



LABOR RELATIONS

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Emotional Distress Damages Not Taxable?

In a recent decision that could have a significant impact on settlement of employment cases, *Murphy v. IRS*, No. 05-5139 (Aug. 22, 2006), the U.S. Court of Appeals for the District of Columbia Circuit held that §104(a)(2) of the Internal Revenue Code (IRC) is unconstitutional insofar as it permits taxation of damage awards for nonphysical personal injuries unrelated to lost wages or earnings, such as emotional distress and loss of reputation.

This month's column discusses the *Murphy* decision and its potential implications.

Background

The *Murphy* case began when Marrita Murphy filed an administrative complaint with the Department of Labor alleging that her former employer, the New York Air National Guard, violated various whistleblower statutes by "blacklisting" her and providing unfavorable employment references after she complained to state authorities about environmental hazards at an airbase run

by the employer. The Department of Labor awarded Ms. Murphy 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." No damages were awarded for lost wages or diminished earning capacity.

Ms. Murphy paid \$20,665 in income taxes on the damage award, but later filed an amended return seeking a refund of that amount 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." The Internal Revenue Service (IRS) denied Ms. Murphy's request for a refund, stating that she had failed to demonstrate the compensatory damages were attributable to "physical injury" or "physical sickness" as was required to be nontaxable.

Thereafter, Ms. Murphy brought suit against the IRS and the United States in federal district court seeking the return of the \$20,665 in income taxes, plus interest, along with declaratory and injunctive relief against the IRS. The district court rejected her claims, also relying upon §104(a)(2) of the IRC.

Section 104(a)(2)

Prior to the enactment of the Small Business Job Protection Act of 1996,

which amended §104 of the IRC, §104(a)(2) excluded from gross income monies received in compensation for "personal injuries or sickness," which included both physical injuries and nonphysical injuries such as emotional distress. Since the 1996 amendment, however, §104(a)(2) has excluded from gross income only damages (other than punitive damages) received "on account of personal physical injuries or physical sickness." Since 1996, §104(a)(2) has further provided specifically that, for purposes of this exclusion, "emotional distress shall not be treated as a physical injury or physical sickness." Under this version of §104(a)(2), damage awards for emotional distress and other nonphysical injuries such as injury to reputation and mental pain and suffering became taxable.

Murphy's Arguments

On appeal to the D.C. Circuit, Ms. Murphy asserted two alternative theories. First, she argued that her compensatory damage award should have been excluded from her gross income under §104(a)(2) of the IRC because it was in fact compensation received for "personal physical injuries," as she manifested physical symptoms of stress caused by the emotional distress such as teeth grinding, shortness of breath and dizziness. In

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the alternative, she maintained that §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 U.S. Constitution, which allows Congress to “lay and collect taxes on incomes....”

In support of the latter argument, Ms. Murphy relied on two U.S. Supreme Court decisions, *Commissioner v. Glenshaw Glass*, 348 US 426 (1955), and *O’Gilvie v. United States*, 519 US 79 (1996). In *Glenshaw Glass*, the Supreme Court held that under the IRC—and, by implication, under the Sixteenth Amendment—Congress may tax “gains” or “accessions to wealth.” Ms. Murphy contended that, being neither a gain nor an accession to wealth, her award was not income and §104(a)(2) was unconstitutional insofar as it made her award taxable as income. The *O’Gilvie* Court 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.” By analogy, Ms. Murphy argued that a damage award for personal injuries—including nonphysical injuries—is not income under the IRC or the Sixteenth Amendment but simply a return of human capital.

Court’s Analysis

Chief Judge Douglas Ginsburg, writing for a unanimous court, rejected Ms. Murphy’s first argument that her award was not taxable pursuant to §104(a)(2) of the IRC. However, the court accepted her second argument and declared that §104(a)(2) is unconstitutional to the extent it permits taxation of compensation for a personal injury unrelated to lost wages or earnings.

With respect to Ms. Murphy’s first argument, the D.C. Circuit focused

on the phrase “on account of” in §104(a)(2), which excludes from gross income only damages awarded “on account of” personal physical injuries or physical sickness. Here, the court held that Ms. Murphy’s damages were clearly “on account of” nonphysical injuries because, even though she suffered from certain physical manifestations of emotional distress, the Department of Labor awarded her the compensation on account of her mental pain and anguish and injury to her reputation.

In deciding the question of §104(a)(2)’s constitutionality, the D.C. Circuit used two lines of reasoning to decide that the compensation Ms. Murphy received for her injuries—which was not excludable from her gross income under §104(a)(2)—was not in fact “income” under the Sixteenth Amendment. First, the court used an “in lieu of” test, examining whether the \$70,000 award she received was “in lieu of” something that was normally taxed as income. The court found that the damages were awarded to make Ms. Murphy emotionally and reputationally whole and not to compensate her for lost wages or taxable earnings of any kind. Since the emotional well-being and good reputation she enjoyed before they were diminished by her former employer were not taxable as income, the court held that the compensation she received in lieu of what she lost cannot be considered income.

Second, the court examined whether the framers of the Sixteenth Amendment would have understood compensation for a personal injury—including a nonphysical injury—to be income. That emotional distress and loss of reputation were both actionable in tort when the Sixteenth Amendment was adopted in 1913 supported the court’s view that compensation for these nonphysical

injuries was not regarded differently than compensation for physical injuries by the framers. Since the term “income,” as understood in 1913, did not include damages received as compensation for a physical personal injury, the D.C. Circuit inferred that it did not include damages received for a nonphysical injury unrelated to lost wages or earning capacity. Therefore, the *Murphy* Court held that §104(a)(2) is unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.

Implications of ‘Murphy’

The *Murphy* case represents a setback to the IRS, and the IRS will likely challenge the D.C. Circuit’s holding. If ultimately sustained, the *Murphy* decision will have a considerable impact on employment cases, particularly in the context of settlement. Since 1996, amounts offered in settlement of a plaintiff’s claims for emotional injury have been regarded as taxable, significantly reducing the value of settlement to the plaintiff. If such payments are not taxable, an employer’s settlement offer will have a greater value to the plaintiff and should encourage settlements of such cases.