Taxpayer Name: [redacted] **Examiner:** Luhrs, Susan

TIN: [redacted]

Tax Form: 1040 **Date:** 1/21/11, 2/17/11, 7/6/11

Tax Year (s): 200712

Wages from Delta Airlines Lead Sheet

Tax Period	Per Return	Per Exam	Adjustment	Reference
200712	136,324.00	136,324.00	.00	

Conclusion: *(Reflects the final determination on the issue.)*

No adjustment made to wages from Delta Airlines for 2007 – Delta properly classi.

Audit Steps: *(Document audit steps taken or to be taken.)*	**Workpaper Reference**
1. Evaluate information provided by taxpayer regarding amount paid as wages by Delta in 2007.	
2. Research online regarding Delta ESOP buybacks paid as wages.	

Facts: *(Document the relevant facts.)*

This issue was selected for audit due to the fact that the taxpayers made an informal claim via their representative regarding this item as Mr. Lynch had received compensation from Delta Airlines in 2007 when he retired from that airline, when, in fact, Delta actually had purchased back stock that he had received through the Delta Employee Stock Ownership Program. Delta had issued the stock to its retirees in 2007 due to bankruptcy reorganization, whereby the retirees were compensated for losing their medical coverage during that process. Research on the internet confirms this. However, Delta had treated the payments as wages and issued a W-2 for the amount if the former employee sold the stock in that year, which Lynch did. The taxpayer has provided information showing that his separation date from Delta was 4/1/05 and his 2005 and 2006 returns are consistent with this; both show pensions from Delta. Review of the IRP transcript for 2006 does not show any wages from Delta, and, after that, only 2007 shows Delta wages.

Mr. Lynch's claim was triggered by adjustments made to another individual's claim regarding the same scenario. That individual, James Munton, had received a refund when an agent in Nevada reclassified Mr. Munton's payments from Delta as a long term capital gain. Contact with that agent and review of that case file (copies of the pertinent items included in the workpapers for this section) did not reveal the agent's justficiation for this adjustment or any clue as to what that individual's representative presented to substantiation such a reclassification..

Law: *(Tax Law, Regulations, court cases, and other authorities. If Unagreed, include Argument)*

Sections 3101 and 3111 of the Internal Revenue Code (the Code) impose FICA taxes on "wages" as that term is defined in section 3121(a). FICA taxes consist of Old-Age, Survivors and Disability insurance tax (social security tax) and the Hospital Insurance (Medicare) tax. These taxes are imposed on both the employer and the employee. The employer must collect the employee's portion of the FICA taxes by deducting the amount of taxfrom wages as and when paid (Section 3102(a) of the Code).

The term "wages" for FICA purposes includes all remuneration for employment, subject to certain specified exceptions (Section 3121(a) of the Code). The Employment Tax Regulations (the Regulations) provide that remuneration for employment, unless specifically excepted, constitutes "wages" even though at the time paid the recipient is no longer an employee

Taxpayer Name:	[redacted]	**Examiner:**	Luhrs, Susan
TIN:	[redacted]		
Tax Form:	1040	**Date:**	1/21/11, 2/17/11, 7/6/11
Tax Year (s):	200712		

Wages from Delta Airlines Lead Sheet

(Section 31. 3121(a)-1(i) of the Regulations). The law excludes from the definition of wages payments an employer makes under a plan or system that provides sickness or accident disability benefits to employees and their dependents (Section 3121(a) of the Code). The Regulations provide that "[t]he term 'wages' does not include the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund to provide for such payment) made to, or on behalf of, an employee or any of his dependents under a plan or system established by an employer which makes provision for his employees ... on account of ... medical or hospitalization expenses in connection with sickness or accident disability of an employee or any of his dependents...." (Section 31.3121(a)(2)-1(a) of the Regulations). However, amounts paid directly to employees in lieu of heath coverage are not subject to this exception.

We use the "origin of the claim doctrine" to determine the proper tax treatment of a court award or settlement. The doctrine focuses on the nature of the claim that led to the award or settlement. United States v. Burke, 504 U.S. 229 (1992). Economic recoveries of back pay arising out of an employment relationship are includable in income and subject to FICA tax withholding, even if the amounts recovered are paid in lieu of nontaxable fringe benefits. See, e.g., United States v. McKean, 33 Fed.Cl. 535 (1995).

For example, Revenue Ruling 75-241, 1975-1 C.B. 316, describes an employee who was paid a cash amount in lieu of certain health and welfare benefits. The revenue ruling concluded that the payments were wages for FICA purposes because "the payments are attributable to service performed by the employees for their employer, although the employers paid the amounts in discharge of a requirement of a Federal statute that minimum fringe benefits in the form of health and welfare benefits be provided." A significant factor in that ruling is that the employee had complete control over the disposition of the funds he received in lieu of certain health and welfare benefits, and the payor of the funds had no legal or contractual obligation to, and did not, verify that the employees used the cash payment to purchase health and welfare benefits. Thus, even though contributions an employer makes under a plan or system that provides sickness or accident disability benefits to employees are generally excepted from FICA withholding, cash payments an employer makes directly to employees in lieu of such contributions are wages subject to FICA withholding.

