

# WHY CIVIL RIGHTS LAWYERS SHOULD STUDY TAX

---

*Stephen Cohen\**  
*Laura Sager\*\**

## INTRODUCTION

Civil rights and income taxation may seem as far apart as any two legal subjects could be, but they actually intersect in a surprising number of significant ways. Consider the following examples.

(1) A *civil rights* clinic taught by one of us uses the following *tax* problem: Your client has sued her employer for sex discrimination, including sexual harassment involving unwanted physical contact. The employer has offered to settle the lawsuit for \$100,000. If the offer is accepted, what are the tax consequences to your client? Specifically, must your client treat the damages as taxable income or are the damages exempt from income taxation?

(2) We were recently consulted about a novel tax problem concerning minority homeowners victimized by predatory home mortgage lending. The lending institutions conceded that the homeowners should not have to repay the full amount due under the terms of the mortgage loan. However, the homeowners now had a tax problem. Longstanding tax principles require that a borrower report as taxable income the amount of debt that is forgiven, and the IRS was therefore asserting that the homeowners must report the forgiven amount of the home mortgage loans as taxable income.

(3) An income tax course taught by one of us asks whether tax benefits might in some circumstances offend the Fourteenth Amendment's Equal Protection Clause or the First Amendment's Establishment Clause. This question arises, for example, when the government provides tax-exempt status to private schools and religious institutions.

This Article discusses the intersection of civil rights law and income taxation in the three areas listed above: damages for unlawful discrimination, the forgiveness of debt by a predatory lender, and tax-exempt status for private educational and religious institutions. Our purpose is not to attempt an exhaustive examination of the issues in each area but to convey a sense of the range of tax problems that civil rights lawyers may need to confront.

---

\* Professor of Law, Georgetown Law Center.

\*\* Clinical Professor of Law, New York University School of Law

## I. DAMAGES FOR UNLAWFUL DISCRIMINATION

In deciding whether to file or settle a claim for unlawful discrimination, civil rights lawyers and their clients need to assess the after-tax value of potential damages. That value depends, in turn, on the extent to which damages will be subject to income taxation. One hundred thousand dollars in damages that are exempt from tax obviously have a much greater value than \$100,000 in damages that are taxed in full. Thus, civil rights lawyers representing victims of unlawful discrimination need to be acutely aware of the tax treatment of discrimination damages.

Since 1996, the Internal Revenue Code has drawn a sharp distinction between damages for physical and nonphysical injury. Under § 104(a)(2),<sup>1</sup> damages for lost earnings or pain and suffering received on account of "personal physical injuries or physical sickness" are excluded from taxation. On the other hand, damages for lost earnings or pain and suffering received on account of a nonphysical injury are subject to the general rule of § 61(a) that "gross income [includes] all income from whatever source derived" and therefore are subject to taxation.<sup>2</sup>

The dramatic difference in the treatment of such damages depending on whether the injury is physical or nonphysical seems arbitrary and unfair. The distinction is especially troubling because its principal effect is to impose a greater tax burden on victims of civil rights violations, including unlawful discrimination, than on victims of physical injury.<sup>3</sup> It seems arbitrary and unfair, for example, that damages for sexual harassment are taxed<sup>4</sup> if damages for a broken leg are tax-exempt.

---

1. Unless otherwise indicated, all section references in the text and footnotes are to the Internal Revenue Code, 26 U.S.C. (2005).

Nina Pillard and Ethan Yale provided insightful comments on an earlier draft of this Article.

2. Regardless of whether the personal injury is physical or nonphysical, punitive damages are taxed and compensation for medical expenses is excluded. Punitive damages received on account of a physical injury are not eligible for the § 104(a)(2) exclusion because the provision explicitly refers to "any damages (*other than punitive damages*)" (emphasis added). Thus, punitive damages for physical injury (as well for a nonphysical injury) are subject to the general rule of § 61(a) that "gross income [includes] all income from whatever source derived" and therefore are subject to taxation. Compensation for medical expenses for a physical personal injury is specifically excluded from taxation by the reference in § 104(a)(2) to "any damages (*other than punitive damages*)." Compensation for medical expenses for a nonphysical personal injury is excluded from taxation by virtue of the following language in § 104(a): "[E]motional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress." The statutory language would be clearer if it contained an affirmative statement that emotional distress shall be treated as a physical injury or sickness to the extent of damages attributable to the amount paid for medical care for emotional distress.
3. See Rev. Rul. 96-65, 1996-2 C.B. 6 (noting that the effect of the 1996 revision of § 104(a)(2) is to tax damages for back pay and emotional distress based on an employment discrimination claim under Title VII of the 1964 Civil Rights Act).
4. Sexual harassment in the workplace is considered a form of employment discrimination based on sex under Title VII of the 1964 Civil Rights Act, 42 U.S.C. § 2000e (2000). See, e.g., *Harris v. Forklift Sys., Inc.*, 510 U.S. 17 (1993); *Meritor Sav. Bank v. Vinson*, 477 U.S. 57 (1986).

Below, we discuss tax policy considerations, review the history of the taxation of personal injury damages, and then explore the possibility of characterizing discrimination as a physical injury or sickness so that the recovery of damages for the injury of discrimination may be excluded from taxation under § 104(a)(2).

#### A. Tax Policy Considerations

Both the exclusion of damages for lost earnings in the case of physical injury and the taxation of damages for pain and suffering in the case of non-physical injury are difficult to defend on tax policy grounds. The ordinary rule that governs the taxation of damages received after trial or settlement of a legal claim (in business tort and contract disputes, for example), is that “recoveries are taxable if they compensate for amounts that would have been taxable if received in due course,”<sup>5</sup> but are excludable if they “compensate for loss of a right that would otherwise have been enjoyed tax-free.”<sup>6</sup> As explained in the leading case on the issue of taxing damages, *Raytheon Production Corp. v. Commissioner*, “the question to be asked is ‘In lieu of what were the damages awarded?’”<sup>7</sup>

Application of this “in lieu of” principle to personal injury damages for lost earnings or pain and suffering would have the following results. Damages for lost earnings would be taxable since earnings are ordinarily taxed. In contrast, damages for pain and suffering (or emotional distress) would be excluded because such damages compensate the victim for the loss of non-market rights that produce psychic benefits and that, absent the injury, are tax-exempt.

From a tax policy perspective, the current tax treatment of personal injury damages is anomalous in two respects. First, lost earnings paid to the victim of a physical injury are excluded from taxation, although the earnings would have been taxable absent the physical injury<sup>8</sup> and although lost earnings paid to the victim of a nonphysical injury are taxable.<sup>9</sup> Second, damages for the emotional suffering caused by a nonphysical injury are taxable,<sup>10</sup> although such damages compensate for a right that, absent the injury, would be enjoyed tax-free,<sup>11</sup> and although damages for the pain and suffering of a physical injury remain tax-exempt.<sup>12</sup>

As explained in the following Section, the exclusion of lost earnings paid to the victim of a personal injury became a fixture of the early twentieth-century income tax and until recently applied to both physical and nonphysical injuries alike. The distinction between physical and nonphysical

---

5. BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 13.1.4 (3d ed. 1999).

6. *Id.* ¶ 5.6.

7. *Raytheon Prod. Corp. v. Comm’r*, 144 F.2d 110, 113 (1st Cir. 1944) (internal citations omitted).

8. § 61(a)(1).

9. §§ 61(a)(1), 104(a)(2).

10. *Id.*

11. Psychic benefits are not subject to taxation. See Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 7 (Robert M. Haig ed., 1921).

12. § 104(a)(2).

injury damages, however, is relatively recent, having been enacted only in 1996.

