

Waiting to Exhale: *Murphy Part Deux* and Taxing Damage Awards

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On July 3, 2007, the U.S. Court of Appeals for the District of Columbia Circuit unanimously rendered its second opinion in *Marrita Murphy v. IRS*.¹ Written by Chief Judge Douglas H. Ginsburg, with judges Janice Rogers Brown and Judith Ann Wilson Rogers participating, the second coming of *Murphy* is a 30-page whopper, holding that none of Marrita Murphy's whistle-blower retaliation damages were excludable under section 104. Moreover, the opinion upholds the constitutionality of a tax on such damages. But as depressing as that double defeat might be, there is a silver lining in *Murphy*'s cloud on the tax treatment of damages.

Many critics of the first iteration of *Murphy* will no doubt be pleased with this more sanguine and traditional tax opinion.² The court now narrowly construes an exclusion from income (section 104) and broadly construes Congress's power to tax just about anything that moves. Tax cases generally follow both those interpretive rules. Although I did not predict any particular outcome in the case, I suppose I am not terribly surprised by *Murphy II*'s constitutional holding.

After all, in the wake of the first iteration of *Murphy*, many observers had feared that once one domino in the unconstitutionality chain toppled, virtually no tax would be safe from constitutional attack. Yale's Michael Graetz said that *Murphy I* would "launch a thousand [other] constitutionality arguments that people would have

thought laughable before."³ Whether or not that is true, there was near hysteria in some sectors about undermining the scope of congressional taxing powers.⁴ That by itself may have foreshadowed at least some part of the result in *Murphy II*.

Yet even academics who thought *Murphy I* was a huge mess have expressed dissatisfaction with Judge Ginsburg's bobbing and weaving in *Murphy II*. The judge may have intended to show the fleetness and dexterity of Muhammad Ali, but he has all the grace of Rocky Balboa. The result is that even on the constitutional holding of *Murphy II*, there is confusion and ambiguity.⁵ Judge Ginsburg's lengthy journey to avoid any hint of reconsideration of his *Murphy I* monograph will fuel continuing debate over the interaction among the 16th Amendment, other constitutional taxing powers, and section 61.

Judge Ginsburg's act of vacating his first opinion means the first opinion disappears as a legal matter when replaced by the second.⁶ Nevertheless, there are few taxpayers, practitioners, or academics who will soon forget round one. This is especially true because the panel nowhere repudiates anything it said in *Murphy I*. Put differently, once one has inhaled *Murphy I*, merely exhaling it does not erase the imagery or argument that will fuel tax cases for years to come.

However, the *Murphy II* opinion is also hugely disappointing in its treatment of the statutory exclusion, an exclusion the IRS has not attempted to interpret since the 1996 statutory change. Although the second *Murphy* opinion is grounded in case law, its myopic focus on the "on account of" nexus in section 104 all but ignores the critical question of just what "physical sickness" and "physical injuries" might be. The *Murphy II* opinion is clearly not the finest hour of the U.S. Court of Appeals for the D.C. Circuit.

Whether the court got the result right may be a matter of opinion. Yet I do not believe I am the only reader who finds it disingenuous that the court nowhere seems to say that it got *anything* wrong the first time around. Presumably, one of the decisions is wrong, but the court goes to Herculean efforts to avoid saying so.

³Quoted in Lattman, "D.C. Circuit Reverses Itself in Tax Ruling," *WSJ Online*, July 3, 2007.

⁴See Sheryl Stratton, "Experts Ponder *Murphy* Decision's Many Flaws," *Tax Notes*, Sept. 4, 2006, p. 822, *Doc 2006-18393*, 2006 *TNT* 171-3.

⁵See comments by Profs. Gregory Germain, Deborah Geier, Bryan Camp, Joseph Dodge, and Alan Gunn available at http://taxprof.typepad.com/taxprof_blog/2007/07/tax-profs-disse.html#more.

⁶See *Dunning v. Citibank*, 950 F.2d 1419, 1424 (9th Cir. 1991), and *O'Connor v. Donaldson*, 422 U.S. 563, 578 (1975).

¹*Doc 2007-15777*, 2007 *TNT* 129-4 (D.C. Cir. 2007).

²Some reactions are laced with hyperbole. Former IRS Commissioner Donald Alexander even declared that with *Murphy II* on the books, "our tax system is safe again." Quoted in Peter Lattman, "D.C. Circuit Reverses Itself in Tax Ruling," *WSJ Online*, July 3, 2007.

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Rather, it asserts that its 180-degree flip-flop (well, that is, if there is any, er, change) came about because the government argued for the first time when requesting a rehearing *en banc* that the tax was constitutional because it was not a direct tax and is uniformly imposed. Plainly, the constitutionality of the tax was argued vigorously the first time around. Nevertheless, the court in *Murphy II* ultimately affirms the district court's judgment "based upon the newly argued ground that Murphy's award, even if it is not income within the meaning of the Sixteenth Amendment, is within the reach of the Congressional power to tax."⁷

I believe some of Judge Ginsburg's rhetoric may actually help some taxpayers in ways the court probably did not intend.