Since the Revenue Ruling is clearly on point regarding the facts and circumstances of Delta's payments to Mr. Lynch, no adjustment will be made to this item and the taxpayer's claim regarding this will be disallowed.

Specific citations:

Taxpayer Position: *(If applicable)*

Jimmy Rogers Marshall & Evelyn Rose Marshall v. Commissioner, U.S. Tax Court, T.C. Memo. 45,406(M), 56 T.C.M. 1006, T.C. Memo. 1989-5, (Jan. 5, 1989)

Click to open document in a browser

Docket No. 24064-87., TC Memo. 1989-5, 56 TCM 1006, Filed January 5, 1989 [Appealable, barring stipulation to the contrary, to CA-9.—CCH.]

[Code Secs. 61, 106 and 1033]

Income: Gross income: Exclusions from: Health insurance: Involuntary conversions: Amounts received in lieu of.–

A lump-sum payment that retired workers received in settlement of their claims against their nearly bankrupt former employer for future health insurance contributions was not excludible from gross income, according to the Tax Court. Payments made directly by an employer to a health plan or to an independent fund or trust are excludible from gross income. Also, although payments made directly to the retirees or employees are generally not excludible as health insurance benefits, they may be if they represent reimbursements for health insurance paid in satisfaction of a legal obligation and if the recipient was required to purchase health insurance. However, since the retirees in the instant test case were not required to purchase health insurance the payments were not excludible from gross income. Furthermore, the Court found that an alleged conversion of their right to tax-exempt medical insurance into a lump-sum cash payment should not be treated as an "involuntary conversion" since the retirees were not forced to accept the lump-sum payment in exchange for their right to benefits under their former employer's health insurance plan. Although the retirees believed that their former employer's precarious financial condition at the time of the lump-sum settlement offer forced them to take the cash rather than face the possibility of receiving nothing in the future if the employer declared bankruptcy, the Court noted that the retirees had the option of taking the lump-sum payment, participating in their former employer's continuing health coverage program for a time, or contesting the employer's threatened discontinuance of their insurance agreement.—CCH.

Brent Edward Vallens, for the petitioner. Mary Tseng, for the respondent.

Memorandum Findings of Fact and Opinion

NAMEROFF, Special Trial Judge:

This case was assigned pursuant to the provisions of section 7443A(b) of the Internal Revenue Code and Rules 180, 181 and 182. [1] Respondent determined a deficiency in petitioners' 1985 income tax return in the amount of $5,270. The sole issue for decision is whether the amount in dispute may be excluded from gross income under section 106. [2]

Findings of Fact

The facts in this matter have been fully stipulated and are so found. The stipulation of facts and exhibits are incorporated herein by this reference. Petitioners are husband and wife who resided in Riverside, California at the time their petition was filed in this case. Petitioners timely filed a joint Federal income tax return for the 1985 tax year with the Internal Revenue Service at Fresno, California. In addition, petitioners filed an amended joint income tax return for the same tax year. Petitioner-husband had worked at Kaiser Steel Corporation ("Kaiser") as a steelworker for 23 years. He retired from Kaiser on November 15, 1983.

Prior to January 1, 1985, Kaiser provided health care benefits pursuant to the Kaiser Steel Health and Insurance Plan ("HIP") for all of its eligible retirees, surviving spouses, and their eligible dependents. [3] The HIP was established pursuant to a 1980 Insurance Agreement entered into by Kaiser and the United Steelworkers of America ("Union"). The cost of the health care benefits was paid entirely by Kaiser. The right to the health care benefits required no contributions by the retirees either before their retirement, as employees, or after their retirement, as retirees.

©2011 Wolters Kluwer. All rights reserved.

In 1984, a dispute arose between Kaiser and the retirees, who were represented by the Union. The dispute involved whether Kaiser had a contractual duty under the aforementioned 1980 Insurance Agreement to continue providing health care benefits to eligible individuals after December 31, 1983. There was also the question whether Kaiser had the financial capacity to continue providing these health care benefits beyond that date. On September 14, 1984, Kaiser and the Union entered into a Memorandum of Understanding wherein Kaiser offered to continue providing health care benefits to all eligible individuals [4] , but in a modified form. The Memorandum of Understanding contained the following points:

1. Full benefits under the HIP would continue for all eligible individuals through December 31, 1984.

2. With respect to the period subsequent to December 31, 1984, a Program of Continuing Coverage would be established. Under the Program, Kaiser would continue to pay the full cost of the HIP benefits to all eligible individuals subject to certain modifications; viz, effective January 1, 1985, Kaiser would no longer pay for the following HIP benefits: (a) dental, (b) vision care, and (c) major medical for all retirees and surviving spouses under age 65 and their dependents, except for permanently incapacitated retirees, their surviving spouses and dependents.

