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Significant Service Center Advice--Payments for Breach of the Duty of Fair Representation.

This responds to your request for Significant Advice received by E-mail on April 7, 1997, in connection with a question posed by the Compliance function of the Austin Service Center.

**DISCLOSURE STATEMENT**

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**ISSUE**

Whether the Service Center should allow claims for refunds of taxes paid on amounts received for a union’s breach of its duty of fair representation because they are excludable from gross income under I.R.C. § 104(a)(2) as damages received on account of personal injuries or sickness.

**CONCLUSION**

Because the payments from the union for breach of its duty of fair representation were not received "on account" of any personal injuries or sickness, the Service Center should disallow the claims for refunds.

**FACTS**

From the information provided, we conclude that taxpayers were members of the plaintiff class in Aguinaga v. United Food and Commercial Workers Int'l Union, 720 F. Supp. 862 (D. Kan. 1989), aff'd in part, rev'd in part, 993 F.2d 1463 (10th Cir. 1993), cert. denied, 510 U.S. 1072 (1994), on remand, 854 F. Supp. 757 (D. Kan. 1994), aff'd as modified, 58 F.3d 513 (10th Cir. 1995); accordingly, we have adopted the findings of fact and conclusions of law contained therein. In Aguinaga, the union members filed a hybrid action alleging that the employer, John Morrell & Co., breached the collective bargaining agreement by conducting a sham closing of a meat packing plant and that the union breached its duty of fair representation by entering into secret agreements that allowed the employer to reopen the plant using nonunion employees. After the employer settled with the employees, the jury, in the liability phase of the trial, found that the union breached its duty of fair representation owed to the plaintiff class.

Thereafter, the district court, in a detailed ruling on the damages issues, held that the employer and the union would not be held jointly and severally liable. Aguinaga, 720 F. Supp. at 869. Rather, the court employed the apportionment formula enunciated by the Supreme Court:

> The governing principle, then, is to apportion liability between the employer and the union according to the damage caused by the fault of each. Thus, damages attributable solely to the employer's breach of contract should not be charged to the union, but increases if any in those damages caused by the union's refusal to process the grievance should not be charged to the employer.

See Vaca v. Sipes, 386 U.S. 171, 197-198 (1967).

As damages, the court ordered the payment of back pay and fringe benefits (and prejudgment interest thereon)[1] from the date of the plant closing to September 1, 1983, the date the Master Agreement would have expired.[2] In ruling on the duration of the

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[1] The prejudgment interest component of each award is clearly taxable under I.R.C. § 61(a)(4). See, e.g., Brabson v. United States, 73 F.3d 1040 (10th Cir. 1996).

[2] The district court explicitly rejected the union's claim that, as a matter of law, it could not be held liable for back pay damages. Aguinaga, 720 F. Supp. at 865-866. This holding

damage period, the district court, acknowledging that a hybrid action is not the same as a common law contract case, nevertheless held:

> . . . damages in a hybrid case must have a contractual basis. Morrell breached the contract. It was the contract that determined the terms and conditions of employment, i.e., the status quo from which damages are to be computed. It was the contract which determined the plaintiffs' right to continued employment.

Aguinaga, 720 F. Supp. at 872.

On appeal, the Tenth Circuit affirmed the jury's finding that the union breached its duty of fair representation. Aguinaga, 993 F.2d at 1471. The appellate court held, however, that the trial court abused its discretion in refusing to allow the union to present evidence that the employer would have reduced its work force in any event. Addressing the union's argument against apportionment of damages, the Tenth Circuit reasoned that the Supreme Court in Bowen v. USPS, 459 U.S. 212, 222 (1983), had already rejected the argument that a union could not be held liable for back pay. Aguinaga, 993 F.2d at 1475. Holding that the back pay remedy should run from the date of the plant closing to February 17, 1987, the date the employer settled the action, rather than to the date the agreement expired, the Tenth Circuit reversed and remanded for a calculation of damages. Aguinaga, 993 F.2d at 1479.

On remand, the district court interpreted the Tenth Circuit's mandate as requiring it to determine "what a now non-party, John Morell & Company would have done concerning the work force and operation of its meat packing plant if its chicanery upon its labor force had not occurred, . . . ." Aguinaga, 854 F. Supp. at 760. Before addressing the specific parameters of the defendant's liability for damages, the court noted that the purpose of an award of back pay (including fringe benefits) is to make employees whole for the losses suffered. Aguinaga, 854 F. Supp. at 761, citing Bowen v. USPS, 459 U.S. at 223; NLRB v. Master Slack, 773 F.2d 77, 83 (6th Cir. 1985). The court then proceeded to define the period of recovery; the applicable wage rate; the number of plaintiffs entitled to damages; and pension and health benefits. Id. The court also addressed plaintiffs' obligation to mitigate their damages including setoffs for interim earnings. Aguinaga, 854 F. Supp. at 768.