Good Facts and Good Law

It is axiomatic that bad facts make bad law.⁸ Murphy's facts were (and to my mind still are) appealing. They are good facts for applying at least some amelioration for the tax treatment of Murphy's recovery. Murphy alleged that her former employer, the New York Air National Guard, blacklisted her and provided unfavorable references after she complained about environmental hazards. Although her claim was about blacklisting, she submitted evidence in an administrative hearing that she had mental and physical injuries from the blacklisting. A physician testified she suffered emotional as well as "somatic" injuries, including bruxism (teeth grinding that can cause permanent tooth damage).

The presiding administrative law judge determined that Murphy also had other physical manifestations of stress, including anxiety attacks, shortness of breath, and dizziness. The ALJ recommended compensatory damages of \$70,000, \$45,000 of which he attributed to "emotional distress or mental anguish" and \$25,000 for "injury to professional reputation." Notably, none of Murphy's award was for lost wages or diminished earning capacity.

The ALJ's award was affirmed by the Department of Labor Administrative Review Board, and Murphy received her money in 2000. She paid her taxes but later filed an amended return claiming the award to be excludable. The IRS denied the refund claim, and Murphy sued in district court. She argued that her recovery was excludable under section 104(a)(2), or, alternatively, that this provision was unconstitutional because her award was not income within the meaning of the 16th Amendment to the Constitution.

The IRS roundly disagreed, and the district court granted summary judgment to the government. Before the D.C. Circuit Court of Appeals, Murphy argued the applicability of the statutory exclusion (bruxism is physical, and so forth), and again argued her constitutional point.

Murphy I

In its first iteration, in what was literally to be an opinion heard round the world, Judge Ginsburg concluded that section 104 in its post-1996 act version did not

exclude this kind of recovery from income. After all, Judge Ginsburg reasoned, the wording of the arbitration award made it clear that Murphy received her recovery for emotional distress or mental anguish and for injury to reputation. Instead, Judge Ginsburg went on to evaluate how taxing those items would stack up under constitutional standards, particularly given the prevailing word choice and authority emanating from the early history of the income tax.

In what was to become a highly criticized opinion, Judge Ginsburg said — somewhat inaccurately but with great egalitarian wisdom — that payments for injuries of this sort don't really make one better off. Moreover, Judge Ginsburg found that there was no suggestion that Congress really believed those awards should be taxed, and that section 104 was unconstitutional to the extent it said otherwise.⁹

Ultimately, most people read the first *Murphy* opinion to hold section 61 (rather than section 104) to be unconstitutional to the extent it taxed such a recovery. Or put somewhat more colloquially, most people read Judge Ginsburg's first *Murphy* opinion as a statement that the 1996 amendments to section 104 (imposing the "physical" requirements) were invalid.

Although the IRS petitioned the D.C. Circuit for a rehearing *en banc*, just before Christmas 2006,¹⁰ Judge Ginsburg denied that motion but simultaneously (on the court's own motion) vacated the first opinion and set the case for new briefing and argument. An unusual case became even more atypical. On April 23, 2007, the court heard the second oral argument in the case. On July 3, 2007, the court issued *Murphy II*.

The Wealth of Nations

It must be daunting to be an individual American taxpayer seeking the remediation of a tax dispute, only to find page after page of discussion by the governing body (in this case the D.C. Circuit Court of Appeals) citing *The Federalist Papers*. The court's constitutional discussion consumes nearly 20 pages of the opinion, and refers to such lofty sources as the Articles of Confederation, Alexander Hamilton, and a slew of court opinions, both great and small. Yet for all its puffery, I do not think *Murphy* will be remembered for its foray into the constitutional underpinnings of the income tax, or for its power to reach just about whatever Congress says it should. I believe *Murphy* will be remembered for its arguably blemished view of section 104.

The taxpayer's statutory argument in *Murphy* was nothing new. Murphy experienced both mental and physical problems. According to the testimony in her

⁹See Lee A. Sheppard, "News Analysis: Murphy's Law — Tax Provision Declared Unconstitutional," *Tax Notes*, Sept. 4, 2006, p. 825, Doc 2006-18403, 2006 TNT 171-4.

¹⁰One observer noted the political spin timing: The shocker order vacating *Murphy I* hit right before Christmas, and the other shoe dropped on the eve of Independence Day, suggesting a politician's guile for deemphasizing bad or embarrassing news. See Roth & Company, "Murphy' Goes Out with a Whimper," <http://www.rothcpa.com/archives/002812.php>.

⁷*Murphy* at 5-6.

⁸Oddly, the genesis of this axiom is unclear.

underlying administrative proceeding, her former employer's blacklisting caused her to suffer somatic and emotional injuries. She suffered bruxism, anxiety attacks, shortness of breath, and dizziness. Yet the ALJ entered the fateful phrases "emotional distress or mental anguish" and "injury to professional reputation" on the award of damages.

