

TO TAX OR NOT TO TAX – THAT IS THE QUESTION IN THE MIDST OF *MURPHY V. I.R.S.*¹

I. INTRODUCTION

Sunday night. Quiet family evening. Mom, dad, and their 7-year-old daughter (we'll call her "Emily") are watching a family movie on television. Suddenly, the door is wrenched open and several men in black uniforms rush in. They attack the father – forcing him on the floor with his hands behind his back – while yelling for everyone to stay calm and reading the father his Miranda² rights. Mom quickly takes Emily into the kitchen, and the child's wide eyes are shining from the doorway – taking in the actions around her father.

The reason for the intrusion? The police misread a house number and arrested the wrong person. A lawsuit follows and the now 8-year-old Emily is awarded emotional distress, post-traumatic stress disorder, fear, separation anxiety, and panic attacks damages in the amount of \$800,000 – \$200,000 punitive and \$600,000 compensatory. The evidence offered to the jury included Emily's overall nervousness, fear, and shuddering every time someone knocked on the door. She did not want to step away from her father and had a fear of most strangers – especially ones dressed in black.

The above hypothetical situation brings up the question of damages taxation: how will Emily's damages be taxed? The relevant section of the Internal Revenue Code is § 104(a)(2),³ but the answer does not come easily, if at all.⁴ This code section has seen differences of opinion,⁵

1. 460 F.3d 79 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

2. *Miranda v. Arizona*, 384 U.S. 436 (1966). The typical Miranda warning advises of the following: the right to remain silent, the right to have an attorney present during questioning, and the right to have an attorney appointed if the suspect cannot afford one. BLACK'S LAW DICTIONARY 1018 (8th ed. 2004).

3. I.R.C. § 104(a)(2) (2006) (all code references throughout the paper refer to the Internal Revenue Code — 26 U.S.C., unless otherwise stated). Partially quoted *infra* note 120.

4. *See infra* Parts IV and V.

5. *See infra* note 38.

amendments,⁶ and commentator mistrust⁷ on numerous occasions, so the plaintiffs are left without any definitive answers regarding taxation of their damage awards.⁸

In 1996, Congress amended § 104 of the Internal Revenue Code adding the word “physical” to the exclusion of “compensatory damages for personal injuries.”⁹ According to this latest version of the statute, Emily’s award would be fully taxable because it was not awarded for a “physical” personal injury¹⁰ and thus, does not fall within the § 104(a)(2) exclusion from income.

In August of 2006, the D.C. Circuit Court of Appeals rendered a monumental decision that could change the course of damages taxation.¹¹ In *Murphy v. I.R.S.*, that court ruled that § 104(a)(2) is unconstitutional insofar as it “permits taxation of compensation for a personal injury, which compensation is unrelated to lost wages or earnings.”¹² If this decision were followed throughout the country, more and more victims in the child’s position would keep their recoveries tax-free.

This note examines § 104(a)(2) and the D.C. Circuit decision in *Murphy v. I.R.S.* focusing on the need for further guidance on taxation of personal damages.¹³ Part II inspects the background of taxation generally and § 104(a)(2) specifically.¹⁴ Additionally, Part II looks at the cases that shaped taxation of personal injury awards and Congress’s interpretation of this taxation.¹⁵ Part III discusses the background and judicial response to *Murphy*’s complaint, including the Secretary of Labor’s findings, Administrative Law Judge’s recommendations, the District Court decision, and the D.C. Circuit arguments and decision.¹⁶ Part IV assesses the reasoning of the D.C. Circuit’s decision, advocating that it is the correct path¹⁷ for the taxation of personal injury awards.¹⁸

6. See *infra* Part II, Section B.

7. See *infra* note 33.

8. See *infra* Part IV, Section E.

9. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (1996).

10. See *infra* notes 53-59 and accompanying text.

11. *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

12. *Id.* at 92.

13. See *infra* Parts IV and V.

14. See *infra* Part II.

15. See *infra* Part II.

16. See *infra* Part III.

17. Although *vacated*. *Murphy v. I.R.S.*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

Furthermore, Part IV looks to the future of § 104(a)(2) and provides recommendations to plaintiffs and their attorneys.¹⁹ The last section of Part IV returns to Emily's hypothetical and discusses what taxation options exist for the child.²⁰ Finally, Part V calls for more analysis and guidance in applying § 104(a)(2) and further for a decision supporting the original *Murphy* ruling.²¹

II. BACKGROUND

A. The Sixteenth Amendment

The modern meaning of taxation goes back to the enactment of the Sixteenth Amendment.²² After the 1894 income tax was struck down by the Supreme Court,²³ the “income tax proponents had to resolve the difficult threshold question: whether to seek a new statute or go first for a constitutional amendment.”²⁴ As history tells us, the Amendment theory prevailed and the final version of the Sixteenth Amendment emerged: “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.”²⁵ “The Supreme Court understood . . . after ratification of the Sixteenth Amendment that ‘incomes’ has a meaning and that, as a result,

18. See *infra* Part IV.

19. See *infra* Part IV.

20. See *infra* Part IV.

21. See *infra* Part V.

22. “The history of the Sixteenth Amendment began shortly after the Garden of Eden, I suppose, but for present purposes we can begin in the late nineteenth century.” Erik M. Jensen, *The Taxing Power, The Sixteenth Amendment, and the Meaning of “Incomes,”* 33 ARIZ. ST. L.J. 1057, 1093 (2001). The Amendment came from the debates over an income tax and a consumption tax – “one’s consistent with ability to pay, one’s not.” *Id.* at 1096. There was a push to make taxation more fair and more aligned with ability to pay. *Id.* at 1093-114.

23. The 1894 income tax was struck down by the Supreme Court in the Income Tax Cases. Jensen, *supra* note 22, at 1107 (citing the *Pollock* cases: *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429 (1895), *modified on reh’g* by 158 U.S. 601 (1895); *Pollock v. Farmers’ Loan & Trust Co.*, 158 U.S. 601 (1895)).

24. Jensen, *supra* note 22, at 1109. “The move for an amendment was intended to do what income tax proponents had attempted in 1894: shifting the tax base from consumption to income, and thereby tying tax burdens to ability to pay.” *Id.* The income tax proponents realized that it was not necessary to amend the Constitution, but “[t]here would be no income tax until the Constitution was amended.” *Id.* at 1114 (discussing a 1909 statement by Representative William C. Adamson of Georgia).

25. U.S. CONST. amend. XVI. This amendment was quickly ratified in 1913. Jensen, *supra* note 22, at 1122.

Congress's power to define what could be covered by an . . . income tax was limited."²⁶

B. Statutory Taxation

Federal statutory taxation of income stems from § 61 of the Internal Revenue Code.²⁷ "[S]ection 61(a) has been liberally construed 'in recognition of the intention of Congress to tax all gains except those specifically exempted.'"²⁸ The Internal Revenue Code provides that some income is excluded from taxation,²⁹ but those exclusions from gross income are construed narrowly.³⁰

The exclusion from gross income in § 104(a) has come under fire in

26. Jensen, *supra* note 22, at 1133.

27. I.R.C. § 61 (2006). "(a) General definition. --Except as otherwise provided in this subtitle, gross income means all income from whatever source derived . . ." *Id.* This section further lists fifteen items of gross income:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

Id. The gross income items listed are not exclusive and the regulations to § 61 state several additional items of gross income. See Treas. Reg. § 1.61-14(a) (as amended in 1993) (containing the additional items: punitive damages, another person's payment of the taxpayer's income taxes, illegal gains, and treasure trove).

28. Lorraine Stancknowitz Boss, Note, *Taxation and Personal Injury Awards: The Search for Workable Guidelines*, 62 ST. JOHN'S L. REV. 628, 628 n.1 (1988) (discussing *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955)).

29. I.R.C. § 101(a) (2007) (proceeds of life insurance contracts payable by reason of death); I.R.C. § 102 (2007) (gifts and inheritances); I.R.C. § 103 (2007) (interest on state and local bonds); I.R.C. § 106 (2007) (contributions by employer to accident and health plans); I.R.C. § 108 (2007) (income from discharge of indebtedness); I.R.C. § 117 (2007) (qualified scholarships); I.R.C. § 119 (2007) (meals or lodging furnished for the convenience of the employer); I.R.C. § 121 (2007) (gain from sale of principal residence); I.R.C. § 127 (2007) (educational assistance programs); I.R.C. § 129 (2007) (dependent care assistance programs), etc.

30. *Comm'r v. Schleier*, 515 U.S. 323, 328 (1995).

*Murphy v. I.R.S.*³¹ Section 104 excludes from taxation damages relating to compensation for injuries or sickness.³² This provision has been one of the more problematic sections in the Internal Revenue Code.³³ It has “developed significantly since the original version,”³⁴ which first appeared in the Revenue Act of 1918 as § 213(b)(6).³⁵ The original § 213(b)(6) exclusion “applied to amounts received through accident or health insurance or under workmen’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.”³⁶ The theory behind the original version was that the “‘human body is a kind of capital’ and . . . the proceeds from [certain damage or insurance] awards represent a ‘conversion of the capital lost through the injury.’”³⁷ Many courts and commentators have attempted

31. See *Murphy v. I.R.S.*, 460 F.3d 79, 84-92 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

32. I.R.C. § 104 (2007).

33. See Timothy R. Palmer, Note, *Internal Revenue Code Section 104(A)(2) and the Exclusion of Personal Injury Damages: A Model of Inconsistency*, 15 J. CORP. L. 83, 83 (1989) (noting that “few provisions . . . have created more problems of application.” Palmer discusses controversies around the terms “personal injuries” and “damages.”). See also Kevin C. Jones, Comment, *Taxation of Personal Injury Damage Awards: A Call for a Definition of the Scope of the Section 104(a)(2) Exclusion*, 66 TEMP. L. REV. 919, 919 (1993) (noting inadequate definition for “damages received” and “personal injury”); Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701, 701 (1986) (“[O]ne would assume that the taxation of such recoveries would be resolved by now. Such a resolution, however, has not occurred. Moreover, the confusion, which has always been rampant, has actually increased.”); *Id.* at 741-42 (“The exclusion for damages received on account of personal injury is a very confused subject. Both the general rules relating to the exclusion and the reasons behind the enactment of the exclusion are sources of mystery.”); Douglas K. Chapman, *No Pain – No Gain? Should Personal Injury Damages Keep Their Tax Exempt Status?*, 9 U. ARK. LITTLE ROCK L. J. 407, 408 (1986/87) (“[o]ver the . . . history of section 104(a)(2) . . . the courts, commentators, and the [IRS] have disputed both the scope of the section, the intent of the original exemption, and whether any such intent is being frustrated or perpetuated”); Cynthia A. Sciuto, Note, *A Tort by Any Other Name: Taxation of Non-Physical Personal Injury Damages After United States v. Burke*, 38 ST. LOUIS U. L.J. 285, 286 (1993) (noting that all the conflicting interpretations of § 104 have caused a “corresponding conflict among the judicial circuits”). The *Murphy* case is a further illustration of Sciuto’s statements.

34. Renee C. Harvey, Note, *Commissioner v. Schleier: An Unfair Interpretation of Section 104(A)(2)*, 30 U.S.F. L. REV. 313, 316 (1995). The section was enacted “to codify the Supreme Court’s decision in *Doyle v. Mitchell Bros. Co.*, [247 U.S. 179 (1918)], [where] the Court held that replacement of production capital was not income for taxation purposes. The Court determined that the definition of ‘income’ for tax purposes did not include the conversion of capital assets, reasoning that a conversion of capital assets to cash does not invariably produce income.” *Id.* (citations omitted).

35. See Harvey, *supra* note 34, at 317 (discussing Revenue Act of 1918, Pub L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919)).

36. *Id.*

37. *Id.* Harvey further notes that the lack of legislative history prevents discovering the exact

to find more justifications for the § 104(a)(2) exclusion and have attempted to give the section validity beyond that given by Congress.³⁸

reasons for Congress's initial enactment of this exclusion. *Id.* But see Palmer, *supra* note 33, at 86 (indicating that the legislative history "strongly suggests" that Congress intended for this section to provide "total" exclusion for such damages).

38. See Palmer, *supra* note 33, at 86-87. Palmer found several justifications including: justification on humanitarian grounds; "plaintiff is merely made whole by the receipt of damages and does not receive any increase in wealth;" this receipt of damages constitutes a return of capital; difficulty with allocation of personal injury awards between that taxable and the nontaxable portions; protects tortfeasors from unfairly high judgments. *Id.* The Seventh Circuit has stated that "[t]he provisions of [§ 104(a)(2)] undoubtedly were intended to relieve a taxpayer who ha[d] the misfortune to become ill or injured, of the necessity of paying income tax upon insurance benefits received to combat the ravages of disease or accident." *Epmeier v. United States*, 199 F.2d 508, 511 (7th Cir. 1952). See also Joseph W. Blackburn, *Taxation of Personal Injury Damages: Recommendations for Reform*, 56 TENN. L. REV. 661, 668-69 (1989). Blackburn had also noted several justifications – "relief[f] [of] a taxpayer who ha[d] the misfortune to become ill or injured," and "inten[t] to benefit injured persons by relieving them of the necessity of paying a tax on the amount awarded them as compensation for their injuries." *Id.* (quoting *Huddle v. Levin*, 395 F. Supp. 64, 87 (D. N.J. 1975), *vacated*, 537 F.2d 726 (3d Cir. 1976) and *Damages--Measure of Damages: Torts--Estimated Income Taxes Must Be Deducted from Damages for Loss of Earning Capacity*, 69 HARV. L. REV. 1495, 1496 (1956)). But see Henry, *supra* note 34, at 723-29 (refuting many of the proffered justifications). Henry begins with the idea that the plaintiff is merely made whole by the receipt of damages. *Id.* at 724. The problem here is the damages attributable to lost income – "[s]ince the taxpayer would have received the net income after tax in the absence of injury but receives the income unreduced by tax by way of damages, the recipient of damages, instead of merely being made whole, obtains increased wealth by receiving damages instead of his regular income." *Id.* at 724. The next justification attacked by Henry is that the receipt of damages constitutes return of capital:

The difficulty with this rationale is that the term capital implies an investment, or basis, in an asset. The term basis is defined as cost. A person does not have a basis in personal rights, because he has paid nothing to acquire them. While one has no basis in his future earnings and while such earnings are taxed, damages received in lieu thereof, which do not constitute gross income, cannot be considered a return of capital, because if they were, the actual earnings would be also. If damages for personal injury do constitute a return of capital, then it should not matter whether the payment is received before or after the injury. However, the courts have consistently held that payments received in advance for consent to an invasion of one's personal rights constitute income, even though receipt of damages for the tort which would have occurred in the absence of an agreement would be tax-free.

