The standard amount set by the IRS is likely to fully compensate taxpayers with just landlines, according to several tax lawyers contacted by Tax Analysts, but households with landlines and cellphones could find themselves shortchanged.

“Based on the [Federal Communication Commission’s] estimated per household [spending] on long-distance and wireless service, the proposed $30 to $60 refunds are not unreasonable,” said Steve Rosen of Levine, Blaszack, Block & Boothby in Washington. But Rosen, who represented taxpayers in four of the five circuit court cases in which the tax was ruled invalid and who is cocounsel in Sloan v. United States, a class-action suit in D.C. district court challenging the refund procedures, said a household’s adjusted gross income is probably a better indication of the amount of telephone excise tax paid than family size. (For the amended complaint in Sloan v. United States, No. 1:06cv00483, see Doc 2006-13066 or 2006 TNT 132-15.)

Tom Sykes of McDermott Will & Emery LLP in Chicago said he thought the standard amount outlined in last week’s IRS announcement might be overly generous to a residential subscriber who had a landline but not a cellphone throughout the 41-month period. But adding in taxes paid on cellphone service for just one line might bring the amount of tax paid over the past three years to over $70.

A family with multiple cellphones could have paid upwards of $150 in telephone excise taxes over the past three years, according to Sykes, who gave as an example a family with five cellphones — one for each parent and two children, plus an additional cell line for a grandparent — that might find it paid $180 or more since March 2003.

Although the standard refund set by the IRS contains a marriage penalty, it also provides a little perk for new parents: Since the refund amount is linked to the number of exemptions on a taxpayer’s 2006 return, new moms and dads will get an extra $10 per child, even for those born in the last few months of 2006 and for those too young to talk.

Rosen pointed out that although the IRS has said it will work to address the problems of small businesses and nonprofits, taxpayers who are not required to file tax returns — a class that includes many seniors — are still disadvantaged under the IRS refund procedures that require a return to be filed.

Experts Ponder Murphy Decision’s Many Flaws

By Sheryl Stratton — sstratto@tax.org

It is not often that an appeals court invalidates a federal tax statute, and it is even rarer that constitutional law scholars join the tax bar in taking potshots at a circuit court chief judge’s ruling.

On August 22 the D.C. Circuit held that a compensatory award for emotional and professional reputation damages is excluded from gross income, finding that section 104(a)(2) is unconstitutional insofar as it allows taxation on compensation unrelated to lost wages or earnings.

The ruling is startling, misguided, and wrong, Wolfman said.

In a unanimous opinion, Chief Judge Douglas Ginsburg determined that Marrita Murphy’s compensatory award was effectively for a loss of a personal attribute and not to compensate her for lost wages or other income. Judge Ginsburg also determined that, based on the history of “personal injury compensation” and the definition of income, the framers of the Sixteenth Amendment would not have considered damages for nonphysical injuries to be included in income. (For the D.C. Circuit’s opinion in Marrita Murphy v. IRS, No. 05-5139 (D.C. Cir. Aug. 22, 2006), see Doc 2006-15916 or 2006 TNT 163-6. For related news analysis, see p. 825.)

General Dismay

The ruling is startling, misguided, and wrong, said Bernard Wolfman, a professor at Harvard Law School.

The decision is an embarrassment to the D.C. Circuit, said George Yin, the former head of the Joint Committee on Taxation, now a professor at the University of Virginia School of Law.

It strikes Michael Graetz, a professor at Yale Law School, as “odd that judges who claim to be conservative, and supposedly want to defer to the legislative branch, can be so ready to strike down this kind of statute,” which Congress enacted only after a great deal of confusion and after many decisions by the Supreme Court on the treatment of damages.

It is a horrible decision for a more fundamental reason than what the tax people are worried about, said Martin S. Lederman, a visiting constitutional law professor at Georgetown University Law Center. The appeals court’s opinion is woefully incomplete, he said, because it failed to perform a full constitutional analysis.
Indeed, tax and constitutional law professors are having a field day with the decision. The TaxProf-Blog (http://taxprof.typepad.com) has been tracking media coverage of the case and keeping a running commentary for anyone who cares to share an opinion.

When not joking about how to convert their partnership incomes into personal injury claims, tax practitioners are mystified by the decision.

The reaction among members of the tax bar has been uniform incredulity, said Pamela Olson, former Treasury assistant secretary for tax policy, now at Skadden, Arps, Slate, Meagher & Flom LLP in Washington. At the same time, tax advisers must figure out what to tell clients whose claims are potentially affected by the decision, she said. “I suspect most will make clients aware of it but advise them not to bank anything on it, but there are likely to be quite a few advisers who accept the decision and try to apply it or use it to their clients’ advantage.”

Nixon Peabody has posted an employment law alert on its Web site calling the decision “extraordinary” and saying that it has the potential to completely change the taxation of many employment judgments and settlements. The most widespread effect in the short run will be that recipients of damages would be advised to file claims for refunds to protect their rights, said Thomas J. McCord of the firm’s Boston office.

Acknowledging that it is very possible that the Supreme Court will reverse the decision, Marvin Kirsner of Greenberg Traurig said he is now recommending to clients that they file refund claims “since the appeal process could take a year or two.”

**Technical Tax Points**

“We law professors must not be doing our jobs right if three federal judges and their clerks can reach a conclusion like this one,” Yin said.

Yin has identified several flaws in the court’s technical analysis. The first is that the court was not familiar with the concept of basis. The court’s opinion reads as if recovery is made to make a taxpayer whole, he said. The logic of comparing the value of what is lost to the value of what is received to determine whether there is an accession to wealth would lead to virtually any exchange as not creating income, he said.

Basis is one of the toughest ideas to teach first-year tax students, said Bryan Camp, a professor at Texas Tech University School of Law. Apparently, the three circuit court judges missed that particular lesson, he said. While the opinion recites the government’s argument about basis, there is little discussion of it, much less any rational discussion, and that is proof enough that they just did not understand it, Camp said.

Camp said the opinion’s essential logic is that Murphy’s emotional well-being and reputation were not taxable items in and of themselves, both were diminished by the tort, and, therefore, the money paid to Murphy to make her emotional state and reputation “whole” should not be taxed because it was “in lieu of” the diminution of a capital asset.

Assuming the vitality of the opinion’s “human capital” concept, Murphy’s damages are excluded from income only if Murphy’s basis in her reputation and emotional well-being was equal to or greater than the damages awarded, Camp said. But until this opinion, it has been widely accepted that taxpayers have no basis in their labor — their “human capital,” Camp said. That lack of basis is why taxpayers cannot take a deduction under section 170 for a donation of services, Camp said.

Yin also took exception to the court’s analysis of what the taxpayer was receiving recovery for as means of determining whether it was taxable. The theory is that the recovery is taxable if it is made in lieu of something that would otherwise be taxable, Yin said. When taken to its logical conclusion, that analysis would result in not treating wages as income, he said, because people work for pay in lieu of having leisure time. (For related coverage of Murphy’s effect on tax protestor arguments, see p. 832.)

Further, the court holds unconstitutional section 104(a)(2), which provides that some recoveries are not income. In striking down an exclusionary provision, it does not follow that there is no income, Yin said.

Indeed, Martin McMahon, a professor at the University of Florida College of Law, said that exclusions from an exclusion provision fall back into section 61. To reach their decision and properly apply the statute, McMahon wrote on the TaxProf-Blog, the circuit court judges should have held that section 61, as applied to the damages in question, as a result of the 1996 amendments to section 104(a)(2), was unconstitutional.

**Tax Policy**

The Murphy court may have been wrong on the law, but right on the tax policy issue, said Stephen Cohen, a tax professor at Georgetown University
Law Center. While there may be doubtful authority to declare, as the circuit court did, an income tax provision unconstitutional on policy grounds, he believes that there is a strong argument that the type of damages involved in Murphy should not constitute income. (See Stephen Cohen and Laura Sager, “Discrimination Against Damages for Unlawful Discrimination,” 35 Harvard Journal on Legislation 447 (1998).)

**Graetz said Murphy is highly unusual — he is aware of only two other cases since the enactment of the 16th Amendment that strike down an income tax provision.**

Tax professors are bewitched by comprehensive tax base theory in a way that sometimes makes it hard to predict how arguments based on other theories will appeal to nontax judges, said Theodore Seto, a professor at Loyola Law School in Los Angeles. Not an “originalist,” Seto said he parts ways with the D.C. Circuit in its mode of constitutional interpretation. But one need not be an originalist to conclude that purely compensatory damages not in lieu of income are not themselves income, he said.

If something is not income, we must eventually ask whether its inclusion in the income tax base is authorized by the Sixteenth Amendment, Seto said.

**Constitutional Analysis**

The focus on whether damages are income or not is beside the point, Lederman said, because congressional power is not limited to taxing income. Congress has the power under Article I, section 8 to lay and collect taxes, he said. “This, in and of itself, is presumably sufficient authority for the tax in the Murphy case.”

The Sixteenth Amendment is not a limitation on congressional powers — it’s an authorization, or, more precisely, it was ratified to clarify that income taxes may be assessed whether or not they are direct taxes, said Lederman. But the decision does not acknowledge Congress’s broad taxing power under Article I, section 8, nor does it identify where in the Constitution any restriction on that taxing power might appear or describe the nature of that constitutional limitation, Lederman said.

Graetz said Murphy is highly unusual — he is aware of only two other cases since the enactment of the Sixteenth Amendment that strike down an income tax provision. And the court did it without asking whether there was power for Congress to tax the recovery apart from the Sixteenth Amendment under its general taxing power, he said. The opinion never discusses why that would be a “direct” tax, which presumably would be the grounds for it being unconstitutional, he said.

To invalidate the tax in Murphy, it is not enough to hold that the award is not “income,” Lederman said. Moreover, it would be necessary to hold that the tax is a direct one, prohibited by Article I, and to explain why it is not otherwise authorized by the Necessary and Proper Clause, he said. (For Lederman’s more extended analysis, see http://balkin.blogspot.com/2006/08/is-federal-tax-on-damages-for.html.)

Only unapportioned direct taxes are unconstitutional, according to Camp. The main constitutional restriction is that if Congress imposes a direct tax, Article I, section 9, clause 4 says it must apportion the tax among the states per the census count, he said.

The opinion’s inexplicable failure to address the power to tax is especially conspicuous considering that the district court judge in the case specifically noted that the possible constitutional limitation derived from the apportionment requirement of Article I and indicated that the tax was permissible if it was assessed on income or if it was not direct, Lederman said. The circuit court simply ignores half of the equation — and without that, the decision provided no reason to invalidate the federal statute, he said.

**Outlook**

Most commentators believe the decision will not stand. Many believe that even in the absence of a dissent, the D.C. Circuit would grant an *en banc* review.

Wolfman believes that if the government were to lose after rehearing and then seek certiorari, the Supreme Court would grant it without waiting for a circuit conflict to develop, and that it would reverse.

Predicting what the Supreme Court will do in a particular case is a risky business, Seto said, but he doubts that a majority would adopt the circuit court’s originalist approach. Beyond that, Seto is less certain. “Unlike many of my colleagues, I believe that non-tax lawyers (there are nine of them on the Supreme Court) might well conclude that the damages in question are not ‘income’ and that this raises potential 16th Amendment problems,” he said.

If the case had not been decided on constitutional grounds, Congress would reverse it right away (and thereby pick up some unexpected revenue), Yin said. “As it is, we will have to await an *en banc* or Supreme Court reversal and suffer an increase in frivolous arguments no matter what happens,” he said.
NEWs analysis

Murphy’s Law: Tax Provision Declared Unconstitutional

By Lee A. Sheppard — lees@tax.org

Boris Bittker woulda loved it.
It’s too bad Prof. Bittker didn’t live to see a tax law declared unconstitutional. He spent part of his distinguished career trying to find constitutional problems with the tax law where there were none. There is, as this article will discuss, very little that Congress cannot do in the way of tax law. (For eulogies to the late Boris Bittker, see Tax Notes, Oct. 3, 2005, p. 119.)

Our favorite story about Bittker concerns the beginning of his career. When he was hired on as a law professor at Yale, he was the low man on the totem pole, so he was asked to teach taxation, a grubby subject that none of Yale’s dons wanted to touch. His preference, which he took up full time many years later, was constitutional law. During his tax career, he tried to find constitutional problems whenever he could, according to his nemesis Stanley Surrey, who developed the concept of the tax expenditure budget.

Surrey was occasionally accused of believing that the federal government had the right to tax gross income. It does. About two decades ago, your correspondent was on the receiving end of a scolding from Bittker himself for obliquely suggesting that the federal government had the right to tax gross income. (See if you can find the offending sentence in Tax Notes, Feb. 13, 1984, p. 557.)

The other day, a three-judge panel of the District of Columbia Circuit declared a tax law unconstitutional. The law in question was section 104(a)(2), which, as amended in 1996, excludes from income tort awards for physical injuries, but not awards for emotional injuries and punitive damages. In Marrita Murphy v. IRS, No. 05-5139 (D.C. Cir. Aug. 22, 2006), Doc 2006-15916, 2006 TNT 163-6, the court held that section 104(a)(2) violated the Sixteenth Amendment on the ground that damages for emotional injury are not income as commonly understood.

The initial reaction of most of our readers to this result is that it is loopy. (For related news coverage, see p. 822.) The problem is that this decision came from the District of Columbia Circuit, not some district court on the dusty plains whose judges were appointed on the basis of party loyalty and ownership of a business suit. The author of the opinion was Chief Judge Douglas Ginsburg. It is a superficially well-reasoned opinion. It is difficult to dissect and refute what appears to be a tightly woven legal argument. But it is untenable and inconsistent with Supreme Court precedent.

There was a time your correspondent would have relished a case like this. Around here, we call federal judges idiots a lot. But that is usually on complicated questions of business taxation that sophisticated practitioners cannot agree about. On this rather simple case, we really wish federal judges weren’t quite so misguided.

It is a superficially well-reasoned opinion. It is difficult to dissect and refute what appears to be a tightly woven legal argument. But it is untenable and inconsistent with Supreme Court precedent.

Congress, home of one or two members who would like to strangle the income tax in a bathtub, has recently visited the tort recovery realm. In the American Jobs Creation Act of 2004 (P.L. 108-357), Congress made attorney fees in employment cases an above-the-line deduction so that plaintiffs would not be subject to alternative minimum tax when they recovered and then deducted these fees. (Section 62(a)(19).) What’s that got to do with this case?

First, it shows a congressional willingness to look out for tort plaintiffs and make changes to the law when necessary. Second, it is evidence of congressional rejection of the Murphy result. At the same time they were lobbying for the above-the-line deduction for attorney fees, the plaintiff’s bar was lobbying to reverse the 1996 restriction of the section 104 exclusion to physical injuries. So far that effort has been unsuccessful. Murphy, to state the obvious, will help this lobbying effort.

The Statute

Section 104(a)(2) excludes damages awarded “on account of personal physical injuries or physical sickness.” It was amended in 1996 to say this so that damages for emotional distress would no longer be excludable from income. Before amendment, section 104 excluded “the amount of any damages (other than punitive damages) received . . . on account of personal injury or sickness.”

Congress was worried about people recharacterizing clearly taxable backpay awards as excludable damages for emotional distress. Congress was also thinking about revenue. At the time, employment discrimination litigation had taken off and, let’s face it, being discriminated against at work is emotionally disturbing. The legislative history gave no thought to the idea that awards for emotional distress might not be considered income from an income measurement or constitutional standpoint.
The pertinent House report was looking for the origin of the claim in deciding what injuries are physical. According to the report, “If an action has its origin in a physical injury or physical sickness, then all damages ... that flow therefrom are treated as payments received on account of physical injury or physical sickness.” The report states that damages for emotional distress or employment discrimination are not excludable.

The famous footnote 55 of the conference report on H.R. 3448, the Small Business Job Protection Act of 1996, says that Congress “intended that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.” The list of symptoms is not intended to be exclusive. (For the conference report, see Doc 96-21936 or 96 TNT 151-6.)

Congress is not blameless on the contentious mess that section 104 has become. Congress could have cleared up a lot of problems by not being so economical with words. The statute reads like a want ad. In 1989 Congress clarified that punitive damages could not be excluded, after years of litigation. It is clear that in 1996, Congress was only thinking about revenue. But it could have enunciated its intentions more clearly to ensure that the assumed revenue would be collected.

This statute has been before the Supreme Court so often in recent years that one would think that personal injury and discrimination lawsuits were an important economic activity.

This statute has been before the Supreme Court so often in recent years that one would think that personal injury and discrimination lawsuits were an important economic activity. As this article will show, nearly every word in this rather ambiguous statute has been separately litigated.

As usual, the IRS could have saved itself some trouble by issuing guidance on the amended section 104. If there were ever a case for a bright-line, good-enough-for-government-work rule, section 104 would be it. Origin of the claim questions are appropriate in many instances, but not in cases of wounded and deprived tort plaintiffs. What public policy justification is there for stingy interpretations of an exclusion for plaintiffs?