*B. Brief History of the Taxation of Personal Injury Damages*

Congress enacted the modern income tax in 1913. Five years later, in 1918, at the Treasury's request, Congress enacted the predecessor of § 104(a)(2) of the Internal Revenue Code to provide explicitly for exclusion of "any damages received . . . on account of [personal] injuries or sickness."<sup>13</sup> Four years later, in 1922, the Bureau of Internal Revenue ruled that damages for the nonphysical injuries of alienation of affection and defamation were covered by the exclusion and therefore were exempt from income taxation.<sup>14</sup>

For nearly seventy years, the interpretation of § 104(a)(2) as excluding from taxation both physical and nonphysical personal injury damages alike remained virtually unchanged. Moreover, with the enactment in the 1960s of comprehensive federal, state, and local anti-discrimination laws affording private rights to sue, taxpayers began to assert that damages received for discrimination claims were excludable under § 104(a)(2).<sup>15</sup> Federal courts of appeal generally ruled that damages in discrimination cases for lost earnings as well as for pain and suffering qualified for exclusion from taxation.<sup>16</sup> The courts cited earlier revenue rulings and judicial decisions that excluded damages received on account of nonphysical torts, particularly *Roemer v. Commissioner*<sup>17</sup> and *Threlkeld v. Commissioner*,<sup>18</sup> which held that awards for the nonphysical injuries of defamation and malicious prosecution qualified as personal injury damages under § 104(a)(2). Applying the reasoning of *Roemer* and *Threlkeld* to the issue of taxing damages in discrimination cases, courts repeatedly held that the right not to suffer discrimination is a personal right,<sup>19</sup> and that discrimination is therefore a personal injury, analogous to traditional common-law torts for both physical and nonphysical harm.<sup>20</sup> Accordingly, these courts held that dam-

13. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

14. Sol. Op. 132, 1922-1 C.B. 92.

15. The Third, Sixth, and Ninth Circuits ruled that damages for discrimination were excludable. *See* *Burke v. United States*, 929 F.2d 1119 (6th Cir. 1991) (back wages in settlement of a pre-1991 Title VII gender discrimination claim); *Metzger v. Comm'r*, 88 T.C. 834 (1987) (damages for claims of discrimination in employment on the basis of gender and national origin under a variety of federal laws, including § 1981 and Title VII), *aff'd*, 845 F.2d 1013 (3d Cir. 1988); *Rickel v. Comm'r*, 900 F.2d 655 (3d Cir. 1990) (damages in settlement of claims of age discrimination in employment); *Pistillo v. Comm'r*, 912 F.2d 145 (6th Cir. 1990) (back pay awarded in trial of age discrimination claim); *Redfield v. Ins. Co. of N. Am.*, 940 F.2d 542 (9th Cir. 1991) (back pay awarded in trial of age discrimination claim). For a contrary result, see *Sparrow v. Comm'r*, 949 F.2d 434 (D.C. Cir. 1991) (damages received in settlement of Title VII employment discrimination claim were taxable).

16. *See supra* note 15.

17. 716 F.2d 693 (9th Cir. 1983).

18. 87 T.C. 1294, 1308 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

19. *See, e.g., Threlkeld*, 87 T.C. at 1308 (the right not to suffer discrimination is based on "rights that an individual is granted by virtue of being a person in the sight of the law").

20. The courts also cited other instances in which damages for violation of constitutional or statutory rights were held to be excludable. *See, e.g., Bent v. Comm'r*, 835 F.2d 67

ages in discrimination cases, like damages for common-law torts, are excluded from taxation.<sup>21</sup>

In 1992 and 1995, however, the Supreme Court ruled in two employment discrimination cases that damages for lost earnings were not received on account of personal injury and were therefore taxable.<sup>22</sup> In the first case, *United States v. Burke*, the Court looked to Treas. Reg. § 1.104-1(c), which states that the § 104(a)(2) exclusion applies to damages based on a “tort or tort type” right.<sup>23</sup> Tort victims, the Court stated, are often compensated for “a broad range of damages,”<sup>24</sup> including medical expenses, lost earnings, and pain and suffering, as well as punitive damages.<sup>25</sup> The Court therefore held that whether or not a claim is based on a “tort or tort type” right depends on the kinds of remedies that may be awarded for that claim<sup>26</sup> and that the § 104(a)(2) exclusion applied only if the victim was afforded a “broad range of damages.”<sup>27</sup>

In the second decision, *Commissioner v. Schleier*, the Supreme Court restricted even further the application of § 104(a)(2) to damages in civil rights cases by reinterpreting the exclusion to incorporate two separate requirements.<sup>28</sup> First, like *Burke*, *Schleier* emphasized that § 104(a)(2) applied only to a tort or tort-type claim and that such a claim was distin-

---

(3d Cir. 1987) (holding that damages, including back wages, in settlement of a § 1983 claim for violation of First Amendment rights were excludable); *Byrne v. Comm’r*, 883 F.2d 211 (3d Cir. 1989) (holding that damages, including back wages, for Federal Labor Standards Act claim were on account of personal injury and therefore excludable).

21. *See supra* note 20.

22. *United States v. Burke*, 504 U.S. 229 (1992); *Comm’r v. Schleier*, 515 U.S. 323 (1995).

23. *Burke*, 504 U.S. at 234.

24. *Id.* at 235.

25. *Id.* at 235, 237. In addition, the Court noted, tort victims are ordinarily entitled to a trial by jury. *See id.* at 238.

26. *Id.* at 234–37. The Court also stated:

A “tort” has been defined broadly as a “civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages.” *See* W. Keeton, D. Dobbs, R. Keeton, & D. Owen, *Prosser and Keeton on the Law of Torts* 2 (1984). Remedial principles thus figure prominently in the definition and conceptualization of torts.

*Id.* at 234.

Prior to *Burke*, the federal appellate courts had generally construed “tort or tort type” rights to mean rights other than those based in contract, namely, “rights that an individual is granted by virtue of being a person in the sight of the law.” *Threlkeld*, 87 T.C. at 1308. *See also* *Roemer v. Comm’r*, 716 F.2d at 700 (defamation of an individual under California law is a personal injury, damages for which are excludable from gross income under § 104).

27. *Burke*, 504 U.S. at 235, 237. In *Burke*, female employees of the Tennessee Valley Authority filed a sex discrimination claim against their employer under the pre-1991 version of Title VII of the 1964 Civil Rights Act. *Id.* at 230–31. Damages under pre-1991 Title VII, which applied to the *Burke* claim, were limited to back pay and injunctive relief, and plaintiffs were not entitled to seek damages for pain and suffering or punitive damages. *Id.* at 238–39. In light of these limitations, the Court held that the sex discrimination claim in *Burke* did not assert a “tort or tort type” right, and that the amount received in settlement of the back pay claim was therefore not excludable under § 104(a)(2). *Id.* at 241–42.

28. 515 U.S. 323, 323 (1995).

guished by the available remedies.<sup>29</sup> However, the Court in *Schleier* shifted the inquiry away from the *Burke* criterion—the general availability of a “broad range of damages”<sup>30</sup>—to focus on the specific availability of damages for pain and suffering.<sup>31</sup>

In addition, *Schleier* articulated a second and independent ground for its decision that the damages in that case were not “received on account of personal injuries” for the purposes of the § 104(a)(2) exclusion.<sup>32</sup> The taxpayer, a pilot, had filed an Age Discrimination in Employment claim for lost wages against his former employer, United Airlines, which had fired him when he reached age sixty.<sup>33</sup> The taxpayer, the Court stated, may have suffered a personal injury, namely emotional distress as a result of being fired. However, the loss of his job was not itself a direct result of such a personal injury. Rather, it was the firing of the taxpayer on account of age that caused the loss of employment. Thus, the Court concluded: “Whether one treats [the taxpayer’s] attaining the age of 60 or his being laid off on account of his age as the proximate cause of [the taxpayer’s] loss of income, neither the birthday nor the discharge can fairly be described as a ‘personal injury’ or ‘sickness.’”<sup>34</sup> In other words, damages for lost earnings in *Schleier* were not “received on account of personal injury,” because a personal injury (in that case, possible emotional distress) did not cause the victim to lose his job and in turn lose wages.<sup>35</sup> In effect, the Court interpreted “received on account of personal injury” to require that damages compensate the victim either for a physical or mental injury or for other harm that is a direct consequence of such physical or mental injury.