3. Effective January 1, 1985, an ongoing contributory program would be established whereby those eligible individuals who no longer had Company-paid coverage for the dental, vision care, and major medical benefits would be able to continue self-paid coverage at group rates. To the extent permissible by law, this program would be paid for through deductions from pension checks.

4. From January 1, 1985 to December 31, 1994, Kaiser would pay for major medical benefits as provided for in the HIP for all eligible retirees and surviving spouses age 65 and over (including, from age 65, those who reach age 65 during this period) and their dependents and for permanently incapacitated retirees, their surviving spouses and their dependents. As an alternative to receiving Company-paid major medical benefits during this period, eligible individuals could elect to receive Company-paid dental and vision benefits. On January 1, 1995, Kaiser's obligation to pay for these benefits would cease.

5. Subsequent to December 31, 1984, the HIP Prescription Drug program would be continued in a revised form. The former $1.00 deductible for prescription drugs would be increased to $3.00. In addition, Kaiser stated that it would establish a mail order prescription/generic drug program which would offer participants the opportunity to have prescriptions filled with no deductible.

Petitioners received a joint letter from Kaiser and the Union dated September 20, 1984. The letter, which contained a copy of the Memorandum of Understanding, explained the options available under that document. An individual could elect to participate in the Program of Continuing Coverage. Those individuals who elected to participate in the Program were required to waive all legal rights they either had or may have had under the 1980 Insurance Agreement.

In the alternative, an individual could elect not to participate in the Program of Continuing Coverage. However, retirees and surviving spouses who made this election were placed in a position of uncertainty. Kaiser had expressed its intent to discontinue all health benefits provided under HIP (except life insurance) effective January 1, 1985, the day following the expiration of the 1980 Insurance Agreement. The Union believed that such a discontinuance would violate Kaiser's obligations under the agreement. Although eligible individuals could take legal action in an effort to enforce their rights under the Insurance Agreement, there was no guarantee that litigation would prove fruitful.

The final option available under the Memorandum of Understanding was a lump-sum buyout. In a letter dated September 24, 1984, Kaiser formally offered this alternative to its eligible retirees and surviving spouses. In exchange for the lump-sum buyout, recipients were required to surrender all rights they had to health care benefits from Kaiser after December 31, 1984. Under the lump-sum buyout option, the amount to be received by any electing retiree or surviving spouse was to be determined by reference to the age and marital status of each electing retiree or surviving spouse. To accept the lump-sum buyout offer, the eligible individual was required to execute and return to Kaiser an "Application for Lump-sum Buyout and Release of Liability" by October 22, 1984. Petitioners elected to receive the lump-sum buyout and timely executed an appropriate application, which was received by Kaiser on October 18, 1984.

Following Kaiser's acceptance of the application, petitioners were entitled to receive a gross (before withholding) lump-sum buyout in the amount of $18,000 in April 1985. Kaiser had informed petitioners in the

©2011 Wolters Kluwer. All rights reserved.

The meaning of section 106 was clearly stated by this Court in *Laverty v. Commissioner* [Dec. 32,209], 61 T.C. 160, 165 (1973), affd. [75-2 USTC ¶9712] 523 F.2d 479 (9th Cir. 1975):

> Section 106 has no application to payments an employer makes directly to his employee ... It deals only with the treatment of *contributions* by an employer to an accident or health plan for the benefit of his employees, either in the form of contributions to a separate fund or trust or by the payment of premiums on a policy of accident or health insurance. [Emphasis in original]

Thus, section 106 does not apply to payments made directly by Kaiser to petitioners.

Petitioners cite Revenue Ruling 57-33, 1957-1 C.B. 303; Revenue Ruling 61-146, 1961-2 C.B. 25; Revenue Ruling 75-241, 1975-1 C.B. 316; and Revenue Ruling 82-196, 1982-2 C.B. 53, in support of their argument to exclude the lump-sum payment from gross income under section 106(a). However, those revenue rulings are not applicable. Taken together, they conclude that direct payments by an employer to either an employee or retiree are excludable from gross income under section 106(a) if the payments are verified reimbursements to the employee for health insurance, which payments were in satisfaction of a legal or contractual obligation. Where the employee was not obligated to purchase the benefits, the exclusion was not available. These facts do not exist in the instant case. Consequently, the rulings do not support petitioners' argument for exclusion.