On appeal, the Tenth Circuit held that the trial court's damage calculation was not clearly erroneous; the record

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was left undisturbed by two opinions of the Tenth Circuit.

supported the determination regarding the number of jobs available to class members; the wage rate selected for back pay computation was not clearly erroneous; but the district court erred in failing to allow carryover of setoffs from one category of damages to another category of damages. Rather than remanding the case to the trial court, the Tenth Circuit ordered a remittitur of $1 million on the damage award, less prejudgment interest thereon, subject to acceptance by the plaintiffs. Aguinaga, 58 F.3d at 521. Plaintiffs accepted the remittitur of the back pay damage award. Some of the Aguinaga plaintiffs have filed claims for refunds of taxes paid on their recovery.

**DISCUSSION**

Except as otherwise provided in the Code, a taxpayer must include in gross income "all income from whatever source derived." I.R.C. § 61(a). The Supreme Court has long recognized that the definition of gross income sweeps broadly and reflects Congress' intent to exert the full measure of its taxing power and to bring within the definition of income "any accession to wealth." Commissioner v. Schleier, 515 U.S. ___, 115 S.Ct. 2159, 2163 (1995); United States v. Burke, 504 U.S. 229, 233 (1992). Accordingly, any receipt of funds by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the exclusions created by other sections of the Code. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

One of these exclusions, found at section 104(a)(2), permits a taxpayer to exclude from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." The regulations interpret the phrase "damages received" as encompassing damages received "through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement in lieu of such prosecution." Treas. Reg. § 1.104-1(c).

In addressing the breadth of section 104(a)(2), the Supreme Court has been guided by the corollary of section 61(a)'s broad construction that "exclusions from income must be narrowly construed." United States v. Centennial Savings Bank FSB, 499 U.S. 573, 583-584 (1991); Burke, 504 U.S. at 244.

In Schleier, the Court set forth a two-part test for exclusion under section 104(a)(2): first the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery was based on tort or tort type rights; and second, the taxpayer must show that the damages were received on account of personal injuries or sickness. 115 S.Ct. at 2167. Thus, the instant taxpayers must demonstrate that (1) a breach of the duty

of fair representation (BDFR) claim sounds in tort and (2) they received the payments on account of personal injuries or sickness. Regardless whether a BDFR claim sounds in tort, we do not believe that taxpayers can meet the "on account of personal injuries or sickness" requirement.

You indicate that, in support of their claims for refund, taxpayers rely on Banks v. United States, 81 F.3d 874 (9th Cir. 1996), where both the trial and appellate courts concluded that damages recovered from a union for breach of its duty of fair representation were excludable from gross income under section 104(a)(2). In Banks, taxpayer had brought suit against his employer and his union when he was terminated and the union settled the grievance rather than taking it to arbitration. The trial court held that the dismissal was unwarranted and, had the union not breached its duty, taxpayer would have been reinstated. Accordingly, the trial court assessed damages for lost wages against both defendants.

In granting summary judgment to Banks in the tax case, the district court reasoned that because it is an allegation of arbitrary, unfair or discriminatory treatment of workers by unions and serves to redress wrongful conduct, a BDFR claim sounds in tort.[3] In addition, the court reasoned, a BDFR claimant is entitled to a jury trial, Chauffeurs Local No. 391 v. Terry, 494 U.S. 558, 570 (1990); back pay and benefits, Vaca v. Sipes, 386 U.S. 171, 197-198 (1967), and Terry, 494 U.S. at 570-573; compensatory damages, IBEW v. Foust, 442 U.S. 42, 49 (1979)[4]; and possible mental anguish or emotional distress damages, Farmer v. ARA Services, Inc., 660 F.2d 1096, 1107 (6th Cir. 1981), and Richardson v. Communication Workers of America, 443 F.2d 974, 984-985 (8th Cir. 1971).

The district court then concluded because BDFR damages

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[3] Although Title VII considered in Burke and the Age Discrimination in Employment Act considered in Schleier possess similar characteristics, the Supreme Court held that they do not sound in tort. The purpose of a statute or cause of action is not dispositive of this test; it is the available remedies which determine the nature of a claim.

[4] Because the "compensatory damages" considered by the Supreme Court in Foust was an award of lost wages (not for the intangible elements of a personal injury), Foust v. IBEW, 572 F.2d 710, 718 (10th Cir. 1978), we disagree with the majority's apparent holding that they constitute tort damages. However, because taxpayers clearly fail the second requirement for exclusion, we pretermit any detailed discussion of the first prong of the test.

compensate for injuries caused by violations of employees' rights and make the injured employee whole, Foust, 442 U.S. at 48-49, they were received "on account of" the taxpayer's personal injury.