The taxpayer in Murphy was in court relying on regulations that predated the 1996 change. The IRS has made some rather restrictive readings of section 104 in letter rulings and in court, but it has not seen fit to memorialize those positions in regulations. A big source of disagreement, as the Murphy case demonstrates, is what sort of injury or illness is physical. The IRS’s hard-line position is that physical injury has to involve battery. The statute doesn’t say that, so taxpayers take equally aggressive positions on their returns and fight about it later. (For discussion, see Tax Notes, June 12, 2006, p. 1233, Doc 2006-10655, or 2006 TNT 113-22.)

The Case

Sympathetic cases make bad law. In Murphy, the taxpayer suffered permanent physical damage to her teeth caused by stress attributable to persecution by her employer.

The taxpayer, Marrita Murphy, suffered physical ailments caused by the considerable emotional distress attributable to having been persecuted for being a whistle-blower. The subject of the whistle-blowing was environmental malfeasance, the sort of thing sure to excite a certain overeducated class heavily represented in Washington. The taxpayer was blacklisted and given unfavorable job references in retaliation for whistle-blowing.

Murphy’s doctor testified at her tort trial before an administrative law judge that she had sustained somatic and emotional injuries including teeth grinding, of which she had no prior history, as a result of her bad treatment by her employer, the New York Air National Guard. Teeth grinding causes real harm to teeth and physical pain, which in Murphy’s case was continuing. She also suffered anxiety, dizziness, and shortness of breath. The secretary of Labor awarded her $70,000, of which $45,000 was for mental pain and $25,000 was for damage to her reputation. The secretary’s order classified the damages as arising out of a tort-like action for discrimination.

Murphy was initially decided on cross-motions for summary judgment. The district court, in a memorandum opinion, denied the taxpayer’s motion for summary judgment and granted the government’s motion. (For the district court opinion, see Doc 2005-6167 or 2005 TNT 58-5.)

Murphy featured some questionable procedural calls. The district court allowed a summary judgment motion because the facts were construed to state that no part of Murphy’s award was for physical injury. The administrative order awarding the damages was deemed to control the treatment of the damages for tax purposes.

Summary judgment was improper in this case. There was a dispute about the material facts. The district court could have denied the motion and held a trial on whether compensation for Murphy’s injuries from teeth grinding was sufficiently physical to be excluded from income. The circuit court...
could have remanded for trial, the normal procedure in a summary judgment, but instead just awarded the taxpayer a refund.

Sounds reasonable — what else would a court have to go on? — but it is not the usual IRS practice to rely on orders signed by courts and administrative judges. That the IRS is in the habit of picking fights about aspects of section 104 treatment that should have been settled by administrative guidance was part of the problem in this case.

**Summary judgment was improper in this case. There was a dispute about the material facts. The district court could have denied the motion and held a trial. The circuit court could have remanded for trial.**

In the absence of administrative guidance on a statutory amendment celebrating its 10th birthday, the district court applied *Commissioner v. Schleier*, 515 U.S. 323 (1995), Doc 95-5972, 95 TNT 116-8. The *Schleier* Court agreed with the commissioner that damages are excludable only when they were both received in a tort-like cause of action and received “on account of” physical injury. Those are independent requirements.

“On account of” is an origin of the claim inquiry. The Court is looking for a causal link between the injury and the compensation. Dealing with age discrimination in *Schleier*, the Court noted that “neither the birthday nor the discharge can fairly be described as a ‘personal injury’ or ‘sickness.’” Just because discrimination causes intangible harms, the Court observed in a footnote, does not mean the compensation was received on account of those harms.

The *Schleier* dissenter argued the majority of limiting the exclusion to physical injuries, which it had previously refused to do in *United States v. Burke*, 504 U.S. 229 (1992). *Burke* involved sex discrimination in the form of lower pay. The class settlement with the employer restored lost wages. The taxpayer argued that the settlement should be excluded because discrimination was tort-like. The majority, in an opinion written by Justice Harry Blackmun, construed the term “personal injuries” in section 104 to refer to tort-like injuries, which did not include back pay awards.

Justice Blackmun reasoned that federal sex discrimination law, which created the cause of action, did not sound in tort because it allowed claims only for back pay, injunctions, and equitable relief, not compensatory and punitive damages. (At the time, Congress had engaged in a bit of sex discrimination of its own, granting tort-like remedies only for other forms of discrimination.) This reading validated the restrictive IRS interpretation in reg. section 1.104-1(c).

Justice Antonin Scalia, concurring, declared that the phrase “personal injuries or sickness” contemplated only the commonly understood concept of health-related, physical, or emotional injuries. “There is no basis for accepting, without qualification, the IRS’s ‘tort rights’ formulation, since it is not within the range of reasonable interpretation of the statutory text,” he snarled. Justice David Souter, concurring, argued that back pay “is quintessentially a contractual measure of damages” and that therefore it does not fall “on the tort side of the line.”

The majority’s reasoning struck the dissenters as hairsplitting. Justice Sandra Day O’Connor, joined by Justice Clarence Thomas, argued that the majority focused unduly on remedies. Federal sex discrimination law, she argued, operates like tort law, encouraging self-examination by defendants, and not like contract law, which enforces promises. The dissenters would nonetheless uphold reg. section 1.104-1(c), deferring to administrative expertise.

The *Murphy* district court found a tort-like cause of action, noting that the Labor order created a tort-like cause of action. The taxpayer’s damages were not, however, received on account of physical injury, again as per the Labor order.

But what about the teeth grinding? “This was only a symptom of her emotional distress, not the source of her claim,” District Judge Royce Lamberth wrote. Compensation for emotional injury is excludable only if the emotional distress arose out of physical injury, not the other way around, said the district court, relying on the legislative history.

**The district court’s slavish adherence to the Labor order raises an interesting prospect for plaintiff’s lawyers doing a bit of tax planning.**

The district court’s slavish adherence to the Labor order raises an interesting prospect for plaintiff’s lawyers doing a bit of tax planning. Although the IRS, the Supreme Court, and Congress want to ferret out the origin of the claim, the district court basically said that the only way to know what the claim is about is to look at the court or administrative order making the award. So it couldn’t hurt to have the order or settlement or judgment drafted to the maximum tax advantage for the plaintiff. Oh, and go right ahead and tell the jury to top up the award for the tax. The content of orders can be manipulated, and the district court is giving the green light.
Judge Lamberth booted the taxpayer’s claims of violations of the Fifth and Sixteenth Amendments to the Constitution. The court relied on the Sixth Circuit’s rebuff of a Fifth Amendment claim in Young v. United States, 332 F.3d 893 (6th Cir. 2003), on the view that Congress was acting rationally in trying to reduce litigation about what damages are excludable.

To the taxpayer’s Sixteenth Amendment argument that damages are not income, Judge Lamberth responded that both the code and the Supreme Court define income broadly. “The Supreme Court has continually affirmed the broad interpretation of the taxing power and the definition of income,” he wrote.

Moreover, in a turn of phrase that would have Bittker rolling in his grave, the judge added, “In clarifying the definition of ‘personal injury’ and eliminating injuries based on emotional distress from the exemption, Congress has limited the scope of its taxation power to damages which are not the result of physical injury or sickness.” The implication is that Congress could tax all damages if it saw fit.

The Opinion

Medical science understands that mental distress can cause physical symptoms ranging from the silly to the severe. The District of Columbia Circuit understood this, too, but held that Murphy’s damages were not received on account of physical injuries, within the meaning of section 104(a)(2). Next, the court decided that the physical injuries limitation on the exclusion was unconstitutional.

It is necessary to rehash the court’s thinking on the working of the statute itself because of its importance to practitioners. Like the district court, the circuit court relied heavily on the Labor order awarding the damages. On appeal, the government did not dispute the taxpayer’s claim that the award was for tort-type rights. This is unusual; it is more usual for the government to fight about the nature of the claim.

The taxpayer argued on appeal that “substantial physical problems caused by emotional distress are considered physical injuries or physical sickness.” She relied on an outmoded regulation, reg. section 1.104-1(c), for its statement that section 104(a)(2) “excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.”

The government, as is its wont, argued about the phrase “on account of,” relying on O’Gilvie v. United States, 519 U.S. 79 (1996). In O’Gilvie, the Supreme Court asked for a strong causal connection between the injuries and the damages.

In so doing, the Court rejected “but for” as the test and endorsed the government’s reading of “on account of” to prohibit exclusion of punitive damages. The question was whether punitive damages received before the 1989 amendment to section 104 could be excluded as having been received on account of a death from toxic shock syndrome. A “but for” test, Justice Stephen Breyer mused, would allow the exclusion of all damages. The Court thought that Congress must have meant to exclude only compensatory damages as the restoration of human capital.

O’Gilvie featured a vigorous dissent by Justice Scalia, who was joined by Justices O’Connor and Thomas. Arguing for a “but for” interpretation, Justice Scalia pointed out that at the time the statute excluded “any damages received...on account of personal injury.” “It seems to me that the personal injury is as proximate a cause of the punitive damages as it is of the compensatory damages; in both cases it is the reason the damages are awarded. That is why punitive damages are called damages,” he wrote (emphasis in original).

Justice Scalia found nothing in the wording of the statute to support a limitation of the exclusion to compensatory damages. “The notion that Congress carefully and precisely used the phrase ‘damages received on account of personal injuries’ to segregate out compensatory damages seems to me entirely fanciful. That is neither the exact nor the ordinary meaning of the phrase, and hence not the one that the statute should be understood to intend,” he wrote in trademark fashion (emphasis in original).

The taxpayer in Murphy was essentially arguing for “but for” interpretation. But for being persecuted for being a whistle-blower, she would never have ground her teeth or had anxiety attacks, so compensation for the persecution must be compensation for the injuries sustained as a result. The government argued that the taxpayer was not being directly compensated for having sustained physical injuries.

The circuit court agreed with the government, stating, “Murphy no doubt suffered from certain physical manifestations of emotional distress, but the record clearly indicates the Board awarded her compensation only ‘for mental pain and anguish’ and ‘for injury to professional reputation.’” Yes, the administrative law judge hath spoken. Had the taxpayer’s lawyer obtained an award for teeth grinding, no one would be in court about the tax. Go ahead and make the drafting of the documents part of the negotiations. (See p. 850 for a related practice article.)

On to the Constitution. The 16th Amendment states that “Congress shall have power to lay and collect taxes on incomes, from whatever source
derived, without apportionment among the several States, and without regard to any census or enumeration."

Judge Ginsburg focused on the word "incomes." Around here, we generally look to section 61 for the idea that income includes just about every accretion to wealth that is not expressly excluded, but that is apparently not the practice in the District of Columbia Circuit Court. Judge Ginsburg consulted Gary Becker. For the record, Gary Becker is a Nobel Prize-winning economist at the University of Chicago, known for his work on human capital and more recently for advocating privatization of Social Security. Last time we looked, Becker was not referenced in the Internal Revenue Code or the Constitution.

According to Becker, as per the taxpayer’s lawyer, a damage award is not income. It is instead simply a return of human capital, regardless of the nature of the injuries that prompted it. Oh. Thank you for clearing that up.

Well, gee, what about all those broad statements about the breadth of the taxing power that the Supreme Court — which speaks with a bit more authority on the question than Becker — previously made? That would be 

\[ \text{Eisner v. Macomber, 252 U.S. 189 (1920), and Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).} \]

Neither case helps the Murphy taxpayer.

In Glenshaw Glass, the Supreme Court held that treble damages for antitrust violations were taxable under the predecessor of section 61. The taxpayer argued that Eisner required these damages to be excluded. Chief Justice Earl Warren saw no limitations on congressional taxing power:

Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted.

Indeed, the Glenshaw Glass Court appears to have assumed that the compensatory damages were taxable. Justice Warren stated: "It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury." Nearly four decades later, the Burke Court stated that there was no question that the back pay awards constituted gross income.

Thus the Glenshaw Glass Court’s statement in a footnote that "damages for personal injury are by definition compensatory only" is dictum on which the Murphy taxpayer could not rely. The Court was merely summarizing administrative rulings exempting compensatory damages. The government resisted the taxpayer’s negative implication from Glenshaw Glass.

Ergo, the taxpayer argued, compensatory damages cannot be taxed. There followed a recitation of the history of the various statutory and administrative antecedents of section 104 that somehow left out the 1996 version. The taxpayer succeeded in taking the circuit court back to the pre-1996 version. Essentially, the taxpayer’s lawyer persuaded the court to find negative implications in old Supreme Court decisions deciding the taxability of punitive damages and the nontaxability of share dividends.

The government argued that Congress has broad taxing power under 

\[ \text{Commissioner v. Banks, 543 U.S. 426 (2005), Doc 2005-1418, 2005 TNT 15-10.} \]

This was the case, much debated in these pages, in which the Court held that the part of a damages award representing contingent attorney’s fees had to be taken into income by a plaintiff before it could be deducted. Justice Breyer emphasized the breadth of the section 61 taxing power: "The Internal Revenue Code defines ‘gross income’ for federal tax purposes as ‘all income from whatever source derived.’ The definition extends broadly to all economic gains not otherwise exempted." (Citation omitted.)

All reasonable, but our readers know that in litigation, the government rarely blows a chance to blow a chance. The government argued that people don’t have a basis in their human capital, and there is no human capital depreciation, so all restoration of human capital is taxable because the taxpayer has a zero basis in her well-being. The government even found dicta to say this. Loopy as this line of inquiry is, there is precedent for it in O’Gilvie. Justice Breyer gave replacement of lost human capital as an additional justification for taxation of punitive damages.

The government could have made a more straightforward argument. Gary Becker does not get to decide what is income. Congress does. Judge Ginsburg would not have gone for that.

"The Sixteenth Amendment simply does not authorize the Congress to tax as ‘incomes’ every sort of revenue a taxpayer may receive," Judge Ginsburg reacted, adding that "the power to tax involves the power to destroy." Just when one thinks one is reading a Posse Comitatus tract, the judge goes on. "It would not be consistent with our constitutional government, and the sanctity of property in our system, merely to rely upon the legislature to decide what constitutes income," he concluded.

The judge then recovered his senses and recited the correct test for determining what is income —
In holding that the physical injuries limitation was unconstitutional, Judge Ginsburg seems to have read the controlling Supreme Court precedent backwards. Remember, the Supreme Court refused an invitation to limit the exclusion to physical injuries in *Burke*. Later, in *Schleier*, the Court emphasized that recompense for lost pay and punitive damages was not excludable, even when the precipitating acts caused psychological harms. The Circuit Court appears to be saying that damages can be taxed only when they represent lost wages or punishment. The Supreme Court has never said that, despite ample opportunity to do so.

Things were out of control when Judge Ginsburg cited Albert Einstein at the end of his opinion. “Albert Einstein may have been correct that ‘[t]he hardest thing in the world to understand is the income tax,’” he wrote. Every week around here, we make the tax law understandable, in plain English, and we are not rocket scientists. Hell, we don’t even believe in the theory of relativity.

### The Constitution

On its face, Judge Ginsburg’s argument that section 104(a)(2) is unconstitutional appears reasonable. It is not. His whole premise is wrong. He may have unwittingly declared section 61 unconstitutional.

Section 104(a)(2) does not exclude damages for emotional distress or the physical manifestations of emotional distress. In failing to exclude them, the statute does not affirmatively make those damages taxable. For those damages to be taxable, they would have to be “income” within the meaning of section 61. Judge Ginsburg could have said that damages are not “income” within the meaning of section 61 without declaring section 104(a)(2) unconstitutional. Instead, he appears to have assumed that all items not excluded by section 104 are income.

But his restrictive reading of the concept of income under the Sixteenth Amendment contradicts that assumption. Judge Ginsburg held that Congress cannot tax gross income, but he necessarily assumed that it could and did do so.

Judge Ginsburg is on very shaky constitutional ground in holding that the failure to exclude an item from income violates the Sixteenth Amendment. The restrictive reading of the Sixteenth Amendment is that it merely removes the requirement that the tax be apportioned among the states. (New York state sends $1.23 to Washington for every dollar it gets back.)

Sixteenth Amendment aside, Supreme Court precedent is very clear that, first, Congress is assumed to act within the Constitution when it legislates, and second, Congress need not afford a benefit to any particular constitutionally protected activity.

Judge Ginsburg’s constitutional discussion did not give Congress the presumption of constitutionality that Supreme Court decisions require. And his holding, that failure to afford a tax benefit to certain kinds of damages is unconstitutional, does not square with the Supreme Court’s constitutional decisions or its section 104 decisions. His decision is unabashedly result-oriented. He could not fit the

---

The government could have made a more straightforward argument. Gary Becker does not get to decide what is income. Congress does.
taxpayer’s damaged teeth into the exclusion, according to controlling precedent, so he decided that the statute must be bad.

