Metzger v. Commissioner, 88 T. C. 834 (1987)

Damages received for personal injuries in employment discrimination settlements may be excluded from gross income under section 104(a)(2) of the Internal Revenue Code.

Summary

Ana Maria Metzger, a former associate professor, settled her claims against Muhlenberg College for $75,000, alleging sex and national origin discrimination. The settlement was divided equally between wage claims and other claims, with the latter designated as compensation for personal injuries. The Tax Court held that at least half of the settlement ($37,500) was excludable from gross income as damages for personal injuries under section 104(a)(2). However, the court disallowed a corresponding portion of Metzger's legal fees deduction, as those fees were allocable to the tax-exempt portion of the settlement.

Facts

Ana Maria Metzger, a Cuban-American professor at Muhlenberg College, was denied tenure and her employment terminated in 1972. She filed claims with state and federal agencies and courts, alleging breach of contract and discrimination based on sex and national origin. In 1975, Metzger settled with the college for $75,000, with half designated as wages and half as compensation for personal injuries. Metzger reported $37,500 as income and deducted $7,750 in legal fees. The IRS challenged the exclusion of the settlement amount and the full deduction of legal fees.

Procedural History

Metzger filed a petition with the U. S. Tax Court after the IRS determined a deficiency in her 1975 tax return. The IRS later amended its answer to assert an increased deficiency, challenging the exclusion of half the settlement payment and the full deduction of legal fees. The Tax Court decided in favor of Metzger on the exclusion issue but upheld the IRS's position on the legal fees deduction.

Issue(s)

1. Whether one-half of the $75,000 payment to Metzger from Muhlenberg College in settlement of litigation is excludable from gross income under section 104(a)(2)?
2. Whether Metzger is entitled to deduct all of the amount she paid as a legal fee if a portion of the settlement payment referred to in issue (1) is excludable?

Holding

1. Yes, because the settlement included claims for personal injuries under tort or tort-type rights, and at least $37,500 was received in satisfaction of these claims.

© 2025 SCOTUSreports.com. All rights reserved.

2. No, because the portion of the legal fee allocable to the excludable portion of the settlement payment is not deductible under section 265(1).

Court’s Reasoning

The court focused on the nature of the claims settled, which included allegations of discrimination under federal and state laws, akin to tort or tort-type rights. The court relied on prior cases like *Bent v. Commissioner* and *Seay v. Commissioner*, emphasizing that the validity of the claims was irrelevant; what mattered was the basis for the settlement. The court found that the college’s intent in settling was to avoid litigation costs, not to admit liability. The allocation of the settlement payment was deemed for tax purposes only, thus not binding on the court’s analysis. For the legal fees, the court applied section 265(1), disallowing deduction for fees allocable to tax-exempt income.

Practical Implications

This decision clarifies that settlements in employment discrimination cases can have portions excluded from income if they are for personal injuries, even if the settlement agreement does not explicitly allocate for such injuries. Practitioners should carefully document the nature of claims settled to support exclusion claims. The ruling also reinforces that legal fees must be allocated proportionally between taxable and non-taxable income, impacting how attorneys structure settlement agreements and advise clients on tax consequences. Subsequent cases like *Commissioner v. Banks* (2005) have further developed the tax treatment of legal fees in settlements.

© 2025 SCOTUSreports.com. All rights reserved.