In 1996, one year after the Court’s decision in *Schleier*, Congress amended the Code to restrict the § 104(a)(2) exclusion to cases of personal *physical* injury or sickness.<sup>36</sup> Notwithstanding the 1996 amendment restricting the availability of § 104(a)(2), the holdings in *Burke* and *Schleier*, as explained below, may continue to be relevant for cases that involve both a discrimination claim and a physical injury.

### C. Can Discrimination Ever Qualify as a Physical Personal Injury?

As a matter of semantics, the critical phrase in § 104(a)(2), “personal physical injuries or physical sickness,” could include physical symptoms, such as an ulcer or migraine headaches, that result from emotional distress. However, both the statute and the legislative history rule out the

29. *Id.* at 337; *Burke*, 504 U.S. at 235.

30. *Burke*, 504 U.S. at 235.

31. *Schleier*, 515 U.S. at 335. Available remedies under the ADEA were somewhat broader than those afforded to the *Burke* taxpayers under the pre-1991 version of Title VII. See 29 U.S.C. § 626 (1988) (amended 1991). In addition to back pay, the ADEA allowed liquidated damages in cases of willful discrimination. *Id.*

32. 515 U.S. at 323.

33. *Id.* at 324.

34. *Id.* at 330.

35. Therefore, damages in *Schleier* were “completely independent of the existence or extent of any personal injury.” *Id.* at 330.

36. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1838.

possibility that the physical symptoms of emotional distress will by themselves constitute a physical injury or sickness for purposes of § 104(a)(2). Section 104(a)(2) specifically provides that “emotional distress shall not be treated as a physical injury or physical sickness.” In addition, the Conference Report on the legislation states, “[i]t is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.”<sup>37</sup> Thus, the current version of § 104(a)(2) would not exclude from taxation “damages received . . . based on a claim of . . . discrimination . . . accompanied by a claim of emotional distress.”<sup>38</sup>

There has, however, been no further elaboration of the meaning of the term “physical injuries or physical sickness” in either the regulations or the case law. The only interpretation available comes from an IRS ruling on the question of what kind of physical contact will qualify as a “physical injury” for purposes of § 104(a)(2). Private Letter Ruling 2000-41-022 states that physical contact will constitute a physical injury if it results in “observable harms,” such as “bruises” or “cuts.”<sup>39</sup> The ruling involves the settlement of an employee’s claims against an employer for sex discrimination under federal and state law and for battery and intentional infliction of emotional distress under state law.

The ruling discusses three separate incidents of sexual harassment. In the first incident, the employer touched the employee without causing “any observable bodily harm . . . to [the employee’s] body” or “extreme pain to [the employee].”<sup>40</sup> In the second incident, the employer assaulted the employee causing extreme pain to the employee. In the third incident, the employer assaulted the employee, cutting and biting the employee, as a result of which the employee “suffered skin discoloration and swelling accompanied by extreme pain for which [the employee] received medical treatment from a doctor.”<sup>41</sup>

After noting that the term “personal physical injuries” is not defined by the Code, the ruling states that “direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a)(2).”<sup>42</sup> Thus, the ruling concludes that the damages attributable to the third incident were received on account of physical personal injury and were therefore excludable from income under § 104(a)(2). The ruling goes on to conclude that the first incident did not constitute a physical injury since it “did not result in any observable harms (e.g., bruises, cuts, etc.) to A’s body or cause A pain.”<sup>43</sup>

---

37. H.R. REP. NO. 104-737, at 369 n.56 (1996) (Conf. Rep.), as reprinted in 1996 U.S.C.C.A.N. 1677, 1861 n.56.

38. I.R.S. PRIV. LTR. RUL. 2000-41-022 (Oct. 13, 2000) (quoting H.R. REP. NO. 104-737, at 369 n.56).

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. I.R.S. PRIV. LTR. RUL. 2000-41-022 (Oct. 13, 2000) (quoting H.R. REP. NO. 104-737, at 369 n.56).

The ruling, however, declines to state whether the second incident constituted a “physical injury.” Although noting that the second incident neither caused observable bodily harm nor required medical treatment—which presumably would have been sufficient to cause it to be classified as a physical injury—the Private Letter Ruling states:

Because the perception of pain is essentially subjective, it is a factual matter. Therefore, . . . we cannot rule whether damages properly allocable to [the second incident] were received on account of personal physical injuries or physical sickness.<sup>44</sup>

Although failing to reach a definitive conclusion regarding the second incident on the facts presented, the ruling implies that physical contact that causes extreme pain may constitute a “personal physical injury” even if there is no “observable bodily harm.”

The private letter ruling therefore does indicate the IRS’s view that a civil rights claim may qualify as a personal physical injury if the discriminatory acts involve physical contact that requires medical treatment or causes extreme physical pain. Such instances, although relatively infrequent and restricted largely to cases involving sexual harassment, nevertheless do afford the opportunity for obtaining tax-free treatment for civil rights damages for pain and suffering. However, even if there is physical contact amounting to physical injury, there is also the further question of whether damages are received “on account of” such physical injury under the Supreme Court’s ruling in *Schleier*, which preceded the amendment restricting § 104(a)(2) to physical injuries or sickness.

To illustrate, suppose that a plaintiff files a sex discrimination claim alleging that she was fired after rebuffing sexual harassment including physical contact that amounts to physical injury under the criteria of Private Letter Ruling 2000-41-022. Damages for pain and suffering caused by the physical contact should be eligible for exclusion under § 104(a)(2) because the physical contact qualifies as a physical injury and the damages are received on account of that injury under *Schleier*. In addition, if the plaintiff missed work because of the physical injury, then damages for back pay are also received on account of that injury and therefore should also be excludable.

However, if the plaintiff also missed work because of the discriminatory firing, then damages for lost pay to that extent appear to be taxable under *Schleier*. Although a personal physical injury has occurred, such damages are received, under *Schleier*’s arguably scholastic reasoning, not on account of the injury but on account of the discrimination. Similarly, damages awarded for emotional distress caused by being fired are not received on account of a physical injury under *Schleier* and are therefore not excludable from taxation under § 104(a)(2).

The fact that § 104(a)(2), as interpreted by the IRS and the courts, makes such fine distinctions in the example above—between emotional distress caused by the physical contact and emotional distress caused by being fired and between lost wages attributable to the physical contact and lost wages attributable to being fired—reinforces the conclusion that the cur-

---

44. *Id.*

rent tax rules make little sense and should be replaced. As indicated above, it would be more in keeping with the “in lieu of” principle, which governs the taxation of other damages, to abolish the distinction between physical and nonphysical injuries and to exempt from taxation all damages for pain and suffering (or emotional distress) while taxing all damages for lost wages. Whether such changes occur, civil rights lawyers need to remain attentive to how taxation affects the after-tax value of recoveries for unlawful discrimination.

## II. PREDATORY LENDING

Civil rights lawyers increasingly represent minority homeowners who have been victimized by predatory home mortgage lending. When civil rights lawyers succeed in getting lending institutions to concede that the full amount of a predatory loan need not be repaid, their clients may have a tax problem. Longstanding tax principles require that a borrower report as taxable income the amount of debt that is forgiven, and the IRS has asserted that a homeowner must report the forgiven amount of a predatory home mortgage loan as taxable income. Below, we discuss the nature and growth of predatory lending to minority homeowners, arguments under current law that forgiveness of a predatory loan should not produce taxable income, and a proposed revision of the Internal Revenue Code to prevent the forgiveness of a predatory home loan from creating taxable income.

### A. *The Nature and Growth of Predatory Lending*

Although there is no precise or universally accepted definition, predatory lending is generally understood to include overpriced and excessively risky home mortgage loans, involving deceptive practices if not outright fraud.<sup>45</sup> Such loans typically involve excessive origination fees and points, which can often absorb up front as much as twenty-five percent of the principal amount loaned.<sup>46</sup> The lender’s objective is to obligate the homeowner to borrow more than the homeowner can afford to repay so that the homeowner will default and the lender will be able to foreclose against and then obtain the property securing the mortgage.