The requirement of the presumption of constitutionality of congressional acts is long-standing, clear, and continually reaffirmed by the Court. “[W]here an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress,” the Court stated in Edward J. DeBartolo Corp. v. Florida Gulf Coast Building & Construction Trades Council, 485 U.S. 568 (1988). (See also NLRB v. Catholic Bishop of Chicago, 440 U.S. 490 (1979).)

Judge Ginsburg’s decision is unabashedly result-oriented. He could not fit the taxpayer’s damaged teeth into the exclusion, according to controlling precedent, so he decided that the statute must be bad.

“What did ‘the people of the United States’ intend when adopting the Sixteenth Amendment? According to Justice Brandeis:

“This facile response to the intractable problem the Court addresses today is disingenuous at best,” Justice Blackmun concluded. Justice O’Connor, dissenting separately, noted that “we must act with ‘great gravity and delicacy’ when telling a coordinate branch that its actions are absolutely prohibited absent constitutional amendment.”

One of the leading cases on the subject of what is constitutional in tax law involved this very organization, back in our previous incarnation. In Regan v. Taxation With Representation, 461 U.S. 540 (1983), the predecessor of Tax Analysts, publisher of Tax Notes, unsuccessfully argued that the prohibition on lobbying by section 501(c)(3) organizations was unconstitutional, noting that veterans organizations are allowed to lobby.

The Supreme Court stated that Congress has broad discretion in taxation and that the taxpayer has the burden of showing unconstitutionality. The Court held that the failure of Congress to subsidize protected political speech through the tax system did not violate the First Amendment. About the veterans, the Court observed that Congress has the power to make rational distinctions among exempt groups. Congress can choose to benefit veterans more than others.

Translating all of this First Amendment abstraction to Murphy, we find a federal judge failing to afford Congress the required presumption of constitutionality to find a constitutional violation in a failure to allow a tax exclusion. Violation of what constitutional provision? A plenary provision that gives Congress the power to define income.

Eisner was wrong, but the corporate income tax depends on wrong Supreme Court decisions to keep it interesting. Justice Holmes, dissenting in Eisner, argued that the purpose of the Sixteenth Amendment “was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest.” In short, Congress has the power to define what constitutes income.

Justice Louis Brandeis was more direct in his criticism of the majority holding that the Sixteenth Amendment prohibits the taxation of share dividends. “Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this court to hold, that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder?” he asked rhetorically.

What did “the people of the United States” intend when adopting the Sixteenth Amendment? According to Justice Brandeis:
In terse, comprehensive language befitting the Constitution, they empowered Congress “to lay and collect taxes on incomes, from whatever source derived.” They intended to include thereby everything which by reasonable understanding can fairly be regarded as income . . . as this court has so often said, the high prerogative of declaring an act of Congress invalid, should never be exercised except in a clear case.

In its prior consideration of section 104, the Supreme Court has indicated that Congress has plenary power to decide what to tax. The Schleier Court was not asked about the Constitution. Nonetheless, the Court emphasized the breadth of the definition of income under section 61, and the corollary “default rule of statutory interpretation that exclusions from income must be narrowly construed.” The clear implication is that Congress has the right to make these cuts.

The Supreme Court’s attitude toward section 104 seems to be that it is a tax expenditure, despite Justice Breyer’s musings about human capital in O’Gilvie. Pondering why Congress did not exclude punitive damages, Justice Breyer commented:

Tax generosity presumably has its limits. The administrative problem of distinguishing punitive from compensatory elements is likely to be less serious than, say, distinguishing among the compensatory elements of a settlement (which difficulty might account for the statute’s treatment of, say, lost wages).

Justice Breyer was prescient here; he wrote that sentence before the messy physical/emotional distinction of amended section 104 became effective. Murphy tells Congress to return to the pre-1996 version of section 104, not because the holding that the current version is unconstitutional is correct, but because the taxpayer’s case demonstrates that Congress should not be adding to the misery of tort plaintiffs by burdening them with new taxes.

Murphy a Boon for Protesters, Critics Say

By Allen Kenney — akenney@tax.org

The headline-grabbing court decision that declared a piece of the Internal Revenue Code unconstitutional is likely to breathe new life into the tax protest movement, according to some legal observers.

Legal analysts interviewed by Tax Analysts predicted that protesters will flood the court system with new challenges to the legitimacy of the income tax, following the D.C. Circuit Court of Appeals’ ruling in Marrita Murphy v. IRS. In its widely panned opinion, the appeals court held last week that section 104(a)(2) is unconstitutional to the extent that it permits the government to tax compensation that is unrelated to lost wages or earnings. (For related news coverage, see p. 822. For related news analysis, see p. 825.)

“It is impossible to overstate the potential damage caused by this decision — in my 15-plus years in this business, this decision takes the cake for judicial mischief,” said Paul Caron, a professor at the University of Cincinnati College of Law who runs the popular TaxProf Blog (http://taxprof.typepad.com). “It undoes much of the work over the past 20 years by Congress, courts, IRS, and [Justice Department] in stamping out the tax protest movement.”

Critics noted that the decision contains a hint of a popular theory among protesters: that “income” only includes items that represent economic profit, such as dividends, rents, and royalties. As such, they expressed concern that the decision could be read as a validation of the popular antitax argument that wages paid for an individual’s labor are not taxable.

Some protesters “are firmly convinced that wages aren’t income because it’s an even exchange,” argued George Mundstock, a professor at the University of Miami School of Law.
Based on the reactions of two of the most widely recognized leaders of the protest movement, it sounds like critics’ concerns are justified.

“The money that we receive for our labor is merely compensation for our loss of human capital. Given the logic of the Murphy decision, compensation from the loss of human capital must also be excluded from taxation on constitutional grounds,” said Bob Schulz, a noted antitax activist and founder of the We the People Foundation for Constitutional Education.

“I really don’t think it changes anything in the legal landscape,” Evans said. “The same people who were going to file frivolous suits are still going to be doing it; they’re just going to throw this into the hopper. Nobody with any sense is going to be encouraged.”

Evans shared the opinion of many that Murphy will eventually be overturned, and he expressed skepticism that other circuits would follow the ruling. He characterized the decision as a harmless arrow in the protesters’ quiver of futile legal arguments.

“Tax protesters will seize onto anything,” Evans said. “They just love any decision that supports the notion that there are things that Congress can’t tax. Any win gets them all excited, because 99.99 percent of the time they lose.”

Peymon Mottahedeh, president and founder of Freedom Law School in California, called Murphy a “very, very good case.” Mottahedeh’s school offers courses on how to avoid paying income taxes, with titles like “Beat the IRS Now!!!”

Like Schulz, Mottahedeh also expressed hope that the case might lead to a reevaluation of the legal definition of income.

“The court in [Murphy] took 4 pages of small print footnotes discussing the intent of the framers in the Sixteenth Amendment. They could take the same time to look at the income tax issue when it comes to taxing our wages and labor,” he said.

Caron said that unless the decision is reversed, it will generate a similar chorus of “I told you so” from the antitax crowd. He speculated that Murphy will spawn a new generation of protesters who will tie up vast government resources as they wage war in the courts.

“They see [Murphy] as opening the doors to holding a good chunk of the income tax as unconstitutional,” said James Maule, a professor at Villanova University School of Law.

Schulz agreed that Murphy could bring new legal challenges.

“I think this decision may signal an opening of the proverbial ‘Northwest Passage’ for the tax honesty movement,” Schulz commented. “The case opens the door to judicial inquiry into a critical aspect of the individual income tax and the IRS’s purported legal authority to tax all forms of income, regardless of source.”

Despite the excitement of the antitax set, Dan Evans, a Philadelphia lawyer and outspoken critic of the tax resistance movement, downplayed the significance of the decision.
**Murphy: Implications and Advice**

By Steven J. Mopsick and David M. Fogel

Steven J. Mopsick spent more than 30 years as an attorney and as district counsel for the IRS. David M. Fogel, CPA, spent more than 26 years as a tax auditor, revenue agent, and appeals officer for the IRS. Both of them are now in private practice with Mopsick and Little LLP, Sacramento, Calif. E-mail: Steve@MopsickLittle.com and Dave@MopsickLittle.com.


Assuming the federal government appeals, if *Murphy* is upheld, it has the potential to generate thousands of refund claims totaling millions of dollars. CPAs, enrolled agents, and other tax practitioners should advise clients who received personal injury settlements and who reported those settlements as taxable income on their income tax returns that they may wish to file amended returns to protect their rights.

**Background**

Our system of income taxation begins with the premise that income derived from whatever source is included in gross income.1 The code allows individuals to exclude from gross income some specific items (sections 101 through 153), and it allows taxpayers to take other deductions from gross income (sections 161 to 249), resulting in taxable income. One of the exclusions is found in section 104: compensation for injuries or sickness.

What happens when a court rules that an award received as a result of a personal injury lawsuit is not included in gross income in the first place? Essentially, that’s what happened in *Murphy*.

**Murphy**

In 1994 Marrita Murphy filed a complaint with the Department of Labor alleging that her former employer, the New York Air National Guard (NYANG), had blacklisted her and had violated whistle-blower laws after she had complained to state authorities about environmental hazards on a NYANG airbase. The secretary of Labor ruled that NYANG had unlawfully discriminated and retaliated against Murphy and sent the case to an administrative law judge to determine compensatory damages. The ALJ recommended damages of $70,000, of which $45,000 was for emotional distress and $25,000 for injury to Murphy’s professional reputation. She received the damage award in 2000.

Murphy reported the $70,000 on her original income tax return and later filed an amended return claiming that the $70,000 was excludable from income under section 104(a)(2). The IRS disallowed her claim, and she filed suit in U.S. district court. In her lawsuit, she argued that the $70,000 represented damages for personal physical injuries and was excludable from income under section 104(a)(2),2 and, in the alternative, that section 104(a)(2) as applied to her award was unconstitutional because the award was not “income” under the Sixteenth Amendment to the Constitution.3

The district court rejected both arguments and Murphy appealed. The Court of Appeals for the D.C. Circuit rejected Murphy’s first argument but accepted her second argument, holding that section 104(a)(2) as applied to her award was unconstitutional.

The appeals court examined the legislative history of the Revenue Act of 1918 (the first revenue act to address the tax treatment of compensatory damages for personal injuries) and concluded that the Sixteenth Amendment, ratified in 1913, did not intend to treat compensation for personal injuries as “income.” The appeals court held that section 104(a)(2) is unconstitutional insofar as it permits the taxation of an award of damages for emotional distress and loss of reputation.4

---

1See section 61(a).

---

Section 104(a)(2) allows a taxpayer to exclude from gross income amounts received for personal injuries. Before 1996, “personal injuries” included nonphysical injuries including emotional distress, injury to one’s reputation, discrimination, wrongful termination, and sexual harassment. The Small Business Job Protection Act of 1996 (P.L. 104-188) changed the law by requiring the damages to be “on account of personal physical injuries or physical illness.”

The Sixteenth Amendment, ratified in 1913, says, “Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

In part, the appeals court relied on *Burk-Waggoner Oil Assn. v. Hopkins*, 269 U.S. 110, 114 (1925), in which the U.S. Supreme Court ruled that the Sixteenth Amendment does not authorize Congress to tax as income every sort of revenue that a taxpayer receives, and in part on *Dotson v. United States*, 87 F.3d 682, 685, Doc 96-20362, 96 TNT 140-8 (5th Cir. 1996), in which the Court of Appeals for the Fifth Circuit said Congress first enacted the personal injury compensation exclusion in 1918 when those...
Far-Reaching Implications

The implication of Murphy is that damages received for personal injuries — including nonphysical injuries including emotional distress, injury to one’s reputation, discrimination, wrongful termination, and sexual harassment — are not included in gross income. Not that they are excluded from gross income, but that they are not included in gross income in the first place. The court specifically carved out an exception for damages for lost earnings and punitive damages, which are included in gross income.

The IRS surely will not agree with the decision. We expect the IRS either to appeal to the U.S. Supreme Court or to announce that it will follow the decision only in cases under the jurisdiction of the D.C. Circuit.

Advice for Tax Practitioners

The IRS may issue guidance on filing amended returns as a result of the Murphy decision. For now, we are recommending to clients who received and reported as income a settlement or award of damages for personal injuries (excluding damages for loss of earnings or punitive damages) to file amended income tax returns for the years in which they received the settlement or damage award, as long as the years are open under the statute of limitation for filing refund claims. We recommend that other tax practitioners also determine which of their clients may be affected by the Murphy decision and assist them with the preparation and filing of amended returns.

Tax-Free Damages: Murphy’s Law Opens Floodgates

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (http://www.woodporter.com) and is the author of Taxation of Damage Awards and Settlement Payments (3d Ed. Tax Institute 2005 with 2006 update), available at http://www.damageawards.org. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Most tax lawyers only dimly remember constitutional law. I took constitutional law 30 years ago at the University of Chicago, and it was taught by a German, Prof. Gerhard Casper. As he went on to bigger and better things (such as serving as president of Stanford), I wondered why I kept saying “Marbury v. Madison” with a German accent and, more broadly, just how the U.S. Constitution was relevant to federal income tax. Now I know — at least about the latter point. I just filed a Tax Court petition arguing unconstitutionality for the first time, feeling oddly like Lawrence Tribe.

I was able to file the petition because on August 22, 2006, the U.S. Court of Appeals for the District of Columbia Circuit decided Marrita Murphy v. IRS.1 Whether you read this case with a German accent or not, it is a whopping decision. In many ways, it is a garden-variety tax case, involving a taxpayer who received a recovery (arising out of a whistle-blower action). Marrita Murphy argued that her recovery was excludable, and those arguments usually fail in court. However, they can often be favorably resolved administratively.

In any event, this opinion is momentous both in its interpretation of section 104(a)(2) (the oft-maligned personal physical injury exclusion), and even more so in its interpretation of the Sixteenth Amendment and its correspondingly restrictive view of Congress’s power to levy taxes.

In short, this case is a big deal.

Pedestrian Background

This tax case arose out of a whistle-blower case. Murphy alleged that her former employer, the New York Air National Guard, blacklisted her and provided unfavorable references after she complained about environmental hazards. Although her claim was about blacklisting, in an administrative hearing she submitted evidence of mental and physical injuries as a result of the blacklisting. A physician testified that she had “somatic” and “emotional” injuries. One of those was bruxism (teeth grinding usually associated with stress that can cause permanent tooth damage). The administrative law judge determined that she had other physical manifestations of payments were considered the return of “human capital” and thus not constitutionally taxable as income under the Sixteenth Amendment.

stress too, including anxiety attacks, shortness of breath, and dizziness. The ALJ recommended compensatory damages of $70,000 — $45,000 of which was for “emotional distress or mental anguish” and $25,000 for “injury to professional reputation.”

Significantly, none of her award was for lost wages or diminished earning capacity. Note the exact wording of the awards because, in the subsequent tax case, it was important exactly how the award was worded. The award was affirmed by a Department of Labor Administrative Review Board, so Murphy got her money. She included the entire $70,000 in her 2000 gross income, paying $20,665 in taxes. Later, she filed an amended return claiming that it was excludable from her income. The IRS denied her refund claim, and Murphy sued in district court.

She argued that her recovery was for personal physical injuries, and therefore excludable under section 104(a)(2). Alternatively, she claimed section 104(a)(2) as applied to her award was unconstitutional because the award was not income within the meaning of the Sixteenth Amendment. The IRS raised various objections, and the district court granted summary judgment to the government. Appealing to the D.C. Circuit, Murphy argued both the section 104 point and the constitutional point.

The One-Two Punch

Whatever happens with the subsequent history of the Murphy case (more about a U.S. Supreme Court bid later), for years there will be discussion about Murphy and its treatment of section 104. Murphy was quite right to argue that section 104(a)(2) could cover her injuries, since bruxism is physical, and since somatic is defined in the dictionary as “relating to or affecting the body, especially as distinguished from a body part, the mind or the environment.” Cleverly, Murphy also argued that the dental records she submitted showed that the bruxism resulted in permanent damage to her teeth.

The D.C. Circuit addressed both the statutory section 104 argument and the more metaphysical “what is income?” question, noting that summary judgment is appropriate only if there is no genuine issue regarding any material fact and if the moving party is entitled to judgment as a matter of law.

Before we discuss how the three-judge panel of the D.C. Circuit treated the statutory and constitutional arguments, it’s worth foreshadowing the conclusion. It was easy to tell early on in the opinion which way the wind was blowing. The court seemed sweet on the taxpayer and harsh in its rejections of government contentions. For that matter, although the court came out in favor of the government on the statutory issue, the judges seemed inclined to listen to the taxpayer’s physical injury arguments as well. More about the significance of that below.

Section 104 in the Limelight

Many people may read the Murphy case and gloss over the statutory discussion. After all, when you have a howitzer, why worry about a BB gun? Yet, long after the constitutional debate has subsided (and in whatever later courts that constitutional debate takes place), I believe that section 104(a)(2) will still be with us and that we tax advisers will still be interpreting it. That makes the section 104 discussion in Murphy the sleeper part of the decision.

