

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

Viewpoint
Revisiting the Roots of the Boston Tea Party (Never Too late; Never Too Often)

An amazing case came down on August 22, 2006: *Murphy v. IRS*, D.C. Cir., No. 05-5139. Over cries by the IRS that it had the authority to revoke in full §104(a)(2), the U.S. Court of Appeals for the D.C. Circuit held that IRC §104(a)(2) is unconstitutional as it applies to an award of damages for emotional distress or mental anguish and loss of reputation due to compensation for non-physical personal injury. This was a phenomenal ruling. *It should have lawyers, including those in personal injury, employment and tax, and accountants rethinking what is taxable when analyzing awards under §104(a) (2).*

In 1996, the Internal Revenue Code was amended so that §104(a)(2) made taxable *non-physical personal injury or sickness awards*.¹ Before then, pursuant to §104(a)(2), awards for nonphysical personal injury or sickness were not taxable.² Of course, the amount of tax that a plaintiff will pay on an award of damages can have an impact on the ultimate dollar amount settled upon.

In *Murphy*, the Plaintiff had filed a Complaint with the Department of Labor claiming that her former employer, the New York Air National Guard ("NYANG"), had violated several whistler-blower statutes and had thereby blacklisted her. There was a determination in the Plaintiffs favor, and the Secretary of Labor remanded her case to an Administrative Law Judge "for findings on compensatory damages." The Plaintiff had put into evidence how she had suffered both mental and physical injuries as a result of the unlawful behavior by NYANG. Among other things, she claimed to have suffered "physical manifestations of stress" including "anxiety attacks, shortness of breath, and dizziness." She received an award of 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." None were for lost wages or diminished earnings capacity. The Plaintiff included the amount in gross income and paid the tax thereon. She then filed an amended return in which she sought a refund of the taxes paid. The IRS denied her request upon a finding that the taxpayer had failed to demonstrate that the award was attributable to or on account of "physical injury" or "physical sickness."

The Plaintiff discussed the fundamental rights of the IRS to tax, including a discussion on the 16th Amendment which was ratified in 1913 and states: "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." There was a lengthy discussion on the intention of the parties at the time that the amendment was ratified, including the meaning behind the words "incomes" and "gross income" in IRC §61 (a). The Plaintiffs argument was that due to the fact that her damage award was neither a gain nor an accession to wealth, the award was not taxable. Furthermore, the Plaintiff alleged that §104(a)(2) was therefore unconstitutional.

To the benefit of the Plaintiff, the Government made brazen arguments to the Court, including that it had the right to revoke §104(a)(2) in its entirety and have everything be taxable. The Court wholly disagreed. They found that the framers of the Constitution set limitations on the Government as to its abilities, including taxing abilities. Least of all, let us not forget the reasons

behind why there even was a Boston Tea Party.

The Court did find that the Plaintiff did *not* meet the requirements under §104(a)(2); the Court found that she did not have a physical personal injury or physical sickness. They found that she had a non-physical injury. Consequently, she did not meet §104(a)(2). However, the Court made a determination that §104(a)(2) was unconstitutional as it relates to the taxation of awards for emotional distress and loss of reputation.

It will be interesting to see which path the IRS decides to take on this matter. Will they challenge the findings of this Court? Will they remain silent?

Because of the impact that taxes have on a damages award, attorneys and accountants must take note of the Murphy case. Painting a clear picture of the damages sustained by the Plaintiff has never been more important. It will be necessary to get into the record fully and accurately describing the character of the damages.

For those who have clients who have suffered non-physical personal injuries (e.g., defamation, intentional and negligent infliction of emotional distress) and received awards as such, this is a wakeup call. If you are of the opinion that the *Murphy* case establishes "substantial authority," then this will have quite an impact on your analysis.

1. **If your client has paid taxes on damages awards of this type**, you will want to quickly check to see if the Statute of Limitations has not run in order for your client to file an amended return.
2. **If your client is about to receive such an award**, then you may well indeed feel that it is not proper to have a 1099 issued to your client for the damages award nor to report such as "gross income" on your client's tax return.

As expected, seminal cases evoke more questions than answers while the dust is settling. One such question is how will the *Murphy* case, if at all, affect structured settlements? The *Murphy* case is exciting law, and we will continue to follow its developments.

¹ Current Law - § 104(a)(2): "The amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal **physical** injuries or **physical** sickness."
[Emphasis added.]

² Prior Law - § 104(a)(2): "The amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness."

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