Predatory lenders often target African American and Latino populations,<sup>47</sup> and minority victims have challenged predatory lending practices under the federal Fair Housing Act, which prohibits discrimination in home mortgage lending.<sup>48</sup> Thus, one article on predatory lending notes:

45. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1259–70 (2002); Lauren E. Willis, *Decision-making & the Limits of Disclosure: The Problem of Predatory Lending*, 2 n.5 (Loyola Law School (Los Angeles), Legal Studies Research Paper No. 2005-14, 2005), available at <http://ssrn.com/abstract=748286>.

46. Willis, *supra* note 45, at 4.

47. *Id.* at 6.

48. 42 U.S.C. § 3605 (2000) (Title VIII of the Civil Rights Act of 1968); see generally Frank Lopez, Note, *Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. ON POVERTY L. & POL’Y 73 (1999) (advocating use of the Fair Housing Act to combat predatory lending).

Predatory lenders . . . target naïve people who, because of historical credit rationing, *discrimination*, the exodus of banks from inner-city neighborhoods, and other social and economic forces, are disconnected from the credit market and hence are vulnerable to predatory lenders' hard-sell tactics.<sup>49</sup>

Over the past ten years, there has been an enormous rise in predatory lending resulting from the large-scale securitization of home mortgage loans, which permits the bundling and sale of home mortgages to investors, and from the widespread repeal of state usury laws, which previously limited the amount of interest that may lawfully be charged on home mortgage loans.<sup>50</sup> In addition, the tax law has contributed directly to the increase in predatory lending that leads to foreclosure because of tax provisions that favor home mortgage loans over other kinds of personal borrowing.

Before 1986, the Internal Revenue Code permitted taxpayers to deduct the interest on personal loans, that is, loans incurred to finance personal consumption (as opposed to a business or investment) without limit.<sup>51</sup> The Tax Reform Act of 1986<sup>52</sup> reversed this treatment by generally denying a deduction for interest on personal consumption loans. This reversal, however, contained two notable exceptions for home mortgages.<sup>53</sup> First, interest on up to \$1 million of home mortgage loans remains deductible if the loans are incurred to purchase or construct a residence (so-called "acquisition indebtedness").<sup>54</sup> Second, interest on up to \$100,000 of home mortgage loans remains deductible if the loan is obtained by pledging as security an existing residence.<sup>55</sup> Thus, for example, an individual who wishes to borrow funds to purchase furniture can still deduct the interest if the loan is secured by a qualifying home mortgage, although the interest on an unsecured loan obtained for the same purpose is no longer deductible. These changes in the tax law, generally permitting the deduction of personal consumption interest only on home mortgage loans, may have inadvertently stimulated predatory lending.

#### *B. Should Settlement of a Predatory Lending Claim Constitute Taxable Income?*

Predatory loans may violate both federal and state statutes designed to prevent abusive lending practices as well as the Fair Housing Act if the homeowner can show that minorities have been targeted.<sup>56</sup> As a result, borrowers victimized by predatory lending may be able to reduce the obligation to repay interest and/or principal by obtaining settlement of or judgment on a claim that predatory lending has violated such statutes.

49. Engel & McCoy, *supra* note 45, at 1258–59 (emphasis added).

50. See generally Willis, *supra* note 45, at 1–10 (examining the development of economic, legal, and social factors that led to the expansion of predatory lending).

51. BITTKER & LOKKEN, *supra* note 5, ¶ 31.1.

52. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

53. I.R.C. §§ 163(h)(1), 163(h)(3) (2000).

54. *Id.* § 163(h)(3)(B).

55. *Id.* § 163(h)(3)(C).

56. See generally Engel & McCoy, *supra* note 45 (discussing various legal attacks on predatory lending, including use of the Fair Housing Act); Willis, *supra* note 45 (examining solutions through the "price side" and "risk side" of loan markets).

Longstanding income tax rules require that a borrower report as taxable income the amount of any forgiven debt.<sup>57</sup> When a loan is made, it is treated as not producing income to the borrower because the cash received is offset by a corresponding liability, producing no net gain. For identical reasons, the repayment in full of a loan is treated as not producing a loss because the cash paid out is offset by a decrease in liabilities, resulting in no net loss. To illustrate, if a taxpayer borrows \$10,000 to pay law school tuition, the taxpayer does not have income because the receipt of an asset (the cash) is balanced by the obligation to repay \$10,000. When the taxpayer repays the \$10,000 loan, there is no loss because the decrease in assets is balanced by a decrease in loan obligations.

Suppose, however, that the lender agrees to accept \$9,000 in full satisfaction of a \$10,000 loan. The \$1,000 difference between what was owed and what was repaid (that is, the amount “forgiven”) is treated as income to the borrower. In the case of forgiveness of debt, the decrease in assets is more than offset by a decrease in loan obligations. The assets are diminished by the \$9,000 repaid, but liabilities have fallen by \$10,000, and the overall effect is a \$1,000 gain.

The principle that forgiveness of debt produces taxable income, however, is subject to a number of exceptions, some of which should apply to predatory lending. These exceptions are discussed below.

#### 1. Section 108(e)(2)

If a predatory lender agrees to forgive an obligation to pay interest (rather than principal), there should generally be no income tax consequences to the borrower under a statutory exception to the general principle that the forgiveness of debt produces taxable income. Section 108(e)(2) of the Internal Revenue Code specifically provides, “[n]o income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.”<sup>58</sup> Thus, when interest that “would have given rise to a deduction” is forgiven, the forgiveness will not produce taxable income. Provided that the mortgage loan meets the requirements for interest deductibility—the taxpayer’s acquisition indebtedness must not exceed \$1 million and home equity indebtedness must not exceed \$100,000—then the requirement of § 108(e)(2) should be satisfied and the forgiveness of interest should not produce taxable income. Because predatory lenders typically target taxpayers of modest means, these conditions will usually be met.

#### 2. The “Disputed Liability” Doctrine

For the reasons explained above, if the settlement of a predatory lending claim involves the forgiveness of an obligation to pay interest, the borrower should generally not have to report taxable income under the exception provided by § 108(e)(2). However, if the lender forgives part of the principle amount of the loan, then the § 108(e)(2) exception is obviously unavailable. Nevertheless, there is some authority for the proposi-

57. § 61(a)(12). See also *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

58. § 108(e)(2).

tion that even in those circumstances forgiveness of debt does not produce taxable income if the enforceability of the liability is disputed in good faith, although the decisions supporting such an exception have been criticized and there may be some doubt as to the applicability of these decisions to the case of predatory lending.

The origin of the disputed liability doctrine is an early depression-era case, *N. Sobel, Inc. v. Commissioner*.<sup>59</sup> In *Sobel*, the taxpayer had borrowed \$21,700 from a bank in order to purchase shares of the bank's stock. At the time when the note became due, the stock was worthless. The taxpayer sued the bank for rescission of the original sale of stock, claiming that the bank had violated its promise to indemnify the corporation against loss in the value of the bank's stock. The claim for rescission was settled, with the taxpayer agreeing to pay \$10,850 in full satisfaction of the \$21,700 loan. The Commissioner asserted that the taxpayer had forgiveness of debt income of \$10,850, equal to the excess of the face amount of the \$21,700 loan over the \$10,850 paid in settlement of the loan obligation. The Board of Tax Appeals (the predecessor of the Tax Court) found that the taxpayer did not have forgiveness of debt income, stating that there was a "question whether the taxpayer bought property in 1929 and a question as to its liability and the amount thereof."<sup>60</sup> In effect, the Court found that the amount of the liability should be treated as the amount paid in settlement of the disputed claim. Thus, for tax purposes, the disputed liability was treated as satisfied for the full amount owed (as determined by the settlement) so that there was no forgiveness of debt.