Indeed, I would argue that this aspect of the case may in time overshadow the more flamboyant constitutionality holding. The statutory argument is nothing new, although the lawyers in Murphy presented it with unusual flare. Basically, Murphy experienced both mental and physical pain. According to the testimony she submitted in her underlying administrative proceeding, her former employer’s blacklisting resulted in somatic and emotional injuries. She suffered bruxism, anxiety attacks, shortness of breath, and dizziness.

Persuaded by that evidence, the ALJ awarded her $45,000 for “emotional distress or mental anguish,” and $25,000 for “injury to professional reputation” due to the blacklisting. Those ALJ findings turned out to be critical to the tax result. I say that because the court stressed that none of her award was for lost wages or diminished earning capacity. That directly fed into the constitutional notion that the amounts were truly not income because they were compensating Murphy for something that was not taxable in the first place (her well-being and reputation).

The wording of the order was also critical from another perspective. Because the ALJ entered the fateful

TAX PRACTICE AND ACCOUNTING NEWS

What is worth reiterating here, particularly to aficionados of procedure, is that the case went to the D.C. Circuit after the government won in the district court on a motion for summary judgment. Because of that, I was expecting (once I tested the wind) for the case to be remanded, and for the summary judgment the IRS had achieved to be vacated. Given that summary judgment is a pretrial motion to obviate trial, I was also expecting the remand to direct the district court to proceed with a trial of the case.

Instead, after concluding that section 104 was unconstitutional, at least as applied to this taxpayer, the appellate court concluded its opinion with:

We remand this case to the district court to enter an order and judgment instructing the Government to refund the taxes Murphy paid on her award plus applicable interest.

That was surprising, at least to me. Perhaps the explanation lies in the overwhelmingly dispositive nature of a constitutionality finding. The statutory argument (which the district court and court of appeals both resolved in favor of the IRS) falls by the wayside. After all, how can it matter what section 104(a)(2) actually says, when the second holding is that it is unconstitutional as applied to this taxpayer?

Footnotes:


5Slip op. at p. 24.
phrases “emotional distress or mental anguish” and “injury to professional reputation,” the argument was foreclosed that section 104(a)(2) applied by its terms. Despite that language, Murphy argued that her award did compensate her for personal physical injuries. There was no question that Murphy’s claim was based on tort or tort-type rights in the applicable whistle-blower statutes. The IRS did not challenge the tort or tort-type rights basis, but disputed whether her injuries were physical.

Any student of this area will recall that the Supreme Court laid down a two-part test for excludability in Commissioner v. Schleier.5 Before a taxpayer can exclude compensatory damages from gross income under section 104(a)(2), Schleier says he must demonstrate that: (1) the underlying cause of action giving rise to the recovery was based on tort or tort-type rights and (2) the damages were awarded on account of personal physical injuries or physical sickness. The latter element, debated in Murphy, may not be the linchpin of the case in light of its unconstitutionality holding. Despite that, it is vitally important.

Getting Physical?

Just what is physical injury, anyway? The IRS has not been speedy in writing regulations to define it. We all know the statute was changed in 1996 to require physical injury or physical sickness, rather than merely personal injury or sickness. We also all know that administratively (in private letter rulings, for example), the IRS has suggested its view that the injury must be visible.6 One can see broken bones and bruising, but many injuries or illnesses are not apparent to the naked eye. (Of course, I’m not even sure the naked eye is all that matters here; maybe “observable” would include viewing it with a microscope?)

For 10 years now, taxpayers have grappled in the dark with the question of which injuries are physical and which are not.7 Are ulcers? The Vincent case suggests that ulcers are indeed physical, although Nancy Vincent did not qualify for an exclusion because the Tax Court concluded that the jury in her underlying case was never asked to consider her physical problems. Thus, quite literally, the Vincent jury is still out on the ulcer question.

What about migraines, cluster headaches, or strokes? The oft-quoted legislative history to the 1996 act states that mere symptoms of emotional distress do not constitute physical injuries. The cited examples include headaches, stomachaches, and insomnia.8 The famous footnote enumerating those three items was allegedly written by House Ways and Means Committee staffer Tim Hanford, now a Washington lobbyist. Hanford says that he believes the list was not meant to be exclusive.

But even for the items on the list, exactly what is a stomachache? Does a bleeding ulcer qualify, or is it, despite its physical situs, beyond a mere stomachache, and therefore more than a symptom of emotional distress? If headaches are not sufficient to constitute physical injuries, what about cluster headaches or migraines? What about an aneurysm? Questions of degree abound.

Murphy argued cogently that the legislative history to the 1996 change surely attempts to separate transitory symptoms from serious and permanent physical injuries and physical sickness. Hers were not comparatively minor, transitory symptoms of emotional distress like headaches, upset stomach, and sleeplessness.

That broaches the territory of one of the great unspoken phrases of the tax law: physical sickness. Section 104 excludes from gross income damages for physical injuries and physical sickness, yet the latter receives no attention in the literature, the case law, or anywhere else.9 If one cannot draw a bright line between physical injuries on one hand and mere symptoms of emotional distress on the other, I submit that the grains of sand are even more intermingled when it comes to physical sickness and symptoms of emotional distress. However, section 104(a)(2) — whether it is constitutional or not — clearly excludes from income damages for physical sickness.

If the IRS will not define the term “physical” in regulations (as so far it doesn’t seem inclined to do), then should taxpayers be able to resort to a dictionary? Murphy thought so.10 She pointed to her physician’s testimony that she had experienced “somatic” and “body” injuries “as a result of [the defendant’s] blacklist[ing].” She also pointed to the American Heritage Dictionary, which defines “somatic” as “relating to, or affecting the body, especially as distinguished from a body part, the mind or the environment.” Murphy also submitted her dental records to the IRS, proving that she had suffered permanent damage to her teeth. Are those not physical?

The word “physical” comes from medieval Latin and was first recorded in English in the 14th century.12 It means bodily or corporeal, as distinguished from spiritual.13 Synonyms for physical include carnal, corporal,

---

9See Conference Committee Report 104-737, p. 300.
11Not only did Murphy use the dictionary in her statutory argument, but she also did so in her constitutional attack. She used several dictionary definitions of accession to wealth to show that she had not received one.
13Id.
corpooreal, material, and somatic. Quite apart from rudimentary sources like a dictionary, what about nontax case law defining the term?

Cleverly, Murphy cited several federal court decisions showing that for various purposes, substantial physical problems caused by emotional distress are considered physical injuries or physical sickness. Those aren’t tax cases, of course, but they are cases in which the physical manifestations of emotional distress were regarded as physical injuries. For example, in Walters v. Mintec/International the Third Circuit held that a plaintiff could recover for physical harm caused by the emotional disturbance of an accident. The court based its decision on the Restatement of Torts, which requires physical harm for damages to be available.

Although admittedly not occurring in the context of an income tax dispute, the Walters case squarely presents the question of whether an injury resulting from emotional disturbance can be “physical” harm. Concluding that it can, the Third Circuit quotes from the comments to the Restatement of Torts:

The fact that [emotional disturbance is] accompanied by transitory, non-recurring phenomena, harmless in themselves, such as dizziness, vomiting, and the like, does not make the actor liable where such phenomena are in themselves consequential and do not amount to any substantial bodily harm. On the other hand, long continued nausea or headaches may amount to physical illness, which is bodily harm; and even long continued mental disturbance . . . may be classified by the courts as illness, notwithstanding their mental character.

Murphy relied on another nontax case, Payne v. General Motors Corp., involving an employee who sued an employer under Title VII of the Civil Rights Act of 1964 and section 1981 for negligent infliction of emotional distress. The employee suffered from constant exhaustion and fatigue, diagnosed by a psychologist as resulting from the employee’s depression. The employee’s depression, in turn, was allegedly caused by the employer’s discrimination. The court held the problems constituted “physical injuries,” which were a prerequisite to maintaining an action for negligent infliction of emotional distress under Kansas law.

Against the background of those nontax cases, Murphy argued that neither section 104 nor its regulations limit the physical injury exclusion to an injury occurring by physical stimulus. In fact, Murphy understandably pointed out that the Treasury regulations under section 104 track the pre-1996 version of section 104, before the “physical” modifier was added. The D.C. Circuit stops short of criticizing the IRS for failing to change its regulations 10 years after the statute was amended.

More than a few readers of Murphy will discern that the appellate court was none too happy with the IRS or the Treasury Department, let alone with Congress. Nevertheless, the court acknowledged that the old section 104 regulations and the current 1996 act version of section 104 were not, in fact, the language of the regulations being at odds with the more explicit language of the statute. In what turned out to be a Pyrrhic victory for the IRS, the court said the statute controlled.

The IRS diverts attention from the word “physical” and instead focuses on the “on account of” nexus. Section 104 provides an exclusion only for amounts paid “on account of” physical injury or physical sickness. The IRS argued that Murphy had to demonstrate that she was awarded her damages “because of” her physical injuries. The IRS claimed that she did not do that, and in fact, that the ALJ finding had been expressly to the contrary. Again, here is where language truly matters. It was of no moment, said the IRS, that Murphy suffered from bruxism or other physical manifestations of stress.

After all, the labor board ruling was quite explicit that her damages were expressly for “mental pain and anguish” and “injury to professional reputation.” Those, said the IRS, are nonphysical injuries. Ultimately, the D.C. Circuit agreed with the government that Murphy failed to carry her burden on that point. Although Murphy argued valiantly that she suffered “physical” injuries, she could not rebut the “on account of” argument. As a result, the D.C. Circuit concluded that on its face, section 104(a)(2) does not permit Murphy to exclude her award from her gross income.

’re On Account Of’ Haiku

Before turning to the constitutional argument that is the headliner of this case, it is worth examining what the “on account of” relationship suggests. If the ALJ order had in fact mentioned bruxism (or the other physical symptoms) as the reason for an award, would not Murphy have satisfied the “on account of” test? I think so.

Moreover, given that the vast majority of cases do not go to a verdict or administrative ruling, but rather are settled, what does that suggest about the settlement process? In most cases, there is an explicit allocation among various amounts paid by a defendant to a plaintiff. In a whistle-blower case, there might be wage and nonwage categories. Although the IRS might seek to limit the holding of Murphy to cases in which wages are not an element (as they were not in Murphy), I believe the analysis of the Murphy Court should apply to many nonwage recoveries even if there is a wage element in the case.

Further, this case may portend a more thorough application of the “on account of” enigma. What if the evidence showed that the ALJ awarded the money to Murphy because of her bruxism, and acknowledged that the bruxism was caused by the emotional distress, which was caused by the defendants? What if the judge’s order so states, or if there is a transcript in which the judge’s reasoning is clear even though the judge ultimately states in his order that the payment is “for emotional distress”?

15758 F.2d 73 (3d Cir. 1985).
My point is that the award for emotional distress and the award for bruxism may not be all that different. If one accepts the notion that the physical injury (or sickness?) results from emotional distress, and that the defendant caused it, then perhaps the physical injury and the emotional distress truly are the same thing. It was clear long before Murphy that the wording of the court order (or here, the administrative order) was crucial.

Since the court in Murphy ultimately concluded (almost reluctantly) that Murphy did not carry her burden of showing that her recovery really was “on account of” the physical injury/sickness, it is worth asking what would have worked. Notes? Pleadings? A transcript? Surely the language of the order itself cannot be the only reference point. The IRS has long taken the position that it is not bound by characterizations in court orders or settlement agreements.18 Surely that rule should work both ways.

Before turning to the U.S. Constitution, let’s belabor the “on account of” link, for much depends on those three little words. In fact, I believe they will continue to be important, despite the current constitutional hiatus Murphy has imposed. The starting point must be section 104 itself, which excludes “...damages ... received ... on account of personal physical injuries or physical sickness.” The relevant nexus is between the damages received and the injury; the statute does not require a relationship between the tortious act and physical injuries or sickness for which damages are received. The “on account of” language originates from a statute enacted in 1918,19 and the same language appeared in the 1939, 1954, and 1986 codes.

In 1996 Congress amended section 104(a)(2) to exclude punitive damages from the statute and to require that the personal injury or sickness be physical. Significantly, the 1996 amendments did not alter the “on account of” language. According to the legislative history:

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. (Emphasis added.)

There are two crucial points here. First, the relevant “on account of” nexus is between damages and a physical injury or sickness (that is, all damages that “flow therefrom”). The action must have its origin in a physical injury or sickness, but there need not be any causal nexus between the tort and the injury.

Second, the recipient need not be the one who suffers physical injuries. A payment can be “on account of” physical injury or sickness even if the plaintiff is not injured, but recovers on behalf of an injured party (for example, recoveries for loss of consortium).

The Supreme Court analyzed the “on account of” language in three decisions over the last 15 years: United States v. Burke;23 Schleier,24 and O’Gilvie v. United States,25 although the Murphy court addressed only O’Gilvie. In Burke, the Court ruled that section 104(a)(2) is not satisfied when the underlying claim does not provide for tort-like remedies (that is, a broad range of damages, including for pain, suffering, and emotional distress). In Schleier, the Court said that to fall within section 104(a)(2), each item of damages must be proximately connected to the physical injury. The Schleier Court used the direct-connection approach, demonstrably stopping short of proximate cause between the cause of action and the damages.24 The relevant nexus is between recovery and injury, not between tortious act and injury.

In O’Gilvie, the issue was whether punitive damages were received “on account of” a personal injury. The Court adopts a stringent “on account of” standard, holding that “on account of” requires that damages be awarded “by reason of, or because of” the personal injury.26 The O’Gilvie Court noted that the original aim of the statute was to exclude damages intended to substitute for physical or personal well-being — “personal assets that the Government does not tax and would not have taxed had the victim not lost them.”26 Applying that reasoning, the Court found that punitive damages were not received “on account of” personal injury or sickness because they do not compensate for any type of loss.

Other courts have applied O’Gilvie to require a causal connection between the injury and the damages (not between the tortious act and the injury). For example, in Barnes v. Commissioner27 the court held that “on account of” requires a “strong causal connection” between the injury and the damages. In Brabson v. United States,28 the Tenth Circuit held that “on account of” requires “a direct link between the injury and the remedial relief.”29 In Fabry v. Commissioner,30 the Eleventh Circuit ruled that “on account of” requires a “direct causal link” between the elements of the tort and the elements of damages.

Even the IRS has sometimes agreed, although it has had trouble maintaining consistency. In LTR 200121031, a taxpayer was awarded damages for her husband’s death from a “physical disease” — lung cancer associated with

---

19See Revenue Act of 1918, ch. 18, section 213(b)(6).
22Supra note 5.
24Schleier, 515 U.S. at 330.
25O’Gilvie, 519 U.S. at 454.
26Id. at 456.
28297 F.3d 1040, Doc 96-3551, 96 TNT 25-24 (10th Cir. 1996).
29Id. at 1047.
31See also Gregg v. Commissioner, T.C. Memo. 1999-10, Doc 1999-3623, 1999 TNT 15-7 (holding that “on account of” requires damages be paid by reason of a personal injury or sickness); Thompson v. Commissioner, T.C. Memo. 1998-214, Doc 98-13631, 98 TNT 117-8 (“The question is for what was the amount paid.”).
the husband’s inhalation of asbestos. Allowing the wife to exclude the recovery from asbestos manufacturers under section 104(a)(2), the IRS reasoned that the husband contracted a physical disease from exposure to asbestos and that the “diseases were the proximate cause of the circumstances giving rise to” the taxpayer’s claims. The IRS ruled: “Because there exists a direct link between the physical injury suffered and the damages recovered, taxpayer may exclude from gross income any economic damages compensating for such injury.”32

Returning to Murphy, what does “on account of” mean? The phrase continues to have a Kafkaesque quality, and given its manifest importance, that itself is troubling. The Murphy court says O’Gilvie makes the exclusion available only for personal injury damages awarded by reason of, or because of, the personal injuries. However, the court again cites O’Gilvie for the notion that something stronger than but-for causation is required.

I find those gradations of “why” a payment is made troubling. I believe the IRS does too. Despite the constitutional reach of Murphy, and multiple Supreme Court cases attempting to explicate the nebulous “on account of” haiku, even Murphy with its sweeping convictions fails to clean that one up.

Constitutional Argument

Having concluded that section 104 did not allow Murphy to exclude her damages from income, the D.C. Circuit went on to address whether that is constitutional. That’s a curious turn of events because section 104(a)(2) is manifestly an exclusionary provision. Is it the constitutionality of section 104 or of section 61 that the court is evaluating? The court invariably refers to section 104(a)(2), but more than a few technicians will doubtless wonder whether the more appropriate attack would have been on section 61.