As a result, Murphy had to argue that despite that language in the order, her award *did* compensate her for personal physical injuries or personal physical sickness. There was no question that Murphy's claim was based on tort or tort-type rights in the applicable whistle-blower statutes. Indeed, the IRS did not even challenge the tort or tort-type rights basis, but disputed whether her injuries were physical and whether the damages were paid on account of them.

Before a taxpayer can exclude compensatory damages from gross income under section 104(a)(2), *Commissioner v. Schleier*¹¹ says he must demonstrate that the underlying cause of action giving rise to the recovery was based on tort or tort-type rights, and that the damages were awarded on account of personal physical injuries or sickness. The statute was changed in 1996 to require *physical* injury or sickness rather than merely *personal* injury or sickness. The IRS has been a veritable tortoise in issuing regulations to define physical injury. Administratively, the IRS has suggested that you really must be able to see the injury.¹² One can see broken bones and bruising, but many injuries or illnesses are not apparent to the naked eye.

Taxpayers have grappled with what is and is not physical.¹³ The oft-quoted legislative history to the 1996 act states that mere symptoms of emotional distress do not constitute physical injuries. The cited examples include headaches, stomachaches, and insomnia.¹⁴ One case suggests that ulcers may be physical,¹⁵ but a vast number of maladies are in a kind of no man's land. If headaches are not sufficient to constitute physical sickness, what about cluster headaches or migraines? What about an aneurysm or stroke?

The first *Murphy* opinion did not answer the question of just what constitutes physical injuries. Indeed, it didn't

even try. But at least *Murphy I* noted that the question was confusing and that the IRS has done little to remedy that posture.

Perhaps much more concerned in *Murphy II* with covering up any mistake it might have made in *Murphy I*, the court doesn't offer any comments about this issue in the second go-round. The first *Murphy* opinion was clear that the IRS had been tardy in writing regulations under the post-1996 act version of section 104. The most Judge Ginsburg does in his *Murphy II* reprise is to drop a footnote blandly saying that when regulations (under section 104) are inconsistent with the statute, the statute plainly controls.¹⁶

'On Account of What?'

Instead, Judge Ginsburg in *Murphy II* focuses myopically on the "on account of" phrase in section 104(a)(2). To put the importance of that phrase in context, the statute says you can exclude from your income damages you receive on account of physical injuries or physical sickness. The critical inquiry, said Judge Ginsburg in *Murphy II*, is when something was paid "on account of" the enumerated items.

With what I find to be a kind of English-as-a-second-language rigidity, Judge Ginsburg notes that Murphy no doubt suffered physical problems. Yet Judge Ginsburg refers to a written record enunciating that the labor board awarded Murphy compensation *only* for mental pain and anguish and for injury to professional reputation. Sure, said Judge Ginsburg, the record shows that there were physical ailments and that the board may have even considered them.

Yet Judge Ginsburg says he simply cannot say the board awarded Murphy damages *because* of her bruxism and other physical manifestations of stress.¹⁷ Murphy noted that both the ALJ and the board in her case expressly cited the portion of her psychologist's testimony establishing her physical injuries. She therefore argued that the board relied on physical injuries in determining her damages. That does seem like a reasonable inference.

Nevertheless, the *Murphy II* opinion refuses to connect the dots. In an odd concluding paragraph on this point, Judge Ginsburg offers to throw Murphy a bone, saying: "At best the Board and the ALJ may have considered her physical injuries . . . but her physical injuries themselves were not the reason for the award."¹⁸ Concluding this portion of the *Murphy II* opinion with a quote, Ginsburg said: "We conclude Murphy's damages were not 'awarded by reason of, or because of . . . [physical] personal injuries.'"¹⁹

Bear in mind that the "on account of" language (to which the court in *Murphy II* adheres like a barnacle) appears in *O'Gilvie*. That case evaluated the tax treatment of punitive damages awarded in a toxic shock syndrome case for the wrongful death of a woman. The jury

¹¹515 U.S. 323, Doc 95-5972, 95 TNT 116-8 (1995).

¹²See LTR 200041022, Doc 2000-26382, 2000 TNT 201-10. See also Wood, "The Case for Excluding Discrimination, Harassment Recoveries Under Section 104," 78 *Daily Tax Report (BNA)* (Apr. 25, 2005), p. J-1.

¹³See Wood, "Post-1996 Act Section 104 Cases: Where Are We Eight Years Later," *Tax Notes*, Oct. 4, 2004, p. 68, Doc 2004-18582, 2004 TNT 189-27. See also Wood, "Damage Awards: Sickness, Causation and More," *Tax Notes*, June 12, 2006, p. 1233, Doc 2006-10655, 2006 TNT 113-22.

¹⁴See Conference Committee Report 104-737, p. 300.

¹⁵See *Vincent v. Commissioner*, T.C. Memo. 2005-95, Doc 2005-9343, 2005 TNT 85-6. The taxpayer in *Vincent* failed to achieve a section 104 exclusion because the Tax Court concluded the jury never even considered the ulcers in reaching a verdict. See also Wood, "Ulcers and the Physical Injury/Physical Sickness Exclusion," *Tax Notes*, June 20, 2005, p. 1529, Doc 2005-13042, 2005 TNT 115-33.

