

²⁷⁴ § 104(a); *see supra* Part II.C, D (discussing the taxation of damage and attorneys' fee awards in non-physical injury cases).

²⁷⁵ 29 C.F.R. § 1604.11(f) (2003).

Prevention is the best tool for the elimination of sexual harassment. An employer should take all steps necessary to prevent sexual

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plaintiffs for negative tax burdens will increase financial consequences on employers, which in turn will encourage employers to avoid liability by implementing preventative programs and taking strong positions against sexual harassment.²⁷⁶ Therefore, this solution furthers the goal of Title VII to eliminate discrimination in society.²⁷⁷ In addition, by maintaining the taxation of employment discrimination damage and settlement awards, the government will still receive the revenue it gained by implementing § 104(a)(2) in the first place.²⁷⁸ Only this time, the government will receive its tax revenue from the blameworthy parties, not the victims.²⁷⁹

CONCLUSION

The federal government has a legitimate and important goal of eliminating the evils of sexual harassment and sex discrimination from society. Through the Civil Rights Acts of 1964 and 1991, Congress attempted to discourage sexual harassment and compensate victims for the considerable harms they may suffer by allowing them to sue for relief under Title

harassment from occurring, such as affirmatively raising the subject, expressing strong disapproval, developing appropriate sanctions, informing employees of their right to raise and how to raise the issue of harassment under Title VII, and developing methods to sensitize all concerned.

Id.

²⁷⁶ *Id.* “Congress prescribed a strong medicine, the anti-employment discrimination laws, to cure the social malady of invidious discrimination. Deterrence is accomplished by placing an economic price on discriminatory acts, and stigmatizing the wrongdoer’s acts before the entire community.” *Mardell v. Harleysville Life Ins. Co.*, 31 F.3d 1221, 1234-35 (3d Cir. 1994).

²⁷⁷ *See supra* Part I.A (discussing the function of Title VII and the EEOC in eliminating sex discrimination in employment).

²⁷⁸ 42 U.S.C. § 2000e (2003); 42 U.S.C. § 1981a (2003); *see supra* note 137 (describing the taxation of non-physical injuries as a means of raising revenue).

²⁷⁹ *See supra* Part III (discussing the negative effects imposed by taxing the victims of sexual harassment).

VII.²⁸⁰ Only five years after providing victims of harassment with a variety of compensatory damages to recover in lawsuits, Congress contradicted itself by taxing employment discrimination victims through § 104(a)(2).²⁸¹ It is already socially undesirable to bring allegations against those guilty of sexual harassment, and now the government has made it financially undesirable by requiring attorneys' fees and compensatory damage awards based on non-physical injuries to be subject to income taxation.²⁸² In doing so, victims are subject to double discrimination and are told that their injuries are not "real." Until Congress passes a law requiring those liable for sexual harassment to pay plaintiffs for tax consequences created by § 104(a)(2), the government will be using the tax code to perpetuate the damaging practice of sex discrimination and sexual harassment throughout society.

²⁸⁰ 42 U.S.C. § 2000e (2003); 42 U.S.C. § 1981(a) (2003).

²⁸¹ 26 U.S.C. § 104(a)(2) (2003).

²⁸² See *supra* text accompanying note 208-09 (discussing the undesirability of bringing lawsuits under Title VII for sexual harassment due to the negative financial consequences posed by Section 104(a)(2)).