In 1990, the Third Circuit affirmed the continuing validity of the disputed liability doctrine in *Zarin v. Commissioner*.<sup>61</sup> An Atlantic City casino had advanced the taxpayer, David Zarin, \$3.4 million in chips on credit, notwithstanding a New Jersey state gaming commission decision identifying Zarin as a compulsive gambler and ordering the casino to refrain from issuing him additional credit. After Zarin lost the chips playing dice, he refused to repay the casino on the ground that the extension of credit violated the state gaming commission order and therefore the debt was unenforceable under New Jersey state law. The parties settled the disputed \$3.4 million liability for \$500,000. The Commissioner asserted that Zarin had forgiveness of debt income equal to the excess of the \$3.4 million debt over the \$500,000 settlement payment. The Third Circuit, citing *Sobel*, held that there was no forgiveness of debt because of the dispute over the debt's enforceability, stating "[w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute."<sup>62</sup> Therefore, the \$500,000 settlement "fixed . . . the amount of debt cognizable for tax purposes."<sup>63</sup>

If taken literally, the *Zarin* decision appears to cover nearly all settlements and judgments in predatory lending cases in which the enforceability of a liability is disputed on grounds of violating federal or state laws. However, a recent decision by the Tenth Circuit casts doubt on the valid-

---

59. 40 B.T.A. 1263 (1939).

60. *Id.* at 1265.

61. 916 F.2d 110 (3d Cir. 1990).

62. *Id.* at 116.

63. *Id.*

ity of such a broad reading of *Zarin*. In *Preslar v. Commissioner*,<sup>64</sup> the Tenth Circuit stated that the mere fact that the legality or enforceability of a debt was disputed was not enough to avoid income arising from forgiveness of debt. In addition, the amount of the debt itself must be a matter of dispute in order for the disputed liability exception to apply:

The problem with the Third Circuit's holding is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the *amount* of a debt be disputed before the [disputed] liability exception can be triggered is that only in the context of disputed debts is the Internal Revenue Service (IRS) unaware of the exact consideration initially exchanged in a transaction . . . . The mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the [disputed] liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt.<sup>65</sup>

Confusing matters further, the Tenth Circuit added a possible exception to the unliquidated liability rule. It stated, without elaboration, that a dispute about a liquidated amount might not produce forgiveness of debt income if the debt is "tainted by fraud or material misrepresentations."<sup>66</sup> This exception could benefit borrowers who allege that a predatory loan should be modified because the lender engaged in fraud, misrepresentation, or other abusive practices. However, the statement concerning the exception for fraud or misrepresentation was dictum. The Tenth Circuit did not explain the rationale for the exception, and the exception appears inconsistent with an authority cited with approval in another part of the opinion. The Tenth Circuit quoted a law review article that argued:

Enforceability of the debt . . . should not affect the tax treatment of the transaction. If the parties initially treated the transaction as a loan when the loan proceeds were received, thereby not declaring the receipt as income, then the transaction should be treated consistently when the loan is discharged and income should be declared in the amount of the discharge.<sup>67</sup>

The rationale of the foregoing authority—that if the receipt of the loan does not produce income, then repayment of less than the amount received should produce income—applies even if there has been misrepresentation or fraud. This rationale also reflects the continuing position of the IRS that the "disputed liability" exception should be restricted to instances in which the amount (rather than the enforceability) of the liability is disputed in good faith. It is therefore uncertain whether the disputed liability doctrine will permit lenders to avoid reporting taxable in-

---

64. 167 F.3d 1323, 1328 (10th Cir. 1999).

65. *Id.*

66. *Id.* at 1331.

67. *Id.* at 1329 (quoting Gregory M. Giangordano, *Taxation—Discharge of Indebtedness Income—Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), 64 TEMP. L. REV. 1189, 1202 n.88 (1991)).

come when a predatory lender forgives a loan obligation and the § 108(e)(2) exception for deductible interest does not apply.

### C. Possible Statutory Reform

Given the uncertainty noted above about the disputed liability doctrine, it would be desirable for Congress to enact a specific exception for predatory home mortgage loans to the general rule that forgiveness of debt produces taxable income. Section 108 of the Internal Revenue Code provides numerous exceptions in other contexts. For example, insolvent or bankrupt taxpayers need not report income arising from forgiveness of debt,<sup>68</sup> nor do taxpayers when the debt is associated with the acquisition of business real estate<sup>69</sup> or a farming business.<sup>70</sup>

Homeowners subject to predatory lending are deserving of similar treatment. One possible difficulty would be limiting this treatment to situations involving predatory lending. As noted above, there is no precise or universally accepted definition of predatory lending. The general definition—overpriced and excessively risky home loans, involving deceptive practices if not outright fraud<sup>71</sup>—may be too imprecise for distinguishing between predatory and non-predatory loans. A second-best solution therefore may be to permit the exclusion of income arising from forgiveness of debt on all home mortgage loans.<sup>72</sup> Since taxpayers of modest means are the principal targets of predatory lending, relief could be limited to mortgages associated with a taxpayer's principal place of residence (thus excluding mortgages on second homes) and the amount entitled to exclusion could be capped at a relatively modest amount, e.g., \$100,000.

## III. THE CONSTITUTIONAL STATUS OF TAX-EXEMPT STATUS<sup>73</sup>

### A. Brief Overview

A recurring issue in constitutional civil rights litigation is whether tax-exempt status constitutes state action under the Fourteenth Amendment's Equal Protection Clause or state support under the First Amendment's Establishment Clause. The Supreme Court most recently considered the

68. §§ 108(a)(1)(A), 108(a)(1)(B).

69. § 108(a)(1)(D).

70. § 108(a)(1)(C).

71. Engel & McCoy, *supra* note 45, at 1259–70 (2002); Willis, *supra* note 45, at 2 n.5.

72. The Internal Revenue Code generally exacts a price when income arising from forgiveness of debt is not initially taxed. The price exacted is a reduction in the basis of associated property (or in the tax attributes of the associated business) so that the untaxed gain will be preserved for possible taxation at some later time. § 108(b)(1). If income arising from forgiveness of a predatory home mortgage loan were excluded from taxation, the basis of the home associated with the loan could be similarly reduced. However, in this case, such basis reduction is unlikely to lead to taxation of the gain at a later date because of § 121, which permits married taxpayers filing jointly to exclude from taxation \$500,000 of the gain on the sale of a principal residence, and single taxpayers to exclude \$250,000.

73. The analysis is based in part on a previous article by one of the authors. See Stephen Cohen, *Exempt Status for Segregated Schools: Does the Constitution Permit Lower Standards for Tax Benefits than for Direct Grants?*, 17 TAX NOTES 259 (1982).

issue, albeit indirectly, in *United States v. Virginia*,<sup>74</sup> a case in which the Court held that the Equal Protection Clause requires the Virginia Military Institute, a military college financed by and subject to the control of the state of Virginia, to admit female applicants.

It was direct state funding rather than tax-exempt status that raised the equal protection issue in the *Virginia* case. Nevertheless, during oral argument counsel for Virginia argued that if the Constitution requires a military college financed and controlled by the state of Virginia to admit women, then it also requires Wellesley College to admit men or lose its federal tax-exempt status.<sup>75</sup> Similarly, in dissenting from the Court's decision in *Virginia*, Justice Scalia wrote that "it is certainly not beyond the Court that rendered today's decision to hold that a [tax deductible] donation to a single-sex college should be deemed contrary to public policy and therefore not deductible if the college discriminates on the basis of sex."<sup>76</sup>

In fact, the Court has avoided equating the benefit of tax-exempt status with direct funding, at least under the Establishment Clause of the First Amendment. In *Walz v. Tax Commission*,<sup>77</sup> a taxpayer asserted that the New York State property tax exemption for churches violated the Establishment Clause.<sup>78</sup> Writing for the Court, Chief Justice Burger upheld the exemption as permissible state support for religion,<sup>79</sup> while hinting that a direct outlay would not be constitutional.<sup>80</sup> To distinguish the exemption from a direct outlay, the Court relied primarily on two historical facts.<sup>81</sup> The Court argued that the drafters of the Constitution saw no incompatibility between the religion clauses and existing exemptions for churches,<sup>82</sup> and that the exemption had been considered constitutional for the nation's entire history.<sup>83</sup>

---

74. 518 U.S. 515 (1996).