The facts and issues of the case at bar are very similar to a recent decision of a District Court. In *Adkins v. United States* [88-2 USTC ¶9437], 693 F.Supp. 574 (N.D. Ohio 1988), the plaintiffs were retirees and surviving spouses of retirees of Crucible Steel Corporation. A lawsuit was instituted by the retirees and surviving spouses against Crucible to prevent the corporation from terminating its contributions to a health plan under which the plaintiffs received benefits. Pursuant to a settlement offer by Crucible, the plaintiffs elected to receive lump-sum buyout payments from the corporation in full settlement of any claims they had or may have had against Crucible for future health benefits. As in this case, the issue was whether the lump-sum payments received by the plaintiffs were excludable from gross income under section 106. In holding for the government, the District Court concluded:

> The facts of this case do not permit the plaintiff to rely on section 106. Section 106 clearly applies to contributions made by the employer to hospital, medical and accident benefit insurance programs, trusts, or funds. Section 106 does not contemplate, nor infer, direct payments to the employees. The plaintiffs have failed on their burden to establish that payments made directly to the plaintiffs are excludable under section 106. [693 F.Supp. at 577.]

Petitioners also contend that the conversion of their right to tax exempt medical insurance into a lump-sum cash payment should be treated as an "involuntary conversion" under section 1033(a). [6] Petitioners believe Kaiser's precarious financial condition at the time of the lump-sum buyout offer forced them to take the cash payment. It appears that petitioners preferred to accept the cash payment in 1985 rather than face the possibility of receiving nothing in the future if Kaiser declared bankruptcy.

Section 1033 provides that, under certain circumstances, gains realized from an involuntary conversion are not to be recognized. However, section 1033 is only applicable where property is "compulsorily or involuntarily converted." Section 1.1033(a)-1(a), Income Tax Regs. This language indicates that section 1033(a) applies where the taxpayer has no alternatives but to surrender his property. This was not the case with petitioners. Petitioners were never forced to accept the lump-sum payment. Petitioners had the option of either taking the payment, participating in the Program of Continuing Coverage, or contesting Kaiser's threatened discontinuance of the 1980 Insurance Agreement. Therefore, since petitioners had alternatives available to them and were not forced to surrender their benefits under the Health and Insurance Plan in exchange for the lump-sum payment, section 1033(a) is inapplicable.

The regulation further states that "An 'involuntary conversion' may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property." Section 1.1033(a)-1(a), Income Tax Regs. None of the foregoing categories are applicable to the case at bar. Petitioners' loss of the benefits under the Health and Insurance Plan was not a result of the destruction, theft, seizure, requisition, or condemnation of property. As such, petitioners were not subject to an involuntary conversion under section 1033(a).

©2011 Wolters Kluwer. All rights reserved.

Petitioners recognize that they are asking this Court to expand the traditional application of section 106 to include the lump-sum payment at issue. Petitioners argue that Congress intended to provide relief to individuals in petitioners' situation. However, a review of the legislative history of section 106 offers no tangible evidence to support this assertion. See H. Rept. No. 1337, 83d Cong., 2d Sess., pp. 15, A35 (1954); S. Rept. No. 1662, 83d Cong., 2d Sess., pp. 185-186 (1954). Congress is at liberty to expand the exclusion under section 106 if it so chooses, but the current language of section 106 and the regulations promulgated thereunder fail to provide an indication that the lump-sum payment at issue is excluded from gross income. Absent such concrete and explicit authority, we must find the lump-sum payment includable in gross income.

Decision will be entered for respondent.

Footnotes

1 All Section references are to the Internal Revenue Code of 1954, as amended, and in effect during the year at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

2 This matter has been selected as a test case. The parties in several cases have entered into stipulations to be bound by this case.

3 Hereinafter, "all eligible retirees, surviving spouses, and their eligible dependents" under the Kaiser Health and Insurance Plan shall be referred to as "eligible individuals."

4 We presume that petitioner-husband was an eligible individual.

5 In the stipulation of facts, the parties agree that petitioners set aside the $18,000 received by them for purchasing health insurance. They also stipulated that Kaiser withheld the Federal income tax and the stipulated exhibits reflect the withheld state income tax. We interpret these conflicting statements to mean that the net was set aside for said purposes.

6 In asserting that the lump-sum payment constitutes an involuntary conversion, petitoners never specifically cite section 1033(a). However, it is evident that petitioners were referring to section 1033(a) based upon the nature of their argument.

©2011 Wolters Kluwer. All rights reserved.

202 622 0735

United States Tax Cases (1913-1999), [95-2 USTC ¶50,382], Arthur H. McKean and Jean D. McKean, et al., Plaintiffs v. The United States, Defendant , (June 23, 1995), U.S. Claims Court, (Jun. 23, 1995)

Click to open document in a browser

[95-2 USTC ¶50,382] Arthur H. McKean and Jean D. McKean, et al., Plaintiffs v. The United States, Defendant

U.S. Court of Federal Claims, 94-256T, 94-279T--94-284T, 94-290T--94-294T, 94-319T, 94-320T, 6/23/95

[*Code Secs. 61 , 106 and 132*]