¹⁶See *Murphy II* at 11.

¹⁷*Id.* at 10.

¹⁸*Id.* at 11.

¹⁹*Id.*, citing *O'Gilvie*, 519 U.S. at 83.

awarded both compensatory and punitive damages, and there was never any question about the excludability of the compensatory damages.

The sole question in *O'Gilvie* was whether punitive damages in a 100 percent physical injury case could be taxed. The statutory change enacted in 1996 made it plain that punitives are taxable, but *O'Gilvie* addressed the question for the past. Not surprisingly, the Supreme Court held that punitive damages are taxable, by definition representing a windfall to the plaintiff. But the Court didn't help the "on account of" debate with its meanderings into causation.

Causation and Taxes

Murphy portends a careful application of the "on account of" enigma. What if the evidence showed that the ALJ awarded the money to Murphy because of her bruxism and acknowledged that the bruxism was caused by the emotional distress, which was caused by the defendants? If the judge's order so stated, or if there was a transcript in which the judge's reasoning was clear, even though the judge ultimately stated in his order that the payment is "for emotional distress," that might be enough for excludability.

Of course, it was clear long before *Murphy II* that the wording of a court order (or as in this case, an administrative order) is important. Because the court in *Murphy I* and *Murphy II* concluded that Murphy did not carry her burden of showing that her recovery was "on account of" physical injury/sickness, it is worth asking what *would* have worked. Notes? Pleadings? A transcript? Surely the language of the order itself should not be the only reference point.

After all, the IRS has long taken the position that it is not bound by characterizations in court orders or settlement agreements.²⁰ That rule should work both ways. Yet the "on account of" phrase continues to be enigmatic, and given its manifest importance, that is disturbing.

The *Murphy II* court says *O'Gilvie*²¹ makes the exclusion available only for personal physical injury damages awarded by reason of, or because of, the personal physical injuries. *Murphy II* cites *O'Gilvie* for the notion that something stronger than but-for causation is required. Such gradations of "why" a payment is made are troubling. In fact, they conjure up notions of the principal purpose provisions of the code, which have always recognized that there are generally multiple reasons for things.

Despite the constitutional reach of *Murphy*, and despite multiple Supreme Court cases that attempt to make "on account of" less nebulous, *Murphy II* fails to clean this one up, and perhaps makes it worse. The starting point must be the statute. The "on account of" language has required a nexus between damages and injuries since

its origin in the 1918 predecessor to section 104(a)(2).²² The same language appeared in the 1939 code, the 1954 code, and the 1986 code. In 1996, Congress amended section 104(a)(2) to exclude punitive damages from the statute, making punitive damages always taxable, and to require the personal injury or sickness to be physical.

As I read it, section 104 makes the relevant nexus between the damages received and the injury. The statute excludes "damages . . . received . . . on account of personal physical injuries or physical sickness." No words in the statute require a relationship between the tortious act and the physical injuries or physical sickness for which damages are received.

Significantly, the 1996 amendments did not alter the "on account of" language, although the legislative history attempts to elucidate the "on account of" nexus between the recovery and the injuries. According to the legislative history, "If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party."²³

There are two crucial points in that statement. First, the relevant "on account of" nexus is between damages and a physical injury or sickness (that is, all damages that "flow therefrom"). In analyzing the wrongful or tortious act, Congress required that the action have its *origin* in a physical injury or sickness. I do not believe that means there must be a causal nexus between the tort and the injury.

Second, the legislative history expressly recognizes that the recipient (plaintiff) need not be the one who suffers the physical injuries. A payment can be "on account of" physical injuries or sickness even if the plaintiff is not injured but recovers on behalf of an injured party. Examples include recoveries for loss of consortium (based on physical injury to a spouse) and wrongful death. Both of those qualify under section 104(a)(2).²⁴

Real-World Examples

Suppose a police officer sues for racial discrimination (and related torts) that prevented a promotion. The promotion would have taken the plaintiff from his patrolman job, in which he walked a beat, to a managerial office job in which he wouldn't have walked a beat. He is injured on the job while walking his beat — something that was, at least in part, caused by the discrimination — and recovers more in his discrimination case because of it.

"But for" causation seems to suggest that the patrolman here recovered (at least in part) for his job-related physical injury because of the discrimination. While this

²⁰See *Robinson v. Commissioner*, 102 T.C. 116, Doc 94-1439, 94 TNT 23-18 (1994), *aff'd in part, rev'd in part*, 70 F.3d 34, Doc 95-10932, 95 TNT 238-7 (5th Cir. 1995); *McKay v. Commissioner*, 102 T.C. 465, Doc 94-3399, 94 TNT 60-9 (1994), *vacated on other grounds*, 84 F.3d 433, Doc 96-13888, 96 TNT 92-7 (5th Cir. 1996); *Brown v. United States*, 890 F.2d 1329, 1342 (5th Cir. 1989).

²¹519 U.S. at 454.

²²See Revenue Act of 1918, ch. 18, section 213(b)(6).

²³H.R. Conf. Rep. No. 104-737, at 300 (1996). (Emphasis added.)

