

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

**Viewpoint
When One Missing Word Costs Plenty**

Certainly a lot of tax professionals are waiting with bated breath to hear what will be the decision in *Murphy v. IRS*.¹ Prior to vacating its August 22, 2006 decision on December 22, 2006, it had been a controversial ruling in which the Court held that IRC §104(a)(2)² was unconstitutional as it applied to an award of damages for emotional distress or mental anguish and loss of reputation due to compensation for non-physical personal injury. A lot rests on how the Court will rule.

In *Green v. Commissioner*,³ the taxpayer did not include roughly \$1,917,671 of a jury award. A California jury had found that the taxpayer had been the subject of retaliation by her employer. The jury had awarded \$1.5 million of economic damages, \$65,000 of non-economic damages and under California's fee-shifting statute, had awarded \$537,841 for attorneys' fees, plus interest. However, nowhere in the Complaint or in the jury's verdict did it contain any reference to personal physical injury or physical sickness. Consequently, the entire award was found to be includable in gross income because it was either a personal non-physical injury or a non-physical sickness. If it had been found that § 104(a)(2) included non-physical rather than merely physical personal injury or sickness, the taxpayer would not have suffered such a serious tax hit, e.g., a \$909,044 deficiency as well as a 20% accuracy-related penalty, which translates into a penalty of \$181,809.

But, it is important to note that one of the reasons why the taxpayer was found liable for the accuracy-related penalty is that nowhere in her tax return did she report the jury award and her reasoning behind why she felt it was excludable from gross income. She included a much smaller number in gross wages and in no way included an explanation on the return or an attachment to the return.

In the same vein is *Seidel v. Commissioner*.⁴ Taxpayer had been employed for more than 20 years with AAA. She had ADD and obsessive/compulsive disorder, and her employer failed to accommodate her. The Complaint alleged four causes of action, none of which cited personal physical injury or physical sickness. The parties entered into a Settlement Agreement prior to trial. Of the \$475,000 settlement, \$157,000 was designated as for payment of "compensation for personal injury (i.e., emotional distress) damages only". As we all are well aware, the current status of § 104(a)(2) is such that unless it is clearly for personal physical injury or physical sickness, the damage awards are includable in gross income. Consequently, the Court went so far as to look up in Black's Law Dictionary the meaning of "i.e." and made the finding that it means "that is" and not "for example". Consequently, they found that the \$157,000 was awarded for emotional distress which is not personal physical injury or physical sickness. Consequently, it is fully includable in her gross income.

¹ *Murphy v. IRS*, D.C. Cir., No. 05-5139.

² Internal Revenue Code of 1986, as amended.

³ *Green v. Commissioner*, T.C. Memo 2007-39

⁴ *Seidel v. Commissioner*, T.C. Memo 2007-45

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