Gross income: Damages: Back pay: Health insurance: No-additional-cost services: Attorneys' fees.--Cash payments of back pay to former flight attendants in settlement of a class action gender discrimination suit were includible in gross income because there was no specific exemption with respect to the payments. The portion of the back pay award representing the value of lost health insurance benefits and lost travel passes was not exempt from tax under the "origin of claim" doctrine because, even though that doctrine has been used to characterize damage awards for tax purposes based upon the nature of the injury, it has not been used to break down an award of back pay into compensation for taxable wages and compensation of nontaxable fringe benefits. The portion of the award representing the lost health insurance benefits was not excludable under Code Sec. 106 because that section did not provide an exemption for cash payments made directly to employees by an employer. Moreover, that portion of the back pay award was not in the nature of reimbursement, and the employer did not verify that the former employees purchased separate insurance coverage during the period following discharge and before payment of the award. Similarly, Code Sec. 132 did not provide a statutory basis for excluding the portion of the back pay award representing the value of lost travel passes. Even though that section excludes form gross income fringe benefits that qualify as a no-additional-cost service, nothing in the section states that the exemption applies to a cash substitute for a no-additional-cost service. Moreover, Code Sec. 132 extended only to no-additional-cost services provided by employers to current, retired, or disabled employees. BACK REFERENCES: 95FED ¶5900.1243, 95FED ¶6803.37 and 95FED ¶7438.04

Henry G. Zapruder, Daniel W. Luchsinger, Zapruder & Odell, 601 Thirteenth St., N.W., Washington, D.C. 20005, for plaintiffs. Loretta C. Argrett, Assistant Attorney General, Elizabeth D. DePriest, Mildred L. Seidman, Department of Justice, Washington, D.C. 20530, for defendant.

OPINION

HODGES, Judge:

This case comes before the court on plaintiffs' motion for summary judgment and defendant's cross-motion for partial summary judgment on Counts I and II of plaintiffs' tax refund suit. The question before us is whether the portion of a Title VII cash backpay award received by plaintiffs representing the value of lost health insurance benefits and lost travel passes is includible in gross income under §61(a) of the Internal Revenue Code, as the government contends, or excludable from gross income, as plaintiffs contend. In addition, we are asked to decide whether plaintiffs may exclude from gross income their *pro rata* share of attorney's fees which United Air Lines paid to counsel for plaintiffs' class action discrimination suit.

FACTS

Plaintiffs are part of a group of former United Air Lines flight attendants who were discharged from employment between 1965 and 1968 as a result of United's requirement that flight attendants remain unmarried. In 1970, one of the discharged attendants brought suit against United on behalf of herself and all similarly situated former United flight attendants, alleging that the termination of their employment upon marriage constituted unlawful gender discrimination in violation of Title VII of the Civil Rights Act of 1964, 42 U.S.C. §2000e-1 *et seq. Romasanta, et al. v. United Air Lines, Inc.*, No. 70 C 1157 (N.D. Ill. 1984). Plaintiffs sought backpay including the value of fringe benefits lost, reinstatement, and other non-monetary relief.

©2011 Wolters Kluwer. All rights reserved.

The *Romasanta* lawsuit was certified as a class action in 1979. In September 1984, the district court awarded backpay of $37,972,500 to the *Romasanta* plaintiffs, based on an estimated 1500 eligible claimants. The backpay award included lost wages plus interest (81.4% of the award), health insurance benefits plus interest (2.8% of the award), and lost travel passes plus interest (15.8% of the award). No restrictions were placed on the recipients' use of any of the backpay proceeds. A July 1986 settlement agreement set United's minimum liability at $32,732,252. Its actual liability depended on the number of claimants who qualified for a full share of the award, and the number who would accept a half-share in exchange for reinstatement. This amount was deposited into an escrow account in January 1987.

The district court ordered United to pay $4,870,000 to class counsel for attorney's fees and costs, in November 1988. In December, United paid each of 1,179 full-share claimants $16,387.65 in backpay wages and benefits. Each full-share claimant also received a check for interest totalling $5,947.92 from the escrowed settlement fund. United paid each of 481 half-share claimants $8,193.83 in backpay wages and benefits, in addition to $1,992.58 of interest.

Pursuant to the settlement agreement, United withheld federal income and FICA taxes, and in some cases, state income taxes from the checks. United also reported for each claimant a *pro rata* share of the $4,866,912 in attorney's fees and costs that United paid to class counsel as "Other Compensation".

Plaintiffs filed federal income tax returns for 1988, reporting as gross income their share of backpay wages and benefits, interest, and attorney's fees. In March and April 1992, plaintiffs filed claims for refund of the federal income taxes withheld on the backpay and paid on the interest they had received in 1988 under the *Romasanta* settlement. Plaintiffs' claims were disallowed in full in May and July 1992 and July 1993.

