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D.C. Circuit Reverses Course and Finds Emotional Distress Damages Are Income Subject to Tax

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Introduction

Reversing its August 22, 2006 opinion, the D.C. Circuit Court held in *Murphy v. Internal Revenue Service*, 2007 U.S. App. LEXIS 15816 (July 3, 2007), that emotional distress damages are taxable income under Internal Revenue Code (IRC) section 61. The court backed away from its earlier ruling holding IRC section 104(a)(2)¹ unconstitutional on the ground that emotional distress damages were not "income" within the meaning of the Sixteenth Amendment to the United States Constitution.

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 regarding hazards on the airbase, her employer both blacklisted her and provided her with unfavorable references.

At a hearing before an administrative law judge (ALJ) 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 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.

The D.C. Circuit originally found that the damages were clearly carved out of the exemption for personal physical injuries under IRC section 104(a)(2). Nonetheless, it reasoned that the damages were not "income" within the meaning of the Sixteenth Amendment because they were akin to a return of "human capital," which is not income subject to tax. The IRS petitioned for rehearing en banc, but the original panel vacated its decision and set a new briefing schedule and oral argument.

The New Opinion

In its July 3, 2007, decision, the court reaffirmed its original finding that the damages did not fall within the exclusion from tax under IRC section 104(a)(2). The court found that the ALJ's damages award was expressly "on account of" her nonphysical injuries. Thus, it found that while the ALJ may have considered her physical injuries indicative of the severity of her emotional distress, her physical injuries were not themselves the reason for the award. Accordingly, her award did not fit within the meaning of IRC section 104(a)(2).

The IRS then turned to whether the award was part of her "gross income" under IRC section 61. In its August 22, 2006, opinion the court failed to even address IRC section 61. The court concluded that the proper inquiry was whether her award was properly included within Code section 61(a), "to wit, all income from whatever source derived." Reading the IRC as a whole, the court found that the only way to make sense of the 1996 amendments to IRC section 104(a)(2), which excluded emotional distress from the definition of personal physical injuries, was to conclude

¹ IRC section 104(2)(2) excludes from tax any income received on account of personal physical injuries. In 1996, Congress amended the section to expressly exclude emotional distress damages, including its physical manifestations, such as ulcers.

that Murphy's award for nonphysical damages fit within that definition.

The court then turned to whether Murphy's award was income subject to the constitutional limitations of a direct and uniform tax. The court rejected both Murphy's and the government's arguments, both of which were based on a historical analysis of original intent of the constitutional provisions, finding that is "more appropriate to analyze this case based on the precedents and therefore to ask whether the tax laid upon Murphy's award is more akin, on the one hand, to a capitation or tax upon one's ownership of property, or, on the other hand, more like a tax upon a use of property, a privilege, an activity, or a transaction."

The court found that the income tax on her award is more akin to a tax on a transaction, even if it constitutes a return of human capital, as argued by Murphy. Because it was not a direct tax, it need not be apportioned under the Constitution. The court also found that because the tax on the award operates with the same force and effect throughout the United States, it was also a uniform tax.

Therefore, because the award was not exempt from taxation under IRC section 104(a)(2), was income within the meaning of IRC section 61, and was not a direct tax subject to the requirements of apportionment and uniformity, the tax on her award was constitutional. As such, the district court's ruling denying Ms. Murphy a refund was affirmed.

This opinion now makes the D.C. Circuit consistent with other circuit courts that have held that emotional distress damages are income subject to tax. *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). Plaintiff's counsel arguing that emotional distress damages are not taxable no longer have any authority to back up that position. To the contrary, the D.C. Circuit's opinion contains a well-reasoned analysis upholding the IRS's ability to levy an income tax on emotional distress damages. Defendants paying emotional distress damages should report such damages to the proper taxing authorities accordingly, and now have significant precedent on their side commanding that they do so.

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