From the desk of Jeanne M. Kerkstra, Esq., CPA

Viewpoint
About Face in "Murphy" Reconsideration

On July 3, 2007, the U.S. Court of Appeals in the DC Circuit reversed its findings that Section 104(a)(2) was unconstitutional and ruled that non-physical personal damages awarded under that provision are indeed taxable.[1]

As both a CPA and an attorney, it was exciting that a court had found a provision of the IRC[2] to be unconstitutional. Since the 1996 change to the Code, it had become more of a minefield as to how to actually phrase damages sought and bases for those damages. Prior to the 1996 change, there was no differentiation in personal injuries. Subsequently, there was a dichotomy between ***physical*** **(e.g., *non-taxable*)** and ***non-physical*** **(e.g., *taxable*).**

When the DC Circuit initially came out with its findings that the Code section was unconstitutional, it could not have foreseen what it was getting itself into. How dramatic the findings were was only heightened by how quickly the DC Circuit vacated its findings. And now, in an opinion 30 pages long, the DC Court reverses its position and finds that Section 104(a)(2) of the Code is constitutional. Consequently because the Plaintiffs compensatory award was not received on account of physical personal injuries, the award is taxable. The Court goes to great lengths to explain the type of award, the types of injuries, and the type of tax (e.g., an excise and not a direct tax). As it was in 1776, there is no more heated a topic than tax.

Tax ramifications significantly affect settlement talks. However, as highlighted by the *Murphy* decision, taxes play an important part in the negotiations from the very beginning. If you require assistance with drafting, call me.

[1] *Murphy v. IRS,* D.C. Cir., No. 05-5139, 7/3/07.

[2] Internal Revenue Code of 1986, as amended.

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