

Tax Court Holds Reverse Discrimination Settlement Taxable

The Tax Court ruled that a \$27,900 settlement in a reverse discrimination class action lawsuit claiming that the Armed Forces improperly favored minorities and women in implementing the personnel reductions was not excludable as a personal physical injury under Section 104(a)(2) in *Hennessey v. Commissioner*, T.C. Memo 2009-132, June 9, 2009.

Before 1993 Kevin Hennessey ("Hennessey") was a commissioned officer serving on active duty with the U.S. Air Force. In 1992, because of congressionally mandated personnel reductions in the Armed Forces, the Secretary of the U.S. Air Force established the Fiscal Year 1993 Reduction-in-Force Board ("Board"). The purpose of the Board was to select U.S. Air Force officers for involuntary separation.

The Secretary of the U.S. Air Force issued a memorandum of instruction ("memorandum") that provided guidance on screening officers for involuntary separation. Paragraph 7 of the memorandum stated that the Board's "evaluation of minority and women officers must clearly afford them fair and equitable consideration." The memorandum also stated that in considering women and minority officers, the Board should be sensitive to the fact that such officers might have been disadvantaged from a career perspective because of past individual and societal attitudes, policies, and practices. It allowed the Board to consider these factors in ensuring that minority and female officers received fair and equitable treatment.

In 1993, pursuant to the Board's recommendation, Hennessey was removed from active duty status with the U.S. Air Force and transferred to the U.S. Air Force Reserve. In reviewing records the Board considered the memorandum regarding selection rates for minority and female officers. On December 28, 1998, Hennessey and other officers whom the Board selected for involuntary separation filed a complaint (later certified as a class action) in the U.S. Court of Federal Claims in the case of *Berkley v. United States*, case No. 98-943C. The plaintiffs claimed that the Board violated their equal protection rights under the Fifth Amendment to the U.S. Constitution because it improperly considered race and gender in selecting officers for involuntary separation.

The class action case was settled and each member of the class had an option of (1) receiving a \$30,000 lump-sum payment less attorney's fees, costs, and expenses of \$2,100 or (2) requesting another retention review. Hennessey received the lump-sum payment in October 2004. The lump-sum payment was not compensation for physical injuries or physical sickness that Hennessey might have suffered as a consequence of any actions taken by employees of the U.S. Air Force. Hennessey filed a joint return for 2004 but did not include in income the \$30,000 lump-sum payment.

Section 104(a)(2) excludes from gross income "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". In *Commissioner v. Schleier* the Supreme Court stated that to be eligible for the Section 104(a)(2) exclusion, a taxpayer must demonstrate that (1) the underlying cause of action giving rise to the recovery is based in tort or tort type rights and (2) the damages were received on account of personal injuries or sickness. After the Supreme Court issued its opinion in *Schleier*, Congress amended Section 104(a)(2) (amendment), effective for amounts received after August 20, 1996, by adding a requirement that in order to be excluded from gross

income, any amount received must be on account of personal injuries that are physical or sickness that is physical.

Hennessey raised several constitutional objections to Section 104(a)(2), contending that the lump-sum payment is not income because there was no accession to wealth and, accordingly, no gain within the meaning of section 61(a). Rather, they argued the payment was intended to make Hennessey “whole” for his losses, which, in addition to the loss of wages, consisted of lost promotional opportunities, lost military pension, damage to reputation, and stigma of involuntary separation. A similar argument was raised by the taxpayer in *Murphy v. IRS*, 493 F.3d 170, 176-177 (D.C. Cir. 2007). The Court of Appeals for the District of Columbia Circuit held that taxation of awards received for personal, nonphysical injuries was within the power of Congress. The Tax Court agreed with the Court of Appeals and rejected this argument.

Hennessey also argued that Section 104(a)(2) violates the Equal Protection Clause of the 14th Amendment as applicable to the Federal Government through the Due Process Clause of the Fifth Amendment under *Bolling v. Sharpe*, 347 U.S. 497, 500 (1954). Hennessey argued that the Code treats taxpayers who receive compensatory damages as a result of physical injuries differently from those who suffer and are paid for nonphysical injuries, with no rational basis for such a distinction. In *Young v. United States*, 332 F.3d 893, 895-896 (6th Cir. 2003), the Court of Appeals for the Sixth Circuit reviewed a similar challenge to section 104(a)(2) on the ground of violation of equal protection and held the statute constitutional. The Tax Court again agreed with the Court of Appeals and rejected this argument.

Hennessey finally argued that taxation of the lump-sum payment violates the Due Process and Takings Clauses of the Fifth Amendment to the U.S. Constitution. According to Hennessey, under Missouri State law reputational damage is damage to property and Hennessey's property interest in his employment and reputation would not have been taxable in the absence of the Board's discriminatory actions, thus taxing such previously untaxable property interest amounts to an unjust taking of petitioners' property and forced conversion of their assets for the public use.

The Tax Court also rejected this Constitutional challenge as having no merit, holding that the Fifth Amendment is not a limitation upon Congress's taxing power, finding that the \$27,900 payment Hennessey received in 2004 was not excludable from income under Section 104(a)(2).