²⁴See *Paton v. Commissioner*, T.C. Memo. 1992-627 (wrongful death), and LTR 200121031, Doc 2001-15011, 2001 TNT 103-10 (wrongful death and loss of consortium).

injury should meet the *Schleier*²⁵ test, the action must also be based in tort. Here, perhaps we don't have enough facts to know what tax result would apply. I believe the recovery should be allocated between taxable wages and taxable nonwage amounts for the discrimination, and nontaxable amounts for the injury.

That is what *should* happen, at least in my opinion. I suspect the IRS would disagree. If the IRS acknowledged that there should be some kind of allocation for the physical injury on this fact pattern, they might limit that allocation to the amount of damages that would be available in a worker's compensation claim. Yet plaintiffs' counsel often go to significant lengths not to be limited to workers' compensation ceilings. Of course, how clear the tort claims are in the complaint should be an important factor.

To take another example, suppose a plaintiff sues for discrimination and failure to accommodate disabilities in the workplace, which allegedly caused additional or more severe sickness. Assuming one has the proper tort-based cause of action too, perhaps it would be easy to allocate between physical and nonphysical elements of the case. That may be the proper (and most practical) result.

A great deal will often turn on the relationship between the harm and the recovery, and medical evidence will be important. The Tax Court has found that uncorroborated testimony about the exacerbation of harm is not enough to support an exclusion.²⁶ That suggests that corroborated testimony might be treated differently. Although exact wording may be more important than the intent of the payer and other traditional reference points, mere wording might not be the only consideration.

Besides, counsel often draft court orders for judges to sign. Plaintiffs' counsel already include battery claims in employment cases on appropriate facts. Given that the vast majority of cases are settled and do not go to a verdict or administrative ruling, the settlement process is likely to become more tax-centric, with increased attention paid to exactly what documents say. Unlike most cases, *Murphy* went to judgment, or at least its administrative equivalent. Settlement by its very nature offers vastly more tax flexibility.

Courts applying the two-tier *Schleier* test may find that a recovery fails the first requirement because it was not based on tort or tort-type rights.²⁷ However, courts often do not make clear whether the taxpayer failed the first or the second *Schleier* test. For example, in *Johnson v. United States*,²⁸ the court held that a guard at a juvenile detention center who suffered injuries while restraining an inmate could not exclude his recovery from income. The guard brought suit under the Americans With Disabilities Act

after his employer failed to accommodate his physical limitations resulting from the incident.

The court found the claim to be tort-based, but it concluded that the recovery was not on account of personal physical injuries or physical sickness. Interestingly, the Tenth Circuit Court of Appeals in *Johnson* said that the link between the discrimination-based discharge and the work-related injuries was simply too tenuous to support an exclusion. A better link between the discharge and the injuries might yield a different result.

As reflected in the Tax Court's statement in *Prasil v. Commissioner*²⁹ that uncorroborated testimony about the exacerbation of harm was not enough to support an exclusion, to some extent, this may simply be a question of degree. Thus, in *Reid v. Commissioner*,³⁰ a cashier at a Chevron station alleged that he injured his shoulder by lifting a bucket of ice. He filed for workers' compensation benefits, but his claim was denied and he was terminated. He later sued for wrongful discharge.

When his case was settled, he argued that the award was excludable under section 104. The Tax Court acknowledged that there might be an ancillary cause of action based on tort or tort-type rights, but it concluded that the recovery was not for personal physical injuries or physical sickness. Here, as in so many of these cases, the IRS and the courts seem to look for the substance of the case and the reason the defendant paid the amount. Language in a settlement agreement can be helpful when the underlying facts of the case and the pleadings support the tax language.

Murphy's imprint on this area is important. *Murphy* argued cogently that the legislative history to the 1996 change attempts to separate transitory symptoms from serious and permanent physical injuries and physical sickness. Hers were not minor and transitory symptoms of emotional distress like headaches, upset stomach, and sleeplessness. Those inconveniences are not permanent in nature. This broaches the territory of one of the great unspoken phrases of the tax law: "physical sickness," an epigram that receives no attention in the literature, the case law, or anywhere else.³¹ If one cannot draw a bright line between physical injuries and mere symptoms of emotional distress, the line is even fuzzier when it comes to physical sickness.

'On Account' vs. 'Physical'

Although the "on account of" phrase is important, we still need to know what is and is not physical. If the IRS will not define the term in regulations (so far it doesn't seem inclined to do so), taxpayers must do the best they can. *Murphy* pointed to her physician's testimony that she had experienced "somatic" and "body" injuries "as a result of [the defendant's] blacklisting." She also pointed to the *American Heritage Dictionary*, which defines somatic as "relating to, or affecting the body, especially as distinguished from a body part, the mind or the environment."

²⁵*Schleier v. Commissioner*, 515 U.S. 323, Doc 95-5972, 95 TNT 116-8 (1995).

²⁶See *Prasil v. Commissioner*, T.C. Memo. 2003-100, Doc 2003-9085, 2003 TNT 69-39.

