***Downey v. Commissioner, 97 T. C. 150 (1991)***

Settlements under the Age Discrimination in Employment Act (ADEA) are excludable from gross income as damages received on account of personal injuries.

## Summary

In Downey v. Commissioner, the U. S. Tax Court ruled that both nonliquidated and liquidated damages received in settlement of an Age Discrimination in Employment Act (ADEA) claim are excludable from gross income under Section 104(a)(2) of the Internal Revenue Code. Burns Downey, a retired airline pilot, sued his former employer, United Air Lines, for age discrimination and settled for $120,000, half allocated to nonliquidated damages (back pay) and half to liquidated damages. The court found that age discrimination constitutes a personal injury under the ADEA, and thus, the entire settlement was not subject to taxation.

## Facts

Burns Downey, an airline pilot born in 1921, was employed by United Air Lines since 1945. In 1981, after turning 60, he was placed on sick leave due to the revocation of his FAA medical certificate. United then retired him, adhering to their policy prohibiting pilots over 60 from any flight deck position, despite the FAA allowing such individuals to serve as second officers. Downey sued United under the ADEA, alleging age discrimination and willful violation of the Act. The case settled for $120,000, with half allocated to nonliquidated damages (back pay) and half to liquidated damages.

## Procedural History

Downey filed a complaint in the U. S. District Court against United Air Lines in 1984. The case was settled in late 1985, with a stipulated dismissal with prejudice. Downey reported the nonliquidated damages as income but excluded the liquidated damages on his 1985 federal income tax return. The IRS determined a deficiency, asserting the liquidated damages were taxable. Downey contested this and amended his petition to also exclude the nonliquidated damages. The case was heard by the U. S. Tax Court.

## Issue(s)

1. Whether the portion of the settlement allocated to nonliquidated damages under the ADEA is excludable from gross income under Section 104(a)(2)?
2. Whether the portion of the settlement allocated to liquidated damages under the ADEA is excludable from gross income under Section 104(a)(2)?

## Holding

1. Yes, because the nonliquidated damages were received in settlement of a claim

 

for age discrimination, which is a personal injury under the ADEA, and thus excludable under Section 104(a)(2).
2. Yes, because the liquidated damages, although punitive in nature from the employer's perspective, serve a compensatory function for the victim of age discrimination and are therefore excludable under Section 104(a)(2).

## Court's Reasoning

The court reasoned that an ADEA claim is a tort-like claim, seeking to redress personal injuries due to age discrimination. It emphasized that the nature of the injury (age discrimination) is personal, and the claim does not depend on a contractual relationship. The court overruled its prior decisions in Rickel and Pistillo, aligning with appellate court decisions that found all damages from age discrimination claims to be excludable. For liquidated damages, the court noted their dual compensatory and punitive nature but focused on their compensatory purpose for the victim, supporting exclusion under Section 104(a)(2). The court also considered the legislative history of the ADEA and FLSA, which supported the view that liquidated damages compensate for nonpecuniary losses.

## Practical Implications

This decision significantly impacts how settlements under the ADEA are treated for tax purposes. It establishes that both types of damages received in ADEA settlements are excludable from income, providing a clear incentive for victims to pursue such claims. Practitioners should advise clients to carefully allocate settlement proceeds between nonliquidated and liquidated damages, as this case confirms both are non-taxable. The ruling may influence how other discrimination statutes are interpreted for tax purposes. Subsequent cases have followed this precedent, affirming the tax-exempt status of ADEA settlements.