75. Transcript of Oral Argument at 45, *Virginia*, 518 U.S. 515 (Nos. 94-1941, 94-2107).

76. *Virginia*, 518 U.S. at 598 (Scalia, J., dissenting).

77. 397 U.S. 664 (1970).

78. *Id.* at 667.

79. *Id.* at 674-75.

80. *Id.* at 675.

81. *Id.* at 676-79.

82. *Walz*, 397 U.S. at 676-79.

83. *Id.* The exemption was also distinguished as being merely "indirect" and thus involving no actual disbursement of funds and few administrative entanglements. *Id.* at 674-75. These particular reasons for the distinction are not very satisfactory. Whether a taxpayer pays more to the tax collector, but receives a check from a different agency—or simply pays less in taxes—seems a distinction without a difference. Moreover, a direct outlay can be designed to impose few administrative burdens on the beneficiary. The degree of entanglement depends on how it is structured, not whether the program is on the direct outlay or tax side.

One commentary on *Walz* noted:

[P]erhaps aware that the sheer force of logic behind these propositions [regarding indirectness and administrative entanglement] is not overwhelming, the Court unwraps the still-serviceable, if somewhat abused, argument that "a page of history is worth a volume of logic," and then proceeds to recite over four pages of historical data. The Court's history demonstrates that, as a matter of legal theory, the tax exemption of church property and the establishment clause have always been deemed compatible and that, as a matter of historical fact, this practice has not led to the entrenchment of religion in our national polity.

Of course, what constitutes impermissible government support under the Establishment Clause does not necessarily determine what constitutes such support under the Equal Protection Clause. The Court has never directly addressed the question of whether tax-exempt status constitutes state action for purposes of the Fourteenth Amendment, although a lower Equal Protection threshold, at least when the issue is racial discrimination in education, is implied by decisions involving exempt status for racially segregated private schools.<sup>84</sup>

In 1969, the Lawyers' Committee for Civil Rights filed *Green v. Kennedy*, an action on behalf of black schoolchildren in Mississippi challenging under the Equal Protection Clause the constitutionality of the grant of exempt status under the federal income tax to racially discriminatory private schools.<sup>85</sup> On January 12, 1970, a special three-judge federal court issued a preliminary injunction ordering the IRS to withhold exempt status from racially segregated schools in Mississippi.<sup>86</sup> In July 1970, the IRS announced a policy of denying exempt status to all racially segregated private schools nationwide.<sup>87</sup> One year later the *Green* court issued a final opinion interpreting the Internal Revenue Code as not granting exempt status to racially discriminatory private schools.<sup>88</sup>

Writing for a unanimous panel, Judge Harold Leventhal gave three reasons for this conclusion. First, under the common law, an organization whose activities are illegal or contrary to public policy is not entitled to privileges and immunities ordinarily afforded to charities.<sup>89</sup> If Fagin's school for pickpockets could not qualify as a charitable trust, then neither should a racially segregated private school.<sup>90</sup> Thus, "[i]f we were to follow the common law approach," the Code would be interpreted to deny exempt status in such cases.<sup>91</sup> Second, the Internal Revenue Code "must be construed and applied in consonance with the Federal public policy against support for racial segregation of schools, public or private."<sup>92</sup> The numerous "sources and evidences of that Federal public policy" included the Thirteenth and Fourteenth Amendments, *Brown* and its progeny, and the 1964 Civil Rights Act.<sup>93</sup> Third, any other construction "would raise serious constitutional questions" and "it would be difficult indeed to es-

---

Alvin C. Warren, Jr., et al., *Property Tax Exemptions for Charitable, Educational, Religious, and Governmental Institutions in Connecticut*, 4 CONN. L. REV. 181, 203 (1971) (footnotes omitted).

84. *Green v. Connally*, 330 F. Supp. 1150, 1164, 1165 (D.D.C. 1971), *aff'd sub nom. Coit v. Green*, 404 U.S. 997 (1971).

85. The named defendant, David Kennedy, was Secretary of the Treasury. After he was replaced by John Connally, the case was retitled *Green v. Connally* and is commonly referred to by that name. Because of the claim that a federal statute was being applied in violation of the Constitution, a three judge federal court was convened under 28 U.S.C. §§ 2282, 2284 (1976).

86. *Green v. Kennedy*, 309 F. Supp. 1127 (D.D.C. 1970).

87. I.R.S. News Releases (July 10 & July 19, 1970), *reprinted in* [1970] 7 Standard Fed. Tax Rep. (CCH) ¶¶ 6,790, 6,814.

88. *Green v. Connally*, 330 F. Supp. 1150 (D.D.C. 1971).

89. *Id.* at 1157-59.

90. *Id.* at 1160.

91. *Id.* at 1161.

92. *Id.* at 1163.

93. *Connally*, 330 F. Supp. at 1163.

establish that such [tax] support can be provided consistently with the Constitution."<sup>94</sup> On appeal, *Green* was affirmed (albeit summarily) by the Supreme Court.<sup>95</sup>

The third ground for the decision in *Green*—that the Code has to be construed to deny exempt status to racially segregated private schools in order to avoid a serious constitutional issue—suggests that had the three-judge court and the Supreme Court faced rather than avoided the issue, they would have decided that exempt status for racially segregated private schools is unconstitutional state support in violation of the Fourteenth Amendment's Equal Protection Clause.

Twelve years later, the Reagan administration tried to reverse the *Green* decision by administrative fiat. On January 8, 1982, the IRS, abandoning existing policy, declared that it would henceforth grant tax exemptions to racially segregated private schools because it had no legal authority under the Internal Revenue Code to deny exemptions to racially discriminatory institutions.<sup>96</sup> In addition, the government asked the Supreme Court to vacate, as "moot," *Bob Jones University v. United States*<sup>97</sup> and *Goldsboro Christian Schools, Inc. v. United States*,<sup>98</sup> two pending cases in which racially discriminatory private schools were challenging denials of tax-exempt status.<sup>99</sup>

Shortly thereafter, the Circuit Court of Appeals for the District of Columbia enjoined the IRS from granting exemptions to any racially segregated school, including Bob Jones and Goldsboro.<sup>100</sup> The government then withdrew the suggestion of mootness in the two Supreme Court cases.<sup>101</sup> In its decision in *Bob Jones University v. United States*,<sup>102</sup> the Court construed the Internal Revenue Code not to permit tax-exempt status to an institution whose practices contravene fundamental public policy. Finding that racially segregated education is contrary to such policy, the Court held that the IRS was *authorized* by the Internal Revenue Code to deny tax-exempt status to racially segregated schools. Because of the statutory authority for the IRS denial of tax-exempt status to racially segregated private schools, the Court did not need, or choose, to address the question whether the Equal Protection Clause of the Fourteenth Amendment also requires that result.

---

94. *Id.* at 1164–65.

95. *Coit v. Green*, 404 U.S. 997 (1971).

96. Press Release, U.S. Dep't of Treasury, Treasury Establishes New Tax-Exempt Policy (Jan. 8, 1982), reprinted in *Administration's Change in Federal Policy Regarding the Tax Status of Racially Discriminatory Private Schools: Hearing Before the H. Comm. on Ways & Means*, 97th Cong. 607–08 (1982) [hereinafter *Policy Change Hearings*].

97. 639 F.2d 147 (4th Cir. 1980), *aff'd*, 461 U.S. 574 (1983).

98. 644 F.2d 879 (4th Cir. 1981), *aff'd*, *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983).

99. Memorandum for the United States, *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983) (Nos. 81-1, 81-3), reprinted in *Policy Change Hearings*, *supra* note 96, at 612–14.

100. *Wright v. Regan*, 656 F.2d 820 (D.C. Cir. 1981), *rev'd sub nom. Allen v. Wright*, 468 U.S. 737 (1984).

101. Stuart Taylor, Jr., *Schools Tax Issue Put to High Court in Shift by Reagan*, N.Y. TIMES, Feb. 26, 1982, at A1.

102. 461 U.S. 574 (1983).