²⁷See *Tamberella v. Commissioner*, Doc 2005-15534, 2005 TNT 140-11 (2d Cir. 2005).

²⁸76 Fed. App. 873, Doc 2003-19761, 2003 TNT 172-6 (10th Cir. 2003), cert. denied, 124 Sup. Ct. 2888 (2004).

²⁹*Supra* note 26.

³⁰T.C. Summ. Op. 2002-55, Doc 2002-12459, 2002 TNT 100-12.

³¹See Wood, "Physical Sickness and the Section 104 Exclusion," *Tax Notes*, Jan. 3, 2005, p. 121, Doc 2004-24100, 2005 TNT 2-41.

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Murphy also submitted her dental records, proving she had suffered permanent damage to her teeth. That certainly sounds physical. Quite apart from rudimentary sources like dictionaries, Murphy cited several federal court decisions showing that for various purposes, substantial physical problems caused by emotional distress are *indeed* considered physical injuries or physical sickness.

For example, in *Walters v. Mintec/International*,³² the Third Circuit held that a plaintiff could recover for physical harm caused by the emotional disturbance of an accident. The court based its decision on the *Restatement of Torts*, which requires physical harm for damages to be available. *Walters* squarely presents the question whether an injury resulting from emotional disturbance can be “physical” harm. Concluding that it can, the Third Circuit quotes from the comments to the *Restatement of Torts*:

The fact that [emotional disturbance is] accompanied by transitory, non-recurring phenomena, harmless in themselves, such as dizziness, vomiting, and the like, does not make the actor liable where such phenomena are in themselves inconsequential and do not amount to any substantial bodily harm. On the other hand, long continued nausea or headaches may amount to physical illness, which is bodily harm; and even long continued mental disturbance . . . may be classified by the courts as illness, notwithstanding their mental character.³³

Murphy also relied on *Payne v. General Motors Corp.*,³⁴ another nontax case, in which an employee sued an employer under Title VII of the Civil Rights Act of 1964, for civil rights violations under section 1981, and for negligent infliction of emotional distress. The employee suffered from constant exhaustion and fatigue, diagnosed by a psychologist as resulting from the employee’s depression. The court held that the problems constituted “physical injuries,” a prerequisite to an action for negligent infliction of emotional distress under Kansas law.

In my practical experience, Murphy was right to focus on what is (or is not) physical. At many levels, the IRS does that too. Because there is little guidance, and because reasonable minds can and do differ on what qualifies, the IRS often looks to medical records and other evidence to see how sick or how injured the taxpayer/plaintiff really was. That is as it should be.

It is unclear how one evaluates whether a particular medical problem is a mere symptom of emotional distress (taxable) or a physical sickness or physical injury in its own right (excludable). Presumably, the IRS will someday propose regulations saying that in its view, one must be able to observe bruising or the equivalent for there to be a physical injury. Yet the statute says damages paid on account of physical *sickness* are excludable too. Many physical sicknesses do not involve bruising or

other outward manifestations of harm, unless one includes EKGs, blood work visible with a microscope, X-rays, etc.

Surely one can rely on such manifestations, if there even is a requirement that the sickness be capable of being seen. After all, the term “physical” as it modifies “sickness” in the statute may simply mean that the sickness can’t be “mental” and still give rise to an exclusion. Physical (as opposed to mental) sickness can be perceived by someone, even if that someone is a medical professional with special skills and equipment.

Problems of Proof

The road to a section 104 exclusion is littered with proof problems. The taxpayer must be prepared to show (even though he may never be asked to show it) that he suffered physical injuries or physical sickness and that there was a causal nexus between the events set in motion by the defendant and this physical injury or physical sickness. In some cases, the plaintiff might be able to demonstrate only that he *claimed* this causal connection, not that it existed.

For example, in *Henderson v. Commissioner*,³⁵ the Tax Court found that, absent a showing of personal physical injuries or physical sickness, recoveries for injury to reputation were fully taxable. The Tax Court was satisfied that Henderson had met the first prong of the *Schleier* test but failed to prove that any portion of his recovery was on account of personal physical injuries or physical sickness. *Witcher v. Commissioner*³⁶ is to the same effect. Another case involving proof problems is *Tritz v. Commissioner*,³⁷ in which the Tax Court found that payments were not excludable despite allegations about carpal tunnel syndrome.

Constitutionally Speaking

Since the *Murphy* debates started, I have shied away from constitutional discussion, mostly out of an acknowledged sense of ignorance. Most tax lawyers (with the exception of a few state and local tax lawyers) are not constitutional scholars and are hardly versed in most of the constitutional provisions. I suspect that may be true even of some of the people who roundly criticized *Murphy I*. Most tax lawyers who have been practicing for any length of time probably assume Congress passes tax laws that, once passed, are enforceable.

Yet even if you (like me) consider the constitutional discussion largely out of your realm, there is at least one constitutional aspect of *Murphy II* that merits examination. That is the notion that Murphy’s recovery might not be income but still might be subject to tax. This may be more of a brainteaser than a Rubik’s Cube. Like quicksand that gets worse the more you move, the court gets itself into this fix by its gyrations explaining its 180-degree turn between *Murphy I* and *Murphy II*.

