

## in this issue:

AUGUST 2006

The Court of Appeals for the District of Columbia Circuit held Internal Revenue Code section 104(a)(2) unconstitutional to the extent that it taxes compensatory damages that are not related to lost wages or earnings. The court reasoned that such damages were “in lieu of” injuries that would not be subject to tax because they are not “income” within the meaning of the Sixteenth Amendment.

Littler Mendelson is the largest law firm in the United States devoted exclusively to representing management in employment and labor law matters.

## Employment Taxes

A Littler Mendelson Newsletter  
specifically for the Employment Taxes

### Are Emotional Distress Damages “Income” Subject to Tax? “No” Says The D.C. Court of Appeals in *Murphy v. United States*

By GJ Stillson MacDonnell and William Hays Weissman

On August 22, 2006, the Court of Appeals for the District of Columbia Circuit held it unconstitutional, within the meaning of the Sixteenth Amendment, to tax compensatory damages for emotional distress damages. *Murphy v. United States*, No. 05-5139 (Aug. 22, 2006). This opinion is likely to cause many plaintiff’s counsel to immediately claim all emotional distress damages are nontaxable, but the decision is clearly not so simple.

#### Background

In *Murphy*, the taxpayer, Marrita Murphy, sued her former employer, the New York Air National Guard for emotional distress and loss of reputation. Murphy alleged that, following disclosures under whistleblower provisions of environmental statutes about hazards on the air base, her employer both blacklisted her and provided her with unfavorable references.

At a hearing before an administrative law judge Murphy submitted evidence that she had suffered both mental and physical injuries as a result of her employer’s actions. She introduced testimony from a physician, who stated that Murphy has suffered both “somatic” and “emotional” injuries, including “bruxism” (teeth grinding), which is often associated with stress and can cause permanent tooth damage. Upon evidence of other “physical manifestations of stress,” such as “anxiety attacks, shortness of breath, and dizziness,” the ALJ awarded Murphy \$45,000 for emotional distress or mental anguish and \$25,000 for injury to her professional

reputation. No damages were awarded for lost wages or diminished earning capacity.

Murphy paid \$20,665 in federal taxes on the award, and thereafter filed claims for refund. The federal district court granted summary judgment to the IRS, and Murphy appealed.

#### Murphy’s Novel Arguments on Appeal

Murphy argued two points on appeal. First, that her award was in fact for “personal physical injuries” under Internal Revenue Code (“Code”) section 104(a)(2), and second, that her award was not “income” within the meaning of the Sixteenth Amendment.

The court quickly dispensed with Murphy’s first argument, finding that the ALJ’s award was clearly “on account of” her nonphysical injuries, and under the plain language of Code section 104(a)(2) as amended, taxable. This was true even though under current law she suffered physical manifestations of her emotional injuries.

The court then addressed the constitutional argument, which appears to be an issue of first impression. Murphy argued that her award was not income that can be taxed under the Sixteenth Amendment because it was neither a gain or an accessions to wealth, as defined by the United States Supreme Court in *Glenshaw Glass Co.*, 348 U.S. 426 (1955). As a result, because it was not “income” and Code section 104(a)(2) was unconstitutional because it subjected her award to tax. Murphy additionally

argued that it is well established that the restoration of capital is not income, and, by analogy, a damage award for personal injuries, including nonphysical injuries, is not income but simply a return of “human capital.”

The IRS made a variety of arguments, including the general presumption that Congress enacts laws within its constitutional limits. It noted that Congress could repeal Code section 104(a)(2), thereby taxing compensation for both physical and nonphysical injuries within the provisions of Sixteenth Amendment. The IRS took exception to Murphy’s “human capital” argument, pointing out that a human has no basis or cost, nor is it subject to depreciation, in contrast to returns of capital. Finally, the IRS pointed out that her award clearly constituted an economic gain, as she had more money after the award than before it.

The court agreed with Murphy’s arguments. Relying upon *Glenshaw Glass*, the court found Code sect 104(a)(2) unconstitutional to the extent that it allows the taxation of compensation for a personal non-physical injury where such compensation is unrelated to lost wages or earnings. Further, to determine whether the award was income within the meaning of the Sixteenth Amendment, the court followed the rational set forth in *O’Gilvie v. United States*, 519 U.S. 79 (1996), which requires a determination of whether the compensatory damages awarded were a substitute for a normally untaxed personal quality, good, or asset. The court then concluded that if the award was “in lieu” of something normally untaxed, then the award was not income within the meaning of the Sixteenth Amendment because it neither constituted a “gain” or an “accession to wealth.”

The court found that the award was solely to compensate her for nonphysical injuries to her emotions and reputation, and not for any lost wages or taxable earnings. Under the court’s “in lieu” test, it found that the award was to compensate for emotional distress and loss of reputation, which were not items considered income at the time the Sixteenth Amendment was enacted. Therefore, the court remanded the case

to the district court for an order entering judgment in favor of Murphy.

