Court says Congress can't tax non-physical personal injury award unrelated to earnings

Murphy v. IRS (CA DC 8/22/2006), 98 AFTR 2d 2006-5357 The Court of Appeals for the DC Circuit, reversing a district court, has held that taxing awards for non-physical personal injury unrelated to lost wages or earnings violates the Sixteenth Amendment and is unconstitutional.

Facts. In an action against her former employer, the New York Air National Guard (NYANG), Marrita Murphy was awarded compensatory damages for emotional distress and loss of reputation NYANG, in violation of various whistle-blower statutes, was found to have "blacklisted" her and provided unfavorable references to potential employers after she complained about environmental hazards on an air base.

Murphy submitted evidence that she had suffered both mental and physical injuries as a result of the NYANG's blacklisting. A physician testified that she had sustained somatic (affecting the body) and emotional injuries, including bruxism or teeth grinding (which is often associated with stress and may cause permanent tooth damage), anxiety attacks, shortness of breath, and dizziness. The compensatory damages awarded to Murphy—as recommended by the administrative law judge and approved by the Dept. of Labor (DOL) Administrative Review Board—totaled $70,000 ($45,000 for emotional distress or mental anguish and $25,000 for injury to her professional reputation from having been blacklisted). None of the award was for lost wages or diminished earning capacity.

Murphy paid $20,665 in taxes on the award However, she later sought a refund of this amount, submitting copies of her dental and medical records. IRS found that she had failed to demonstrate that the compensatory damages were attributable to physical injury or physical sickness and denied her claim. She brought a refund suit in the district court, which found against her.

Background. Code Sec. 61(a) provides that, except as otherwise allowed, gross income means all income from whatever source derived. Under Code Sec 104(a)(2) , damages, other than punitive damages, received by a taxpayer in a suit or agreement (whether in a lump-sum or as periodic payments) as compensation for personal physical injury or personal physical sickness are excluded from income.

The Sixteenth Amendment, ratified in 1913, provides that Congress has the 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.

Taxpayer's argument. Murphy contended that under Code Sec. 104(a)(2), her award should have been excluded from gross income because it was compensation received "on account of personal physical injuries or physical sickness." Alternatively, she maintained that Code Sec 104(a)(2) was unconstitutional because it failed to exclude from gross income amounts that are not "income" within the meaning of the Sixteenth Amendment.

In the constitutional argument, Murphy relied on the Supreme Court's decision in Glenshaw Glass Co. (1955), 348 U.S. 426, which in determining what "income" can be taxed, held that Congress may "tax all gains" or "accessions to wealth." Since her damage award was neither a gain nor an accession to wealth, she maintained it was not income; Code Sec. 104(a)(2) was unconstitutional if it would make the award taxable. Murphy pointed out that the Supreme Court has long recognized the principle that a restoration of capital is not income. Thus, by analogy, a damage award for personal injuries, including nonphysical injuries, is not income but simply a return of capital—"human capital."

IRS's argument. IRS argued that the exclusion under Code Sec. 104(a)(2) is applicable only to those personal injury damages that are awarded because of personal injuries In fact, the compensatory damages awarded Murphy was clearly because of her nonphysical injuries. The damages were for emotional distress or mental anguish and injury to professional reputation That she suffered from bruxism or other physical symptoms of stress was of no significance, IRS argued, because she was awarded her damages, not to compensate her for those injuries, but explicitly for the nonphysical injuries.

As to the constitutional argument, IRS first invoked the presumption that Congress enacts laws within its constitutional limits. It maintained that Code Sec. 104(a)(2) was constitutional even if it did allow the taxation of compensatory damages. IRS further argued that should Congress so wish, it could, repeal Code Sec 104(a)(2) altogether, taxing compensation even for physical injuries, and still be within the Sixteenth Amendment. IRS also argued that compensatory damages were plainly economic gain. The taxpayer unquestionably had more money after receiving the damages than she had before the receipt of the award. In addition, IRS challenged the validity of Murphy's analogy between a return of "human capital or well-being" and a return of financial capital, the latter which it acknowledged doesn't constitute income under the Sixteenth Amendment. If it was akin to capital in the normal sense, what was human capital's basis, its cost, its depreciation (exhaustion) adjustment?

DC Circuit's interpretation of Code Sec. 104(a)(2). Accepting IRS's argument, the DC Circuit found that Murphy's damages were not awarded by reason of, or because of physical personal injuries. While she no doubt suffered from certain physical manifestations of emotional distress, it was clear that the DOL Administrative Review Board expressly awarded her compensation only for mental pain and anguish and injury to professional reputation. Accordingly, under Code Sec. 104(a)(2) , the award was not excludable from income. However, the Court's analysis didn't end there

DC Circuit finds Code Sec. 104(a)(2) unconstitutional. The DC Circuit concluded that to the extent Code Sec. 104(a)(2) allows the taxation of compensation for a personal injury where the compensation is unrelated to lost wages or earnings, it is unconstitutional. Relying on the Supreme Court's *Glenshaw Glass,* it found that not all receipts of money are income. The Court rejected IRS's "breathtakingly expansive" claim of congressional power, and concluded that the Sixteenth Amendment simply does not authorize Congress to tax as "income" every sort of revenue a taxpayer may receive

To determine whether Murphy's compensation was income under the Sixteenth Amendment, the Court followed the Supreme Court's guidance in O'Gilvie (1996), 519 US 79 by first determining whether the taxpayer's award of compensatory damages was a substitute for a normally untaxed personal quality, good, or asset. If the $70,000 Murphy received was "in lieu" of something normally untaxed, then her compensation wasn't income under the Sixteenth Amendment since it was neither a "gain" nor an "accession to wealth."

The Court found that it was 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. Under this analysis, the compensation she received in lieu of what she lost could not be considered income, and the Sixteenth Amendment did not empower Congress to tax her award. And because the Court found that the term "income," as understood in 1913, clearly did not include damages received in compensation for a physical personal injury, it further inferred that it likewise did not include damages received for a nonphysical injury that were unrelated to lost wages or earning capacity.

The Court concluded that Murphy's compensatory award was not received "in lieu of" something normally taxed as income. Nor was the award within the meaning of the term "incomes" as used in the Sixteenth Amendment. Accordingly, the Court remanded the case to the district court to enter an order and judgment instructing IRS to pay Murphy's refund, plus interest

RIA Research References: For treatment of recovery for injury to personal rights, see FTC 2d/FIN J-580; United States Tax Reporter 1044.02; TaxDesk 182,001; TG 13201.

Source: Federal Taxes Weekly Alert (preview) 08/31/2006, Volume 52, No 35