In Count I of plaintiffs' complaints, to which these cross-motions for summary judgment apply, plaintiffs seek to exclude from gross income their *pro rata* shares of the portions of the backpay award representing the value of lost health insurance benefits and lost travel passes. [1] Plaintiffs also seek in Count II the exclusion from income of their *pro rata* share of attorney's fees, paid to counsel by United for the class action plaintiffs pursuant to the *Romasanta* settlement. [2]

DISCUSSION

Section 61(a) of the Internal Revenue Code defines gross income to include "all income from whatever source derived." 26 U.S.C. §61(a) (1988). The Supreme Court consistently has held that section 61(a) subjects to taxation all accessions to wealth that are clearly realized and over which a taxpayer has complete dominion, except those specifically exempted. *Commissioner v. Glenshaw Glass Co.* [55-1 USTC ¶9308], 348 U.S. 426, 430 (1955).

The payments to plaintiffs representing lost health insurance benefits and lost travel passes are accessions to wealth which must be included in their incomes in the year of receipt, unless the taxpayers can show that Congress unequivocally has provided an exemption for the payments. *See e.g., United States v. Wells Fargo Bank* [88-1 USTC ¶13,759], 485 U.S. 351 (1988) ("exemptions from taxation are not to be implied; they must be unambiguously proved").

Plaintiffs argue that the portion of their cash backpay award representing the value of lost health insurance benefits and lost travel passes should be exempt from tax under the "origin of claim" doctrine as set forth by the Supreme Court in *United States v. Gilmore* [63-1 USTC ¶9285], 372 U.S. 39, 48-49 (1963). The origin of claim doctrine traditionally has been used to characterize legal expenses for federal income tax purposes by the origin of the claim litigated. *See Woodward v. Commissioner* [70-1 USTC ¶9348], 397 U.S. 572 (1970).

Courts have extended the origin of claim doctrine to the characterization of Title VII damage recoveries, looking to the nature of the claimed injury as the basis for the taxability of the damage award (*i.e.*, personal or economic); *see, e.g., Roemer v. Commissioner* [83-2 USTC ¶9600], 716 F.2d 693, 697 (9th Cir. 1983).

The Supreme Court has ruled that a personal injury stemming from the violation of an anti-discrimination employment statute may be characterized as personal or economic depending on the nature of remedies provided by the statute, and that any damage recovery for personal violations would be nontaxable while economic damages are taxable. *United States v. Burke* [92-1 USTC ¶50,254], 112 S.Ct. 1867 (1992). Thus,

©2011 Wolters Kluwer. All rights reserved.

where a statute provides only for the remedies of backpay and injunctive relief, such relief is economic in nature and any recovery of backpay would be taxable. *Id.* at 1872.

While the origin of claim doctrine has been used to characterize damage awards for tax purposes based on the nature of the injury recovered on, it has not been used to break down an award of backpay into compensation for taxable wages and compensation for nontaxable fringe benefits. We have no precedent for such apportionment of a cash backpay award. To the contrary, the Internal Revenue Service has made it clear that court-awarded damages of cash backpay are includible in gross income in their entirety, even where a portion of the backpay represents lost nontaxable fringe benefits. *See*Rev. Rul. 85-44 , 1985-1 C.B. 22.

Plaintiffs rely heavily on Justice Frankfurter's concurring opinion in *United States v. Kaiser* [60-2 USTC ¶9517], 363 U.S. 299 (1960), specifically for the proposition that "payment which compensates for a loss of something which would not itself have been an item of gross income is not a taxable payment." *Id.* at 311. Justice Frankfurter derives this principle from twenty-five Internal Revenue Service and Treasury Department pronouncements contained in an appendix attached to his concurring opinion. *Id.* at 317. Justice Frankfurter's principle calling for the exclusion of recoveries of nontaxable items did not intend to override Internal Revenue Service and Treasury Department pronouncements, but rather is defined and circumscribed by such pronouncements.

In Rev. Rul. 85-44 , 1985-1 C.B. 22, a recent example of the type of pronouncement considered by Justice Frankfurter in *Kaiser*, the Internal Revenue Service has made it clear that court-awarded damages in the form of cash payments representing nontaxable fringe benefits are includible in gross income. The Service's reasoning is based on Rev. Rul. 75-241 , 1975-1 C.B. 316, which states that cash payments to employees in lieu of nontaxable fringe benefits are taxable. Nothing in Justice Frankfurter's concurring opinion in *Kaiser* undermines either the correctness or the authority of these rulings.

Plaintiffs argue alternatively that the portion of their cash backpay award representing the value of lost health insurance benefits and lost travel passes should be excluded on statutory grounds. They contend that section 106 of the Internal Revenue Code provides a statutory basis for excluding the portion of the payments representing lost health insurance benefits.

Resolution of taxpayers' claims to exemption from tax must begin with the language of the statute. *Herbert v. United States* [88-1 USTC ¶9385], 850 F.2d 32, 34 (2d Cir. 1988). Section 106(a) provides that the "[g]ross income of an employee does not include employer-provided coverage under an accident or health plan." Therefore this section provides an exemption only for employer contributions to an "accident or health plan." It does not carve out an exclusion for cash payments made directly to employees by an employer.