Id. at 725 (citations omitted). This reasoning is similar to the IRS's argument in *Murphy* where it argues that a person does not have a basis, for accounting purposes, in their body. See Brief for the Appellees at 16-17, *Murphy v. I.R.S.*, 460 F.3d 79, (D.C. Cir. 2006) (No. 05-5139). The next rationale attacked is that "a single unallocated judgment often consists of several components, some taxable, some tax-free, [and] a successful plaintiff would have difficulty determining the amount taxable." Henry, *supra* note 33, at 726. But Henry believes this is no more difficult than for taxpayers who receive unallocated sums in other contexts and "have to divide the total into its components to compute their taxes, so the taxpayer whose lump sum consists of damages for personal injury can do the same." *Id.* Further, a tax conscious lawyer would request a complete breakdown of the judgment in order to avoid taxation difficulties for their client. *Id.* Henry also addresses a justification that this exclusion benefits the tortfeasor, but he finds that the "tortfeasor would have to pay more than the victim would have earned to make the victim whole" in cases of

The Bureau of Internal Revenue had, at first, “interpreted Section 213(b)(6) to allow exclusions only for damages received from *physical* injury claims or nonphysical injury claims to the extent that such awards compensated *physical* sickness resulting from a nonphysical tort.”³⁹ Several years later, “the Bureau ruled that compensation for a *nonphysical* tort or personal right, such as alienation of affections or defamation, constituted a replacement, and not a gain, of human capital, and thus was *not* within the definition of income.”⁴⁰ The Bureau seemed to “view the Section 213(b)(6) exclusion as unnecessary because the term ‘gross income’ did not encompass injury damage awards.”⁴¹ This idea was followed in *Murphy*.⁴²

The § 213(b)(6) exemption was not changed by the Revenue Act of 1939, although it became § 22(b)(5).⁴³ It was changed to § 104(a)(2) by the Revenue Act of 1954.⁴⁴ In 1982, § 104(a)(2) was amended, clarifying that “periodic payments as personal injury damages are excludable from gross income of the recipient.”⁴⁵

A 1989 amendment to § 104 added a provision regarding the inapplicability of paragraph (a)(2) to punitive damages with respect to

damages for loss of earnings. *Id.* at 728. The last justification addressed by Henry is sympathy by Congress toward victims who have suffered enough – but that does not account for “why one who receives compensation after the tort is worthy of the tax exemption while one who is compensated before the tort is unworthy.” *Id.* at 728-29. *See also* Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43 (1988). Cochran disputes some of the justifications given for the exclusion from income of personal injury damage awards. *Id.* He opposes the “made whole” rationale for the award because of the basis in the capital – the normal exclusion for return of capital is to the extent of the taxpayer’s basis in the capital, but Cochran notes that the taxpayer’s basis is zero in this context, because he generally does not pay for his limbs or organs. *Id.* at 45-46. Cochran also disputes the “involuntary nature of the transaction” rationale and the “imputed income” rationale, among others. *Id.* at 46-52.

39. Harvey, *supra* note 34, at 318 (emphasis added). The memorandum discussed here has also held that “alienation of affections is not a personal injury because there is no injury to the capital asset, the body, and that there is no return of capital unless there is physical illness from the alienation of affection.” *Id.* at 318 n.24 (discussing Solic. Int. Rev. Mem. 1384, 2 C.B. 71 (1920)).

40. *Id.* at 318 (emphasis added) (this decision was from Solic. Int. Rev. Op. 132, I-1 C.B. 92 (1922)). This aligned with the Supreme Court’s decision in *Eisner v. Macomber* (discussed *infra* at Part II, Section C(1)). *See* Sciuto, *supra* note 33, at 291.

41. Harvey, *supra* note 34, at 318.

42. *Murphy v. I.R.S.*, 460 F.3d 79, 91 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006) (“Note that the service regarded such compensation not merely as excludable under the IRC, but more fundamentally as not being income at all.”).

43. I.R.C. § 22(b)(5) (1939).

44. I.R.C. § 104(a)(2) (1954).

45. Chapman, *supra* note 33, at 415 (quoting S. REP. NO. 97-646, at 4 (1982)). It was further explained that “this provision is intended to codify, rather than change, the present law.” *Id.* (quoting S. REP. NO. 97-646, at 4).

cases not involving physical injury or sickness.⁴⁶ Punitive damages received in personal injury cases “have been a source of great confusion” for tax purposes⁴⁷ and the 1989 legislation helped answer the pleas of courts and commentators for clarification.⁴⁸

The 1996 amendment to § 104(a)(2) is the center of discussion of this note and an analysis of its context is necessary. Taxation under the pre-1996 version of the statute was often evaluated with a test from *Commissioner v. Schleier*:⁴⁹ “A taxpayer must meet two independent requirements before a recovery may be excluded under § 104(a)(2): The underlying cause of action giving rise to the recovery must be ‘based upon tort or tort type rights,’ and the damages must have been received ‘on account of personal injuries or sickness.’”⁵⁰

The pre-1996 version of the statute embraced “nonphysical injuries to the individual . . . those affecting emotions, reputation, or character.”⁵¹ “[T]he statutory exclusion for personal injuries which was contained in the tax code from 1918 to 1996 was based upon an understanding by the

46. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989). Congress was worried that the courts had been construing the § 104(a) exclusion too broadly. H. R. REP. NO. 101-247, at 1354 (1989) (Conf. Rep.).

47. Palmer, *supra* note 33, at 121. Cases following *Eisner* (discussed *infra*) have viewed punitive damages as excludable from gross income based on *Eisner*’s gross income definition of “the gain derived from capital, from labor, or from both combined.” *Id.* at 121-22. That favorable tax treatment of punitive damages ended with *Glenshaw Glass Co. v. Commissioner* (discussed *infra*), which held, along with a new interpretation of income (“any instance of undeniable accession to wealth, clearly realized, over which the taxpayer has complete control,” *Glenshaw Glass*, 348 U.S. 426, 431(1955)), that punitive damages fell within the new standard and were taxable. Palmer, *supra* note 33, at 122-23. Later, in 1975, the IRS changed the tax treatment of punitive damages yet again in Rev. Rul. 75-45 by noting that “under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income.” Rev. Rul. 75-45, 1975-1 C.B. 47. That ruling has met with some criticism and was revoked in 1984 by Revenue Ruling 84-108. Palmer, *supra* note 33, at 123-24. That ruling, relying on *Glenshaw Glass*, has decided that punitive damages were, again, taxable. Rev. Rul. 84-108, 1984-2 C.B. 32. The 1989 amendments to § 104(a)(2) retained this interpretation by the IRS. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379 (1989). See also Henry, *supra* note 33, for an excellent discussion of pre-1989 history of punitive damages taxation (“The taxation of punitive damages received for personal injury has had a long, illustrious, and confused history.”). Taxation of punitive damages by § 104(a)(2) is not a subject of this Note, and the discussion on this topic is limited.

48. See Chapman, *supra* note 33, at 430-31 (“Whether punitive damages should be taxed . . . [is a] question that, left unresolved, will only lead to further confusion and taxpayer feelings of unfairness.”)

49. 515 U.S. 323 (1995).

50. *Id.* at 323 (syllabus).

51. *Venable v. Comm’r*, 86 T.C.M. (CCH) 254, 3 (2003) (discussing *United States v. Burke*, 504 U.S. 229, 235 (1992) (Although it “did not include purely economic injuries.”))

authors of that code, from its very inception, that such compensatory damages were not constitutionally taxable.”⁵²

The 1996 amendment was passed within the Small Business Job Protection Act of 1996.⁵³ It inserted the word “physical” before words “injuries” and “sickness,”⁵⁴ thereby eliminating the exclusion from taxation of personal nonphysical injury damages.⁵⁵ By the time this version was proposed, opposition to it was already mounting in legal circles.⁵⁶ The *Schleier* test was updated by inserting the word “physical” to comply with the new version of the statute.⁵⁷

This new version was a blow to persons receiving damages for emotional, nonphysical injuries and has created a split.⁵⁸ As the Tax Court stated, “[t]he amended version of the statute provides that emotional distress is not a physical injury or physical sickness, except to

52. Appellant’s Brief at 23, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139). Chapman, in 1987, provided a good description of pre-1996 § 104(a)(2) taxation:

Today, section 104(a)(2) allows for tax-exempt recoveries for traditional injuries incurred in automobile accidents, from defective or harmful products, and in slip-and-fall type accidents. It also goes well beyond those injuries and provides for the excludability of compensatory awards for libel and slander, breach of contract to marry, mental and physical strain and injury to health and personal reputation in the community, death of a spouse, and injuries to the body or mind, whether intentionally or negligently caused.

Chapman, *supra* note 33, at 411 (citations omitted) (giving several examples from Revenue Rulings, the Board of Tax Appeals, and Tax Court decisions).

53. Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (1996).

54. *Id.*

55. *Id.* “In making this change, Congress’ [sic] sought to turn some damages awards that were previously exempt from taxation – awards for emotional distress not resulting from physical injury, for example – into taxable events.” J. Thomas Price, *Settlements and Judgments: Taxing Issues Remain*, 50 BOSTON B.J. 20 (2006).

56. In his 1989 article, Blackburn wrote:

Recently, Congress has proposed revision of section 104(a)(2). If enacted, these proposals would limit section 104 exclusion solely to damages received on account of physical injury or physical sickness. The Committee Report cites broad interpretations by the courts extending the exclusion to ‘damages in cases involving employment discrimination and injury to reputation where there is no physical injury or sickness’ as the reason for its action. This Draconian approach to reform is simple to enforce, though illogical in a modern society that recognizes the importance of both physical and mental health, and that protects its citizens from both physical and nonphysical injury.

Blackburn, *supra* note 38, at 690-91 (citations omitted).

57. *Venable v. Comm’r*, T.C. Memo 2003-240, at 4 (2003). Under the new version of the test, a taxpayer must meet two independent requirements before a recovery may be excluded under § 104(a)(2): the underlying cause of action giving rise to the recovery must be based upon tort or tort type rights, and the damages must have been received on account of personal physical injuries or physical sickness. *Id.*

58. See generally Jensen, *supra* note 22; Richard B. Risk, Jr., Comment, *Structured Settlements: The Ongoing Evolution From a Liability Insurer’s Ploy to an Injury Victim’s Boon*, 36 TULSA L.J. 865 (2001).

the limited extent of allowing an exclusion for damages up to the amount paid for medical care necessitated by emotional distress.”⁵⁹

C. Case Law

The statutory interpretation of the personal injury exclusion from income⁶⁰ has been set to the background of several important cases, which helped shape Congress’s understanding and interest in what was to be legislated in this confusing⁶¹ area.

1. Eisner v. Macomber⁶²

This landmark case was the first to advance a definition of taxable income as “the gain derived from capital, from labor, or from both combined.”⁶³ It began when The Standard Oil Company of California issued “additional shares sufficient to constitute a stock dividend of 50 per cent. [sic] of the outstanding stock”⁶⁴ and one of its shareholders brought suit opposing payment of tax on that dividend.⁶⁵ The Supreme Court held that the dividend was capital for purposes of the Income Tax Law.⁶⁶ To aid in its decision, the Court felt that a clear “definition of the term ‘income,’ as used in common speech,” was needed in order to determine its meaning in the Sixteenth Amendment.⁶⁷ No income was recognized at the time of the stock dividend, but if upon sale of those

59. *Venable*, T.C. Memo 2003-240, at 8.

60. I.R.C. § 104 (2007).

61. *See supra* note 33.

62. *Eisner v. Macomber*, 252 U.S. 189 (1920).

63. *Id.* at 207 (quoting *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918)).

64. *Id.* at 200.

65. *Id.* at 200-01.

66. *Id.* at 202-03. Specifically the Court said:

‘A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.’ In short, the corporation is no poorer and the stockholder is no richer than they were before.

Id. (citations omitted) (quoting *Gibbons v. Mahon*, 136 U.S. 549, 559-60 (1890) and citing *Logan County v. United States*, 169 U.S. 255, 261 (1898)). Further, Justice Pitney noted that a ‘stock dividend’ is no more than a book adjustment – it is not a dividend but the opposite – no funds were distributed to the shareholder and he realized no income. *Id.* at 210-12.

67. *Id.* at 206-07. The Court had looked to dictionaries in common use at that time and to two cases – *Stratton’s Independence v. Howbert*, 231 U.S. 399 (1913), and *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918) – for aid in determining the definition of income. *Id.*

shares gain is realized, that gain will be reported as income just as if the original sales were sold for profit.⁶⁸ The above-mentioned definition was rendered in a case about dividend distributions, but its meaning has reached other areas of taxation law including the exclusion under § 104(a)(2).⁶⁹

In *Macomber*'s wake, the Internal Revenue Service held that certain nonphysical damages for "defamation of personal character" are not taxable.⁷⁰ Since there was "no gain or profit from a payment for invasion of a personal right . . . [those damages] did not fit with the *Macomber* definition of income."⁷¹ The idea behind the opinion was that these nonphysical damages did not constitute income at all under the Sixteenth Amendment.⁷²

2. Commissioner v. Glenshaw Glass Company⁷³

This case arose out of two separate cases in the Tax Court.⁷⁴ The two cases were consolidated at the Appeals level and heard en banc, with a decision for the taxpayers.⁷⁵ The issue faced by the Supreme Court concerned the interpretation of § 22(a) of the Internal Revenue

68. *Eisner*, 252 U.S. at 212.

69. *Id.*

70. Jones, *supra* note 33, at 922-23 (discussing Sol. Op. 132, I-1 C.B. 92 (1922)).

71. *Id.* at 922.

72. *Id.* at 923. "The implication was that the enactment of the exclusion not only encompassed non-physical as well as physical injuries, but as a mere codification of the idea that damages were not income, was not necessary to achieve the goals of Congress." *Id.* See also *supra* note 41 and accompanying text.

73. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). Palmer calls this "probably the most important tax case of this era." Palmer, *supra* note 33, at 92.

