

# One Minute Memo™



## Statute Which Subjects an Award for Emotional Distress/Injury to Personal Reputation to Taxation Found Unconstitutional

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*, held that Section 104(a)(2) of the Internal Revenue Code was unconstitutional insofar as it permitted the taxation of compensation for a personal injury and that was unrelated to lost wages or earnings. 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 the Internal Revenue Service 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.

In this case, the taxpayer had filed a complaint with the Department of Labor alleging that her former employer, the New York Air National Guard (NYANG), in violation of various whistleblower statutes, had “blacklisted” her and provided unfavorable references to potential employers after she had complained to state authorities of environmental hazards on a NYANG airbase. Ultimately, the taxpayer was awarded compensatory damages of \$45,000 for “emotional distress or mental anguish” and \$25,000 for “injury to professional reputation.” No award was given for lost wages or diminished earning capacity.

Section 104(a)(2) of the Internal Revenue Code provides that, with certain exceptions, gross income does not include the 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 and that, for this purpose, emotional distress is not considered a physical injury or physical sickness. The version of Section 104(a)(2) that was in effect prior to 1996 had excluded from gross income amounts received in compensation for “personal injuries or sickness,” which included both physical and nonphysical injuries (including emotional distress).

The United States Court of Appeals for the District of Columbia Circuit first rejected the taxpayer’s claim that her award should be excluded from gross income under Section 104(a)(2) 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 found that the award was made to compensate the taxpayer “for mental pain and anguish” and “for injury to professional reputation,” rather than for “physical” injury (even though the taxpayer did suffer certain physical manifestations of this mental pain and anguish/injury to professional reputation).

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However, the Court instead found that the award received by the taxpayer (as an amount to make the taxpayer “emotionally and reputationally ‘whole’ and not to compensate her for lost wages or taxable earnings of any kind”) was not “income” in the first instance within the intendment of the Sixteenth Amendment of the United States Constitution<sup>1</sup>; therefore, the award was not an amount that Congress was empowered to tax. According to the Court, the Sixteenth Amendment did not differentiate between damages received for a physical personal injury and damages received for a nonphysical injury unrelated to lost wages or earning capacity - neither constituted “income.”

As a result of this decision, one could expect, among other things, that plaintiffs in employment litigation cases will try and “couch” their injuries as “emotional distress,” “injury to personal reputation” and/or some other personal injury (whether physical or nonphysical). Thus, instead of the benefit to a plaintiff (and an employer/defendant) of such characterization being merely that the resulting judgment award/settlement payment is non-wage income (exempt from withholding and payroll taxes, but taxed as ordinary income nonetheless), the resulting judgment award/settlement payment may potentially be exempt from income tax altogether.<sup>2</sup>

Should you have any questions about the *Marrita Murphy and Daniel J. Leveille v. Internal Revenue Service and United States of America* case or the taxation of judgment awards/settlement payments in general, feel free to contact the Seyfarth Shaw attorney with whom you work or the authors of this alert: Marc Kushner (212-218-5621, [mkushner@seyfarth.com](mailto:mkushner@seyfarth.com)) and Steven Crainer (212-218-5622, [scrainger@seyfarth.com](mailto:scrainger@seyfarth.com)).

<sup>1</sup>The Sixteenth Amendment of the United States Constitution provides that “[t]he 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.”

<sup>2</sup>One would expect that the Government will try and appeal this decision to the United States Supreme Court and/or try and litigate the constitutionality of Section 104(a)(2) in another circuit with the goal of trying to obtain an opposite holding from one or more of the other United States Courts of Appeal (and to then appeal to the United States Supreme Court to resolve the conflict among the circuits).

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