### B. Exempt Status and the Fourteenth Amendment

The following Section discusses whether the Constitution prohibits tax-exempt status for racially discriminatory private schools, as well as for single-sex colleges. As noted above, neither *Green* nor *Bob Jones* directly confronted the question whether exempt status for racially segregated private schools would violate the Equal Protection Clause of the Fourteenth Amendment. However, the issue of whether and when exempt status invokes the obligation not to discriminate could easily arise again, particularly if, as Justice Scalia suggested in his *Virginia* dissent, exempt status for a women-only college such as Wellesley offends the Equal Protection Clause.

First, we analyze the principal objection offered by tax policy theorists to treating tax-exempt status as imposing equal protection obligations: that exempt status should not be regarded as providing a special financial benefit because it is consistent with measuring income and therefore is not functionally equivalent to a subsidy. Second, we discuss whether the Supreme Court's decision in *Walz v. Commissioner*, holding that exempt status for churches does not violate the First Amendment's Establishment Clause, implies that exempt status for racially segregated private schools does not violate the Fourteenth Amendment's Equal Protection Clause. Finally, we argue that notwithstanding our conclusion that the Fourteenth Amendment prohibits exempt status for racially segregated private schools, and notwithstanding the Supreme Court's decision in *Virginia*, exempt status can be constitutionally provided in most instances to single-sex private educational institutions.

#### 1. The Income-Measurement Argument

A number of tax theorists have argued that the charitable contribution deduction is consistent with measuring taxpayers' income and therefore should not be regarded as providing a special financial benefit or as functionally equivalent to a subsidy.<sup>103</sup> Since the deduction does not provide a special benefit or subsidy, it cannot violate either the First Amendment's Establishment Clause or the Fourteenth Amendment's Equal Protection Clause.<sup>104</sup> This argument raises the question whether it is reasonable to consider the charitable deduction as an income-measurement provision.

---

103. See generally William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 346-74 (1972) (deduction for charitable contributions is consistent with measuring income and is not functionally equivalent to direct subsidy for charitable giving); Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 46-49 (1972) (deduction for charitable contributions is not functionally equivalent to direct subsidy for charitable giving).

104. See generally Boris I. Bittker & Kenneth M. Kaufman, *Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code*, 82 YALE L.J. 51, 61-63 (1972) (exempt status is not functionally equivalent to a subsidy). For a recent argument that tax-exempt status cannot violate the Fourteenth Amendment unless Congress specifically intended to discriminate, see Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407 (1999) (arguing that tax-exempt status for segregated private schools does not violate the Fourteenth Amendment's Equal Protection Clause). For a more general analysis of whether special tax provisions should be regarded as providing special financial benefits that raise constitutional questions, see Edward A. Zlinsky,

The primary reason for a private school to seek exempt status is so that donors can deduct gifts to the school as charitable contributions.<sup>105</sup> Most private educational institutions lack net income because receipts are generally more than offset by expenses. The attorney for Bob Jones and Goldsboro confirmed this explanation during congressional hearings:

I know of no religious school today which has a nickel to spare. Their resources are only as deep as their parishioners' pockets. . . . [T]he tax exemption becomes pretty important because [of] the deductibility of a contribution. . . .<sup>106</sup>

The income-measurement argument starts with the generally accepted standard, the Haig-Simons definition:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.<sup>107</sup>

Income, in other words, equals the value of what is consumed plus what is saved. Since donations are neither consumed nor saved by the donor, they are not income to the donor and must be deducted from the donor's tax base. The contributions are actually used up only by the ultimate beneficiaries of the charity.<sup>108</sup>

However, the donor's consumption can be defined to include the satisfaction derived from making a charitable donation, and the value of such satisfaction might equal at least part of the value of the gift. It is therefore arguable whether a full deduction for charitable contributions is consistent with measuring the donor's income. "When they turn their attention to charitable contributions, tax economists almost uniformly argue that these are consumption expenditures from which the donor gets what he pays for, *viz.*, personal satisfaction undiminished by the fact that the recipients also benefit from his generosity."<sup>109</sup>

Even conceding this point, it is not enough to focus solely on the donor; the income-measurement issue requires considering the tax treatment of both donor and recipient together. If the donor does not benefit from the gift and is therefore entitled to a deduction, then logically there should be income to the ultimate beneficiary who consumes it. Yet the beneficiary never reports the item because § 102(a) permits donees to exclude all gifts in computing taxable income. The beneficiary's gift exclusion combines with the donor's charitable deduction to result in the income represented by the donation never being taxed. The non-taxation of both donor and

---

*Are Tax Benefits Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L. REV. 379 (1998).

105. See *Tax-Exempt Status of Private Schools: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 96th Cong. 254 (1979) (statement of Jerome Kurtz, I.R.S. Commissioner).

106. *Id.* at 287, 302 (statement of William Ball).

107. HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

108. Andrews, *supra* note 103, at 346; Bittker, *supra* note 103, at 59.

109. CHARLES O. GALVIN & BORIS I. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* 53-54 (1969).

donee is consistent with income measurement only when the ultimate beneficiaries of the gift are too poor to owe taxes. This condition might be satisfied if charitable deductions today were limited to the category of "relief of the poor," but it is doubtful that the condition is more than occasionally met by the ultimate beneficiaries of tax-exempt status for schools, who are the students and the parents of students attending private schools.<sup>110</sup>

Another version of the income-measurement argument views the charitable deduction as income-defining because it is needed to equalize the tax treatment of a donor who contributes cash or property with a donor who makes a gift of his or her own services.<sup>111</sup> Consider a doctor and a lawyer, both of whom wish to contribute to a hospital. The doctor works five hours per week on the wards without pay. Because his contribution takes the form of imputed income from services, the donation is disregarded in determining his taxable income. The lawyer contributes the fees from five hours of legal work. His position is like the doctor's except that he donates income in non-imputed cash form, which means that it must be reported as income. In order to treat the lawyer the same as the doctor, an offsetting deduction for the cash donation might be allowed. But as a general rule we do not correct for differences in treatment caused by non-taxation of imputed income. If a lawyer pays someone else to write a will or a baker buys another's cakes, no deduction is allowed for the expenditure even though each might have consumed his own services and thereby realized no taxable income.

The income-measurement view also appears at odds with the general rule (to which the charitable deduction is a clear exception) that ordinary gifts may not be deducted.<sup>112</sup> Why do gifts to the Red Cross and Yale University reduce the donor's Haig-Simons income, but not gifts to a Political Action Committee or a favorite nephew? Gifts to ordinary donees are, in the same sense, neither saved nor consumed by the donor. And the general rule is not considered to cause over-taxation even if the donor is in a higher tax bracket than the donee or if a disparity exists *vis-à-vis* donors who make gifts of imputed income.

The critical problem for proponents of the income-measurement view is to justify special treatment for charitable gifts when ordinary gifts are not deductible. They appear to rely primarily on the idea that gifts to charity,

110. See Andrews, *supra* note 103, at 356–57:

Many contributions are to private schools, whose student bodies are probably still disproportionately representative of the affluent part of the population.

Cf. Boris I. Bittker & William K. Raedher, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 334 (1976):

[T]he students who attend exempt schools . . . probably come from higher income classes than most of the beneficiaries of other charitable organizations . . . [I]t weakens one argument in favor of exempting many other nonprofit organizations—that the burden of a tax would fall largely on persons at the bottom of the income ladder.