74. *Comm'r v. Glenshaw Glass Co.*, 211 F.2d 928 (3rd Cir. 1954). One of the cases was *Glenshaw Glass Co. v. Comm'r*, 18 T.C. 860 (1952). *Glenshaw Glass Co.* was a Pennsylvania corporation engaged in the business of manufacturing glass bottles and containers. *Glenshaw Glass*, 348 U.S. at 427. It was litigating with the Hartford-Empire Company for "demands for exemplary damages for fraud and treble damages for injury to its business by reason of Hartford's violation of the federal antitrust laws." *Id.* at 428. After reaching settlement, Hartford paid *Glenshaw* approximately \$800,000. *Id.* Finally, approximately \$325,000 of the total settlement was determined to represent punitive damages for fraud and antitrust violations. *Id.* This portion of the settlement was not reported as income in the tax year involved. *Id.* This suit followed after the Commissioner determined a deficiency for the entire sum. *Id.* The second case was *William Goldman Theatres, Inc. v. Comm'r*, 19 T.C. 637 (1953). *William Goldman Theatres* was a Delaware corporation which operated motion picture houses in Pennsylvania. *Glenshaw Glass*, 348 U.S. at 428. *Goldman* sued *Loew's, Inc.* for violation of the federal antitrust laws and for treble damages and won. *Id.* The trial court awarded \$125,000 for loss of profits and \$375,000 in treble damages. *Id.* *Goldman* did not report \$250,000 on its return claiming that it was punitive damages and not taxable. *Id.* at 428-29.

75. *Glenshaw Glass*, 348 U.S. at 427.

Code of 1939.⁷⁶ While there is no constitutional barrier to the imposition of a tax on punitive damages,⁷⁷ are those payments within § 22(a)'s definition of income?⁷⁸ Glenshaw argued that "punitive damages, characterized as 'windfalls' flowing from the culpable conduct of third parties, are not within the scope of the section."⁷⁹ Chief Justice Warren singled out the phrase "gains or profits and income derived from any source whatever" as a catchall provision, noting that "[t]he importance of that phrase has been too frequently recognized since its first appearance in the Revenue Act of 1913 to say now that it adds nothing to the meaning of 'gross income.'"⁸⁰ The source of taxable receipts had not been limited by Congress and the Court recognized the "intention of Congress to tax all gains except those specifically exempted."⁸¹ The Court also rejected the argument, based on *Eisner v. Macomber*,⁸² calling for a narrower reading of § 22(a).⁸³ There are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."⁸⁴ Further, the Court discussed the

76. *Id.* The exact issue was stated as: "whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income under § 22(a) of the Internal Revenue Code of 1939." *Id.* Section 22(a) read as follows:

22. Gross Income

(a) General definition. 'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

I.R.C. § 22(a) (1939).

77. *Glenshaw Glass*, 348 U.S. at 429.

78. *Id.*

79. *Id.*

80. *Id.* at 429-30.

81. *Id.* The Court cited *Comm'r v. Jacobson*, 336 U.S. 28 (1949), and *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84 (1934).

82. *Eisner v. Macomber*, 252 U.S. 189 (1920).

83. *Glenshaw Glass*, 348 U.S. at 430. The Court in *Eisner* defined income as "the gain derived from capital, from labor, or from both combined." *Eisner*, 252 U.S. at 207 (quoting *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918)). The issue in *Eisner* was "whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder or changed 'only the form, not the essence,' of his capital investment." *Glenshaw Glass*, 348 U.S. at 430-31 (citing *Eisner*, 252 U.S. at 210). Since the taxpayer "received nothing out of the company's assets for his separate use and benefit," the distribution was not a taxable event. *Glenshaw Glass*, 348 U.S. at 431 (quoting *Eisner*, 252 U.S. at 211). The definition served a useful purpose – distinguishing gain from capital, but "it was not meant to provide a touchstone to all future gross income questions." *Id.*

84. *Glenshaw Glass*, 348 U.S. at 431.

Commissioner's consistent position of taxing punitive damages and decided that they are in fact taxable.⁸⁵ The Court drew a distinction between personal injury recoveries and punitive damages, noting that personal injury recoveries are "nontaxable on the theory that they roughly correspond to a *return of capital* . . . [They] are by definition compensatory only."⁸⁶

3. O'Gilvie v. United States⁸⁷

This litigation arose out of a tort suit against the maker of the product that caused the death of Betty O'Gilvie from toxic shock syndrome.⁸⁸ The question before the Court was the petitioners' legal entitlement to a refund of taxes paid on punitive damages.⁸⁹ Justice Breyer followed the Government's interpretation of the § 104 phrase "*on account of personal injuries*"⁹⁰ and held that punitive damages are not

85. *Id.* at 431-32. Chief Justice Warren rejected Congress's acquiescence with a decision by the Board of Tax Appeals that held punitive damages nontaxable. *Id.* at 431 (discussing *Highland Farms Corp.*, 42 B.T.A. 1314 (1940)). The Commissioner also published his non-acquiescence to this holding and, "before and since, consistently maintained the position that [punitive damages] receipts are taxable." *Id.* at 432. There are no exemptions in the Code that would allow exemption of the punitive damages. *Id.*

86. *Glenshaw Glass*, 348 U.S. at 432 n.8 (emphasis added). But punitive damages cannot be considered a restoration of capital for taxation purposes. *Id.* The court further discussed the new, amended 1954 Code and § 61(a) which "is as broad in scope as section 22(a)." *Id.* at 432 n.11. The definition of income in the new § 61(a) includes "'all income from whatever source derived'" and was "based upon the 16th Amendment and the word 'income' is used in its constitutional sense." *Id.*

87. *O'Gilvie v. United States*, 519 U.S. 79 (1996).

88. *Id.* at 81. Her husband brought suit based on Kansas law, and he and two children received an award of \$1,525,000 actual damages and \$10 million punitive damages. *Id.* The plaintiffs paid taxes on the punitive damages award but immediately sought a refund. *Id.*

89. *Id.* This was a consolidation of two suits "in the same Federal District Court: [the husband's] suit against the Government for a refund, and the Government's suit against the children to recover the refund that the Government had made to the children earlier." *Id.* The Government is entitled to sue to recover refunds erroneously made by 26 U.S.C. § 7405(b). *Id.* at 81-82. Section 104(a) was at the center of the opinions by the District Court and the Court of Appeals for the Tenth Circuit, but the District Court was reversed. *Id.* The District Court held that the § 104 phrase "damages . . . on account of personal injury or sickness" included punitive damages. *Id.* at 82. This allowed nontaxability of the O'Gilvie \$10 million punitive damages award and entitled the children to keep their refund. *Id.* This was a short-lived victory since an appeal by the IRS brought a reversal of the District Court decision. *O'Gilvie v. United States*, 66 F.3d 1550 (10th Cir. 1995). The Tenth Circuit sided with the Fourth, Fifth, Ninth, and Federal Circuits in holding that § 104(a) does not exclude from income punitive damages. *Id.* at 1556-60. *O'Gilvie* dealt with the pre-1996 revision § 104(a) when there was no distinction as to excludability of damages based on nonphysical or physical injuries. See *O'Gilvie*, 519 U.S. 79. Despite the seemingly different issue, the excludability of punitive damages, Murphy relied on *O'Gilvie* and the historical arguments presented in that case to achieve her objective of excluding damages based on nonphysical injuries. *Murphy v. I.R.S.*, 460 F.3d 79, 84-85 (D.C. Cir. 2006).

90. *O'Gilvie*, 519 U.S. at 81 (emphasis in original).

excluded where “those damages ‘are not compensation for injury [but] [i]nstead . . . are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.’”⁹¹

Further, the Court dealt with the history of § 104, which is what attracted Murphy’s interest to this case.⁹² The principle that “a restoration of capital was not income” is pervasive in the *O’Gilvie* opinion.⁹³ In 1918, several cases were decided based on that principle, which led to the Attorney General advising the Secretary of the Treasury that:

Proceeds of an accident insurance policy should be treated as nontaxable because they primarily ‘substitute . . . capital which is the source of *future* periodical income . . . merely tak[ing] the place of *capital in human ability* which was destroyed by the accident. They are therefore [nontaxable] ‘capital’ as distinguished from ‘income’ receipts.’⁹⁴

The Treasury Department followed with a decision that “*upon similar principles . . . an amount received by an individual as the result of a suit or compromise for personal injuries sustained by him through accident is not income [that is] taxable.*”⁹⁵

It was not long after those decisions that Congress enacted the first predecessor of § 104(a) – § 213(b) of the Revenue Act of 1918.⁹⁶ The *O’Gilvie* Court noted that the statute followed closely the materials from the Attorney General and the Secretary of the Treasury, suggesting that

91. *Id.* at 83 (alteration in original) (quoting *International Brotherhood of Electrical Workers v. Foust*, 422 U.S. 42, 48 (1979)). The Court felt that this provides a “stronger causal connection, making the provision applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries.” *Id.* According to Justice Breyer, “[punitive damages] are not ‘designed to compensate [the] victims, instead, they are ‘punitive in nature.’” *Id.* at 84 (citations omitted) (quoting *Comm’r v. Schleier*, 515 U.S. 323, 332 (1995)).

92. *Id.* at 84-86.

93. *Id.* at 84.

94. *Id.* at 84-85 (alterations in original) (second emphasis added) (quoting 31 Op. Att’y Gen. 304, 308 (1918)).

95. *Id.* at 85 (alterations in original) (emphasis added) (quoting T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918)). The emphasized language implies that the accident damages are nontaxable because they are “merely taking the place of human capital” – the same principle that the Attorney General espoused. *Id.* (discussing 31 Op. Att’y Gen. at 308). Both the Attorney General’s opinion and the Treasury Department’s decision exhibit, quite clearly, the view on definition and taxability of income at the time when § 104 got its beginnings.

96. *Id.* at 85. Section 213 excluded from income “amounts received, through accident or health insurance or under workmen’s compensation acts, as compensation or personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.” *Id.* at 85 (quoting Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1066 (1919)).

Congress meant to adopt the human capital theory.⁹⁷ To further strengthen this position, the Court quoted a contemporaneous House Report:

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.⁹⁸

The Court recognized that the early language was very expansive excluding from taxation not only the "human capital,"⁹⁹ but also compensation for lost wages "mak[ing] the compensated taxpayer better

97. *Id.* at 85.

98. *Id.* at 85-86 (quoting H.R.Rep. No. 65-767, at 9-10 (1918)). Even though the House Report seems doubtful about the taxability of those amounts, Justice Breyer seemed to think that the final version of the statute showed which way Congress swayed and agreed upon. *Id.* Chapman believes that this "cryptic" statement can be brought to light if the chronology of events that led to it is also examined:

In January of 1915, the Commissioner of Internal Revenue ruled that insurance proceeds, received on account of an accident, were included as gross income to the insured person. By analogy, the Commissioner ruled that damages for 'pain and suffering' received from a lawsuit or compromise were in fact no different than insurance proceeds, and thus were also includable as gross income. In May and June of that same year, however, the Supreme Court decided four cases that only served to muddy the waters. In these cases, the Court discussed the issue of how to distinguish taxable income from nontaxable return of capital, and in *Doyle v. Mitchell Brothers Co.*, it expressed the view that not all of the proceeds of a conversion of capital assets were to be treated as income. Shortly thereafter, the Secretary of Treasury inquired of the Attorney General as to his opinion regarding the taxability of accident insurance proceeds received by a taxpayer on account of personal injury. In response, the Attorney General discussed the recent Supreme Court decisions and concluded by saying that: 'Without affirming that the human body is in a technical sense the 'capital' invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of *future* periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore 'capital' as distinguished from 'income' receipts.'

This response was followed by a statement from the Commissioner that the Treasury Department and the Service would agree with the Attorney General and hold that neither accident insurance proceeds nor [sic] damages received on account of personal injury would be taxed as income. This position was codified in section 213(b)(6) of the Revenue Act of 1918.

Chapman, *supra* note 33, at 414-15 (alteration in original) (citations omitted). This chronology illustrates that this area of the law was not clear even to the insiders and conflicting opinions made it difficult to understand the taxability of damages for personal injuries.

99. *O'Gilvie*, 519 U.S. at 86. Those damages would "substitute for a victim's physical or personal well-being – personal assets that the Government does not tax and would not have been taxed had the victim not lost them." *Id.*

off from a tax perspective than had the personal injury not taken place.”¹⁰⁰ Despite the encompassing language, Justice Breyer felt that the original focus of the statute was still clear: “upon damages that restore a loss, that seek to make a victim whole, with a tax-equality objective providing an important part of, even if not the entirety of, the statute’s rationale.”¹⁰¹

Further, the Court attempted to find reasons for Congress’s exclusion of punitive damages and found none,¹⁰² but its description of punitive damages provided a better look at what is excluded from taxation: “[t]hose damages are not a substitute for any normally untaxed personal (or financial) quality, good, or ‘asset.’ They do not compensate for any kind of loss.”¹⁰³

III. STATEMENT OF THE CASE

A recent case has brought a new twist into § 104(a)(2) arguments and has encouraged many new looks upon this section.¹⁰⁴ *Murphy v. I.R.S.* has surfaced only in the last few years as an interesting twist in § 104(a)(2) interpretation. The 2006 opinion – from the D.C. Circuit – declared § 104(a)(2) unconstitutional.¹⁰⁵ The declaration of unconstitutionality did not last long because the decision was vacated within four months,¹⁰⁶ but this monumental decision still warrants an analysis of its reasoning, and could prove useful to plaintiffs in personal injury actions.

A. Administrative History

Marrita Murphy (“Murphy”) complained to state authorities that her employer, the New York Air National Guard (“NYANG”), was guilty of

100. *Id.* Lost wages were just the Court’s example showing damages which would have been taxed had the victim earned them. *Id.*

101. *Id.*

102. *Id.* at 86-90. The Court looked to reasons for congressional generosity, tax policy, different versions of the statute, and legislative history without finding reasons for exclusion of punitive damages. *Id.* See *supra* note 47 for some notes on punitive damages. This paper does not discuss taxability of punitive damages and the discussion of the Court’s rationale on those would be misplaced.

103. *O’Gilvie*, 519 U.S. at 86-87. This language suggests that any damages that compensate for a loss would be nontaxable.

104. *Murphy v. I.R.S.*, 460 F.3d 79, 81 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

105. *Id.* at 92.

