

One Minute Memo[®]



Statute Which Subjects an Award for Emotional Distress/Injury to Personal Reputation to Taxation Found ~~Un~~Constitutional – Court Reverses Itself in *Marrita Murphy* Case

On August 22, 2006, the United States Court of Appeals for the District of Columbia Circuit, in *Marrita Murphy and Daniel J. Leveille v. Internal Revenue Service and United States of America*, 460 F.3d 79 (2006), had held that Section 104(a)(2) of the Internal Revenue Code was unconstitutional insofar as it permitted the taxation of an award for a personal injury and that was unrelated to lost wages or earnings – that is, that such an award was not “income” within the intendment of the Sixteenth Amendment of the United States Constitution¹ and, thus, was not an amount that Congress was empowered to tax. In so holding, the court reversed the decision of the United States District Court for the District of Columbia granting summary judgment for the Government and remanded the case back to the District Court to enter an order and judgment instructing the Government to refund the taxes the taxpayer paid on her award plus applicable interest. *For a summary of the facts of the case and the court’s August 22, 2006 decision, please see our August 2006 One Minute Memo entitled, “[Statute Which Subjects an Award for Emotional Distress/Injury to Personal Reputation To Taxation Found Unconstitutional.](#)”*

Following this decision, the Government petitioned the court for a rehearing en banc (and arguing for the first time that even if the award was not “income” within the meaning of the Sixteenth Amendment, there was still no constitutional impediment to taxing the award by reason of the subject tax not being a “direct tax” and which was imposed uniformly) and, on December 22, 2006, the court, on its own motion, vacated its August 22, 2006 judgment and agreed to rehear the case. Following the re-hearing, the court, on July 3, 2007, affirmed the District Court’s decision granting summary judgment for the Government based upon this new constitutional argument raised by the Government.

First, the court again rejected the taxpayer’s argument that her award should be excluded from gross income under Section 104(a)(2) of the Internal Revenue Code by reason of such award being based upon tort type rights and made as compensation for “physical” injuries resulting from the stress caused from her “blacklisting” (i.e., permanent teeth damage from teeth grinding and other physical manifestations). The court also rejected the taxpayer’s further arguments that her award was not

¹The Sixteenth Amendment of the United States Constitution provides that “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.”

“gross income” under Section 61 of the Internal Revenue Code² by reason of the award being a “restoration of [human] capital” (and, thus, not income) and also that the subjecting of the award to tax would conflict with the “make whole” relief intended to be afforded plaintiffs under tort law and provisions of various environmental statutes and Title VII of Civil Rights Act of 1964. To this end, the court noted that Congress’ amending of Section 104(a)(2) in 1996 to narrow the exclusion to amounts received on account of “personal physical injuries or physical sickness” (instead of all personal injuries or sickness, both physical and non-physical) and to explicitly provide for emotional distress to not be treated as a “physical injury or physical sickness” strongly suggested that Section 61 should be read to include, as “gross income”, an award for damages for nonphysical harms (that is, by amending Section 104(a)(2), Congress “implicitly amended” Section 61).

Finally, the court addressed the constitutional arguments raised by the parties and, in particular, whether Congress had the constitutional authority to tax the taxpayer’s award pursuant to its general taxing authority under Article I, Section 8 of the United States Constitution, as limited by Article I, Sections 2 and 9 of the United States Constitution.³ The court concluded that as the subject tax was an

“indirect”, rather than “direct”, tax (and, thus, not subject to the “apportionment” requirement) and which satisfied the uniformity requirement, Congress was constitutionally empowered to impose the tax (even if the award was not otherwise “income” within the meaning of the Sixteenth Amendment).

Accordingly, as a result of the court’s reversal of its earlier decision, plaintiffs in employment litigation cases will no longer have the additional incentive to try and “couch” their injuries as “emotional distress,” “injury to personal reputation” and/or some other personal injury in an effort to try and qualify their awards for exemption from income tax, as only awards received on account of personal physical injuries or physical sickness under Section 104(a)(2) will so qualify.

*Should you have any questions about the *Marrisa Murphy and Daniel J. Leveille v. Internal Revenue Service and United States of America* cases or the taxation of judgment awards/settlement payments in general, feel free to call either Marc Kushner at (212) 218-5621 or Steven Crainer at (212) 218-5622.*

²Section 61 (a) of the Internal Revenue Code provides that “[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items [enumerated items not listed although, and as the court noted, damage award for emotional distress not enumerated item]”.

³Article I, Section 8 of the United States Constitution provides, as relevant, that “The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defence and general welfare of the United States; but all duties, imposts and excises shall be uniform throughout the United States.” Article I, Section 9 of the United States Constitution provides, as relevant, 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.” Article I, Section 2 of the United States Constitution provides, as relevant, that “. . . direct taxes shall be apportioned among the several states which may be included within this union, according to their respective numbers”

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