In *Adkins v. United States* [89-2 USTC ¶9489], 882 F.2d 1078 (6th Cir. 1989), the court held that lump-sum payments to taxpayers in settlement of lawsuits against their former employer concerning the employer's proposed termination of contributions to a health benefits plan did not fall with the section 106 exclusion for contributions by an employer to accident or health plans. The court ruled that section 106 did not provide an exemption for payments made by an employer directly to its employees. *Id.* at 1080-81, citing *Laverty v. Commissioner* [CCH Dec. 32,209], 61 T.C. 160, 165 (1973), *aff'd* [75-2 USTC ¶9712], 523 F.2d 479 (9th Cir. 1975).

Furthermore, Rev. Rul. 85-44 , 1985-1 C.B. 22 states that payments made to an individual as court-awarded damages for unpaid health insurance premiums are includible in the individual's gross income notwithstanding section 106 . The backpay award made by United was not in the nature of a reimbursement, as plaintiffs contend, and thus is not excludable under section 106 pursuant to Rev. Rul. 61-146 , 1961-2 C.B. 25. United did not verify that plaintiffs purchased separate insurance coverage during the period they were discharged from employment, before paying the award.

Plaintiffs contend that section 132 provides a statutory basis for excluding the portion of the backpay award that represented the value of lost travel passes, because travel passes qualify as a no-additional-cost service. Section 132(a) provides that "[g]ross income shall not include any fringe benefit which qualifies as a--(1) no-additional-cost service." However, nothing in section 132 states that a cash substitute for no-additional-cost services also is subject to the exclusion (except for the case of certain reimbursements for parking expenses). Furthermore, even if plaintiffs' settlement had called for the back payment of no-additional-cost services in kind, the section 132 exclusion extends only to those no-additional-cost services

©2011 Wolters Kluwer. All rights reserved.

provided by an employer to current, retired, or disabled employees. Temp. Treas. Reg. §1.132-1T(b)(1)(i) (1985).

Congress intended for Title VII to compensate victims of discrimination by restoring them to the wage and employment positions they would have occupied absent the unlawful discrimination. *Burke* [92-1 USTC ¶50,254], 112 S.Ct. at 1873 (citing *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 412 (1975)). But receiving cash is not the same as receiving a fringe benefit of the same value. *See*Rev. Rul. 75-241 , 1975-1 C.B. 316. An award of cash in lieu of nontaxable fringe benefits allows plaintiffs to use the cash however they see fit. Our tax laws declare the price of such economic freedom to be the taxability of those funds. Plaintiffs here received cash in lieu of nontaxable fringe benefits as part of the settlement of their discrimination suit. Including the portion of their cash awards representing these fringe benefits in gross income, supports the policy of parity in economic position called for by Title VII.

Plaintiffs also seek to exclude from income their *pro rata* share of attorney's fees paid to counsel for the class action discrimination suit, and they offer substantial support for their position on this issue. Defendant does not challenge plaintiffs' position on this issue as applied in the two cases designated by plaintiffs in their motion. Because defendant does not challenge the merits of plaintiffs' position in its cross-motion for summary judgment, plaintiffs' motion for summary judgment with regard to the issue of excluding attorney's fees will be granted.

CONCLUSION

The payments to plaintiffs for lost health insurance benefits and lost travel passes are includible in gross income absent a specific exemption. Plaintiffs have not shown clear support for excluding these payments. Defendant's cross-motion for partial summary judgment on Count I of the consolidated complaints is GRANTED plaintiffs' motion on that count is DENIED.

Defendant does not challenge the merits of plaintiffs' position on the question involving excludability of plaintiffs' *pro rata* share of attorney's fees paid by United to counsel for the class action discrimination suit. Plaintiffs' motion for summary judgment on Count II of the *Kirklen* and *Miller* complaints therefore is GRANTED.

Footnotes

1 Plaintiffs' motion for summary judgment with regard to Count I of plaintiffs' complaints does not include the consolidated cases of *McKean* and *Dulin*. These two cases are subject to motions to dismiss by defendant on separate grounds not applicable to the other plaintiffs. Plaintiffs' motion does include two of the plaintiffs joined to the *Hanscom* complaint through notice filed on June 10, 1994: *Kirklen* and *Miller*.

2 Plaintiffs request summary judgment with regard to Count II of the complaints in only two of the consolidated cases: *Kirklen* and *Miller*. These are two of the cases joined to the *Hanscom* complaint through notice filed on June 10, 1994. The remainder of the consolidated cases are subject to defendant's motion to dismiss on variance grounds, except for *McKean* and *Dulin*, which are subject to motions to dismiss by defendant on separate grounds.

©2011 Wolters Kluwer. All rights reserved.