106. *Murphy v. I.R.S.*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

environmental hazards on its airbase.¹⁰⁷ This action began in 1994, when Murphy¹⁰⁸ and Daniel Leveille (“Leveille”) alleged that their, now former employer NYANG, was in violation of six whistle-blower statutes,¹⁰⁹ “had ‘blacklisted’ [them] and provided unfavorable references to potential employers” as a result of their complaints to state authorities.¹¹⁰ The case was remanded to an Administrative Law Judge after the Secretary of Labor’s findings that “NYANG had unlawfully discriminated and retaliated against Murphy.”¹¹¹ Murphy was awarded \$70,000 in damages on October 25, 1999.¹¹² This income was included on Murphy’s 2000 tax return.¹¹³ Murphy filed three amended tax returns¹¹⁴ asking for a refund of the compensatory damages plus interest.¹¹⁵ Her claims for a refund were denied¹¹⁶ and Murphy sued the IRS and the United States in district court.¹¹⁷

B. District Court Decision

In district court, the Defendants filed a motion to dismiss¹¹⁸ and a motion for summary judgment.¹¹⁹ Murphy followed with a cross motion

107. *Murphy*, 460 F.3d at 81.

108. Then Marrita Leveille, but now, Marrita Murphy. *Id.*

109. The alleged violations arose under the following six statutes: Toxic Substances Control Act, 15 U.S.C. § 2622 (1994); Safe Drinking Water Act, 42 U.S.C. § 300j-9(I) (1994); Clean Air Act, 42 U.S.C. § 7622 (1994); Solid Waste Disposal Act, 42 U.S.C. § 6971 (1994); Clean Water Act, 33 U.S.C. § 1367 (1994); Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. § 9610 (1994). *Murphy v. I.R.S.*, 362 F. Supp. 2d 206, 210 (D.D.C. 2005).

110. *Murphy*, 460 F.3d at 81.

111. *Id.* Remand was to determine compensatory damages. *Id.* Murphy had two experts testify on her injuries, which included a “condition known as ‘bruxism,’ or teeth grinding.” *Murphy v. IRS*, 362 F. Supp. 2d 206, 210 (D.D.C. 2005). Further, there were findings of other “physical manifestations of stress.” *Id.* The Administrative Law Judge recommended compensatory damages of \$45,000 for “emotional distress or mental anguish” and \$25,000 for “injury to professional reputation.” *Murphy*, 460 F.3d at 81. Daniel Leveille’s complaint was dismissed due to untimely filing. *Murphy*, 362 F. Supp. 2d at 210.

112. *Murphy*, 460 F.3d at 81.

113. *Murphy*, 460 F.3d at 81. It was included in her “gross income” in accordance with § 61 of the Internal Revenue Code. *Id.*

114. *Murphy*, 362 F. Supp. 2d at 211. The dates of the amended returns were: April 15, 2001, December 25, 2001, and October 8, 2002. *Id.*

115. *Id.* Her reasons for a refund were that “such damages were exempted from taxation under 26 U.S.C. § 104(a)(2).” *Id.*

116. Murphy requested an appeal to the Appeals Office of the IRS, but there was no response for 180 days, which allowed her to sue in federal court. *Murphy*, 362 F. Supp. 2d at 211; *see also infra* note 122 (discussing authority for exhaustion of administrative remedies).

117. *Murphy*, 362 F. Supp. 2d at 211.

118. Arguing lack of jurisdiction over the IRS “because Congress has not explicitly authorized the IRS as an agency to be sued *eo nomine*.” *Id.* at 210.

119. *Id.*

for partial summary judgment.¹²⁰ The district court determined that under the Administrative Procedure Act § 702(a), the IRS was a proper party to the suit¹²¹ and that Plaintiff had exhausted all administrative remedies available to her through the IRS prior to filing suit in district court.¹²² The court further explained the history of § 104(a)(2) and the

120. The issue for both the motion for summary judgment and for partial summary judgment was “whether or not plaintiff’s damages were received ‘on account of physical injuries or physical sickness’ under the 1996 amended definition of Internal Revenue Code § 104(a)(2).” *Id.* at 210. The parties further argued the constitutionality of amended § 104(a)(2) under the Fifth Amendment and the Sixteenth Amendment. *Id.* Prior to the 1996 amendment, § 104(a)(2) declared:

§ 104 Compensation for injuries or sickness

In general – Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include –

...

(2) 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 injuries or sickness.

I.R.C. § 104 (1995). The current version reads as:

§ 104 Compensation for injuries or sickness

In general – Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include –

...

(2) 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.

I.R.C. § 104 (2006) (emphasis added).

121. *Murphy*, 362 F. Supp. 2d at 211. Section 702 states:

[a] person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof. An action in a court of the United States seeking relief other than money damages . . . shall not be dismissed nor relief therein be denied on the ground that it is against the United States or that the United States is an indispensable party . . .

5 U.S.C. § 702 (2000). The district court further stated that it had original jurisdiction in the case according to 28 U.S.C. § 1346, which provides jurisdiction in the “recovery of an internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal revenue laws.” *Murphy*, 362 F. Supp. 2d at 211. This case was properly in the district court because *Murphy* suffered a legal wrong by an agency action satisfying 5 U.S.C. § 702(a), and because a claim of an illegally collected federal tax revenue is involved. *Id.* at 212.

122. *Murphy*, 362 F. Supp. 2d at 212. “[N]o one is entitled to judicial relief for a supposed or threatened injury until the prescribed administrative remedy has been exhausted.” *Myers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41, 50-51 (1938). *Murphy* paid the tax, prior to asking for a refund. *Murphy*, 362 F. Supp. 2d at 212. Consequently, she has asked the IRS for a refund, which was denied, so she appealed to the Appeals Office. 26 U.S.C. § 7422(a) (2005) (requiring a claim for a refund to be filed with the Secretary prior to court proceedings). Since she followed proper procedures, the Defendants’ motion to dismiss was denied. *Murphy*, 362 F. Supp. 2d at 218.

requirements for exemption under that section,¹²³ deciding that Murphy did not fulfill the second prong (not attributable to a physical injury or physical sickness) and that her damages were lawfully taxed.¹²⁴ Next, the court tackled the constitutionality questions¹²⁵ and reached a decision that § 104(a)(2) in its post-1996 revision form was constitutional.¹²⁶

C. The Court of Appeals Decision

After summary judgment was granted for the Government in the district court, Murphy appealed to the Circuit Court for the D.C. Circuit with respect to her claims on § 104(a)(2) and the Sixteenth Amendment.¹²⁷ Judge Ginsburg's opinion reviewed the district court's grant of summary judgment de novo.¹²⁸ The court first looked at the validity of the IRS as a defendant, and determined that it could not be sued *eo nomine* here.¹²⁹

123. The Sixteenth Amendment gave Congress the power to tax income, and "exclusions from income must be narrowly construed." *United States v. Burke*, 504 U.S. 229, 248 (1992); *Murphy*, 362 F. Supp. 2d at 213. The court mentioned the 1996 amendment to the statute and pointed out that the House Report specifically said that "emotional distress is not considered a physical injury or physical sickness" so such claims do not fall under the exclusion of § 104(a)(2). *Murphy*, 362 F. Supp. 2d at 214 (discussing H.R. REP. NO. 104-737, at 302 (1996) (Conf. Rep.)). The requirements for the § 104(a)(2) exemption are (1) damages have to be received through a tort or tort-like action, and (2) damages have to be "on account of" a personal injury. *Comm'r v. Schleier*, 515 U.S. 323, 336-37 (1995). Additionally, the 1996 amendment requires that those damages be "physical in nature." *Murphy*, 362 F. Supp. 2d at 214.

124. *Murphy*, 362 F. Supp. 2d at 215. The court cited House Report 104-737 to show that for emotional distress to be exempted under § 104(a)(2), it has to be "attributable to a physical injury or physical sickness" and here it was not. *Id.* The revised version of § 104(a)(2) was not applied retroactively because the damages were awarded in 1999, three years after the amended section was passed. *Id.*

125. The court found no merit under the Fifth Amendment due process clause and the takings clause. *Id.* at 216-17. The Sixteenth Amendment discussion began with noting that it eliminated the apportionment requirement for the income tax. *Id.* at 217. Plaintiff's argument that her compensatory damages were not income and cannot be taxed under the Sixteenth Amendment failed "because of the broad definition of 'income' purported by the tax code and the courts' subsequent interpretation thereof." *Id.* at 217. The "in lieu of what" test argued by the Plaintiff came from *Raytheon Production Corp. v. Comm'r*, 144 F.2d 110, 113 (1st Cir. 1944) (asking in lieu of what were the damages awarded), but the court did not spend much time on this, reverting back to the revised language of § 104(a)(2) reiterating that only "physical" injuries and sickness are exempted from the definition of "income." *Murphy*, 362 F. Supp. 2d at 218. The court further said that Congress was not acting outside of its power to tax given by the Sixteenth Amendment in revising § 104(a)(2), because it only clarified the law in an attempt to reduce litigation. *Murphy*, 362 F. Supp. 2d at 218 (citing H.R. REP. NO. 104-737 (1996) (Conf. Rep.)).

126. *Murphy*, 362 F. Supp. 2d at 218.

127. *Murphy v. I.R.S.*, 460 F.3d 79, 82 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

128. *Id.*

129. *Id.* at 83. "Congress has preserved the immunity of the United States from declaratory

The court further went on to the discussion of the § 104(a)(2) 1996 amendment¹³⁰ and then into the two-prong analysis of *Commissioner v. Schleier*.¹³¹ Murphy's argument for the second prong was that her injuries were considered physical in nature and, accordingly, fell under § 104(a)(2).¹³² According to her, neither § 104 nor its regulation "limits the physical disability exclusion to a physical stimulus."¹³³ The Government's argument centered not on the word "physical," but on the phrase "on account of," citing *O'Gilvie v. United States*, which required a "strong causal connection" between the damages and personal injuries.¹³⁴ Because Murphy's compensatory damages were awarded "because of" her nonphysical injuries and not on account of her "bruxism or other physical symptoms," the Circuit court ruled that she did not meet the *Schleier* test.¹³⁵

The constitutionality of § 104(a)(2) was the last challenge by the Appellants.¹³⁶ The historical meaning of income according to the Sixteenth Amendment, § 61(a) of the I.R.C., and the Supreme Court is that Congress may "tax all gains" or "accessions to wealth."¹³⁷ Murphy's argument is that "being neither a gain nor an accession to wealth, her award is not income and § 104(a)(2) is therefore unconstitutional insofar as it would make [her] award taxable as income."¹³⁸ Murphy contended that the Supreme Court, in *Glenshaw*

and injunctive relief with respect to all tax controversies except those pertaining to the classification of organizations under § 501(c) of the IRC." *Id.* at 82 (talking about I.R.C. § 7421(a) and 28 U.S.C. § 2201(a)). The IRS shares that immunity as an agency of the Government and only actions against the United States can be sued here. *Id.* at 83.

130. *Id.* Judge Ginsburg discussed the differences between the pre-1996 and the current versions of the statute, focusing on the "physical" injuries requirement. *Id.*

131. *Id.* The Government did not contest Murphy's position on the first prong, which required the award to be based on tort-like rights. *Id.*

132. *Id.*

133. *Id.* Murphy reasoned that the regulation under § 104(a)(2), "excludes from gross income the amount of any damages received . . . on account of personal injuries or sickness," and it tracks the pre-1996 text of § 104(a)(2), which excluded compensation for both physical and for nonphysical injuries. *Id.*

134. *Id.* at 84 (citing *O'Gilvie v. United States*, 519 U.S. 79 (1996)). The Government's argument was that Murphy needs to be awarded damages "because of" physical injuries. *Id.* at 84.

135. *Id.* at 84. Despite *O'Gilvie's* discussion of the pre-1996 amendment version of § 104(a)(2), the phrase "on account of" was kept in the modern version of the statute. *Id.* at 84. The Administrative Law Judge expressly stated that the damages awarded to Murphy were for mental pain and anguish and for injury to professional reputation. *Id.* at 81.

136. *Id.* at 82.

137. *Id.* at 85 (citing *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430-31 (1955)).

138. *Id.* at 85. She asserts that her award is not income but a return of capital—"human capital." *Id.* at 85. And since a return of capital is not "income," her award cannot be taxed. *Id.* at 85 (citing *O'Gilvie v. United States*, 519 U.S. 79, 86 (1996)).

Glass, concluded that the “recovery of compensatory damages for a ‘personal injury’ – of whichever type – is analogous to a ‘return of capital.’”¹³⁹ Next, Murphy focused on the *O’Gilvie* Court’s discussion of the authorities supporting its opinion which, according to her, helped demonstrate that the I.R.C. was drafted so that compensatory damages designed to make a person whole are excluded from the definition of “income.”¹⁴⁰ The first source discussed whether proceeds from an accident insurance policy were income under the I.R.C.,¹⁴¹ and the Attorney General’s view was that the proceeds were a substitute for capital which is the source of future periodical income.¹⁴² He distinguished them as “capital,” as opposed to “income.”¹⁴³ Similarly, the Department of the Treasury said that “an amount received by an individual as the result of a suit or compromise for personal injuries sustained . . . through accident is not” taxable income.¹⁴⁴ The last *O’Gilvie* source relied upon by Murphy was the House Report on the bill that became the Revenue Act of 1918.¹⁴⁵ The Report doubted whether damages for a personal injury were required to be included in gross income.¹⁴⁶ The 1918 Act, passed soon thereafter, excluded from income the damages discussed in the House Report.¹⁴⁷ Murphy’s main point in referencing the above is the fact that the 1918 Act followed soon after the ratification of the Sixteenth Amendment and “the statute reflects the meaning of the Amendment as it would have been understood by those who framed, adopted, and ratified it.”¹⁴⁸

The Government began its reply to Murphy’s unconstitutionality argument by saying that Congress has so much power as to be able to tax compensation even for physical injuries and still be within the Sixteenth

139. *Id.* at 85.

140. *Id.* at 85-86. The three sources from the *O’Gilvie* opinion are “an Opinion of the Attorney General, a Decision of the Department of the Treasury, and a Report issued by the Ways and Means Committee of the House of Representatives.” *Id.* at 85.

141. *Id.* at 86. The I.R.C. prior to the 1918 Act. *Id.*

142. *Id.* (discussing 31 Op. Att’y Gen. 304, 308 (1918)).