111. See Andrews, *supra* note 103, at 352–54; Bittker, *supra* note 103, at 59–60.

112. Ordinary gifts are considered personal consumption expenses, which are not deductible under § 262.

unlike gifts to relatives or friends that finance private consumption, satisfy a moral obligation or provide desirable public goods:

[C]haritable contributions represent a [moral] claim of such a high priority that . . . a case can be made for excluding them in determining the amount of income at the voluntary disposal of the taxpayer in question . . . . Side by side with taxpayers who can satisfy their charitable impulses by making a contribution of their time . . . are others who feel the same charitable impulse, but must discharge their moral obligation by contributing cash or property.<sup>113</sup>

Almost all charitable organizations other than those that distribute alms to the poor produce something in the nature of common or social goods or services. The benefit produced by a contribution to a private school, for example . . . . [T]he product is essentially a common good . . . . [T]he ultimate benefits from schooling flow beyond the immediate recipients. General education makes better citizens . . . .<sup>114</sup>

In the end, whether or not we consider the charitable deduction *generally* to be an income-measurement provision depends on a whole range of value judgments, all of which are debatable. However, unless racially segregated education is deemed to serve a moral goal or provide a desirable public good, then a critical premise of the income-measurement view (that may be appropriate in other contexts) is not valid in the specific case of gifts to racially segregated private schools. The income-measurement view of the charitable deduction therefore does not pose an obstacle to treating exempt status as a subsidy involving Fourteenth Amendment state action.

## 2. *The Significance of Walz*

Does the decision in *Walz v. Commissioner*, that tax-exempt status for churches is permitted by the First Amendment's Establishment Clause, imply that tax-exempt status for racially segregated private schools is permitted by the Fourteenth Amendment's Equal Protection Clause? As noted above, the Supreme Court held in *Walz* that tax exemptions for religious institutions do not violate the Establishment Clause because the exemption had been considered constitutional for the nation's entire history. However, history has an altogether different significance when the beneficiary of exempt status is a racially segregated school. At the time of the enactment of the Fourteenth Amendment, almost all public and private schools were racially segregated. The Equal Protection Clause was not generally understood at the time as a bar either to racially segregated

---

113. Bittker, *supra* note 103, at 59–60.

114. Andrews, *supra* note 103, at 357, 359; *cf.* Bittker, *supra* note 103, at 61:

[T]he deduction can be viewed as a mechanism for permitting the taxpayer to direct . . . the social functions to be supported by his tax payments. . . . [T]he deduction gives the taxpayer a chance to divert funds which would otherwise be spent as Washington determines and to allocate them to other socially approved functions.

public education or to tax-exempt status for racially segregated private schools.<sup>115</sup> Yet the equal protection obligations of the Constitution have expanded along with increasing awareness of the evils of racial discrimination in education and have never been frozen by nineteenth-century attitudes. If historical practice does not make the segregation of public schools constitutional, neither can it justify exempt status for private institutions that discriminate.

Moreover, the affirmative reasons for holding in *Walz* that church exemptions do not violate the First Amendment have little relevance to equal protection analysis of exemptions for private schools. On the one hand, the Court admitted that the exemption does provide a financial benefit, thereby tending to establish churches.<sup>116</sup> However, removing the exemption might entangle the government in church affairs, as tax collectors pore over financial records and church and state become embroiled in tax disputes.<sup>117</sup> Since taxation could be used to oppress religion, the "exemption constitutes a reasonable and balanced attempt to guard against those dangers."<sup>118</sup> *Walz* is the product of two competing constitutional values of equal stature, prohibiting both government support for, and government interference with, religion.

In the equal protection area, there are also competing values between the policy that forbids state support for racially segregated education and rights of privacy and association, including the right to attend a racially segregated private school. But in this case, the competing values are not of equal stature. The policy against support for racial discrimination in education is valued more highly than the right to send one's children to schools that discriminate.

The constitutional balance is very different here than in *Walz*, primarily because racially segregated schools occupy a much lower constitutional status than do churches:

[A]lthough the Constitution does not proscribe private bias, it places no value on discrimination as it does on the values inherent in the Free Exercise Clause. Invidious private discrimination may be characterized as a form of exercising freedom of association . . . but it has never been accorded affirmative constitutional protections.<sup>119</sup>

Thus, the holding in *Walz* that permits tax benefits to churches should not be extended to equal protection analysis of exempt status for racially discriminatory private schools.

---

115. See, e.g., RICHARD KLUGER, *SIMPLE JUSTICE* 633–34 (1976) (explaining how in 1868, for example, in the North, segregated schools were permitted in eight states, and in another five states public education was made entirely unavailable to black children).

116. *Walz v. Tax Comm'n*, 397 U.S. 664, 674–75 (1970).

117. *Id.* at 674.

118. *Id.* at 673.

119. *Norwood v. Harrison*, 413 U.S. 455, 469–70 (1973).

3. *Does Exempt Status for Wellesley Also Violate the Fourteenth Amendment?*

Notwithstanding our conclusion that the Fourteenth Amendment prohibits exempt status for racially segregated private schools, and notwithstanding the Supreme Court's decision in *Virginia*, can exempt status be constitutionally provided to single-sex private educational institutions? The constitutional status of whites-only private schools is vastly different from that of single-sex educational institutions. Although in *Bob Jones*, the Supreme Court cited the "unmistakably clear" agreement among "all three branches of the Federal Government" that racial discrimination must be eliminated,<sup>120</sup> there is no evidence of a similar hostility to single-sex educational institutions. Thus, an *amicus* brief in the *Virginia* case contrasted racially segregated education with single-sex education to counter the suggestion that if a military college financed by, and subject to the control of, the state of Virginia is required to admit female applicants, then Wellesley College must admit men or lose its federal tax-exempt status:

The three branches of the federal government have not, acting independently or in concert, articulated a position against, much less launched a crusade to dismantle, private single-sex colleges . . . . In short, there is no "fundamental public policy" or "declared position of the whole Government" which the maintenance or establishment of private single-gender undergraduate college programs contravenes . . . . Moreover . . . the evidence is clear and well-established that single-sex education for women is particularly effective in preparing them for leadership and success, generally, and in male-dominated fields, more particularly.<sup>121</sup>

As the Court noted in *Virginia*, it has "reserved most stringent judicial scrutiny for classifications based on race or national origin . . . ."<sup>122</sup>

In addition, there is a vast difference between the kind of support afforded the Virginia Military Institute—the college was largely financed and controlled by the state of Virginia—and the less extensive and intrusive support afforded by tax-exempt status. The Court's opinion in *Virginia* noted the special circumstances of the case, addressing "specifically and only an educational opportunity recognized . . . as 'unique,' . . . an opportunity available only at Virginia's premier military institute, the Commonwealth's sole single-sex public university or college."<sup>123</sup>

Of course, depending on the context and the myriad of different ways that single-sex education might be implemented, it is conceivable that in special circumstances, tax-exempt status for a single-sex private educational institution might offend the Equal Protection Clause. In the absence of special circumstances, however, the Fourteenth Amendment should permit an all-men's (as well as an all-women's) college to benefit from tax-

120. 461 U.S. at 598.

121. Brief for Twenty-Six Private Women's Colleges as Amici Curiae Supporting Petitioner, *United States v. Virginia*, 518 U.S. 515 (1996) (Nos. 94-1941, 94-2107), 1995 WL 702837, at \*23, \*25.

122. *United States v. Virginia*, 518 U.S. 515, 532 n.6 (1996).

123. *Id.* at 533 n.7.

exempt status—even though more intrusive government financing and control of the kind in the *Virginia* case would raise equal protection issues and despite the fact that racially segregated private schools should ordinarily not be permitted to receive exempt status given the especially high constitutional value placed on ending racial discrimination in education.

#### CONCLUSION

As a matter of first impression, civil rights and taxation may appear to be unrelated subjects. However, on closer examination, civil rights lawyers need to be aware of potential tax implications of civil rights litigation to a surprising degree. Whenever money damages are sought in civil rights litigation, the tax treatment of damages will affect the amount that actually benefits the plaintiff after taxes. In addition, even when litigation seeks non-money damages, as in predatory lending cases, civil rights lawyers need to attempt to structure the relief so that it does not cause undesirable tax consequences, such as income arising from forgiveness of debt. In our final example, civil rights lawyers may need to analyze the financial and other consequences of tax benefits, such as tax-exempt status, in order to ascertain whether such benefits raise issues under the First Amendment's Establishment Clause and the Fourteenth Amendment's Equal Protection Clause.