

ERISA SETTLEMENT HELD TAXABLE: IS THERE ANY ROOM LEFT?¹

By Robert W. Wood

As most employment lawyers know, since August 20, 1996, Section 104 and its exclusion from income have been narrowed considerably. No one is entirely certain exactly what "physical" means, even two years after the radical change in the law passed. We do know that headaches, stomachaches and insomnia are not physical in the minds of Congress. How much more of a definition the IRS will eventually put on the term "physical" remains to be seen.

However, it is safe to conclude that employment practitioners (both plaintiffs' attorneys and management attorneys) are currently confused about whether allocations to personal physical injuries or personal physical illness will be upheld.

Certain specific types of employment litigation have continued to generate case law in the tax field. For example, recoveries under the Employee Retirement Income Security Act of 1974 (as amended) ("ERISA") have been the subject of several recent suits. Most recently, the Eighth Circuit Court of Appeals in *Michael A. Mayberry, et ux. v. United States*, No. 97-4165 (8th Cir., Aug. 10, 1998) put their own interpretation on this volatile field. The Eighth Circuit in *Mayberry* reversed a district court decision which had held that the proceeds from an ERISA settlement were excludable under Section 104. The Eighth Circuit held instead that the recovery was taxable.

Michael Mayberry was a member in a class action suit against Continental Can Company. The suit brought claims under Section 510 of ERISA. Eventually, Continental Can agreed to settle the case by paying \$415 million. Each class member received several elements:

- Compensation for mental anguish, emotional distress and other non-pecuniary losses; and
- Compensation for economic loss.

The award to each individual plaintiff was calculated based on age and years of service. Mr. Mayberry received \$21,000, which he initially reported as taxable on his 1992 return. He later filed an amended return, claiming the entire \$21,000 to be excludable. Predictably, the IRS denied the refund claim, so Mayberry sued for a refund. The district court ruled in Mayberry's favor, in doing so refusing to apply case law developed after the settlement. The case law after the class action settlement had held that ERISA Section 502 does not authorize the recovery of tort-type damages. This is yet another example of the impact of substantive employment law on tax law. Tort-like damages were historically viewed as equivalent to the exclusion under Section 104 under pre-August 20, 1996 law.

Eighth Circuit Reverses

In the Eighth Circuit, the appellate court agreed with the IRS that Section 502 of ERISA authorizes only equitable relief. For this important proposition, the IRS (and the Eighth Circuit) cited *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993). The Supreme Court in *Mertens* precluded the possibility that Mr. Mayberry's settlement was personal injury damages, because under the law, Mayberry could not establish that his cause of action was based on tort or tort-type rights.

¹ Adapted from an article originally published in BNA's Employment Discrimination Report, Vol. 11, No. 9, p. 312 (August 26, 1998). Copyright 1998 by The Bureau of National Affairs, Inc. (800-372-1033).

Interestingly, the Eighth Circuit went on to state that it was irrelevant that Continental Can's conduct caused personal injury and that the settlement payments were in fact intended to compensate for that injury. Practitioners should be aware precisely how significant this statement by the court is. The court referred to *Commissioner v. Schleier*, 151 U.S. 323 (1995), and *U.S. v. Burke*, 504 U.S. 229 (1992). In a confusing mix of these two landmark Supreme Court cases, the Eighth Circuit stated that the proper focus in determining the scope of Section 104 is the remedial scheme in the statute providing the cause of action, as well as the nature of the relief available under that remedial scheme.

More specifically, the Eighth Circuit Court of Appeals rejected Mr. Mayberry's attempt to distinguish the *Burke* and *Schleier* decisions, and his argument that the nature of the cause of action need not be examined when the character of the recovery is, to use his words, evident on its face.

Double Whammy

The Eighth Circuit Court of Appeals also resolved the question whether the settlement payment to Mr. Mayberry constituted wages for purposes of Social Security tax. Mayberry had argued that the settlement could not be considered remuneration for employment because class members were fully compensated for services they had rendered to Continental Can. The court found that this argument treated the concept of "service" too narrowly, referring only to productive activity. The Eighth Circuit, finding that the settlement payment did constitute wages, said that the Internal Revenue Code definition of wages for Social Security purposes means not only payments for work actually done, but include any payments made in the entire employer-employee relationship.

What About the Future?

In light of the Supreme Court's holding in *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993), it is no surprise that the Eighth Circuit concluded in *Mayberry* that ERISA damages are fully taxable. What is perhaps more troublesome is the court's treatment of the employer-employee relationship and payments that may be made in the context of that relationship. After all, no one would disagree with the notion that an employer may pay wages to a current employee, and at the same time make a separate tort payment if there has been a tort committed on the employee.

Suppose an employee is defamed, for example, and the employer pays the employee \$5,000 for a release of the defamation cause of action. Workers compensation insurance issues aside, few would argue that this \$5,000 release payment would impact income tax withholding or Social Security payments. Indeed, assuming that \$5,000 is a reasonable payment for the release attained, it is simply irrelevant that the person was an employee at the time the tort was committed and at the time the settlement was paid. Of course, prior to August 20, 1996, it might be possible to argue that the defamation recovery was excludable from income under Section 104. Now, it would simply be income (but in my view would not be taxable as wages).

The Eighth Circuit in *Mayberry* seemed to spout dicta about the employer-employee relationship that could be construed by another court (or by the IRS) as all-encompassing. At least the Eighth Circuit does limit its comments to any "compensation" that is paid in this relationship (or presumably, after it).

There still seems nothing wrong with an analytical approach that seeks to determine whether the payment is truly for services rendered, to be rendered, or that would have been rendered (wage differential payments or payments that would be due upon a promotion that should have been granted). However, as with so many other areas in this confusing area of the law, precise bounds will need yet to be drawn.

No More Section 104 Exclusion

Regardless of the employment tax consequences of an ERISA settlement or judgment, what is clear is that no claim that an ERISA payment is excludable from income under Section 104 is likely. In a significant volume of other employment litigation (for example, sexual harassment litigation), there are still tremendous gray areas to be clarified about the bounds of the Section 104 exclusion and just what constitutes physical injuries or physical sickness in this context.