143. *Id.*

144. *Id.* (discussing 20 Treas. Dec. Int. Rev. 457 (1918)).

145. *Id.*

146. *Id.* (discussing H.R. REP. NO. 65-767, at 9-10 (1918)). The House Report did not distinguish between physical and nonphysical emotional damages. H.R. REP. NO. 65-767, at 9-10.

147. *Id.* Section 213(b)(6) excluded from gross income “[a]mounts received, through accident or health insurance or under workman’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.” *Id.* (quoting Revenue Act of 1918, Pub L. No. 65-254, § 213(b), 40 Stat. 1057, 1066 (1919)).

148. *Id.*

Amendment.¹⁴⁹ The Government contended that it does not mean that the exclusion is mandated by the Sixteenth Amendment if Congress “has historically excluded personal injury recoveries from gross income,” it might just signify an abandoned Congressional policy.¹⁵⁰ Next, the Government attacked Murphy’s reliance on the House Report in *O’Gilvie* on the grounds that the Report used the word “doubtful” when referring to exclusion of compensation for personal injury or sickness from taxation.¹⁵¹ According to the Government, that doubtfulness “does not establish that Congress believed taxing compensatory personal injury damages would be unconstitutional.”¹⁵² The Government’s final attack was upon the analogy between “a return of ‘human capital or well-being’ and a return of ‘financial capital.’”¹⁵³ Human capital, according to the Government, cannot be considered such because people do not carry monetary bases in their bodies.¹⁵⁴

Ginsburg tossed aside the Government’s “expansive claim of congressional power,” saying that such power is not consistent with our constitutional government.¹⁵⁵ Further, the D.C. Circuit adopted the “in lieu of” test advocated by the Appellant, to determine whether Murphy’s damages were received “in lieu of” something “normally untaxed.”¹⁵⁶ After concluding that these damages were for emotional well-being and reputation, which are not taxable as income, the court advanced to a more in-depth definition of income.¹⁵⁷

The relevant issue, as stated by the Court, was “whether the people

149. *Id.* (invoking *Rust v. Sullivan*, 500 U.S. 173, 191 (1991)).

150. *Id.* at 87. The Government said that since *Glenshaw Glass* references are based only on the I.R.C. in effect at that time, it only expressed a “now abandoned congressional policy, not the outer limit of the Sixteenth Amendment.” *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.* As opposed to financial capital, which can be depreciated and adjusted for expenses, losses, etc., there is no basis in human capital. *Id.* A person cannot depreciate it or add funds to it to increase his or her well-being. *Id.* (discussing dictum in *Roemer v. Comm’r*, 716 F.2d 693 (9th Cir. 1983)).

155. *Id.* at 87.

156. *Id.* at 88. If the damages were “in lieu of” something that was normally untaxed, then they are not income and under the Sixteenth Amendment would not be taxed. *Id.* But see *Palmer*, *supra* note 33, at 87-88 (arguing that the “In Lieu of What” test is “inappropriate for determining the taxability of damages received under section 104(a)(2),” and “when dealing with damages received for employment discrimination, the courts should focus on the nature of the underlying claim.”).

157. *Murphy*, 460 F.3d at 88. As was instructed by the Supreme Court in *Merchants’ Loan & Trust Co. v. Smetanka*, 255 U.S. 509, 519 (1921), the definition of income should be how it was understood at the time of the adoption of the Sixteenth Amendment. *Id.* at 88-89.

when they adopted the Sixteenth Amendment,’ or the Congress when it implemented the Amendment, would have understood compensatory damages for a nonphysical injury to be ‘income.’”¹⁵⁸ The Court agreed with the Government on the uselessness of the House Report to answer this question because of the ambiguity present there, but sided with Murphy’s view of the Attorney General’s 1918 opinion and the Treasury Department’s 1918 ruling.¹⁵⁹ These sources suggest that “the term ‘incomes’ as used in the Sixteenth Amendment does not extend to monies received solely in compensation for a personal injury and unrelated to lost wages or earnings.”¹⁶⁰ Ginsburg looked at the causes of action in the early 1900s and saw “no meaningful distinction between Murphy’s award and the kinds of damages recoverable for personal injury when the Sixteenth Amendment was adopted.”¹⁶¹ He inferred that the 1913 understanding of “income” did not include Murphy’s damages.¹⁶²

In conclusion, the D.C. Circuit held § 104(a)(2) unconstitutional “insofar as it permits the taxation of an award of damages for mental distress and loss of reputation” because these damages are not income within the meaning of the Sixteenth Amendment.¹⁶³ Two reasons given were: first, the damages are not received in lieu of income and second, “the framers of the Sixteenth Amendment would not have understood compensation for a personal injury – including a nonphysical injury – to be income.”¹⁶⁴

IV. ANALYSIS

The historical look at cases discussing the meaning of “income” shows that those cases have often held that income under the Sixteenth Amendment is “gain derived from capital, from labor, or from both

158. *Id.* at 89.

159. *Id.*

160. *Id.*

161. *Id.* at 91.

162. *Id.* at 91. This conclusion was reached because damages received in compensation of a physical personal injury were not income in 1913, so likely the nonphysical injury damages were also not income. *Id.* at 89-91.

163. *Id.* at 92. *But see* Cochran, *supra* note 38, at 43 (arguing that “[h]owever emotionally appealing [the § 104(a)(2)] exclusion may be, under the modern definition of gross income personal injury damage awards clearly constitute an accession to wealth and would, but for the exclusion provided by section 104(a)(2), be taxable.”). Cochran advocated a total repeal of § 104(a)(2). *See id.*

164. *Murphy*, 460 F.3d at 92.

combined.”¹⁶⁵ The D.C. Circuit in *Murphy* followed that rationale in understanding the word as it was understood at the time of ratification of the Sixteenth Amendment.¹⁶⁶

As Professor Jensen has stated, “[t]he idea that Congress can define the meaning of ‘taxes on incomes’ seems to mean nothing other than that the term has no limiting content at all, and what Congress enacts in the taxing area is *ipso facto* constitutional.”¹⁶⁷ Further, this position is “. . . not mandated by constitutional text or the nature of the Constitution.”¹⁶⁸ *Eisner v. Macomber*¹⁶⁹ stands for “the idea that the 1913 Congress had a good idea of the meaning of the Sixteenth Amendment,” one of the principles of *Macomber* is “that the concept of ‘income’ isn’t boundless.”¹⁷⁰ Further, the “courts must observe the boundaries of the definition.”¹⁷¹ Many early-twentieth century decisions have included such language.¹⁷² “The early cases not only concluded that ‘incomes’ has meaning; they also concluded the term ought to be understood as it was in 1913.”¹⁷³ The D.C. Circuit was not going out on a limb in looking at the historical perspective of the Sixteenth Amendment; it had ample precedent to encourage adoption of the definition of ‘income’ as understood at the time of the adoption of the Amendment.¹⁷⁴ “Regardless of which definition has been used, the Court consistently

165. Appellant’s Brief at 19, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139) (quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (1920); *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); discussing *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918)).

166. See *Murphy*, 460 F.3d 79.

167. Jensen, *supra* note 22, at 1091.

168. *Id.* “Not all taxes are automatically constitutional.” Erik M. Jensen, *Interpreting the Sixteenth Amendment (By Way of the Direct-Tax Clauses)*, 21 CONST. COMMENT. 355, 404. (2004).

169. 252 U.S. 189 (1920). See also *supra* Part II, Section C(1).

170. Jensen, *supra* note 22, at 1134.

171. Jensen, *supra* note 22, at 1135. The *Murphy* court is attempting to follow the Constitutional language and the definition of income without allowing Congress too much power in defining the meaning of ‘income.’

172. Another case where the Supreme Court was illustrating that ‘incomes’ has a meaning was *Edwards v. Cuba R.R. Co.*, 268 U.S. 628, 631 (1925): “The Sixteenth Amendment, like other laws authorizing or imposing taxes, is to be taken as written, and is not to be extended beyond the meaning clearly indicated by the language used.” *Id.* Also, *Burk-Waggoner Oil Ass’n v. Hopkins*, 269 U.S. 110, 114 (1925) said “[i]t is true that congress cannot make a thing income which is not so in fact.” Jensen, *supra* note 22, at 1140 (quoting 269 U.S. 110, 114 (1925)). “[I]n determining the definition of . . . ‘income,’ . . . this Court has . . . approved . . . what it believed to be the commonly understood meaning of the term which must have been in the minds of people when they adopted the Sixteenth Amendment . . .” *Id.* at 1141 (alteration in original) (quoting *Merchants’ Loan & Trust v. Smietanka*, 255 U.S. 509, 519 (1921)).

173. Jensen, *supra* note 22, at 1146.

174. *Murphy v. I.R.S.*, 460 F.3d 79, 88-91 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

interpreted the inclusion of the term ‘income’ in the Sixteenth Amendment as a term of limitation as to the scope of the taxing authority provided by that amendment. Thus, neither Congress nor the Courts are permitted to “‘make a thing income which is not so in fact.’”¹⁷⁵ If Congress had mistaken the constitutional limits, the Courts are responsible for reasserting those limits.¹⁷⁶ *Murphy* is continuing the fight of the courts and commentators in order to “reassert those limits” and establish taxation of personal damages as it was understood at the time of Sixteenth Amendment ratification.¹⁷⁷

Despite all the controversy, there has not been a precise definition of income specified by Congress.¹⁷⁸ Some commentators, just like the *Murphy* Court,¹⁷⁹ believe that when Congress enacted the original legislation,¹⁸⁰ it “did not carve out an exception for an item it believed normally would constitute income, but instead clarified that damage awards are not income in the first place.”¹⁸¹

A. Restriction of Murphy to the Facts for Unconstitutionality

Judge Ginsburg had limited the holding of *Murphy* to the facts of the case,¹⁸² encompassing only the damages for mental distress and loss of reputation.¹⁸³ Declaring § 104(a)(2) unconstitutional for anything beyond the facts of the case would have been dicta,¹⁸⁴ and would not

175. Appellant’s Brief at 19, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139) (quoting *Burk-Waggoner*, 269 U.S. at 114). See also Brief of Amicus Curiae No Fear Coalition in Support of Appellants at 4-5, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139). The Amicus Curiae Brief discusses Congress’s right to “enforce . . . by appropriate legislation” the protections of the Fourteenth Amendment. *Id.* In *City of Boerne v. Flores*, 521 U.S. 507, 536 (1997), Justice Kennedy insisted that the Fourteenth Amendment’s Enforcement clause has never been “understood to grant Congress anything approaching unrestrained legislative authority.” *Id.* (discussing *City of Boerne v. Flores*, 521 U.S. 507, 536 (1997)). The Amicus Curiae extend that Supreme Court restraint toward Congress’s supposed change of the Sixteenth Amendment here. *Id.*

176. Brief of Amicus Curiae No Fear Coalition in Support of Appellants, *supra* note 175, at 4.

177. See generally *supra* note 170.

178. Jones, *supra* note 33, at 921.

179. See generally *Murphy v. I.R.S.*, 460 F.3d 79, 90-91 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

180. Revenue Act of 1918, Pub L. No. 65-254, § 213(b), 40 Stat. 1057, 1066 (1919).

181. Jones, *supra* note 33, at 921-22 (“As a mere clarification, section 213(b)(6) did nothing to change the law as it existed, but only shed light on the inadequately defined term ‘income.’”).

182. *Murphy*, 460 F.3d at 92 (“[W]e hold § 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.”).

183. *Id.*

184. See *United States v. Dixon*, 509 U.S. 688, 714 (1993) (Rehnquist, C.J., concurring in part, dissenting in part) (“dicta . . . and thus not binding.”); *Watchtower Bible and Tract Society of New York, Inc. v. Village of Stratton* 536 U.S. 150, 159 (2002) (quoting *Watchtower Bible and Tract*

have been binding on the courts unless litigated.¹⁸⁵ Despite the limited holding, the D.C. Circuit has, in its discussion, enveloped a much larger area than its *Murphy* holding indicates.¹⁸⁶ The court looked at various

Soc. of New York, Inc. v. Village of Stratton, 240 F.3d 553 (6th Cir. 2001) (“language was dicta and therefore not binding.”)); *Wainwright v. Witt*, 469 U.S. 412, 436 n.1 (1985) (Stevens, J., concurring) (“I . . . agree with the Court’s observation that dictum is not binding in future cases.”); *Humphrey’s Ex’r v. United States*, 295 U.S. 602, 627 (1935) (noting that dicta “may be followed if persuasive” but are not binding).

185. See *Dixon*, 509 U.S. at 714 (Rehnquist, C.J., concurring in part, dissenting in part); *Watchtower Bible*, 240 F.3d 553; *Wainwright*, 469 U.S. at 436 n.1; *Humphrey’s*, 295 U.S. at 627.