Those niceties aside, the attack is a powerful one in both its verbiage and in its historical moment. Plus, not too many tax decisions cite those hoary and hallowed decisions of yore. The D.C. Circuit refers to Helvering v. Clifford,33 which held that the word “incomes” in the Sixteenth Amendment and the phrase “gross income” in section 61(a) are coextensive. From there, the court goes on to construct the statute, as the Supreme Court did in Eisner v. Macomber.34

Speaking of Eisner takes me back to my first tax class,35 and I suspect many other tax lawyers have a similar memory. In Eisner (no, not Michael Eisner, but generations earlier), the Supreme Court held that the taxing power extended to any “gain derived from capital, from labor, or from both combined.” Refining that concept in Commissioner v. Glenshaw Glass Co.,36 the Supreme Court said that Congress was able to tax all gains or accessions to wealth.

In addition to asking what constitutes “physical” injuries, or what “on account of” means, we also have to ask just what is a gain? What is an accession to wealth? Tax advisers rarely consider such esoterica. I know I don’t.

Plucky Ms. Murphy, however, argued that restorations of capital are not income. Accordingly, she argued that her damage award for personal injuries, including non-physical injuries, was simply not income but rather a restoration of capital — human capital, that is. For that proposition, Murphy cited — as did the D.C. Circuit — Nobel Laureate Gary Becker.37 Murphy argued that the concept of human capital was read into the IRC by the Supreme Court in Glenshaw Glass.

That’s a mouthful, but there it is. Bear in mind that Glenshaw Glass was a case in which the Supreme Court sought to determine the tax treatment of punitive damages. Not only that, but Glenshaw Glass was a case in which the Court said the damages were taxable. As you chew on that, note that the court in Murphy quotes from the Glenshaw Glass opinion:

The long history of... holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property... damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.38

Murphy argued that the Supreme Court in Glenshaw Glass made clear that a recovery of compensatory damages for a personal injury — of whatever type — is analogous to a return of capital and therefore is not income under the code or the Sixteenth Amendment. (Another more unadorned reading of Glenshaw Glass might have been that “punitive damages are income.”)

In any event, historical analysis then blossomed. Murphy went on to argue that the code was drafted shortly after the 1913 passage of the Sixteenth Amendment. Murphy focused on three sources that the Supreme Court quoted 80 years later in O’Gilvie. It is worth repeating those sources because Murphy’s argument — accepted by the D.C. Circuit — was that those timely musings indicated the contemporaneous common understanding of the word “income.” This is fundamental stuff.

Pages of History

First, in an opinion rendered to the secretary of Treasury on whether proceeds from an accident insurance policy were income (under the code as it existed before the 1918 act), the attorney general stated:

32LTR 200121031, Doc 2001-15011, 2001 TNT 103-10 (emphasis added).
33309 U.S. 331 (1940).
34252 U.S. 189 (1920).
35That was in 1976, with the University of Chicago’s Walter J. Blum, who inspired me to become a tax lawyer.
3648 U.S. 426 (1955).
38See Glenshaw Glass, 348 U.S. at 432, note 8.
Without affirming that the human body is in a technical sense the “capital” invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore “capital” as distinguished from “income” receipts.\footnote{39}31 Op. Att’y Gen. 304, 308 (1918).

Not long thereafter, Treasury reasoned in a revenue ruling that:

Upon similar principles . . . an amount received by an individual as the result of a suit or compromise for personal injuries sustained . . . through accident is not income [that is] taxable.\footnote{40}T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

The third quote came from the House report on what became the Revenue Act of 1918:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen’s compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income.\footnote{41}H.R. Rep. No. 65-767, at 9-10 (1918).

When Congress passed the Revenue Act of 1918, it included a provision to exclude from gross income “amounts received, through accident or health insurance or under workman’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.”\footnote{42}40 Stat. 1057, 1066 (1919), enacting section 213(b)(6).

Because the 1918 act followed soon after ratification of the Sixteenth Amendment, Murphy argued that the statute reflected the meaning of the amendment as it would have been understood by those who framed, adopted, and ratified it. She noted that in \textit{Dotson v. United States},\footnote{43}37 F.3d 682, 96 TNT 144-9 (5th Cir. 1996), the court concluded (on the basis of that House report) that “Congress first enacted the personal injury compensation exclusion . . . when such payments were considered the return of human capital, and thus not constitutionally taxable ‘income’ under the 16th amendment.”\footnote{44}

Constitutional arguments in tax cases generally don’t fare well. Murphy had winnowed her arguments significantly by the time her case reached the D.C. Circuit. In the district court she had also argued that the 1996 amendments to section 104 resulted in an unconstitutional retroactive application of law, and that it violated the due process and takings clauses of the Fifth Amendment. The district court rejected those arguments, and Murphy dropped them on appeal.

It is easy to imagine IRS (and Justice Department) blood boiling over the mere mention of those arguments, let alone imagine that a court would take them seriously. After all, how many Supreme Court cases have upheld the taxation of nonwage recoveries? Wasn’t that all vetted many times over the years, most recently when Congress amended section 104 to explicitly tax nonphysical injuries? Surely Congress had the power to do that, didn’t it?

With considerable verve, the government advanced many arguments, some general and some specific, about why Murphy’s constitutional argument should fail. Despite that valiant effort, the court rejected every government argument. The government (understandably) argued that there is a presumption that Congress enacts laws within its constitutional limits.\footnote{45}It argued that as recently as \textit{Commissioner v. Banks},\footnote{46}45 U.S. 426, 1871 U.S. 173 (1991), the Supreme Court underscored Congress’s power to tax income, affirming that the power “extends broadly to all economic gains.”\footnote{47}Glenshaw Glass Co. v. Commissioner,\footnote{48}465 U.S. 426, 48716 F.2d 693 (1983).

That Congress historically chose in its discretion (and maybe even generosity) to exclude some personal injury recoveries did not mean that the Sixteenth Amendment mandated that exclusion, the government noted.

Indeed — although that argument plainly did not play well to the D.C. Circuit — the IRS stated flatly that Congress could repeal section 104 entirely, and that doing so would plainly not violate the Sixteenth Amendment! Taking issue with Murphy’s “human capital” theory, the IRS even attempted to explain the corollary concept of “financial capital,” citing concepts such as basis under section 1012, how one adjusts basis, and so forth. That got messy and inelegant.

The IRS argued that people do not pay cash or cash equivalents to acquire their own well-being, so they have no basis in it. When they have gain or loss on the realization of compensatory damages, that means they have no basis on which to calculate that gain or loss. Those arguments somehow did the government more harm than good here.

\textbf{All Things Great and Small}

Just as Murphy made some obscure points (like footnote 8 in the \textit{Glenshaw Glass} opinion), the government found itself relying on dicta from the Ninth Circuit opinion in \textit{Roemer v. Commissioner}.\footnote{49}In \textit{Roemer}, a defamation recovery was held excludable under the old version of section 104. The dicta relied on by the government in Murphy suggests that since there is no tax basis in a person’s health and personal interests, money received for an injury to those interests might be considered a realized accession to wealth.\footnote{50}Maybe relying on that obscurity was a mistake.

In any event, nothing went well for the government in this case. After lining up the arguments, the D.C. Circuit flatly said, “we reject the government’s breathtakingly expansive claim of congressional power under the Sixteenth Amendment.”\footnote{51}Take that!

The D.C. Circuit then went on to say that when the Sixteenth Amendment was drafted, the word “incomes”...
had well-understood limits. A return of capital is just not income.\(^{51}\) Turning away from the return of capital point, the circuit court then said that the question in this case was not about return of capital — "except insofar as Murphy analogizes human capital to physical or financial capital."\(^{52}\) The question, said the D.C. Circuit, is fundamental: Was the compensation she received for her injuries income?

In an appropriate attempt at harmonization among the circuits, the Murphy court launched its "is it income?" analysis by saying, "We join our sister circuits by asking: 'in lieu of what were the damages awarded?'"\(^{53}\) For that fundamental query, the court cites Raytheon Products Corp. v. Commissioner\(^{54}\) and other cases. Finding significant support for the "in lieu of" test in case law (referring to both O'Giltie and Glenshaw Glass), the court said that if Murphy received the money in lieu of something that is normally untaxed, her compensation is not income under the Sixteenth Amendment.

Simply and elegantly, the court then said that the record was clear that the damages Murphy received were to make her emotionally and reputationally whole, not to compensate her for lost wages or taxable earnings of any kind. Her emotional well-being and good reputation — before they were diminished by her former employer — were not taxable as income. Therefore, said the court, the compensation she received in lieu of what she lost cannot be considered income.

Showing a moment of reticence, the circuit court proffered that "it would appear" that the Sixteenth Amendment does not empower Congress to tax Murphy's award. However, the court noted that "our conclusion at this point is tentative because the Supreme Court has also instructed that, in defining 'incomes,' we should rely on 'the commonly understood meaning of the term which must have been in the minds of the people when they adopted the 16th Amendment.'"\(^{55}\) Citing from Myers v. United States,\(^{56}\) and again from Eisner v. Macomber,\(^{57}\) the court went on to discuss the Revenue Act of 1918, and generally agreed with Murphy's view of the more or less contemporaneous writings suggesting that the term "incomes" as used in the Sixteenth Amendment does not extend to moneys received solely in compensation for a personal injury and unrelated to lost wages or earnings.

The court then stated that emotional distress and loss of reputation were both actionable in tort when the Sixteenth Amendment was adopted. That fact supported the view that compensation for those nonphysical injuries was not regarded differently than compensation for physical injuries. Therefore, said the court, it was not considered income by the framers of the Sixteenth Amendment, nor by the state legislatures that ratified it.

By 1913, 39 of the then 48 states and the District of Columbia included the concept in their tort law that compensatory damages for "mental suffering" were recoverable in the same manner as compensatory damages for physical harms.

Moreover, in 34 of those states, there were reported cases involving defamation and other reputational injuries. The Murphy court dropped a four-page footnote string citing state law cases to prove it. On top of that, in at least five other states, an action for alienation of affections (also a nonphysical injury) was allowed. All in all, the court found no meaningful distinction between Murphy's award and the kinds of damages recoverable for personal injury when the Sixteenth Amendment was adopted. Completing its argument, the court said:

Because, as we have seen, the term "incomes," as understood in 1913, clearly did not include damages received in compensation for a personal injury, we infer that it likewise did not include damages received for a nonphysical injury and unrelated to lost wages or earning capacity.\(^{58}\)

The court referred to early IRS authority making clear that the Service (then) drew no distinction between nonphysical and personal injuries. Concluding that compensation for loss of personal attributes is not received in lieu of income, and that the framers of the Sixteenth Amendment would not have understood compensation for a personal injury — including a nonphysical injury — to be income, the court was done:

Therefore, we hold § 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.\(^{59}\)

As noted above, the Murphy court does not remand the case to district court for trial, but rather directs the district court to issue an order and judgment instructing the government to refund Murphy's taxes, plus interest. In the same paragraph, the court quotes Albert Einstein saying that "the hardest thing in the world to understand is the income tax,"\(^{60}\) but the court says plainly that "it is not hard to understand that not all receipts of money are income."\(^{61}\) Deftily, the D.C. Circuit just wiped away volumes of tax case law and decades of jurisprudence, and dramatically threw into disarray the post-1996 law of section 104.

**Where to From Here?**

It is not hyperbole to say that Murphy is nothing short of amazing. Many tax lawyers (myself included, I confess) are dusting off their copies of the Constitution and referring to constitutional arguments in their pleadings. Except perhaps for state and local tax lawyers who argue about sales tax, nexus, and points of that ilk, constitutional arguments have generally been relegated to tax accounting.
protesters. No more. As I noted at the outset, I just made my first constitutional argument in a Tax Court petition, and I have never represented a tax protester.

Whether or not one agrees with the opinion and its reasoning, the D.C. Circuit can hardly be dismissed as flaky. The three judges on the Murphy panel are notable circuit court judges — Chief Judge Douglas H. Ginsburg plus Judges Judith Ann Wilson Rogers and Janice Rogers Brown — and they are to be reckoned with. But exactly how will they be reckoned with? The IRS has multiple choices.

It can petition the D.C. Circuit for a rehearing. I would suppose that would be done here, although I somehow doubt that a rehearing, even if requested and granted, is likely to result in a sea change. Court watchers may have statistics on the number of times a case is reversed in a rehearing. This case is of such enormous impact that the oddsmakers may start to weigh in.

Second, the IRS can petition the U.S. Supreme Court for certiorari. I suspect that is likely to occur. Despite the constitutional holding in the case, there is no right to appeal, but only a discretionary power in the Supreme Court to take the case or not. Again, there will be oddsmakers and statistics. Maybe on such a fundamental constitutional question the High Court will have no choice.

But remember the multiple times the Supreme Court refused to resolve the attorney fee question, denying certiorari despite a vehement split among the circuits? Like Julius Caesar, who, according to Mark Anthony’s funeral oration, thrice refused a kingly crown, the High Court kept denying certiorari before it finally took on Banks.62 If the IRS seeks certiorari, as I hope it will, it is possible the Supreme Court will step sideways. (Incidentally, look what ended up happening to Caesar.)

Third, the IRS could do nothing. Tacticians will readily appreciate that despite the undoubted conviction the IRS must have that Murphy is overwhelmingly wrong (if not downright blasphemous), the IRS might not wish to risk a far greater loss in the Supreme Court. I hope that caution does not prevail. Indeed, until we know whether Murphy is the law of the land, this entire area will be thrown into disarray.

Fourth, the IRS could acquiesce in the Murphy decision and then apply its rationale nationwide. That seems as unlikely as Bob Dole marryng Britney Spears. Finally, whether or not the IRS attempts to push this case into the Supreme Court, the Service could continue to litigate nonphysical injury cases across the country, seeking appropriate litigation vehicles in other circuits. That seems likely.

Categories of Cases to Which This Will Apply

Leaving aside the situs questions Murphy raises about the reach of a D.C. Circuit case across the country, although we’ll return to that topic shortly, what kinds of cases may be affected by Murphy? In addition to whistleblower cases that do not involve wages (similar to the Murphy fact pattern), I suggest that the following types of cases may be affected:

- defamation;
- intentional and negligent infliction of emotional distress;
- false imprisonment;
- malicious prosecution; and
- invasion of privacy.

Of course, there may be many others. The $64,000 question may be Murphy’s effect on employment cases. The IRS may argue that Murphy should apply only to cases not arising in the employment context (that is, cases in which there are no wages). However, that seems difficult to argue.

After all, Murphy did arise in the employment context. Whether or not Murphy received an award attributable to wages, the rest of the decision should not be affected. Although one might argue that the wage vs. nonwage dichotomy might lead to abuses, with taxpayers having even greater reasons to push an allocation further away from wages, that dichotomy has always existed.

Short Circuit?

In the D.C. Circuit, Murphy now represents the law of the land. I believe that means the IRS is bound by the decision until someone says otherwise. The Murphy case strikes down section 104(a)(2) as it is applied to a taxpayer like Murphy. Plus, it is probably within the spirit of the case that section 61 (which is unmarred by the decision) cannot now be used by the IRS to contradict the Murphy holding. Plainly, taxpayers in the D.C. Circuit are not going to report their emotional distress and other nonwage and nonphysical injury settlements. That means taxpayers in the D.C. Circuit will be back to pre-1996 act law, when section 104(a)(2) did not use the word “physical.”

Moreover, that will occur not only from the August 22, 2006, date of Murphy, but retroactively for taxpayers who settled their cases earlier in 2006 or, indeed, in 2005, 2004, and 2003. For some taxpayers, 2002 will still be open. Some taxpayers will file amended returns. From firsthand experience, I can tell you that taxpayers are already planning those maneuvers.

Can taxpayers go back to years closed by the statute of limitations? My first reaction is that the statute of limitations is an absolute bar, and that taxpayers cannot go back and amend returns for years before the applicable statute. But perhaps someone will think of a way to do even that.

Although I see the reach of Murphy as quite far, there may be differences of opinion about the “nonwage” linchpin of the case. Murphy did arise in an employment context, even though no wages were awarded. As noted above, I don’t see an appropriate line being drawn
between nonemployment cases on one hand (such as defamation cases, false imprisonment, intentional or negligent infliction of emotional distress, and so on) and employment cases on the other.

It is a foregone conclusion that the reasoning of Murphy does not apply to wage recoveries. But, in a case in which someone recovers $200,000 in wages and $300,000 in nonwage nonphysical personal injury damages, I see no credible basis on which to argue that the Murphy holding does not apply to the $300,000. Plainly, there may be questions about the appropriateness of the allocation between wage and nonwage, but that strikes me as the only ground for debate. Of course, the wage vs. nonwage issue has always been there. It will surely remain present.

Murphy’s nonwage focus could have the curious effect of making recoveries in the nonemployment field (garden-variety intentional infliction of emotional distress cases, for example) more attractive from a tax perspective than a similar case in the employment arena. The taint of wages will clearly be stronger in the employment context. That’s a reversal of the position that exists regarding attorney fees, in which the new above-the-line deduction in employment cases makes employment cases taxed more favorably than nonemployment ones (when it comes to attorney fees). Given that the vast majority of cases settle, and it is a rare employment case in which all amounts are treated as wages, Murphy will surely affect many employment cases.