After the district court rendered its judgment, the Supreme Court decided Schleier enunciating the two-part test for exclusion under section 104(a)(2). The critical holding in Schleier was that, while a wrongful discharge in violation of public policy -- the federal policy against age discrimination -- may inflict intangible personal injuries such as pain and suffering and emotional distress, it does not **in and of itself** constitute a personal injury for purposes of section 104(a)(2). Similarly here, while the union's failure adequately to represent taxpayers' interests was the proximate cause of their loss of income, this action cannot be fairly described as a "personal injury" or "sickness." Schleier, 115 S.Ct at 2164.

To illustrate the "on account of" requirement, the Court employed a hypothetical where a taxpayer, injured in an automobile accident, recovers lost wages, medical expenses not previously deducted, and damages for pain and suffering and for emotional distress. The Court indicated that all components of the recovery would be excludable from gross income because they were received as a result of personal injuries. The Court then contrasted a taxpayer's recovery of lost wages in the employment discrimination context and held that while discrimination causes both personal injury, e.g., humiliation, and a loss of wages, neither is linked to the other. The amount of back wages recovered, the Court concluded, is completely independent of the existence or extent of any personal injury. Schleier, 115 S.Ct at 2163-2164. Accord, Rev. Rul. 85-97, 1985-2 C.B. 50.

Rejecting the Government's argument that the district court's judgment in Banks must be reversed under the Schleier "on account of" test, a panel of the Ninth Circuit, one judge dissenting, affirmed the district court's judgment. The majority of the panel concluded that Schleier was distinguishable on the grounds that unions do not pay wages to its members and that the purpose of BDFR suits is to compensate for personal injuries. The dissenting opinion noted that the majority placed too much emphasis on the source of the payment and ignored the requirement of a direct link between the lost wages and any personal injury.

Although Counsel and the Justice Department believed that this panel erred in applying the tests for exclusion, we did not recommend Supreme Court review because no conflict among the circuits existed. Moreover, the Banks dissent noted that although a union generally does not pay wages to its members, the majority ignored Ninth Circuit precedent that has allowed damages measured by wages in the context of a BDFR claim. See Galindo v.

Stoody Co., 793 F.2d 1502 (9th Cir. 1986).

It is readily apparent that there is no substantive difference between Banks and Schleier. Indeed, the Ninth Circuit failed to provide any explanation how a wrongful discharge attributable to the union's arbitrary conduct constitutes a personal injury while a wrongful discharge attributable to an employer's illegal age discrimination does not constitute a personal injury. The only difference between the two cases is the reason for the discharge. This distinction, we believe, is legally insignificant.[5]

We believe that the Service should disallow claims for refunds of taxes paid/withheld from these recoveries because the trial court in Aguinaga did not consider any personal injury in determining the amount of wage and benefits damages sustained by the employees. Clearly then, the loss of wages and benefits in the instant case was completely independent of the existence or extent of any personal injury sustained by the employees.

It is clear that in this hybrid action, the damages available from the employer are derived from the collective bargaining agreement. DelCostello v. Int'l B'hd of Teamsters, 462 U.S. 151, 163-165 (1983). In order to prevail on the BDFR claim, plaintiffs must prove first that the employer breached the agreement and then that the union breached its duty of fair representation. Id. See also Aguinaga, 58 F.3d at 517, fn. 2. Further, in holding that the trial court erred in its setoff analysis, the Tenth Circuit noted that the purpose of a back pay award in a BDFR case is to make the employee whole and restore the **economic** status quo that would have been obtained but for the wrongdoing of the employer and the union. Aguinaga, 58 F.3d at 520 (emphasis supplied). Thus, not unlike the back pay recovery considered in Schleier, the back pay in the instant case did not compensate for any personal injury; it was a legal injury of an economic character.

In summary, the Service should disallow claims for refunds of taxes paid on the subject proceeds because the four opinions in Aguinaga clearly indicate that plaintiffs' recovery of back pay and fringe benefits was totally unrelated to the existence or extent of any personal injury. Further, we believe that Banks

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[5] In Burns v. United States, No. 94-16639 (9th Cir. Jan. 24, 1996), another panel of the Ninth Circuit held (in an unpublished opinion) that economic damages received in a state wrongful discharge suit are not received "on account of personal injuries" under Schleier. The Fifth Circuit reached the same result in McKay v. Commissioner, No. 94-41889 (5th Cir. April 10, 1996).

was decided incorrectly because the liability of that union for breaching its duty of fair representation was but a mere extension of the economic damages suffered due to the nonpayment of wages by Banks' employer.

If you have any questions or need further assistance, please contact Mr. Keith A. Aqui at FTS (202) 622-7900.

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