186. The discussion of other cases by the Court indicates agreement with various damages not being taxed and shows how wide the Court had considered its holding to be. *Murphy*, 460 F.3d at 85 (discussing *Murphy’s* view of *Glenshaw Glass*, “the [c]ourt thereby made clear that the recovery of compensatory damages for a ‘personal injury’ – of whatever type – is analogous to a ‘return of capital’ and therefore is not income under the IRC or the Sixteenth Amendment.” (emphasis added)); *Id.* at 85 (discussing the opinion by the Attorney General in 1918 for “capital” in the human body concerning proceeds of an accident policy); *Id.* at 86 (discussing the House Report and Revenue Act of 1918 – “the Congress passed the Act, § 213(b)(6) of which excluded from gross income ‘[a]mounts received, through accident or health insurance or under workman’s compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.’”); *Id.* at 85 (“by 1913, . . . , the law made compensatory damages for ‘mental suffering’ recoverable in the same matter as compensatory damages for physical harms; . . . there are reported cases involving defamation and other reputational injuries – the very sort of injury *Murphy* suffered.”); *Id.* at 92 (discussing turn-of-century cases for actions that were considered to be nontaxable at their time – “compensatory damages for mental distress resulting from the publication of defamatory words actionable in themselves”; “action for publication not libelous per se [without having] to allege or prove special damages . . . for mental anguish”; “injury to the feelings, and mental suffering endured in consequence”; “damages in action for slander ‘to compensate [plaintiff] for the mortification and shame he might have suffered, and the disgrace and dishonor attempted to be cast upon him, and all damages done to his reputation’”; “[w]here words spoken are actionable *per se* . . . there need be no direct evidence of mental suffering to enable the jury to consider it in their estimate of damages” (emphasis in original); “mental ‘pain and suffering may be considered by the jury in determining the amount of damages in cases where the words spoken are actionable [as slander] *per se*’”; “‘mental suffering alone [will] sustain a right of action’ if ‘the words spoken or pictures published are of such a nature . . . that they will tend to degrade the person, or hold him up to public hatred, contempt, or ridicule, or cause him to be shunned and avoided’”; “[a] woman might have a bad reputation and a bad character, neither of which would be changed by such a [libelous] publication, and yet be entitled to substantial damages for injuries to her feelings resulting from the publication”; “[a]ward] to the plaintiff should be such as would reasonably compensate him for any wrong done to his reputation, good name, or fame, and for any mental suffering caused thereby as shown by the evidence”; “‘amount of damages’ in slander action ‘depends in part upon the effect of the malice upon the plaintiff’s mind’”; “general damages for injury to . . . feelings and the mental suffering . . . endured as a natural result of the [libelous] publication”; “injured feelings, mental suffering and anguish, and personal and public humiliation”; “injury to the feelings and injury to the reputation”; “when the words spoken are actionable the jury have a right to consider the mental suffering which may have been occasioned to a party by the publication of the slanderous words”; “‘proper for the jury to consider’ slanderous words used in course of an assault and battery ‘with all the circumstances in evidence, and the humiliation, degradation, shame, and loss of honor, and mental anguish . . . caused thereby, in determining the amount of damages’”; “damages for injury to . . . feelings, shame, and loss of the good opinion of . . . fellows, and injury to

damages in existence at the time of the ratification of the Sixteenth Amendment, and inferred that “the term ‘incomes,’ as understood in 1913, . . . did not include damages received in compensation for a physical personal injury . . . [and] did not include damages received for a *nonphysical* injury.”¹⁸⁷ Despite holding that only Murphy’s damages¹⁸⁸ make § 104(a)(2) unconstitutional, the variety of actions discussed by the Court indicates that, according to the Court’s holding of unconstitutionality, many other damages for personal injuries could be considered nontaxable because they fit under a wide umbrella of “damages on account of personal injuries” – without distinction among physical and nonphysical personal injuries.¹⁸⁹

It is possible to assume that Judge Ginsburg adopted one of the justifications for § 104(a)(2)—misfortune for the taxpayers to become ill or injured¹⁹⁰— and felt troubled that these taxpayers would have to pay taxes on the awards that simply make them whole.¹⁹¹ The D.C. Circuit wanted to tailor its decision so that these nonphysical damages would not be taxable to the victims. The hint at the view that the Court wanted to tailor its decision is evident right after the discussion of “in lieu of what” were Murphy’s damages awarded.¹⁹² The Court concluded that these damages were “not to compensate her for lost wages or taxable earnings of any kind” which, according to the Court, already cannot be considered income,¹⁹³ but the Court stated that “[its] conclusion at this

. . . standing in the community”; “the publication of a libel exposes the publisher, not only to compensatory damages for the loss of business, but also to a judgment for the mental suffering that the libel or slander inflicts upon the plaintiff”; “action by plaintiff passenger against railroad for its employee’s slander, which caused plaintiff ‘to undergo the pain and mortification of being publicly denounced’”; “actual damages embraces recovery for loss of reputation, shame, mortification, injury to feelings, etc.”; “the elements of damages in the action for malicious prosecution are the injury to the reputation or character, feelings, health, mind, and person, as well as expenses incurred in defending the prosecution”; “damages in slander action may compensate for ‘mental suffering and mortification’”; “[t]he most natural result from an injury to reputation is mental suffering and it is a proper element to be considered in estimating damages in a libel suit”; “jury should consider the damage to her character, as well as her mental suffering caused [by the slander]”; “anxiety and suffering [due to slander] were proper subjects for compensation to the plaintiff, and ought to be atoned for by the defendant”; “[o]utrage to the plaintiff’s feelings and peace of mind may be considered’ by the jury in awarding damages for slander”; “action for ‘alienation of affection’ [allowed] recover[y] of damages for mental suffering and reputational damage[s] arising from the defendant’s interference in the relationship between the plaintiff and his or her spouse”).

187. *Id.* at 91 (emphasis added).

188. Compensatory damages for emotional distress and loss of reputation. *Id.* at 92.

189. *See id.* at 84, 92.

190. *See supra* note 38 (discussing proposed justifications for § 104(a)(2)).

191. Even though this is *simply* “human capital.” *See Murphy*, 460 F.3d at 86-87.

192. *Id.* at 88.

193. *Id.*

point is tentative”¹⁹⁴ upon the meaning of the term “income” at the time of adoption of the Sixteenth Amendment.¹⁹⁵ Even though the final ruling found § 104(a)(2) unconstitutional, it is noticeable that the Court had wanted and expected that result early on in the decision.¹⁹⁶

It is likely that the new *Murphy* decision will be narrower and not envelop such a wide variety of damages. Such a decision would be more likely to withstand attacks and appeals, but it is likely that if § 104(a)(2) is declared unconstitutional yet again, the problem will still lie in the addition of the word “physical” in the 1996 amendment to this section.¹⁹⁷ As discussed below, even if the second decision by the D.C. Circuit finds § 104(a)(2) unconstitutional, the IRS is likely to wait for further developments in this area to seek out advantages of an appeal to the Supreme Court.¹⁹⁸ Further developments are also advantageous to the taxpayers since they could validate the analysis that keeps their damages awards tax-free.¹⁹⁹

B. Declaration of Unconstitutionality

Many statutes have been declared unconstitutional in the history of the United States legal system, and there could be many reasons for unconstitutionality.²⁰⁰ “Legislators enact statutes for broad, programmatic purposes . . . [and] it is logical to assume that the greatest deterrent to the enactment of unconstitutional statutes by a legislature is the power of the courts to invalidate such statutes.”²⁰¹ An unconstitutional statute must be treated as if it had never been enacted.²⁰² In the words of the United States Supreme Court, “[a]n unconstitutional act is not a law; it confers no rights; it imposes no duties; it affords no

194. *Id.*

195. *Id.* at 88-89.

196. *See Murphy*, 460 F.3d at 88-92.

197. *See supra* notes 149-164 and accompanying text.

198. *See infra* Part IV, Section C.

199. *See infra* Part IV, Section C.

200. *See, e.g.,* *Midkiff v. Tom*, 702 F.2d 788 (9th Cir. 1983), *rev'd*, 467 U.S. 229 (1984) (declaring the Hawaii Land Reform Act, HAW. REV. STAT. § 516, unconstitutional); *Beskind v. Easley*, 197 F. Supp. 2d 464 (W.D.N.C. 2002), *vacated in part*, 325 F.3d 506 (4th Cir. 2003) (declaring a North Carolina sale and distribution of alcoholic beverages law as violating the Commerce Clause); *United States v. Louisiana*, 225 F. Supp. 353 (E.D. La. 1963) (declaring unconstitutional a Louisiana voter registration requirement).

201. *Illinois v. Krull*, 480 U.S. 340, 352 (1987) (discussing an Illinois statute that was found to violate the Fourth Amendment).

202. *E.L. Bruce Co. v. Comm’r*, 19 B.T.A. 777, 778 (1930).

protection; it creates no office; it is, in legal contemplation, as inoperative as though it had never been passed.”²⁰³

A declaration of unconstitutionality “informs that legislature of its constitutional error . . . and often results in the legislature’s enacting a modified and constitutional version of the statute.”²⁰⁴

A . . . statute may be declared unconstitutional in toto – that is, incapable of having constitutional applications; or it may be declared unconstitutionally vague or overbroad – that is, incapable of being constitutionally applied to the full extent of its purport. In either case, a federal declaration of unconstitutionality reflects the opinion of the . . . court that the statute cannot be fully enforced.²⁰⁵

It is important to know the extent of unconstitutionality that the *Murphy* Court intended in its decision. It is unlikely that the D.C. Circuit intended to totally invalidate § 104(a)(2). This statute, in some form, has existed for almost 100 years²⁰⁶ and seems to be well-rooted in the Tax Code.²⁰⁷ Rather, Judge Ginsburg declared partial unconstitutionality in relation to the word “physical.”²⁰⁸ This word²⁰⁹ came up numerous times within the opinion.²¹⁰ Despite limiting the decision to taxation of an award of damages for mental distress and loss of reputation,²¹¹ the unconstitutionality of the word “physical” within § 104(a)(2) brings the decision closer to the court’s discussion of “human capital”²¹² and the “in lieu of what”²¹³ tests. Both of those tests involve nonphysical injuries as well as physical injuries and the Court’s reasoning would eliminate that distinction.²¹⁴ Such wide nonrecognition

203. *Id.* (quoting *Norton v. Shelby County*, 118 U.S. 425, 442 (1886)).

204. *Krull*, 480 U.S. at 352.

205. *Steffel v. Thomson*, 415 U.S. 452, 470-71 (1974) (quoting *Perez v. Ledesma*, 401 U.S. 82, 124 (1971)).

206. *See supra* Part II, Section B.

207. *See supra* Part II, Section B.

208. *See Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

209. Or its opposite, “nonphysical.”

210. Within the Sixteenth Amendment unconstitutionality discussion, discussing *Murphy*’s argument, the Court said – “a damage award for personal injuries – including nonphysical injuries – is not income but simply a return of capital,” and these words have also been implied in the absence of the word “physical” in the prior versions of the statute – “Congress passed the Act, § 213(b)(6) of which excluded from gross income . . . ‘[a]mounts received . . . as compensation for personal injuries or sickness.’” *Murphy*, 460 F.3d at 85-86.

211. *Id.* at 92.

212. *Id.* at 85-91.

213. *Id.* at 88-91.

214. *See id.*

of income takes the statute back to its pre-1996 version where the word “physical” preceding “injuries” and preceding “sickness” did not exist.²¹⁵

C. Next Steps for the § 104(a)(2) Exclusion and the I.R.S.

The § 104(a)(2) exclusion is not simply an interesting topic for a scholarly paper, its ramifications are felt by numerous people in the real world – people who have suffered and continue to suffer even upon payment of damages.²¹⁶ This section has not been applied consistently across the court system and the IRS,²¹⁷ and there has not been a clear mandate by the legislature that gives a concrete understanding of taxation of damages.²¹⁸ Even ten years after the 1996 amendment changes, many questions remain in the interpretation of “physical” in § 104(a)(2).²¹⁹ Many calls to Congress have been made for changes and additional definition to § 104(a)(2).²²⁰ Demands for “clarification, reform, and even repeal” have been put forth.²²¹ This exclusion is much “more than a tax benefit to an injured taxpayer. Without this exclusion, fewer plaintiffs would be willing to settle their cases. Costs of settlements and the number of trials might dramatically increase – other factors remaining constant.”²²²

The IRS now faces several choices of action. It has already appealed the decision for an en banc rehearing of the D.C. Circuit, but that decision has been dismissed and the case has been vacated with a new oral argument scheduled for April 2007.²²³ Even with uncertainty about the D.C. Circuit decision, the litigants have to be prepared for every contingency. If the decision is against the IRS, it can appeal to the U.S. Supreme Court to stop the reliance upon *Murphy* by other

215. I.R.C. § 104(a)(2) (1994).

216. See Palmer, *supra* note 33, at 127 (“Given the number of personal injury suits flooding the courtrooms, the taxation of damages is an important topic.”).

217. Palmer, *supra* note 33, at 127 (“In fact, the I.R.S. has only added to the confusion surrounding section 104(a)(2).”).

218. Blackburn, *supra* note 38, at 678.

219. Price, *supra* note 55, at 20.

220. See Sciuto, *supra* note 33, at 306 (discussing *United States v. Burke*, 504 U.S. 229 (1992), “the Court dislikes the current working of section 104(a)(2), and wants Congress to do something about it.”). See also Blackburn, *supra* note 38 at 678 (“[i]f any remedial action is to be taken, it is obvious that Congress, and not the courts or the Service, must act”).

221. Sciuto, *supra* note 33, at 307. See generally *id.* (discussing uneven treatment of taxpayers due to variety of § 104 interpretations).

222. Blackburn, *supra* note 38, at 689-90 (citation omitted).

223. *Murphy v. I.R.S.*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

taxpayers.²²⁴ If the Supreme Court declares the statute constitutional, the IRS will be relieved of a significant source of concern, but the confusing nature of § 104(a)(2) will not be solved.²²⁵ Another step the IRS can take if things do not go its way is coming up with “more precise regulations for § 104(a)(2)”²²⁶ in order to answer a barrage of commentaries and cases²²⁷ that follow every change in the statute and every decision made that involves this statute. The IRS can also follow the unconstitutional ruling nationally and exclude non-physical damages awards from taxation, but that course of action is highly improbable.²²⁸ Too much tax revenue will be lost based on the decision of one case – the IRS will not be willing to accept that without a fight.

If *Murphy* is decided for the taxpayer, the best course of action for the IRS is to accept the case only in the D.C. Circuit²²⁹ while waiting for similar cases to be decided in other circuits.²³⁰ If *Murphy* is appealed to the Supreme Court at this time, the IRS will be taking a chance that the Justices will agree with the D.C. Circuit and § 104(a)(2) will be declared unconstitutional on a national basis. It is safer for the IRS to do nothing right now and to wait for future developments in the other circuits and in the D.C. Circuit. Once the decisions from around the country begin to accumulate, the IRS will have better arguments in the Supreme Court if the decisions are favorable to it, or it will be able to put the disparities to rest if the decisions are on both sides of the issue or purely for taxpayers.

D. Application to Other Areas of Law

No matter which action the IRS will take to respond to the *Murphy* decision, better guidelines for taxation of personal damages are needed and they are needed quickly.²³¹ Section 104(a)(2) does not only reach litigants in *Murphy*’s position but also many plaintiffs in other areas of law. Civil rights laws may be less effective if nonphysical damages are

224. Paul J. Lesti, *Tax Considerations*, STRUCTURED SETTLEMENTS 2D § 4:13.9 (2006).

225. See *supra* note 33 (telling of the commentator confusion with this section).

226. Lesti, *supra* note 224.

227. Cases that are sure to be filed in the wake of *Murphy*.

228. See Lesti, *supra* note 224.

229. Or even ignore it altogether.

230. See Lesti, *supra* note 224. “*Murphy* is the first decision by any U.S. Court of Appeals ruling that the taxation of damages paid for non-physical emotional distress is unconstitutional” so the IRS can wait for more decisions. Merrick T. Rossein, 2 EMPLOYMENT DISCRIMINATION LAW AND LITIGATION § 18:15.