This was not a “we got it wrong the first time,” *mea culpa*, nor even a “we reconsidered after rereading the case law.” Hardly. The about-face, the court says, is

³²758 F.2d 73 (3d Cir. 1985).

³³See *Restatement (2d) of Torts* section 436A, Comment C (1965), quoted in *Walters v. Mintec/International*, 758 F.2d 73 at 1985 U.S. App. Lexis 29782, p. 6.

³⁴731 F. Supp. 1465, 1474-1475 (D. Kan. 1990).

³⁵T.C. Memo. 2003-168, Doc 2003-14014, 2003 TNT 111-12.

³⁶T.C. Memo. 2002-292, Doc 2002-26347, 2002 TNT 229-6.

³⁷T.C. Summ. Op. 2001-76, Doc 2001-15770, 2001 TNT 108-12.

attributable to a new and novel argument the IRS raised for the first time in its petition for rehearing *en banc* (of course, the court denied that motion). This new and novel argument, says the court, is that while Murphy's recovery may not be income within the meaning of the 16th Amendment, Congress can still tax it without violating the Constitution.

Although I am still studying the opinion, the court never really deals with that argument. My cynicism suggests that it leaves the matter open to appear thoughtful, but that it covers its tracks for what some people regard as poor constitutional analysis the first time around.

Some readers may read only the headnotes to *Murphy II*, observing that section 104 was not applied and that the tax is constitutional. That might suggest there is no need to wade through the opinion. That would be a mistake. Indeed, some of the arguments Murphy makes, the way the court deals with them, and the court's own extraordinary backpedaling to save face may offer a silver lining for at least some taxpayers.

As with the first iteration of the case, Murphy argued that her award was not a gain or accession to wealth, and therefore could not be part of her gross income. Again citing Nobel Laureate Gary Becker, Murphy argued that human capital was not income. Her damages, she argued, represent a restoration of capital.

Although all three judges considering *Murphy I* were impressed by the taxpayer's historical analysis the first time around, the discussion of the prevailing 1918 linguistics and authority are abbreviated in *Murphy II*. In its attempt to pound multiple nails in the coffin of every *Murphy* descendant, the government ends up arguing that even if the concept of human capital is built into section 61, Murphy's award must nevertheless be taxable because Murphy has no tax basis in her human capital.

Under the government's argument, the taxpayer's gain on the disposition of property is the difference between the amount realized on that disposition and her tax basis.³⁸ That is adjusted for expenditures, receipts, losses, or other items properly chargeable to capital account.³⁹ The government continued its argument that one cannot claim a basis in one's human capital, so Murphy's gain would have to be the full value of the award.⁴⁰

Although the *Murphy II* court *seems* to acknowledge that *Glenshaw Glass*⁴¹ requires there to be an accession to wealth for an award to constitute income, Judge Ginsburg said, "It is unnecessary to determine if there was an accession to wealth in this case."⁴² Sidestepping the question whether there was an accession to wealth here, the *Murphy II* court says that Congress cannot make

something income that is not income.⁴³ However, it can *label* something as income and tax it, as long as Congress acts within its constitutional authority. Huh?

That authority, says Judge Ginsburg, includes not only the 16th Amendment to the Constitution, but also Article I, sections 8 and 9.⁴⁴ Thus, Judge Ginsburg puts aside whether Murphy had an accession to her wealth and says the heart of the matter is simply whether her award is properly included within the "all income from whatever source derived" language of section 61.

But here the court seems to waffle. Judge Ginsburg admits that section 61(a) by itself contains no indication that it should cover Murphy's award, unless the award is income as defined by *Glenshaw Glass*. Indeed, Judge Ginsburg agrees with Murphy that damages received for emotional distress are not listed among the examples of income in section 61. However, Judge Ginsburg declines to follow the maxim that ambiguities in the meaning of a revenue-raising statute should be resolved in favor of the taxpayer.

Instead, Judge Ginsburg relies on the 1996 act's legislative history, which made it crystal clear (he says) that Congress intended to tax emotional distress recoveries. The court then says that while the 1996 amendment to section 104 suggests section 61 should be read to include awards for nonphysical harms, the court nevertheless recognizes that "amendments by implication, like repeals by implication, are disfavored."⁴⁵ More quicksand.

The court then strings together various quotes and references to case law, indicating that it is a "classical judicial task" to figure out whether gross income as defined in section 61(a) includes awards for nonphysical damages such as Murphy received. The court holds that it does, regardless of whether the award is an accession to wealth. The court does not cite *Eisner v. Macomber*,⁴⁶ and more than a few readers may wonder if Judge Ginsburg (intentionally or not) has either undermined that case or even overruled it.

Judge Ginsburg then recites Congress's broad taxing power established by Article I, section 8. Because it is relevant to inquire whether the tax is a direct tax under that provision, the panel then confronts that question. After an exhausting (if not exhaustive) romp through historical direct vs. indirect verbiage, through apportionment, confederation, and confoundment, the framers' intent on Congress's ostensibly plenary taxing power — even on negotiations between the representatives of the slave states and those of the free states (no, I am not joking) — the court eventually rules.