The effect of Tax Court Rule 143 may also be debated. In general, that rule provides that trials in the Tax Court are to be conducted under the rules of evidence applicable to trials without jury in the U.S. District Court for the District of Columbia. Before you get too excited, the “D.C. trumps the rest of the U.S.” rule is limited to the rules of evidence and does not extend to substantive interpretations of tax law. Still, some have argued that this makes (some) tax cases coming out of the D.C. District or Circuit court more important than tax cases in any other circuit. If you are a taxpayer and, like most taxpayers, your court of choice is the Tax Court (where, notably, you don’t have to pay your tax before you dispute it), you may agree. Yet, it seems unlikely that anything in the Murphy case can be made out to be a ruling on evidence.

Still, it is a ruling of an important circuit court — not an allegedly wacko one, as some have labeled the Ninth Circuit, or an allegedly agrarian one, as some have labeled the Tenth. The D.C. Circuit is right up there with the Second Circuit, the former home of Learned Hand, whose ruminations on tax law still feature prominently in tax jurisprudence, particularly in tax shelter litigation and other economic substance debates.

Other Circuits
The presence of a split in the circuits on those issues is daunting. Many litigators and tax practitioners will remember the split in the circuits on attorney fee issues that existed before the Supreme Court decided Banks in 2005. A split in the circuits tends to encourage manipulative behavior, although it is certainly understandable why it does.

Will taxpayers attempt to somehow import D.C. Circuit law to their cases in other states and other circuits? Will taxpayers actually move to the D.C. Circuit? To take advantage of the circuit’s law, must they move before their case is resolved, before they receive the money, or only in time to file their Tax Court petition (if they even have to fight about it)? Tax procedure aficionados will start thinking about the Golsen rule, which indicates the applicable law when a Tax Court case is filed.

That I am raising those questions does not mean I have all the answers. I am not even certain those are all the right questions. Taxpayers and practitioners will be scrambling. Moreover, the far larger and more amorphous questions concern Murphy’s effect throughout the country — without any maneuverings.

What if there are no conflicting circuit court cases in other jurisdictions? The Murphy court positions itself as following the “in lieu of” test of all its sister circuits. Will the IRS treat Murphy as substantial authority throughout the United States? Whether the answer to that question is yes or no, many taxpayers will doubtlessly adopt the view of the Murphy court. Whether they are in Kansas or California, Louisiana or Maine, I imagine, will take the position that a nonphysical injury recovery (for emotional distress, defamation, and so forth) is simply not income.

Is Murphy Substantial Authority?
Given that many taxpayers may take filing positions based on Murphy (new filing and amended filing), it is appropriate to question whether the IRS could impose penalties on taxpayers should those positions not be sustained. Generally speaking, penalties should not be imposed on a taxpayer even if the taxpayer ultimately loses a tax case, as long as the taxpayer had “substantial authority” for the position.

The substantial authority standard is objective, involving an analysis of the law and an application of the law to the facts. The substantial authority standard is less stringent than the “more likely than not” standard, but more stringent than the “reasonable basis” standard. Just what is and what is not substantial authority isn’t always clear. The regulations tell us that the weight of authorities supporting the tax treatment claimed must be

---

64See section 7453.
65For full details, see Wood, “Taxation of Attorneys’ Fees Altered by the Jobs Act and the Supreme Court,” 57th Annual Tax Institute, USC Law School, 2005 Tax Institute, ch. 4, no. 1.
67See Golsen v. Commissioner, 54 T.C. 742, 747 (1970), aff’d on other issue, 445 F.2d 983 (10th Cir. 1971).
68See reg. section 1.6662-4(d)(2).
“substantial” in relation to the authorities’ supporting contrary positions. That sounds circular. If it is substantial, then it’s substantial?

The weight of an authority depends on its relevance, its persuasiveness, and the type of document providing the authority. The regulations mention revenue rulings, private letter rulings, technical advice memorandums, and so on. Age is relevant too, and some documents more than 10 years old are generally given very little weight. That’s a curious reference point, although surely it is not meant to suggest that recent authority is entitled to heavy weight.

When it comes to court cases, the regulations state that the applicability of a court case to a particular taxpayer by reason of the taxpayer’s residence in a particular jurisdiction generally is not taken into account in determining whether there is substantial authority for the position. However, substantial authority does exist when the tax treatment of the item is supported by controlling precedent of the circuit court of appeals to which the taxpayer has a right of appeal. I take that to mean that if you have controlling precedent in your circuit, where your Tax Court case would be appealed, you do have substantial authority. Conversely, if you are relying on another circuit’s precedent — say you’re relying on Murphy even though you live in the Ninth Circuit — that doesn’t necessarily mean you do not have substantial authority.

In *Wise v. Commissioner*, the Tax Court (interpreting former reg. section 1.6661-3(b)(1), the predecessor to reg. section 1.6662-4(d)(3)) held that the taxpayer’s reliance on a single Eleventh Circuit case supporting his position was substantial authority, even though the IRS’s position was supported by opinions of the Fourth, Fifth, Sixth, and Eighth Circuits, as well as several Tax Court opinions. In *Unger v. Commissioner*, the Tax Court found substantial authority (again, declining to impose the former section 6661 penalty) when the taxpayer was able to present some cases in support of a “novel” legal argument.

In other words, if you have a good case in your own circuit, you are apparently golden. If you have a good case somewhere else, whether you have substantial authority is likely to depend on how recent it is (evidently something hot off the press is better than something 60 years old), how persuasive its logic is, just how much other adverse authority there is that contradicts it, and so forth. From what I can tell so far (although I stress I’ve not yet made a study of this point), a case like *Murphy* has little to contradict it. If I’m right, that may mean that taxpayers on similar facts throughout the United States may have substantial authority to exclude that which the 1996 act sought to tax with its addition of the “physical” qualifier.

However, the regulations suggest that a return position that is arguable but fairly unlikely to prevail in court does not meet the substantial authority standard. Many tax lawyers might say that a repeat of the *Murphy* case, involving another unconstitutional finding by any other circuit court or by the U.S. Supreme Court, is quite unlikely. That may suggest caution, but I do not believe many taxpayers will be cautious in light of the sweeping taxpayer victory *Murphy* presents.

**Company Reactions**

It is not only plaintiffs who will react. Plaintiffs’ lawyers are already attempting to educate themselves and their clients about what this will mean. There will be many misguided efforts and a great deal of misinformation. Corporate America must also respond. Corporate defendants will face requests to not issue IRS Forms 1099 for nonwage settlements. If a payment is excludable under section 104, it should not be the subject of a Form 1099. Taxpayers know that. Plaintiffs’ lawyers know that. Defendants know that.

True, there are often debates at settlement time, and there are often mistakes made and blood spilled over Form 1099 issues. However, when the lawyers involved in settling a case consider the issue at settlement time, those issues usually get worked out. In my experience, there is give and take at arm’s length between plaintiffs and defendants, with plaintiffs not asking for too much and defendants not yielding too much. In the main, that leads to equitable results.

How that will change with *Murphy* I don’t know. Plaintiffs will become much more aggressive, and defendants must know how to respond. In the D.C. Circuit, that may be easy. Elsewhere, it will not be.

**Settle Your Case!**

Pragmatists will readily note that *Murphy* was a tax refund case. Potential Form 1099 mismatch issues aside, had Murphy not reported her recovery on her initial return, she likely would not have faced a tax dispute. A fight avoided is often a fight won.

Of course, *Murphy* was also a case that went to judgment, or at least its administrative equivalent. The vast majority of cases settle, and the tax flexibility a settlement generally offers cannot be gainsaid. Just look at the mutual fund and brokerage industry settlements and, more recently, Boeing’s settlement tax antics.

Everyone knows — or should know — that the time to address those issues is before settlement documents are signed. I am convinced that, quite apart from litigation risks, concerns about publicity, the high cost of lawyers’
fees, and other factors that auger toward settlement, many cases settle as much for tax reasons as for any of those seemingly more dispositive reasons.

**IRS Guidance**

Whatever else it may be, Murphy is a wake-up call to the IRS to issue guidance under section 104, preferably in the form of regulations. Although it may not be able to embark on that course until it attempts to clear the air of the constitutional gauntlet now in play, I believe that in the future we will still be dealing with the confines of section 104 in one way or another.

I also believe the IRS will suffer a chilling affect on attacks under section 104. Every taxpayer will now come (to audits, appeals conferences, and so forth) armed with constitutional invective, and IRS employees at many different levels may see that. Even before Murphy, I saw IRS employees put their own gloss on section 104, often according a more liberal view than I believe the National Office espouses. (That is yet another unintended backfire the IRS achieved by not issuing regulations under section 104.)

Now, I expect that trend will be more pronounced. If the IRS has any hope of damage control, it must give firm and fast internal guidance to the field about how to address those issues. Even if the IRS gives this guidance, the tide of exclusions may become Katrina-like. Napoleon had his Waterloo. Like the Federal Emergency Management Agency, the IRS may have its New Orleans.

**Scrabble Game**

Speaking of wake-up calls, lawyers got one too. Yes, they got a subtle lesson about how settlement is almost always better than a verdict, but they also got some pointers in tax lingua franca. If “on account of” means what it seems to mean, exact wording may be more important than the intent of the payer and other traditional indicia.

Plaintiffs’ lawyers often draft court orders for judges to sign. Although that change will not happen overnight, I believe plaintiffs’ lawyers will become even more sensitized to tax linguistics. I note that plaintiffs’ lawyers already want to include battery claims in employment cases on appropriate facts, a plain (if not immediate) reaction to the “physical” adjective now in section 104. In short, they will learn.

Quite apart from court orders, settlement documents, already a fertile field for tax considerations, will plainly become more so. The vast, vast, vast majority of cases settle. You do the math.

**Structured Settlements**

Murphy may also affect the structured settlement industry, the arm of the life insurance business that implements periodic payment settlements to plaintiffs. Section 104 makes clear that payments on account of physical injuries or physical sickness are excludable regardless of whether they are made in a lump sum or via periodic payments. A structured settlement enables the plaintiff to receive a stream of payments, with the entirety of each payment being excludable from income, even though (under traditional annuity principles) one might view a portion of each payment as constituting interest.

Section 104 may be the reason the structured settlement industry exists, but section 130 is its linchpin. Under section 130, a qualified assignee has no income on receipt of an assignment from a defendant, as long as the qualified assignee purchases a qualified funding annuity and the periodic payments are excludable from the claimant’s gross income under section 104(a)(2). The qualified assignee is the owner of the annuity. It has income when the annuity issuer makes payments under the annuity, and then has a corresponding deduction in the same amount when the payment is received by the claimant. Those are the basics of qualified assignments.

The structured settlement industry has adapted to the linkage between section 130 and section 104 by using “nonqualified” assignments for any case that falls outside section 104, and thus outside the protection of section 130. By employing an assignment company that is not subject to tax in the United States, the industry avoids the mismatch between the one-time assignment from the defendant with its lump sum payment and the corollary stream of payments to the claimant over time. Interestingly, the nonqualified side of the industry is growing tremendously, fueled by the increased use of structured settlements in employment cases, and in many other nonpersonal physical injury suits.

How does Murphy affect that? It’s not clear. Some have argued that if a payment is not excludable under section 104(a)(2) — because under Murphy the payment is not income at all — section 130 cannot apply either. That technical point is an interesting one, and arguably important given the billions of dollars flowing into structured settlement annuities every year.

It is hard for me to imagine that logic being applied; however, one of the principal effects of Murphy will be a reexamination of what is and is not excludable. Practitioners won’t care if it is section 104 or the Constitution that exempts a settlement or judgment from tax.

However, because Murphy strikes down section 104(a)(2) only “as applied” to some cases, it should have no effect on most section 130 assignments. Traditionally, section 130 assignments are only for true physical injury tort cases. The cases in the gray Murphy area are now those that are nonwage and nonphysical. That would include defamation, intentional and negligent infliction of emotional distress, and so forth. Today (or at least pre-Murphy), those cases are treated by the structured settlement industry as nonqualified, not relying on section 130.

If tomorrow the industry were to suddenly start treating, based on Murphy, all those recoveries as excludable, using ostensibly “qualified assignments” for those cases, there may be a problem. However, it is hard to imagine the structured settlement industry treating all

---

79 Perhaps a paraphrase of the Murphy court’s holding is that to be constitutional, section 104(a)(2) must now be read without the word “physical.”

---

those nonwage nonphysical injury cases as excludable — at least until some of Murphy’s dust settles. Even if the industry were to start doing that, I’m not convinced that the distinction between gross income excludable under section 104(a)(2) and amounts that are not gross income at all would be drawn by the IRS, which surely has bigger fish to fry. But it’s a risk, and an interesting technical point.

Conclusion

It is too soon to say which of my predictions about Murphy will come true. Yet, from whatever perspective you view this case, it is epochal. Even if the D.C. Circuit changes its mind on rehearing, or the U.S. Supreme Court hears the case and reverses it, some teachings of the case will remain, and may help generations of taxpayers.

But I should hardly talk as if a reversal of Murphy is a foregone conclusion. Clearly, many taxpayers (not to mention employment lawyers) nationwide are dancing jigs, hoping that the Supreme Court will do nothing — or if the Court does take the case, that Murphy’s superb lawyering will carry the day a second time.

The IRS and Justice Department must be scrambling. For them, Murphy merits a veritable slough of metaphors and allusions. Truly, this is the IRS’s worst nightmare — salt in a wound; snakes on a plane; the IRS’s own bridge of sighs; the Gordian knot. However you cast it, it has to be one of the most devastating and potentially far-reaching of losses for the IRS.

TAX NOTES WANTS YOU!

Tax Notes has a voracious appetite when it comes to high-quality analysis, commentary, and practice articles. Do you have some thoughts on tax reform? Circular 230? Tax shelters? Federal budget woes? Recent IRS guidance? Important court decisions? Maybe you’ve read a revenue ruling that has flown under the radar but is full of traps for the unwary.

If you think what you have to say about any federal tax matter might be of interest to the nation’s tax policymakers, academics, and leading practitioners, please send your pieces to us at taxnotes@tax.org.
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued February 24, 2006               Decided August 22, 2006

No. 05-5139

MARRITA MURPHY AND
DAVID J. LEVEILLE,
APPELLANTS

v.

INTERNAL REVENUE SERVICE AND
UNITED STATES OF AMERICA,
APPELLEES

Appeal from the United States District Court
for the District of Columbia
(No. 03cv02414)

David K. Colapinto argued the cause for appellants. With him on the briefs was Stephen M. Kohn.

Colin M. Dunham was on the brief for amicus curiae No Fear Coalition in support of appellant.

Before: GINSBURG, Chief Judge, and ROGERS and BROWN, Circuit Judges.

Opinion for the Court filed by Chief Judge GINSBURG.

GINSBURG, Chief Judge: Marrita Murphy brought this suit to recover income taxes she paid on the compensatory damages for emotional distress and loss of reputation she was awarded in an administrative action she brought against her former employer. Murphy contends that under § 104(a)(2) of the Internal Revenue Code (IRC), 26 U.S.C. § 104(a)(2), her award should have been excluded from her gross income because it was compensation received “on account of personal physical injuries or physical sickness.” In the alternative, she maintains § 104(a)(2) is unconstitutional insofar as it fails to exclude from gross income revenue that is not “income” within the meaning of the Sixteenth Amendment to the Constitution of the United States.

We hold, first, that Murphy’s compensation was not “received ... on account of personal physical injuries” excludable from gross income under § 104(a)(2). We agree with the taxpayer, however, that § 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.

I. Background

In 1994 Marrita Leveille (now Murphy) filed a complaint with the Department of Labor alleging that her former employer, the New York Air National Guard (NYANG), in violation of various whistle-blower statutes, had “blacklisted” her and provided unfavorable references to potential employers after she
had complained to state authorities of environmental hazards on a NYANG airbase. The Secretary of Labor determined the NYANG had unlawfully discriminated and retaliated against Murphy, ordered that any adverse employment references to the taxpayer in Office of Personnel Management files be withdrawn, and remanded her case to an Administrative Law Judge “for findings on compensatory damages.”

On remand Murphy submitted evidence that she had suffered both mental and physical injuries as a result of the NYANG’s blacklisting her. A physician testified Murphy had sustained “somatic” and “emotional” injuries. One such injury was “bruxism,” or teeth grinding often associated with stress, which may cause permanent tooth damage. Upon finding Murphy had also suffered from other “physical manifestations of stress” including “anxiety attacks, shortness of breath, and dizziness,” the ALJ recommended compensatory damages totaling $70,000, of which $45,000 was for “emotional distress or mental anguish,” and $25,000 was for “injury to professional reputation” from having been blacklisted. None of the award was for lost wages or diminished earning capacity.