231. See *supra* note 33.

taxable.²³² The Civil Rights Act of 1991²³³ expressly authorizes the recovery of compensatory damages.²³⁴ At the time of passage of the Civil Rights Act of 1991, these damages were believed to be nontaxable and attempted to make the injured plaintiff “whole.”²³⁵ Once the 1996 amendment to § 104(a)(2) was passed, these injuries, as nonphysical ones, are taxable and fail to make the plaintiff “whole” – thereby confusing the statutory scheme of the Civil Rights Act of 1991.²³⁶ The *Murphy* district court held that the primary purpose of the 1996 amendment was to “decrease litigation,”²³⁷ and that will happen if the plaintiffs stand to lose, through taxation, a large portion of their damages award. A decrease in litigation, though, is not the goal of discrimination statutes – those statutes attempt to bring perpetrators to justice and one of the ways to accomplish that is to provide incentives to the victims to come forward and point to the wrongdoers.²³⁸ Section 104(a)(2), as interpreted by the IRS, conflicts with the purpose of the Civil Rights Act of 1991²³⁹ and brings even more confusion into the world of damages taxation than prior to the 1996 amendment.²⁴⁰

E. What Should Litigants Do Now?

Murphy is a fairly new decision with much argument over its validity and the new decision still in the future. As mentioned above,²⁴¹ § 104(a)(2) has been interpreted in a variety of different ways and by a variety of different courts, commentators, and legislatures. The

232. Brief of Amicus Curiae No Fear Coalition in Support of Appellants at 5-9, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139).

233. Discrimination on the basis of race, sex and national origin are covered under this Act. *See id.* at 7 (giving examples from H.R. REP. NO. 102-40, pt. 1, at 64-65 (1991)).

234. *Id.* at 6. Some of the compensatory damages authorized are: emotional pain, suffering, and mental anguish. *Id.*

235. *Id.* at 8.

236. *Id.* at 8-9.

237. *Murphy v. IRS*, 362 F. Supp. 2d 206, 218 (D.D.C. 2005).

238. *See* Brief of Amicus Curiae No Fear Coalition in Support of Appellants at 8-9, *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006) (No. 05-5139).

239. As is stated in the Amicus Curiae Brief:

[The] purpose [of current § 104(a)(2)], however, directly conflicts with the underlying purpose of Title VII [and the Civil Rights Act of 1991]. Our civil rights laws depend for their enforcement on private actions to vindicate individual rights. If victims of discrimination are to be made ‘whole’ it is completely inappropriate to discourage legitimate claims by taxing compensatory damages to ‘decrease’ litigation.

Id. at 9.

240. *See supra* note 33.

241. *See generally supra* Part II, Section B.

anticipation of the next steps in the *Murphy* case provides little certainty in the confusing area of damages taxation.²⁴²

Since the future is uncertain, attorneys must look to both sides of the dispute and be prepared for either situation to occur. “Plaintiffs who have reported recoveries for non-physical injuries as taxable income, as many surely have done, should be advised to consider filing protective claims for refund.”²⁴³ Further, *Murphy* applies only to litigants residing in the District of Columbia, so victims in the other circuits should be very careful²⁴⁴ in relying upon this revolutionary case.²⁴⁵ In their current tax returns, these victims should be very cautious in reporting this income as nontaxable – there should be a “reasonable basis” for their position.²⁴⁶ Otherwise, the taxpayer can be hit with penalties if the return is audited and the IRS position ultimately prevails.²⁴⁷ The tax planning involving § 104(a)(2) – just as any other tax planning – should begin “as early as the initial demand or drafting of the complaint, and should in any case be factored into any settlement discussions.”²⁴⁸

Each attorney should push for allocations of damages among

242. See *supra* note 33.

243. Price, *supra* note 55, at 21. This should be done to prepare for the next steps in the *Murphy* case or other cases that could come up in the future. See *id.* Also, filing a claim for refund will ensure that the three-year statute of limitations on refunds will not run out. I.R.C. § 6511(a).

244. Although it is very advantageous for them to rely upon it.

245. But if there is no countering authority in their circuit, those taxpayers will likely use *Murphy* to argue that their nonphysical damages are not income. Lesti, *supra* note 224.

246. I.R.C. § 6662(d)(2)(B). This section states:

§ 6662 Imposition of accuracy-related penalty on underpayments

Imposition of penalty. — If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies

...

(d) Substantial understatement of income tax. —

...

(2) Understatement. —

...

(B) Reduction for understatement due to position of taxpayer or disclosed item. —The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a *reasonable basis* for the tax treatment of such item by the taxpayer.

I.R.C. § 6662 (emphasis added).

247. Price, *supra* note 55, at 21.

248. *Id.*

various injuries that their client might be compensated for.²⁴⁹ If some of the award is allocated to the physical personal injury, the taxpayer will avoid taxation even if the recipient is not the injured party as long as the origin of the claim is physical personal injury.²⁵⁰

Murphy is a pro-victim decision, so plaintiffs and their attorneys should be moving toward similar decisions in other circuits to give the 1996 amendment to § 104(a)(2) less validity.²⁵¹ Even if the vacated decision is not upheld upon rehearing, the number of cases challenging the constitutionality of § 104(a)(2) should increase in the attempt to duplicate the 2006 *Murphy* decision²⁵² and to call upon Congress to give clearer guidance in taxation of personal damages.

F. Other Recent Attacks on § 104(a)(2)

The *Murphy* case is not the only attempt to declare the 1996 amendment to § 104(a)(2) unconstitutional. In *Lockmiller v. Commissioner*,²⁵³ the petitioner attempted to avoid taxation of his settlement agreement lump-sum payment of \$20,000, which was awarded him because of a dispute concerning the terms of his compensation package.²⁵⁴ He did not claim to have personal physical injuries or physical sickness, but claimed that the amendment adding the word “physical” to § 104 was unconstitutional.²⁵⁵ The tax court did not agree with the plaintiff²⁵⁶ holding that “[t]ax legislation carries a ‘presumption of constitutionality’”²⁵⁷ and that “[t]he distinction made by section 104(a)(2) between personal physical injury or sickness and nonphysical personal injury or sickness is rationally related to the objectives articulated in that section’s legislative history.”²⁵⁸

249. *See id.*

250. *Id.* See also *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006), where *Murphy* contends that her damages are not taxable because they arise from physical injuries, but the Court holds that her damages were not awarded “because of” physical injuries, but “because of” her non-physical injuries and thus do not pass the *Schleier* test. *See also supra* Part III.

251. *See Lesti, supra* note 224.

252. *Murphy*, 460 F.3d 79.

253. T.C. Summary Opinion 2003-108 (2003).

254. *See id.* at 1.

255. *Id.* at 2.

256. The Tax Court also noted that “implicit in petitioner’s contention is the assumption that [his settlement] would be excludable from income” prior to the 1996 amendment, but the court held that assumption “highly questionable under the two-prong standard of *Commissioner v. Schleier*, 515 U.S. 323, 336 (1995).” *Id.* at 2 n.5.

257. *Id.* (quoting *Regan v. Taxation with Representation*, 461 U.S. 540, 547 (1983)).

258. *Id.* at 4.

*Young v. United States*²⁵⁹ took a different approach from *Murphy*²⁶⁰ attacking § 104(a)(2) on equal protection grounds – contending that the “distinction between physical and non-physical injury violates the . . . Fifth Amendment.”²⁶¹ The Sixth Circuit noted that since § 104(a)(2) “does not ‘interfere with the exercise of a fundamental right, such as freedom of speech, or employ a suspect classification, such as race,’ the distinction that it creates is constitutional as long [as] it bears a rational relationship to a legitimate government purpose.”²⁶² The plaintiff failed to overcome his burden of negating “every conceivable basis which might support” the legislative arrangement – “Congress sought to establish a uniform policy regarding taxation of damage awards and to reduce the amount of litigation regarding whether damages awards were taxable. [This] distinction . . . is rationally related to these . . . government purposes.”²⁶³

Yet another argument has been advanced in *Allum v. Comm’r*²⁶⁴ – the plaintiff claimed that § 104(a)(2) is unconstitutionally vague.²⁶⁵ The tax court stated that “[t]he language of the statute is not vague or ambiguous such that ‘men of common intelligence must necessarily guess at its meaning’”²⁶⁶ and “[a]lthough the standard established in section 104(a)(2) may be difficult to apply to particular factual circumstances, this fact does not render the statute vague or ambiguous.”²⁶⁷ Since this section has been applied in numerous opinions without any concern about vagueness, it was easy for the tax court to declare it constitutional.²⁶⁸

G. Emily’s Plight

What is the current stance of taxation for Emily’s damages? Those

259. 332 F.3d 893 (6th Cir. 2003).

260. Murphy had also attempted this attack in the district court, but was not successful with it. See *Murphy v. I.R.S.*, 460 F.3d 79, 81-82 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

261. *Young*, 332 F.3d at 894.

262. *Id.* at 895 (quoting *Regan v. Taxation with Representation of Washington*, 461 U.S. 540, 547 (1983)).

263. *Id.* at 896 (citation omitted).

264. T.C. Memo 2005-177 (2005).

265. *Id.* at 6. This contention stemmed from the argument that the local Taxpayer Advocate Service office was unable to give a “definitive” answer to the taxpayer’s initial inquiry regarding the applicability of § 104(a)(2) to his settlement proceeds. See *id.*

266. *Id.* at 7 (quoting *Baggett v. Bullitt*, 377 U.S. 360, 367 (1964)).

267. *Id.*

268. See *id.*

damages are currently taxable, particularly due to the D.C. Circuit's vacating the *Murphy* decision.²⁶⁹ The tax is based on the exclusion in § 104(a)(2)²⁷⁰ and that exclusion does not cover nonphysical personal injury damages, so those damages are not excluded from income and are taxable.²⁷¹ If the new decision in the *Murphy* case affirms the August 2006 decision,²⁷² Emily's lawyers will have a Circuit Court to back-up their claims of non-taxability, but right now a similar fight for non-constitutionality of § 104(a)(2) is needed for a court to pronounce her damages nontaxable.

A large portion of the D.C. Circuit's analysis in *Murphy* rested upon the principle that personal injury damages are roughly a "return of capital" and that is how they have been historically viewed.²⁷³ The "human capital" concept includes ownership in both physical and nonphysical human attributes.²⁷⁴ Many will argue that "human capital" does not exist²⁷⁵ but it is a difficult argument if looking at Emily's damages.²⁷⁶

Emily was a well-adjusted child prior to the unwarranted house storming by the police. She is now constantly afraid and has difficulty being away from her father. It is easy to see that this child has lost something that had been a part of her being before – she has lost a feeling of safety and security – something that is easily seen as a "human capital" ownership.

V. CONCLUSION

The section 104(a)(2) exclusion has created much controversy and confusion over the years and it is time for Congress to act. The D.C. Circuit's *Murphy* decision has brought this section into the limelight and pointed to the shortcomings of the exclusion and of the 1996 amendment to that section. Whichever way the D.C. Circuit will rule, *Murphy* does not take away the difficulty in applying this section to the facts of

269. *Murphy v. I.R.S.*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

270. I.R.C. § 104(a)(2) (2007).

271. *See infra* Part II, Section B.

272. *Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006), *vacated*, No. 05-5139, 2006 U.S. App. LEXIS 32293 (D.C. Cir. Dec. 22, 2006).

273. *See id.* at 87-91.

274. *Id.* at 85 (quoting *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 432 n.8 (1955) ("holding personal injury [both physical and nonphysical] recoveries nontaxable on the theory that they roughly correspond to a return of capital . . .")).

275. The IRS has argued this vehemently. *Murphy*, 460 F.3d at 87.

276. *See supra* Part I.

individual cases and does not minimize the confusion and lack of certainty for victims, attorneys, commentators, judges, and the public generally.

VI. AFTERWORD

Since this note was originally completed, the *Murphy* case has not been dormant. On July 3, 2007, the D.C. Circuit has rendered a decision on rehearing (“*Murphy II*”) and effectively overruled its August 22, 2006 decision that is the subject of this note.²⁷⁷ The court went over the same points as the original (“*Murphy I*”) decision, but also addressed issues newly presented by the Government.²⁷⁸ An overview of *Murphy II* will shed some light on the thinking of the D.C. Circuit and allow an observation that this decision was a means to an end, reversing the controversial decision of *Murphy I*.²⁷⁹

The court began by giving the background of the case as has already been covered in detail earlier in this note.²⁸⁰ Next, the Court recognized that it is unusual to allow new arguments on rehearing, but that exceptional circumstances allow it to proceed to avoid injustice that might otherwise result.²⁸¹ The analysis begins with the review of the IRS as a defendant concluding that it may not be sued *eo nomine* in this case.²⁸² The discussion on whether *Murphy*’s damages were awarded on account of physical injuries adhered to the *Murphy I* discussion on the same points.²⁸³ *Murphy* argued that her award was based on physical injuries and pointed to her psychologist’s testimony that she experienced “somatic” and “body” injuries.²⁸⁴ Her main position here was that §

277. *Murphy v. I.R.S.*, 493 F.3d 170, 186 (D.C. Cir. 2007) (“*Murphy II*”).

278. *See id.*

279. *See* Petition for Rehearing En Banc at 2-4, *Murphy v. I.R.S.*, No. 05-5139 (D.C. Cir. Aug. 17, 2007). *See also* Posting by Prof. Bryan Camp, TaxProf Blog, http://taxprof.typepad.com/taxprof_blog/new_cases/index.html (July 6, 2007); J.P. Finet, *Attorney Says Circuit’s ‘Murphy’ Reversal Will Lead to Increased Litigation Expenses*, BNA DAILY TAX REPORT, No. 132, at K-1, (July 11, 2007).

280. *See supra* Part III; *Murphy II*, 493 F.3d at 171-173.