IRS Rulings & Other Documents (2001-Earlier), Payments to employees in lieu of health and welfare benefits., Rev. Rul. 75-241, 1975-1 CB 316, Internal Revenue Service, (Jan. 1, 1975)

Click to open document in a browser

Section 3121.--Definitions

26 CFR 31.3121(a)-1: Wages.

(Also Sections 106, 3306, 3401; 1.106-1, 31.3306(b)-1, 31.3401(a)-1.)

[IRS Headnote] Payments to employees in lieu of health and welfare benefits.--

Amounts employees received directly from a government contractor, in satisfaction of the Service Contract Act requirement that health and welfare benefits or cash in lieu thereof be provided on a parity with those benefits prevailing in the locality constitute wages for purposes of the FICA, FUTA, and income tax withholding, and are includible in their gross income; Rev. Rul. 61-146 distinguished.

[Text]

Advice has been requested whether cash payments of health and welfare benefits to employees, under the circumstances described below, are "wages" for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954). Advice has also been requested whether the payments are includible in the gross income of the employees for Federal income tax purposes.

A contractor, performing a service contract for the United States Government, was required to pay health and welfare benefits to his employees on a parity with those prevailing in the locality where the services were performed pursuant to the Service Contract Act of 1965, as amended, 41 U.S.C.A., sections 351-358 (Supp. 1974). Under the Act, a contractor may elect to discharge this obligation by paying a cash amount to his employees in lieu of the specified health and welfare benefit. There is no requirement under the Act that the employer verify that the payments are used by employees to purchase health and welfare benefits.

The payments here under consideration were based on a specified rate for each hour the employee performed services for the contractor, and were made in cash either by including them in the employee's regular paychecks or by separate checks. The contractor made no attempt to verify that his employees actually purchased health and welfare benefits.

Section 3121(a) of the Federal Insurance Contributions Act and section 3306(b) of the Federal Unemployment Tax Act provide, with certain exceptions, that the term "wages" means all remuneration for employment. Section 3401(a) of the Code, relating to the withholding of income tax, contains a similar definition.

Sections 3121(a)(2) and 3306(b)(2) of the Acts except in part, from the term wages, that amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund to provide for any such payments) made to, or on behalf of, an employee under a plan or system established by an employer that makes provision for his employees generally on account of sickness or accident disability or medical or hospitalization expenses in connection with sickness or accident disability.

Section 106 of the Code provides that gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness.

Rev. Rul. 57-33, 1957-1 C.B. 303, holds that certain payments made by employers directly to employees pursuant to a union contract of employment, for the purpose of purchasing individual hospitalization and surgical insurance coverage, are wages for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages. In that Revenue Ruling, when member employers had no existing company program to cover their employees, the union asumed the responsibility of making sure that its members sent the weekly payment for such benefits. The union had made direct arrangements with a hospital service for this purpose and in no instance were the

©2011 Wolters Kluwer. All rights reserved.

payments under the contract being made or used for a purpose other than providing the hospitalization and surgical insurance benefits. Nevertheless the Revenur Ruling stated that the fact that the union assumed the responsibility for the employees' disposition of such payments and the purchase of hospitalization and surgical insurance was immaterial. The payments were required under the terms of a labor agreement, were directly related to the units of service performed by the employees, and were paid directly to the employees by the employers. Thus, they were a basic part of the compensation of each employee involved.

Rev. Rul. 61-146, 1961-2 C.B. 25, holds that reimbursements by an employer to his employees for his share of premiums for hospital and medical insurance for them may be considered as contributions by the employer to accident or health plans for his employees so as to result in the exclusion of such payments from the gross income of the employees under section 106 of the Code. For those employees, in that case, not covered by the employer's group policy, but covered under other types of hospital and medical insurance for which they paid the premiums directly to the insurers, the employer paid a part of such premiums upon proof that the insurance was in force and was being paid for by the employees. Rev. Rul. 57-33 was distinguished since, under the facts in that case, the employers had no accident or health plan of their own in effect, and, with respect to the payments that they made directly to the employees, they did not require an accounting either by the employees or the employees' union that the funds were expended in the acquisition of insurance coverage.

Since the contractor in this case had no legal or contractual obligation to and did not verify that the cash payments were used by the employees to purchase health and welfare benefits, the employees had complete control of the disposition of the funds. Thus, the payments are attributable to service performed by the employees for their employer, although the employers paid the amounts in discharge of a requirement of a Federal statute that minimum fringe benefits in the form of health and welfare benefits be provided.

Accordingly, the payments in the instant case are wages for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages, and are includible in the gross income of the employees for Federal income tax purposes.

Rev. Rul. 61-146 is distinguished since in that case the employer either had an accident or health plan of his own or, with respect to the payments made directly to the employees, required an accounting to insure that the insurance was in force and was being paid for by the employees.

©2011 Wolters Kluwer. All rights reserved.