In 1999 the Department of Labor Administrative Review Board affirmed the ALJ’s findings and recommendations. See Leveille v. N.Y. Air Nat’l Guard, 1999 WL 966951, at *2-*4 (Oct. 25, 1999). On her tax return for 2000, Murphy included the $70,000 award in her “gross income” pursuant to § 61 of the IRC. See 26 U.S.C. § 61(a) (“[G]ross income means all income from whatever source derived”). As a result, she paid $20,665 in taxes on the award.

Murphy later filed an amended return in which she sought a refund of the $20,665 based upon § 104(a)(2) of the IRC, which provides that “gross income does not include ... damages ... received ... on account of personal physical injuries or
physical sickness.” In support of her amended return, Murphy submitted copies of her dental and medical records. Upon deciding Murphy had failed to demonstrate the compensatory damages were attributable to “physical injury” or “physical sickness,” the Internal Revenue Service denied her request for a refund. Murphy thereafter sued the IRS and the United States in the district court.

In her complaint Murphy sought a refund of the $20,665, plus applicable interest, pursuant to the Sixteenth Amendment, along with declaratory and injunctive relief against the IRS pursuant to the Administrative Procedure Act and the Due Process Clause of the Fifth Amendment to the Constitution of the United States. She argued her compensatory award was in fact for “physical personal injuries” and therefore excluded from gross income under § 104(a)(2). In the alternative Murphy asserted § 104(a)(2) as applied to her award was unconstitutional because the award was not “income” within the meaning of the Sixteenth Amendment. The Government moved to dismiss Murphy’s suit as to the IRS, contending the Service was not a proper defendant, and for summary judgment on all claims.

The district court denied the Government’s motion to dismiss, holding that Murphy had the right to bring an “action[] for declaratory judgments or ... [a] mandatory injunction” against an “agency by its official title,” pursuant to § 703 of the APA, 5 U.S.C. § 703. Murphy v. IRS, 362 F. Supp. 2d 206, 211-12, 218 (2005). The court then rejected all Murphy’s claims on the merits and granted summary judgment for the Government and the IRS. Id. at 218. Murphy now appeals the judgment of the district court with respect to her claims under § 104(a)(2) and the Sixteenth Amendment.
II. Analysis

We review the district court’s grant of summary judgment de novo, Flynn v. R.C. Tile, 353 F.3d 953, 957 (2004), bearing in mind that summary judgment is appropriate only “if there is no genuine issue as to any material fact and if the moving party is entitled to judgment as a matter of law,” Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250 (1986). Before addressing Murphy’s claims on their merits, however, we must determine whether the district court erred in holding the IRS was a proper defendant.

A. The IRS as a Defendant

The Government contends the courts lack jurisdiction over Murphy’s claims against the IRS because the Congress has not waived that agency’s immunity from declaratory and injunction actions pursuant to 28 U.S.C. § 2201(a) (Courts may grant declaratory relief “except with respect to Federal taxes”) and 26 U.S.C. § 7421(a) (“no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person”); and insofar as the Government has waived immunity for civil actions seeking tax refunds under 28 U.S.C § 1346(a)(1), that provision on its face applies to “civil action[s] against the United States,” not against the IRS. In reply Murphy argues only that the Government forfeited the issue of sovereign immunity because it did not cross-appeal the district court’s denial of its motion to dismiss. See Fed. R. App. P. 4(a)(3). Notwithstanding the Government’s failure to cross-appeal, however, the court must address a question concerning its jurisdiction. See Occidental Petroleum Corp. v. SEC, 873 F.2d 325, 328 (D.C. Cir. 1989) (“As a preliminary matter ... we must address the question of our jurisdiction to hear this appeal”).
Murphy and the district court are correct that § 703 of the APA does create a right of action for equitable relief against a federal agency but, as the Government correctly points out, the Congress has preserved the immunity of the United States from declaratory and injunctive relief with respect to all tax controversies except those pertaining to the classification of organizations under § 501(c) of the IRC. See 28 U.S.C. § 2201(a); 26 U.S.C. § 7421(a). As an agency of the Government, of course, the IRS shares in that immunity. See Settles v. U.S. Parole Comm'n, 429 F.3d 1098, 1106 (D.C. Cir. 2005) (agency “retains the immunity it is due as an arm of the federal sovereign”). Insofar as the Congress has waived sovereign immunity with respect to suits for tax refunds under 28 U.S.C. § 1346(a)(1), that provision specifically contemplates only actions against the “United States.” Therefore, we hold the IRS, unlike the United States, may not be sued eo nomine in this case.

B. Section 104(a)(2) of the IRC

Section 104(a) ("Compensation for injuries or sickness") provides that "gross income [under § 61 of the IRC] does not include the amount of any damages (other than punitive damages) received ... on account of personal physical injuries or physical sickness." 26 U.S.C. § 104(a)(2). Since 1996 it has further provided that, for purposes of this exclusion, "emotional distress shall not be treated as a physical injury or physical sickness." Id. § 104(a). The version of § 104(a)(2) in effect prior to 1996 had excluded from gross income monies received in compensation for "personal injuries or sickness," which included both physical and nonphysical injuries such as emotional distress. Id. § 104(a)(2) (1995); see United States v. Burke, 504 U.S. 229, 235 n.6 (1992) ("§ 104(a)(2) in fact encompasses a broad range of physical and nonphysical injuries to personal interests"). In Commissioner v. Schleier, 515 U.S. 323 (1995), the Supreme Court held that before a taxpayer may
exclude compensatory damages from gross income pursuant to § 104(a)(2), he must first demonstrate that “the underlying cause of action giving rise to the recovery [was] ‘based upon tort or tort type rights.’” Id. at 337. The taxpayer has the same burden under the statute as amended. See, e.g., Chamberlain v. United States, 401 F.3d 335, 341 (5th Cir. 2005).

Murphy contends § 104(a)(2), even as amended, excludes her particular award from gross income. First, she asserts her award was “based upon ... tort type rights” in the whistle-blower statutes the NYANG violated -- a position the Government does not challenge. Second, she claims she was compensated for “physical” injuries, which claim the Government does dispute.

Murphy points both to her physician’s testimony that she had experienced “somatic” and “body” injuries “as a result of NYANG’s blacklisting [her],” and to the American Heritage Dictionary, which defines “somatic” as “relating to, or affecting the body, especially as distinguished from a body part, the mind, or the environment.” Murphy further argues the dental records she submitted to the IRS proved she has suffered permanent damage to her teeth. Citing Walters v. Mintec/International, 758 F.2d 73, 78 (3d Cir. 1985), and Payne v. General Motors Corp., 731 F. Supp. 1465, 1474-75 (D. Kan. 1990), Murphy contends that “substantial physical problems caused by emotional distress are considered physical injuries or physical sickness.”

Murphy further contends that neither § 104 of the IRC nor the regulation issued thereunder “limits the physical disability exclusion to a physical stimulus.” In fact, as Murphy points out, the applicable regulation, which provides that § 104(a)(2) “excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness,” 26 C.F.R. § 1.104-1(c), does not distinguish between physical injuries stemming from physical
stimuli and those arising from emotional trauma; rather, it tracks the pre-1996 text of § 104(a)(2), which the IRS agrees excluded from gross income compensation both for physical and for nonphysical injuries.

For its part, the Government argues Murphy’s exclusive focus upon the word “physical” in § 104(a)(2) is misplaced; more important is the phrase “on account of.” In O’Gilvie v. United States, 519 U.S. 79 (1996), the Supreme Court read that phrase to require a “strong[] causal connection,” thereby making § 104(a)(2) “applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries.” Id. at 83. The Court specifically rejected a “but-for” formulation in favor of a “stronger causal connection.” Id. at 82-83. The Government therefore concludes Murphy must demonstrate she was awarded damages “because of” her physical injuries, which the Government claims she has failed to do.

Indeed, as the Government points out, the ALJ expressly recommended, and the Board expressly awarded, compensatory damages “because of” Murphy’s nonphysical injuries. The Board analyzed the ALJ’s recommendation under the headings “Compensatory damage for emotional distress or mental anguish” and “Compensatory damage award for injury to professional reputation.” In describing the ALJ’s proposed award as “reasonable,” the Board stated Murphy was to receive “$45,000 for mental pain and anguish” and “$25,000 for injury to professional reputation.” That Murphy suffered from bruxism or other physical symptoms of stress is of no moment, the Government argues, because “the Board awarded her damages, not to compensate [her for that] particular injury, but explicitly with respect to nonphysical injuries.”

In reply Murphy merely reiterates that she suffered
“physical” injuries. She does not address the Government’s point that she received her award “on account of” her mental distress and reputational loss, not her bruxism or other physical symptoms.

Murphy’s failure to address the Government’s position is telling. Although the pre-1996 version of § 104(a)(2) was at issue in O’Gilvie, the Court’s analysis of the phrase “on account of,” which phrase was unchanged by the 1996 Amendments, remains controlling here. Murphy no doubt suffered from certain physical manifestations of emotional distress, but the record clearly indicates the Board awarded her compensation only “for mental pain and anguish” and “for injury to professional reputation.” Leveille, 1999 WL 966951, at *5. The Board thus having left no room for doubt about the grounds for her award, we conclude Murphy’s damages were not “awarded by reason of, or because of, ... [physical] personal injuries,” O’Gilvie, 519 U.S. at 83. Therefore, § 104(a)(2) does not permit Murphy to exclude her award from gross income.* But is that constitutional?

C. The Sixteenth Amendment

The Government of the United States is a government of limited powers: “Every law enacted by Congress must be based on one or more of its powers enumerated in the Constitution.” United States v. Morrison, 529 U.S. 598, 607 (2000). The

*Insofar as compensation for nonphysical personal injuries appears to be excludable from gross income under 26 C.F.R. § 1.104-1, the regulation conflicts with the plain text of § 104(a)(2); in these circumstances the statute clearly controls. See Brown v. Gardner, 513 U.S. 115, 122 (1994) (finding “no antidote to [a regulation’s] clear inconsistency with a statute”).
The constitutional power of the Congress to tax income is provided in the Sixteenth Amendment, ratified in 1913:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Supreme Court has held the word “incomes” in the Amendment and the phrase “gross income” in § 61(a) of the IRC are coextensive. See Helvering v. Clifford, 309 U.S. 331, 334 (1940) (§ 61 represents the “full measure of [the Congress’s] taxing power”). When it first construed those terms in Eisner v. Macomber, 252 U.S. 189, 207 (1920), the Supreme Court held the taxing power extended to any “gain derived from capital, from labor, or from both combined.” Later, after explaining that Eisner was not “meant to provide a touchstone to all future gross income questions,” the Court added that under the IRC -- and, by implication, under the Sixteenth Amendment -- the Congress may “tax all gains” or “accessions to wealth.” Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955).

Murphy argues that, being neither a gain nor an accession to wealth, her award is not income and § 104(a)(2) is therefore unconstitutional insofar as it would make the award taxable as income. Broad though the power granted in the Sixteenth Amendment is, the Supreme Court, as Murphy points out, has long recognized “the principle that a restoration of capital [i]s not income; hence it [falls] outside the definition of ‘income’ upon which the law impose[s] a tax.” O’Gilvie, 519 U.S. at 84; see, e.g., Doyle v. Mitchell Bros. Co., 247 U.S. 179, 187-88 (1918); S. Pac. Co. v. Lowe, 247 U.S. 330, 335 (1918) (return of capital not income under IRC or Sixteenth Amendment). By analogy, Murphy contends a damage award for personal injuries

According to Murphy, the Supreme Court read the concept of “human capital” into the IRC in *Glenshaw Glass*. There, in holding that punitive damages for personal injury were “gross income” under the predecessor to § 61, the Court stated:

The long history of ... holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property .... Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.

348 U.S. at 432 n.8. In Murphy’s view, the Court thereby made clear that the recovery of compensatory damages for a “personal injury” -- of whatever type -- is analogous to a “return of capital” and therefore is not income under the IRC or the Sixteenth Amendment.

In support of her reading of the caselaw, Murphy contends the IRC, as drafted shortly after “passage of the [Sixteenth] Amendment demonstrates that compensatory damages designed to make a person whole are excluded from the definition of ‘income.’” She focuses upon the three sources the Supreme Court quoted in *O’Gilvie*, 519 U.S. 84-87, to wit, an Opinion of the Attorney General, a Decision of the Department of the Treasury, and a Report issued by the Ways and Means Committee of the House of Representatives -- each of which predates the first version of § 104(a)(2), namely, § 213(b)(6) of

In an opinion rendered to the Secretary of the Treasury on the question whether proceeds from an accident insurance policy were income under the IRC as it stood prior to the 1918 Act, the Attorney General stated:

Without affirming that the human body is in a technical sense the “capital” invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore “capital” as distinguished from “income” receipts.

31 Op. Att’y. Gen. 304, 308 (1918). In a revenue ruling, the Department of the Treasury then reasoned that

upon similar principles ... an amount received by an individual as the result of a suit or compromise for personal injuries sustained ... through accident is not income [that is] taxable.


As for the House Report on the bill that became the Revenue Act of 1918, it states:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen’s compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income.
H.R. Rep. No. 65-767, at 9-10 (1918). Thereafter, the Congress passed the Act, § 213(b)(6) of which excluded from gross income “[a]mounts received, through accident or health insurance or under workman’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.” 40 Stat. 1057, 1066 (1919).

Because the 1918 Act followed soon after ratification of the Sixteenth Amendment, Murphy contends that the statute reflects the meaning of the Amendment as it would have been understood by those who framed, adopted, and ratified it. She observes that in Dotson v. United States, 87 F.3d 682 (5th Cir. 1996), the court concluded upon the basis of the House Report that the “Congress first enacted the personal injury compensation exclusion ... when such payments were considered the return of human capital, and thus not constitutionally taxable ‘income’ under the 16th amendment.” Id. at 685.

The Government attacks Murphy’s constitutional argument on all fronts. First, invoking the presumption that the Congress enacts laws within its constitutional limits, see Rust v. Sullivan, 500 U.S. 173, 191 (1991), the Government asserts at the outset that § 104(a)(2) is constitutional even if, as amended in 1996, it does permit the taxation of compensatory damages. Indeed, the Government goes further, contending the Congress could, consistent with the Sixteenth Amendment, repeal § 104(a)(2) altogether and tax compensation even for physical injuries.

Noting that the power of the Congress to tax income “extends broadly to all economic gains,” Commissioner v. Banks, 543 U.S. 426, 433 (2005), the Government next maintains that compensatory damages “plainly constitute economic gain, for the taxpayer unquestionably has more money
after receiving the damages than she had prior to receipt of the award.” On that basis, the Government contends Murphy’s reliance upon footnote eight of *Glenshaw Glass* is misplaced; merely because the Congress “has historically excluded personal injury recoveries from gross income, based on the make-whole or restoration-of-human-capital theory, does not mean that such an exclusion is mandated by the Sixteenth Amendment.” Because the Supreme Court in *Glenshaw Glass* was construing “gross income” with reference only to the IRC, the Government argues footnote eight addresses only a now abandoned congressional policy, not the outer limit of the Sixteenth Amendment.

According to the Government, the same is true of the 1918 Act and the interpretive rulings that preceded it. Although the Government acknowledges that the dictum in *Dotson*, 87 F.3d at 685, accords with Murphy’s position, the Government notes the court there relied solely upon the House Report. Because the House Report merely states “it is doubtful whether ... compensation for personal injury or sickness ... [is] required to be included in gross income,” H.R. Rep. No. 65-767, at 9-10 (1918), the Government observes that the “report simply does not establish that Congress believed taxing compensatory personal injury damages would be unconstitutional.”

In addition, the Government challenges the coherence of Murphy’s analogy between a return of “human capital or well-being” and a return of “financial capital,” the latter of which it acknowledges does not constitute income under the Sixteenth Amendment. See *Doyle*, 247 U.S. at 187; *S. Pac. Co.*, 247 U.S. at 335. The Government first observes that financial capital, like all property, has a “basis,” defined by the IRC as “the cost of such property,” 26 U.S.C. § 1012, adjusted “for expenditures, receipts, losses, or other items, properly chargeable to [a] capital account,” id. § 1016(a)(1); thus, when a taxpayer sells property,
his income is “the excess of the amount realized therefrom over the adjusted basis.” Id. § 1001(a). The Government then observes that “[b]ecause people do not pay cash or its equivalent to acquire their well-being, they have no basis in it for purposes of measuring a gain (or loss) upon the realization of compensatory damages.” Nor is there any corresponding theory of “human depreciation,” which would permit “an offsetting deduction for the exhaustion of the taxpayer’s physical prowess and mental agility.” Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts ¶ 5.6 (2003). Finally, the Government points to the Ninth Circuit’s dictum in Roemer v. Commissioner, 716 F.2d 693 (1983), suggesting that “[s]ince there is no tax basis in a person’s health and other personal interests, money received as compensation for an injury to those interests might be considered a realized accession to wealth.” Id. at 696 n.2.