281. *Murphy II*, 493 F.3d at 173 (quoting *Eli Lilly & Co. v. Home Ins. Co.*, 794 F.2d 710, 717 (D.C. Cir. 1986)). The court rests its argument on the fact that it is forced by the “balancing of considerations of judicial orderliness and efficiency against the need for the greatest possible accuracy in judicial decisionmaking [sic]. The latter factor is of particular weight when the decision affects the broad public interest.” *Id.* (quoting *Consumers Union of U.S., Inc. v. Fed. Power Comm’n*, 510 F.2d 656, 662 (D.C. Cir. 1975)).

282. *Id.* at 173-74. *See also supra* Part III, section C. and accompanying footnotes for the same discussion in *Murphy I*.

283. *Murphy II*, 493 F.3d at 174-76. *See also supra* Part III, section C.

284. *Murphy II*, 493 F.3d at 174.

104(a)(2) does not limit “the physical disability exclusion to a physical stimulus,” but the Government argued that more important was the phrase “on account of,” which required Murphy’s award to have a strong causal connection to her physical injuries.²⁸⁵ The Court agreed with the Government noting that the Administrative Law Judge clearly awarded damages “for mental pain and anguish” and “for injury to professional reputation.”²⁸⁶ Therefore, Murphy’s damages are not excluded from taxation under § 104(a)(2), as currently written, because they are not based on “physical” injuries.²⁸⁷

The Court goes on to discuss whether Murphy’s damages would be considered “income” under § 61 of the I.R.C.²⁸⁸ Here, Murphy argues her “restoration of human capital” theory that appeared successful in *Murphy I*, and the Government goes through several arguments trying to prove her incorrect.²⁸⁹ The Court disregards the arguments of both parties and notes that “although the ‘Congress cannot make a thing income which is not so in fact,’ it can *label* a thing income and tax it, so long as it acts within its constitutional authority.”²⁹⁰ The Court finds that Congress “labeled” Murphy’s damages as income through enacting the 1996 amendment to § 104(a).²⁹¹ The amendment has no effect in taxing awards for nonphysical damages if those awards are not included in income by § 61, but according to the Court, “we must presume that ‘[w]hen Congress acts to amend a statute . . . it intends its amendment to have real and substantial effect.’”²⁹² Even if § 61 did not include Murphy’s damages in income prior to 1996, “the presumption indicates the Congress *implicitly* amended § 61 to cover such an award when it

285. *Id.* at 175.

286. *Id.* at 176.

287. *Id.*

288. *Id.* at 176-80.

289. *Id.* at 177-78. The Government brings forth four arguments: (1) Murphy had economic gain because she was better off financially after receiving the damages; (2) Murphy’s case law “does not support the proposition that Congress lacks the power to tax as income recoveries for personal injuries,” it merely proves that Congress did not want to tax them at the time of *O’Gilvie v. United States*, 519 U.S. 79 (1996), and *Comm’r v. Glenshaw Glass, Co.*, 348 U.S. 426 (1955), but the decisions did not articulate the “Court’s own view whether such damages could constitutionally be taxed”; (3) “Treasury decisions dating even closer to the time of ratification treated damages received on account of personal injury as income” thereby showing that those damages were considered taxable by those writing the Sixteenth Amendment; and (4) no monetary tax basis in Murphy’s human capital, thus restoration of it cannot be restoration of capital. *Id.*

290. *Id.* at 179 (emphasis in original) (quoting *Burk-Waggoner Oil Ass’n v. Hopkins*, 269 U.S. 110, 114 (1925)).

291. *Id.*

292. *Id.* (alteration in original) (quoting *Stone v. I.N.S.*, 514 U.S. 386, 397 (1995)).

amended § 104(a).²⁹³ Thus, completely obliterating its reasoning in the *Murphy I* decision, the D.C. Circuit finds that “gross income in § 61(a) must . . . include an award for nonphysical damages such as Murphy received, regardless whether the award is an accession to wealth.”²⁹⁴

The court went on to address the new issue brought by the Government about Congress’s power to tax.²⁹⁵ The discussion centered on whether the § 104(a)(2) tax on nonphysical damages fell within Congress’s power to tax as limited by the U.S. Constitution in Article I, Section 9, which declares that “[n]o capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.”²⁹⁶ There have always been difficulties in determining taxes that are direct and those that are indirect, but there are three that are definitely direct: “(1) a capitation, (2) a tax upon real property, and (3) a tax upon personal property.”²⁹⁷ Murphy argued that “if the tax cannot be shifted to someone else . . . then it is a direct tax; but if the burden can be passed along through a higher price . . . then the tax is indirect.”²⁹⁸ Per Murphy, her tax burden cannot be shifted to anyone else, and thus it must be a direct tax and subject to apportionment.²⁹⁹ The Government argues that “only ‘taxes that are capable of apportionment in the first instance . . . are direct taxes.’”³⁰⁰

The Court, again, does not adopt either view.³⁰¹ It phrases the question as “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,

293. *Id.* at 180 (emphasis added). The Court did realize that amendments by implication are disfavored, but it felt justified due to the “classic judicial task of reconciling many laws enacted over time, and getting them to ‘make sense’ in combination, [which] necessarily assumes that the implications of a statute may be altered by the implications of a later statute.” *Id.* (quoting *United States v. Fausto*, 484 U.S. 439, 453 (1988)).

294. *Id.*

295. *Id.* at 180-86.

296. *Id.* at 180 (quoting U.S. CONST. art.1, § 8, cl. 1 and U.S. CONST. art. 1, § 2, cl. 3 (“direct taxes shall be apportioned among the several states which may be included within this union, according to their respective numbers.”)).

297. *Id.* at 181.

298. *Id.* Murphy uses a variety of sources to strengthen her argument: ALBERT GALLATIN, A SKETCH OF THE FINANCES OF THE UNITED STATES (1796); THE FEDERALIST NO. 21 & NO. 36 (Alexander Hamilton); Eric M. Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334 (1997).

299. *Murphy II*, 493 F.3d at 182.

300. *Id.* The Government further argued that when the Constitution gave the new national government plenary taxing power, it would have made “no sense to treat ‘direct taxes’ as encompassing taxes for which apportionment is effectively impossible, because ‘the Framers could not have intended to give Congress plenary taxing power, on the one hand, and then so limit that power by requiring apportionment for a broad category of taxes, on the other.’” *Id.* at 183.

301. *Id.* at 184.

or, on the other hand, more like a tax upon a use of property, a privilege, an activity, or a transaction.”³⁰² According to the Court, Murphy’s situation is similar to an involuntary conversion of assets and since she is taxed only after she receives a compensatory award, her tax is a tax laid upon a transaction.³⁰³ Further, the Court notes that this tax is actually a tax on the “facility” of the legal system that allowed Murphy to receive her award, and this “privilege” is taxed by excise.³⁰⁴ In conclusion, the Court finds Murphy’s award taxable according to every argument presented.³⁰⁵

The reasoning of the *Murphy II* opinion shows that the Court was going after a result-driven analysis.³⁰⁶ At first, the Government’s new arguments are admitted on the theory of avoiding the injustice that might otherwise occur,³⁰⁷ but throughout the opinion the Court does not follow those arguments, instead, it provides its own reasoning.³⁰⁸ The issue of whether § 61 encompasses Murphy’s award was decided on the Court’s own reasoning of an implicit amendment of that section through the 1996 § 104(a)(2) amendment.³⁰⁹ Further, the direct taxation issue was also decided on the Court’s own reasoning.³¹⁰ The question arises: if the Court used its own reasoning, why was this not done in *Murphy I* with the final result of *Murphy II*? The Court seems to have changed its mind between the two decisions and tried to come-up with a solution and reasoning to make the nonphysical damages award taxable.³¹¹

This case has not reached a resolution because the next step taken by Murphy is a petition for rehearing en banc.³¹² In her petition, Murphy argues many of the points that she had argued in the previous briefs,³¹³

302. *Id.*

303. *Id.* at 184-85.

304. *Id.* at 186 (“The tax may be laid upon the proceeds received when one vindicates a statutory right, but the right is nonetheless a ‘creature of law’ . . . [which is] a ‘privilege’ taxable by excise.”).

305. *Id.* The last point the Court makes is that all excise taxes must be “uniform throughout the United States,” and a tax laid upon an award of damages for a nonphysical personal injury meets that requirement. *Id.* (quoting U.S. CONST. art. I, § 8, cl.1).

306. *See id.* at 173-86.

307. *Id.* at 173.

308. *Id.* at 178-79, 184.

309. *Id.* at 178-80; *supra* notes 290-294 and accompanying text..

310. *Murphy II*, 493 F.3d at 184-86 (“[T]he Supreme Court . . . has strongly intimated that Murphy’s position is not the law . . . [N]either need we adopt the Government’s position that direct taxes are only those capable of satisfying the constraint of apportionment. . . . We find it more appropriate to analyze this case based upon the precedents . . .”).

311. *Compare Murphy I*, 460 F.3d 79 (D.C. Cir. 2006), with *Murphy II*, 493 F.3d 170.

312. Petition for Rehearing En Banc, *Murphy v. I.R.S.*, No. 05-5139 (D.C. Cir. Aug. 17, 2007).

313. *See supra* Part III, Section C and Part VI.

but also has a few arguments stemming directly from *Murphy II*. First, she notes that *Murphy II* “does not overrule or disagree with the essential holding of *Murphy I* that Murphy’s damages are not ‘income.’”³¹⁴ This is the first time that a court amends § 61 by implication “to create a tax not expressly enacted by Congress” and this decision “conflicts with Supreme Court cases, and cases decided in [the D.C. Circuit] and other circuits.”³¹⁵ Murphy also attacks the Court’s *sua sponte* “unprecedented and unsupportable . . . holding . . . that Congress . . . [enacted] a special federal excise tax on plaintiffs for utilizing the legal system to obtain damages awards.”³¹⁶ The petition calls for the en banc rehearing to give more certainty to this field of tax law, and to apply the nearly 80-year stance of the IRS and the courts that Murphy’s damages do not fall into the category of “income” under the Internal Revenue Code or under the U.S. Constitution.³¹⁷ The petition for *en banc* rehearing was denied on September 14, 2007.³¹⁸ Murphy filed a petition for certiorari with the Supreme Court on December 13, 2007.³¹⁹

At this date, *Murphy* remains unresolved and the tax world is waiting with bated breath the final resolution of the case. It is a topic

314. Petition for Rehearing En Banc, *supra* note 279, at 1.

315. *Id.* at 1-2. Murphy argues that despite the “amendment by implication” reasoning of the D.C. Circuit, any § 61(a) tax has to satisfy the “accession to wealth” test and that there is a long line of cases from the Supreme Court and from different circuit courts supporting her position. *Id.* at 4-5 (noting *Doyle v. Mitchell Bros.*, 235 F. 686, 688 (6th Cir. 1916), *S. Pac. Co. v. Lowe*, 247 U.S. 330, 335 (1918), *Burk-Waggoner Oil v. Hopkins*, 269 U.S. 110, 114 (1925), *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 432, n. 8 (1955), *United States v. Kaiser*, 363 U.S. 299, 311 (1960), *O’Gilvie v. United States*, 519 U.S. 79, 84-86 (1996), *Hawkins v. Comm’r*, 6 B.T.A. 1023, 1024-25 (1927), *Dotson v. United States*, 87 F.3d 682, 685 (5th Cir. 1996)). Since her award was not an accession to wealth, Murphy argues that an amendment by implication is not possible in this situation. *Id.* at 5-8. Further, Murphy notes that “a tax levying statute may not be extended by implication, and where there is doubt as to the validity of the tax, all doubt must be construed most strongly in favor of the taxpayer and against the Government.” *Id.* at 8. Since there was no “clear and manifest” Congressional intent to amend § 61 by implication when adopting the 1996 amendment to § 104(a)(2), the D.C. Circuit overstepped its boundaries in ruling that an “amendment by implication” existed in this case. *Id.* at 9-10.

316. *Id.* at 2. The “‘forced sale’ formulation . . . impermissibly confers a right on the wrongdoer,” and creates a sale of “human health,” which is “void . . . as a matter of law and public policy.” *Id.* at 12-13. Murphy raises a few interesting questions in regard to the new-found “excise” tax found by the Court: “what is the tax rate for such an implied ‘excise’?”; “does this . . . [tax] apply equally to all damages recovered through the legal system, or only to the kind of damages obtained by Murphy?”; “[d]oes the ‘excise’ fall on defendants, or only on successful plaintiffs?” *Id.* at 13-14. The *Murphy II* decision does not provide answers to any of these questions and it is interesting to see if the Court will address them in the en banc rehearing, if granted.

317. *Id.* at 2-3.

318. *Murphy v. I.R.S.*, 493 F.3d 170, 186 (D.C. Cir. 2007), (No. 07-802).

319. Petition for Writ of Certiorari, *Murphy v. I.R.S.*, 493 F.3d 170 (D.C. Cir. 2007)

that is prevalent throughout the legal and tax circles because it touches many aspects of the law – employment, torts, whistleblower, academia, tax, civil rights, etc.³²⁰ The *Murphy II* decision has not given an acceptable answer to the taxability of nonphysical personal injury awards because the court's reasoning was noticeably result-driven and weaved in and out of arguments with a motive to end with a taxable result.³²¹ The historical view of taxation of nonphysical awards shows that these awards were believed to be nontaxable by the writers of the Sixteenth Amendment, that § 61 does not include them in income, and that they are not taxable under the “make whole” principle, but *Murphy II* did not follow historical precedent.³²² As this note discussed, there is much controversy surrounding § 104(a)(2) and the *Murphy II* decision did not clear up any confusion, in fact, it created even more controversy by holding taxable the awards that have been untaxed for over eighty years.³²³ The uncertain position of the D.C. Circuit throughout *Murphy I* and *Murphy II*³²⁴ gives a louder voice to those calling for legislative action and more definition of § 104(a)(2) – maybe Congress will take notice.

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320. *Id.* at 3. See generally Robert W. Wood, *Waiting to Exhale: Murphy Part Deux and Taxing Damage Awards*, 116 TAX NOTES 265 (2007), available at <http://woodporter.com/pdf/TN072307p265.pdf>.

321. See Petition for Rehearing En Banc, *supra* note 317, at 2-4; Posting of Prof. Bryan Camp to TaxProf Blog, http://taxprof.typepad.com/taxprof_blog/new_cases/index.html (July 6, 2007).

322. See *supra* Parts II, III, IV.

323. See generally *supra* Parts I, II, III, IV, V and VI.

324. Maybe even *Murphy III*?