## Analysis of the *Murphy* Decision

The decision raises several interesting questions. Perhaps the most important is the court’s holding stating that Code section 104(a)(2) “is unconstitutional as applied to her award because compensation for a non-physical personal injury is not income under the Sixteenth Amendment if, as here, it is unrelated to lost wages or earnings.” The court does not explain what it means for an award to be “unrelated to lost wages or earnings.” The facts indicate that no amount was awarded for lost wages or earnings, and that she filed under whistleblower provisions of environment statutes that allowed for compensatory damages.

However, does this mean that if the statutes at issue had allowed for wage claims, or if she had made a wage claim, her emotional distress damages would have been taxable? Or is an award only deemed not subject to tax if no wage related damages are awarded? For example, if the ALJ had awarded her \$1 in back wages, would that have made her \$70,000 award subject to tax under Code section 104(a)(2)? If only the \$1 would be subject to tax but the \$70,000 was still nontaxable, then what relevance is there to any relationship to lost wages or earnings? The court’s opinion provides no guidance on these questions.

Further, Code section 61 defines income subject to tax. All income is generally subject to tax unless specifically excluded. See *Glenshaw Glass, supra* (predecessor to Code section 61 broadly interpreted “to tax all gains except those specifically exempted”). Code section 104 is an exclusion from tax for personal injuries. Code section 104(a)(2) is an exception to or limitation on that exclusion by asserting that nonphysical injuries are not within the meaning of a personal physical injury that is exempt from tax. Thus, Code section 104(a)(2) does not subject Murphy’s award to tax; Code section 61 does. However, the court did not state that Code section 61 was unconstitutional to the extent that it subjects the award

to tax. This seems to make the court’s reasoning inconsistent.

## Effect of Decision in Employment Cases

Employers should be very wary of plaintiffs counsel’s demands to exclude from tax reporting obligations all emotional distress damages in employment related cases for several reasons. To begin with, this case is limited to the District of Columbia Circuit, and thus applies only to cases arising in the District of Columbia. Further, the IRS is highly likely to issue a nonacquiescence to the opinion, meaning that the IRS will not follow its reasoning outside the District of Columbia.

In addition, there are several cases expressly holding that emotional distress damages are not excluded from income under Code section 104(a)(2), and are thus taxable. See, e.g., *Rivera v. Baker W., Inc.*, 430 F.3d 1253 (9th Cir. 2005); *Lindsey v. Comm’r*, 422 F.3d 684 (8th Cir. 2005). Thus, although those cases did not address the constitutionality of Code section 104(a)(2), there is at least a split in authority between the District of Columbia Circuit and the Eighth and Ninth Circuits regarding whether emotional distress damages are subject to income tax.

Also, as discussed above, the court’s decision is unclear regarding the relationship of the award to lost wages or earnings, and is inconsistent with Code section 61.

As a result, employers should be wary of demands by plaintiffs to not report emotional distress damages via a 1099-MISC. Some employers may question why it matters, given that the tax at issue is not the employer’s tax liability. The reason that it matters to employers is because the IRS is likely to more closely scrutinize settlements that assert any measurable claim of emotional distress damages, particularly if there are potentially available wage-related claims asserted. In doing so, it may question not only the allocation of awards between wages and emotional distress and other kinds of damages, but whether there was a valid basis for paying emotional distress damages at all.

For example, assume a case settles, with the parties agreeing to pay \$25,000 in attorneys' fees, \$25,000 in lost wages, and \$50,000 in emotional distress. Further assume that there is no evidence of actual emotional distress, such as visits to a doctor or psychologist, or symptoms of stress and its physical manifestations. The IRS could assert that no amount was properly classified as emotional distress because there was no basis to allocate amounts to such as claim. See, e.g., *Robinson v. Comm'r*, 102 T.C. 116 (1994) (denying allocation in settlement that was not based on evidence consistent with the claims). This suddenly turns \$50,000 in "non-taxable" award in \$50,000 in wages that were not reported by the employer, subjecting the employer to additional taxes, penalties and interest.

Therefore, employers should carefully consider the implications of this case before agreeing to not report emotional distress damages outside of the limited jurisdiction of the District of Columbia.

Employers and their counsel should also carefully consider the potential implications of allocating amounts to emotional distress damages in settlements and their tax reporting obligations as a result of such allocations. Consultation with qualified legal counsel is greatly encouraged.

---

*GJ Stillson MacDonnell is a shareholder and chair of Littler's Employment Taxes Practice Group and William Hays Weissman is an associate in Littler's Employment Taxes Practice Group. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Ms. MacDonnell at gjmacdonnell@littler.com or Mr. Weissman at wwweissman@littler.com.*

---