At the outset, we reject the Government’s breathtakingly expansive claim of congressional power under the Sixteenth Amendment -- upon which it founds the more far-reaching arguments it advances here. The Sixteenth Amendment simply does not authorize the Congress to tax as “incomes” every sort of revenue a taxpayer may receive. As the Supreme Court noted long ago, the “Congress cannot make a thing income which is not so in fact.” Burk-Waggoner Oil Ass’n v. Hopkins, 269 U.S. 110, 114 (1925). Indeed, because the “the power to tax involves the power to destroy,” McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819), it would not be consistent with our constitutional government, and the sanctity of property in our system, merely to rely upon the legislature to decide what constitutes income.

Fortunately, we need not rely solely upon the wisdom and beneficence of the Congress for, when the Sixteenth Amendment was drafted, the word “incomes” had well
understood limits. To be sure, the Supreme Court has broadly construed the phrase “gross income” in the IRC and, by implication, the word “incomes” in the Sixteenth Amendment, but it also has made plain that the power to tax income extends only to “gain[s]” or “accessions to wealth.” Glenshaw Glass, 348 U.S. at 430-31. That is why, as noted above, the Supreme Court has held a “return of capital” is not income. Doyle, 247 U.S. at 187; S. Pac. Co., 247 U.S. at 335. The question in this case is not, however, about a return of capital -- except insofar as Murphy analogizes human capital to physical or financial capital; the question is whether the compensation she received for her injuries is income.

To determine whether Murphy’s compensation is income under the Sixteenth Amendment, we are instructed by the Supreme Court first to consider whether the taxpayer’s award of compensatory damages is “a substitute for [a] normally untaxed personal ... quality, good, or ‘asset.’” O’Gilvie, 519 U.S. at 86. Accordingly, we join our sister circuits by asking: “In lieu of what were the damages awarded”? Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944); see Francisco v. United States, 267 F.3d 303, 319 (3d Cir. 2001) (treating

---

* In any event, the Government’s quarrel with Murphy’s analogy, based upon Glenshaw Glass, of “human capital” to financial or physical capital is not persuasive. To be sure, the analogy is incomplete; personal injuries do not entail an adjustment to any basis, nor are human resources, such as reputation, depreciable for tax purposes. But nothing in Murphy’s argument implies a need to account for the basis in or to depreciate anything. Her point, rather, is that as with compensation for a harm to one’s financial or physical capital, the payment of compensation for the diminution of a personal attribute, such as reputation, is but a restoration of the status quo ante, analogous to a “restoration of capital,” Glenshaw Glass, 348 U.S. at 432 n.8; in neither context does the payment result in a “gain” or “accession[] to wealth,” id. at 430-31.
Raytheon’s “in lieu of” test as authoritative); Tribune Publ’g Co. v. United States, 836 F.2d 1176, 1178 (9th Cir. 1988) (applying “in lieu of” test to determine whether settlement proceeds were income); Gilbertz v. United States, 808 F.2d 1374, 1378 (10th Cir. 1987) (adopting “in lieu of” test to determine whether compensatory damages were income). Here, if the $70,000 Murphy received was “in lieu of” something “normally untaxed,” O’Gilvie, 519 U.S. at 86, then her compensation is not income under the Sixteenth Amendment; it is neither a “gain” nor an “accession[] to wealth.” Glenshaw Glass, 348 U.S. at 430-31.

As we have seen, it is clear from the record that the damages were awarded to make Murphy emotionally and reputationally “whole” and not to compensate her for lost wages or taxable earnings of any kind. The emotional well-being and good reputation she enjoyed before they were diminished by her former employer were not taxable as income. Under this analysis, therefore, the compensation she received in lieu of what she lost cannot be considered income and, hence, it would appear the Sixteenth Amendment does not empower the Congress to tax her award.

Our conclusion at this point is tentative because the Supreme Court has also instructed that, in defining “incomes,” we should rely upon “the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment.” Merchants’ Loan & Trust Co. v. Smietanka, 255 U.S. 509, 519 (1921). And, to discern the original understanding of a provision of the Constitution, we must examine any contemporaneous implementing legislation. See Myers v. United States, 272 U.S. 52, 175 (1926) (“This court has repeatedly laid down the principle that a contemporaneous legislative exposition of the Constitution ..., acquiesced in for a long term of years, fixes the
construction to be given its provisions”); see Macomber, 252 U.S. at 202 (district judge correctly treated “construction of the [Revenue Act of 1913] as inseparable from the interpretation of the Sixteenth Amendment”). Therefore, we must inquire whether “the people when they adopted the Sixteenth Amendment,” or the Congress when it implemented the Amendment, would have understood compensatory damages for a nonphysical injury to be “income.”

In the years immediately following ratification of the Sixteenth Amendment, the Congress created and then thrice revised the IRC. See Revenue Act of 1913, ch. 16, 38 Stat. 114 (1913); Revenue Act of 1916, ch. 463, 39 Stat. 756 (1916); Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917); Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919). Of the four enactments, that of 1918 was the first to address the tax treatment of compensatory damages for personal injuries, and it did so without distinguishing between physical and nonphysical injuries. We agree with the Government that the House Report on the 1918 Act is ambiguous and therefore unhelpful on the question before us. We concur in Murphy’s view, however, that the Attorney General’s 1918 opinion and the Treasury Department’s ruling of the same year strongly suggest that the term “incomes” as used in the Sixteenth Amendment does not extend to monies received solely in compensation for a personal injury and unrelated to lost wages or earnings.

That emotional distress and loss of reputation were both actionable in tort when the Sixteenth Amendment was adopted supports the view that compensation for these nonphysical injuries was not regarded differently than was compensation for physical injuries and, therefore, was not considered income by the framers of the Amendment and the state legislatures that ratified it. By 1913, in at least 39 of the then-48 states and in the District of Columbia, the law made compensatory damages for
“mental suffering” recoverable in the same matter as compensatory damages for physical harms; indeed, in 34 of those states, there are reported cases involving defamation and other reputational injuries* -- the

* See, e.g., Garrison v. Sun Printing & Publ’g Ass’n, 207 N.Y. 1, 6, 100 N.E. 430, 431 (1912) (plaintiffs are “entitled to recover compensatory damages for mental distress resulting from the publication of defamatory words actionable in themselves”); Guisti v. Galveston Tribune, 105 Tex. 497, 504-05 150 S.W. 874, 877 (1912) (holding statute afforded “right to maintain an action for a publication not libelous per se [without having] to allege or prove special damages .... for mental anguish”); Fields v. Bynum, 72 S.E. 449, 451 (1911) (general damages in defamation actions “include injury to the feelings, and mental suffering endured in consequence”); Comer v. Advertiser Co., 172 Ala. 613, 55 So. 195, 198 (1911) (in libel actions “damages for mental pain and suffering ... must in all cases be fixed by the jury, in view of all the facts and circumstances surrounding any particular case”); Miller v. Dorsey, 149 Mo. App. 24, 129 S.W. 66, 69 (1910) (upholding jury award of damages in action for slander “to compensate [plaintiff] for the mortification and shame he might have suffered, and the disgrace and dishonor attempted to be cast upon him, and all damages done to his reputation”); Jozsa v. Moroney, 125 La. 813, 821, 51 So. 908, 911 (1910) (in libel action “damages for mental suffering alone can be recovered, although the party may have suffered no other loss”); Moore v. Maxey, 152 Ill. App. 647, 1910 WL 1686, at *2 (1910) (“Where words spoken are actionable per se .... there need be no direct evidence of mental suffering to enable the jury to consider it in their estimate of damages”); Davis v. Mohn, 145 Iowa 417, 124 N.W. 206, 207 (1910) (holding mental “pain and suffering may be considered by the jury in determining the amount of damages in cases where the words spoken are actionable [as slander] per se”); Henry v. Cherry & Webb, 30 R.I. 13, 73 A. 97, 102 (1909) (noting that “mental suffering alone [will] sustain a right of action” if “the words spoken or pictures published are of such a nature that the court can conclude, as a matter of law, that they will tend to degrade the person, or hold him up to public hatred, contempt, or ridicule, or cause him to
be shunned and avoided’’); Neafie v. Hoboken Printing & Publ’g Co., 75 N.J.L. 564, 566, 68 A. 146, 147 (1907) (rejecting view that ‘‘mental anguish cannot be considered in estimating compensatory damages in an action of libel’’); McArthur v. Sault News Printing Co., 148 Mich. 556, 558, 112 N.W. 126, 127 (1907) (‘‘A woman might have a bad reputation and a bad character, neither of which would be changed by such a [libelous] publication, and yet be entitled to substantial damages for injuries to her feelings resulting from the publication’’); Todd v. Every Evening Printing Co., 22 Del. 233, 66 A. 97, 99 (1907) (‘‘amount to be awarded to the plaintiff should be such as would reasonably compensate him for any wrong done to his reputation, good name, or fame, and for any mental suffering caused thereby as shown by the evidence’’); Gendron v. St. Pierre, 73 N.H. 419, 62 A. 966, 969 (1905) (‘‘amount of the damages’’ in slander action ‘‘depends in part upon the effect of the malice upon the plaintiff’s mind’’); Ott v. Press Pub. Co., 40 Wash. 308, 310, 82 P. 403, 404 (1905) (‘‘upon a proper showing damages for mental pain and suffering may be recovered’’ in libel action); Wash. Times Co. v. Downey, 26 App. D.C. 258, 1905 WL 17653, at *4 (1905) (holding ‘‘plaintiff is ... entitled to recover as general damages for injury to her feelings and the mental suffering which she endured as a natural result of the [libelous] publication’’); Hanson v. Krehbiel, 68 Kan. 670, 75 P. 1041, 1042 (1904) (noting that general damages for libel and slander actions are ‘‘designed to compensate for that large and substantial class of injuries arising from injured feelings, mental suffering and anguish, and personal and public humiliation’’); Finger v. Pollack, 188 Mass. 208, 209, 74 N.E. 317, 318 (1905) (‘‘In an action for slander one of the elements of damage is mental suffering’’); Davis v. Starrett, 97 Me. 568, 55 A. 516, 519 (1903) (‘‘plaintiff is entitled to recover compensation [for] slander, such as injury to the feelings and injury to the reputation’’); Bedtkey v. Bedtkey, 15 S.D. 310, 89 N.W. 479, 480 (1902) (holding ‘‘evidence of injury to feelings having been admitted without objection, damages therefore are recoverable’’); Kidder v. Bacon, 74 Vt. 263, 52 A. 322, 324 (1902) (‘‘It is well settled that when the words spoken are actionable the jury have a right to consider the mental suffering which may have been occasioned to a party by the publication of the slanderous words, and to allow damages therefor’’);
Hacker v. Heiney, 111 Wis. 313, 87 N.W. 249, 251 (1901) (rejecting contention that “no recovery can be had for injury to feelings” in action for slander); McCarty v. Kinsey, 154 Ind. 447, 57 N.E. 108, 108 (1900) (holding it was “proper for the jury to consider” slanderous words used in course of an assault and battery “with all the circumstances in evidence, and the humiliation, degradation, shame, and loss of honor, and mental anguish, if any, caused thereby, in determining the amount of damages”); Gray v. Times Newspaper Co., 78 Minn. 323, 324, 81 N.W. 7, 7 (1899) (plaintiff “was entitled to some damages for injury to his feelings, shame, and loss of the good opinion of his fellows, and injury to his standing in the community”); Louisville Press Co. v. Tennelly, 105 Ky. 365, 49 S.W. 15, 17 (1899) (“the rule is well settled that the publication of a libel exposes the publisher, not only to compensatory damages for the loss of business, but also to a judgment for the mental suffering that the libel or slander inflicts upon the plaintiff”); Cole v. Atlanta & W.P.R. Co., 102 Ga. 474, 31 S.E. 107, 108 (1897) (permitting action by plaintiff passenger against railroad for its employee’s slander, which caused plaintiff “to undergo the pain and mortification of being publicly denounced”); Fry v. McCord, 95 Tenn. 678, 33 S.W. 568, 571 (1895) (damages for slander per se may include “pain, mental anxiety, or general loss of reputation”); Taylor v. Hearst, 170 Cal. 262, 270, 40 P. 392, 393-94 (1895) (“actual damages embraces recovery for loss of reputation, shame, mortification, injury to feelings, etc.; and while special damages must be alleged and proven, general damages for outrage to feelings and loss of reputation need not be alleged in detail”); Taylor v. Dominick, 36 S.C. 368, 15 S.E. 591, 593-94 (1892) (“the elements of damages in the action for malicious prosecution are the injury to the reputation or character, feelings, health, mind, and person, as well as expenses incurred in defending the prosecution”); Stallings v. Whittaker, 55 Ark. 494, 18 S.W. 829, 831 (1892) (damages in slander action may compensate for “mental suffering and mortification”); Republican Pub. Co. v. Mosman, 15 Colo. 399, 410, 24 P. 1051, 1055 (1890) (“in cases of written slander where the defamatory matter is libelous per se, the mental suffering of the plaintiff, occasioned by the false publication, may be taken into consideration, in awarding general compensatory damages”); Commercial Gazette Co. v. Grooms, 10
very sort of injury Murphy suffered -- and at least five more states allowed an action for alienation of affections, also a nonphysical injury." As a result, we see no meaningful distinction between Murphy’s award and the kinds of damages recoverable for personal injury when the Sixteenth Amendment was adopted. Because, as we have seen, the term “incomes,” as understood in 1913, clearly did not include damages received in compensation for a physical personal injury, we infer that it likewise did not include damages received for a nonphysical

Ohio Dec. Reprint 489, 1889 WL 346, at *4 (1889) (“The most natural result from an injury to reputation is mental suffering and it is a proper element to be considered in estimating damages in a libel suit”); Boldt v. Budwig, 19 Neb. 739, 28 N.W. 280, 283 (1886) (“jury should consider the damage to her character, as well as her mental suffering caused [by the slander]”); Riddle v. McGinnis, 22 W.Va. 253, 1883 WL 3242, at *15 (1883) (“in ... actions for wilful and wanton injuries done to the person and reputation ... the plaintiff is entitled to recover damages ... for his mental anguish”); Swift v. Dickerman, 31 Conn. 285, 1863 WL 763, at *7 (1863) (holding “anxiety and suffering [due to slander] were proper subjects for compensation to the plaintiff, and ought to be atoned for by the defendant”); Beehler v. Steever, 1 Miles 146, 1837 WL 3209, at *6 (1837) (noting in syllabus that “[o]utrage to the plaintiff’s feelings and peace of mind may be considered” by the jury in awarding damages for slander).

* See, e.g., Greuneich v. Greuneich, 23 N.D. 368, 137 N.W. 415 (N.D. 1912); Hillers v. Taylor, 116 Md. 165, 81 A. 286 (Md. 1911); Seed v. Jennings, 47 Or. 464, 83 P. 872 (Or. 1905); Tucker v. Tucker, 74 Miss. 93, 19 So. 955 (Miss. 1896); Samuel v. Marshall, 30 Va. 567, 1832 WL 1822 (Va. 1832). An action for “alienation of affection” enabled the plaintiff to recover damages for mental suffering and reputational damage arising from the defendant’s interference in the relationship between the plaintiff and his or her spouse. See generally Restatement (Second) of Torts § 683 cmt. f (1977) (“It is unnecessary for recovery that the acts of the defendant cause any financial loss to the injured spouse”).
injury and unrelated to lost wages or earning capacity.

The IRS itself reached the same conclusion when it first addressed the question, expressly affirming that personal injuries included nonphysical personal injuries:

[T]here is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character .... If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit.

Sol. Op. 132, 1-1 C.B. 92, 93 (1922); see also Hawkins v. Commissioner, 6 B.T.A. 1023, 1024-25 (U.S. Bd. of Tax App. 1927) (holding “compensation for injury to [plaintiff’s] personal reputation for integrity and fair dealing” was not income because it was “an attempt to make the plaintiff whole as before the injury”). Note that the Service regarded such compensation not merely as excludable under the IRC, but more fundamentally as not being income at all.

In sum, every indication is that damages received solely in compensation for a personal injury are not income within the meaning of that term in the Sixteenth Amendment. First, as compensation for the loss of a personal attribute, such as well-being or a good reputation, the damages are not received in lieu of income. Second, the framers of the Sixteenth Amendment would not have understood compensation for a personal injury -- including a nonphysical injury -- to be income. Therefore, we hold § 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.
III. Conclusion

Albert Einstein may have been correct that “[t]he hardest thing in the world to understand is the income tax,” *The Macmillan Book of Business and Economic Quotations* 195 (Michael Jackman ed., 1984), but it is not hard to understand that not all receipts of money are income. Murphy’s compensatory award in particular was not received “in lieu of” something normally taxed as income; nor is it within the meaning of the term “incomes” as used in the Sixteenth Amendment. Therefore, insofar as § 104(a)(2) permits the taxation of compensation for a personal injury, which compensation is unrelated to lost wages or earnings, that provision is unconstitutional. Accordingly, we remand this case to the district court to enter an order and judgment instructing the Government to refund the taxes Murphy paid on her award plus applicable interest.

So ordered.