It disagrees with Murphy. Yet the court also fails to adopt the IRS's position that direct taxes are only those capable of satisfying the constraint of apportionment.⁴⁷

³⁸See section 1001.

³⁹See sections 1012 and 1016(a)(1).

⁴⁰For this proposition, the government — and the *Murphy II* court — cites *Roemer v. Commissioner*, 716 F.2d 693, 696 n.2 (9th Cir. 1983).

⁴¹348 U.S. at 430-431.

⁴²See *Murphy II* at 16.

⁴³For this proposition, the court cites *Burk-Waggoner Oil Association v. Hopkins*, 269 U.S. 110 (1925).

⁴⁴For this, the court cites *Penn Mutual Indemnity Co. v. Commissioner*, 277 F.2d 16 (3d Cir. 1960).

⁴⁵See *Murphy II* at 18, citing *United States v. Welden*, 377 U.S. 95, 103 n.12 (1964).

⁴⁶252 U.S. 189 (1920).

⁴⁷See *Murphy II* at 26.

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Instead, the court asks “whether the tax laid upon Murphy’s award is more akin, on the one hand, to a capitation or a tax upon one’s ownership of property, or, on the other hand, more like a tax upon a use of property, a privilege, an activity or a transaction.”⁴⁸

Ultimately, Judge Ginsburg concludes that Murphy’s situation is akin to an involuntary conversion of assets. She was forced to surrender part of her mental health and reputation in return for money damages. The court even mentions section 1033. Although noting that Murphy had resisted the formulation of her award as a “transaction,” the court firmly treats it as a transaction — an involuntary conversion of human capital — with a tax on that property deal.

As an excise tax — which seems to be what the court is now calling the income tax on damage awards — this excise tax would have to be uniform. The court on the last page of its 30-page opinion concludes that the tax laid on an award of damages for a nonphysical personal injury operates uniformly throughout the U.S. It is direct.

Property vs. Income?

It will no doubt take some time for practitioners, academics, and plain old taxpayers to digest the court’s verbiage. Indeed, first reactions may be dangerous. Still, some income tax advisers may now start calling themselves excise tax advisers, even if they never venture into the arcane fields of gasoline, cigarette, or airline excise taxes per se. Less linguistically, some taxpayers will find some edible meat in *Murphy II*.

For example, although perhaps not arising in the typical employment case, there has long been some attention paid to the capital vs. ordinary distinction in the damage awards arena. That is true in intellectual property cases, business cases, antitrust cases, and some others. Judge Ginsburg’s *tour de force* through the excise tax that we all pay under section 61 by itself suggests that involuntary conversions of assets — whether or not we have basis in those assets — may be a new way of looking at many litigation recoveries.

Silver Linings

I see *Murphy*’s cloud as having several silver linings. One, its attention on exact language should propel even more plaintiffs to the settlement table. There is nearly always more tax planning possible at settlement, and more certainty too, because one can (and should) address Forms 1099 and other reporting issues. And, when they discuss settlement and reach an agreement in principle, there will be that much more impetus for dotting i’s and crossing t’s in the tax language.

Second, and more important, all of the transactional (and nearly transcendental) analysis *Murphy II* provides will cause more taxpayers and advisers to consider the contexts in which litigation recoveries can be treated as capital rather than ordinary. Judge Ginsburg all but invites it. Although clearly there are basis issues and asset characterization issues to be observed, there is much food for thought here. Note too that Judge Ginsburg mentions section 1033, the involuntary conversion amelioration

provision. Section 1033 has been used by litigants before, but the prominent reference to it in *Murphy II* suggests that more taxpayers will explore this tack in the future.

More globally, reflect on the lines of cases involving capital vs. ordinary characterization.⁴⁹ They may just get you basis recovery and thereafter capital gain treatment. There has always been some concern whether in settling litigation one needed to have a sale or exchange to reach capital gain nirvana.⁵⁰ Although there is helpful authority on the other side of that issue,⁵¹ *Murphy II* should make taxpayers much more comfortable about it.

Of course, I am intentionally talking in generalities here, recognizing that capital gain theories in some types of litigation recoveries will have little bearing. But, in a general sense, the D.C. Circuit may have unleashed a vibrant and potent theory across a fertile field of litigation recoveries.

By the way, if I’ve flipped 180 degrees on anything I’ve said here compared with my prior *Murphy* articles, I’ve probably just made a plain old mistake. There, that wasn’t so hard!

⁴⁹See, e.g., *Big Forno Industries v. Commissioner*, 40 T.C. 1055 (1963), *acq.*, 1964-1 C.B. (Pt. 1) 4.

⁵⁰See Rev. Rul. 74-251, 1974-1 C.B. 234. See also *Steel v. Commissioner*, T.C. Memo. 2002-113, *Doc 2002-10804*, 2002 TNT 88-23.

⁵¹See *Inco Electroenergy Corp. v. Commissioner*, T.C. Memo. 1987-437.

⁴⁸See *id.* at 27.