Case No. 05-5139

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

MARRITA MURPHY, *et al.*,

Plaintiffs/Appellants,

v.

INTERNAL REVENUE SERVICE, *et al.*,

Defendants/Appellees.

On appeal from the
U.S. District Court for the District of Columbia

APPELLANTS' RESPONSE TO APPELLEES' PETITION FOR REHEARING *EN BANC*

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RESPONSE TO APPELLEES' STATEMENT UNDER FRAP 35(b)(1)

The personal injury damages awarded to Ms. Marrita Murphy are not taxable as "incomes" under the 16th Amendment to the U.S. Constitution, or under any cognizable definition of income or gain in the tax code. In an unbroken line of cases, the Supreme Court and the U.S. Courts of Appeals have drawn a sharp distinction between monetary awards which constitute a taxable "gain" or "accession to wealth" and awards that make a person "whole" for restoring a personal loss.[1] Applying the consistent and unbroken line of cases interpreting the meaning of "income" under the 16th Amendment as well as the history surrounding its passage as well as the understood meaning of "income" under the tax codes that were passed under the 16th Amendment, requires a finding that Murphy's compensatory damages award for an actual loss of reputation and damage to her emotional or physical well being is not income.

The Supreme Court has ***never*** stated that the statute in question (as amended in 1996) was valid. *Cf.* Govt. Pet., p. 1. In prior cases, the Court has never reviewed Section 104(a)(2), as amended in 1996, which is the version of the statute the panel reviewed in this case. The issue concerning the taxing of "make whole" damages for non-physical personal injuries under Section

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[1] *See, e.g., Doyle v. Mitchell Bros.*, 235 F. 686, 688 (6th Cir. 1916) (monies paid to compensate for losses in a fire are not income); *Southern Pacific Co. v. Lowe*, 247 U.S. 330, 335 (1918) (return of capital not income under the tax code or 16th Amendment); *Burk-Waggoner Oil v. Hopkins*, 269 U.S. 110, 114 (1925) (Brandeis, J.) (neither Congress nor the Courts are permitted to "make a thing income which is not so in fact"); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432, n. 8 (1955) (personal injury recoveries are "by definition compensatory only" and nontaxable); *U.S. v. Kaiser*. 363 U.S. 299, 311 (1960) (Frankfurter, J., concurring) ("The principle at work here is that payment which compensates for a loss of something which would not itself have been an item of gross income is not a taxable payment"); *O'Gilvie v. United States*, 519 U.S. 79, 84-86 (1996) ("a restoration of capital [is] not income; hence it [falls] outside the definition of 'income' upon which the law impose[s] a tax); *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1024-25 (U.S. Bd. Tax. App. 1927) ("compensation for injury to [plaintiff's] personal reputation" was not income because it was "an attempt to make the plaintiff whole as before the injury."); *Dotson v. U.S.*, 87 F.3d 682, 685 (5th Cir. 1996) (personal injuries for physical or emotional well-being nontaxable as a "return of human capital").

104 has not been considered by the Supreme Court, and there was no reason for the Court to consider that issue because prior to 1996 there was no question that "make whole" compensatory damages awards for non-physical personal injuries were not taxable. No other courts of appeals have considered the issue decided by the panel in this case either.

In its petition for rehearing *en banc* the government misconstrues the record as well as the constitutional and statutory authority to tax income. It is completely disingenuous for the Government to raise Congress' taxing power under Article I of the Constitution as an issue for the first time in its petition for rehearing *en banc*. *Cf.* Govt. Pet., pp. 1, 4-5, 14. Even though the Government blames the panel for supposedly ignoring Congress' Article I taxing power, the Government ***never raised that issue*** before the panel, and it must be deemed waived. An issue raised for the first time in a petition for rehearing *en banc* is not grounds for *en banc* review.

Before the panel the Government agreed with Murphy that the definition of "income" in 26 U.S.C. § 61(a) is based on the 16th Amendment and "is used in its constitutional sense." *Glenshaw Glass Co.,* 348 U.S. at 432-433 n. 11. Indeed, every modern tax code has been enacted pursuant to and under the authority of the 16th Amendment, and there is a long unbroken line of Departmental rulings and Supreme Court cases finding that the taxing of income is governed by the 16th Amendment. The Government conceded to the panel, as it must, that the 16th Amendment governs the definition of income under the tax code. Accordingly, the panel correctly stated that the word "incomes" in the 16th Amendment and the definition of "gross income" under 26 U.S.C. § 61(a) are "coextensive." Op. 10.[2] The Government agreed with that point before the panel, but takes issue with it now only after losing on the merits.

The panel's conclusion in this case, that a "make whole" award for damage to emotional

[2] "Op." refers to the panel's slip opinion, dated August 22, 2006, which is now published. *See Murphy v. I.R.S.*, 460 F.3d 79 (D.C. Cir. 2006).

well-being and reputation is not income and therefore not subject to tax is completely consistent with a long line of departmental rulings, including but not limited to an Attorney General Opinion and Treasury Decision from 1918, a Solicitor's Opinion in 1922[3] (holding that non-physical compensatory damages are not income under the 16th Amendment and are outside the scope of the tax code), and many formal Revenue Rulings before and after the Supreme Court's *Glenshaw Glass* decision was issued. Additionally, the panel's conclusion that Murphy's "make whole" damages are not income is in line with every Supreme Court decision considering what is income. As the Supreme Court noted after reviewing this history, the courts held a number of times after the 16th Amendment was enacted that "a restoration of capital was not income; hence it fell outside the definition of 'income'…" *O'Gilvie,* 519 U.S. at 84. The Government has not provided any reason to justify such a drastic departure from this well-settled rule.

In order to conclude that documented "make whole" damages awards for personal injuries are income, the Government has advanced a nonsensical approach to the value of human life. The Government argues damages received for personal injuries should be taxed as income because there is no value in human capital and since the basis in "lost" human capital is "zero" all damages received for personal injuries must be considered a "gain" unless expressly excluded from gross income by Congress. This argument defies not only the history of our tax code and the 16th Amendment as well as the unbroken line of Supreme Court cases and Departmental rulings interpreting the definition of income under the 16th Amendment, but also collides with centuries of jurisprudence assigning a monetary value to human capital losses to award damages for emotional distress or loss of reputation. More importantly, there is not one Supreme Court case that endorses the Government's unique theory that "make whole" compensatory damages

[3] *See* Op. 23, citing Sol. Op. 132, 1-1 C.B. 92, 03 (1922).

awarded solely to restore a loss of human capital are somehow a "gain" that can be taxed.

The panel's ruling is narrowly tailored to limit the taxing of "make whole" damages which fall outside the constitutional or statutory definition of income. Whether the "coextensive" statutory meaning of taxable income under 26 U.S.C. §61(a), or the constitutional meaning of incomes under the 16th Amendment are analyzed, the results are the same. The Government cannot reconcile its unsupported theory that compensatory damages for personal injuries are a "gain" with the long line of cases and other authorities, which recognize that "make whole" damages for personal injuries are not a realized gain and are akin to a restoration of loss or return of capital. Nor can the Government reconcile its theory of a "gain" with the facts of this case.

ARGUMENT

A. The Panel Correctly Declared the Tax On Murphy's Damages Unconstitutional.

1. The Government's first argument in support of the petition for rehearing *en banc* based on Article I, § 8, cl. 1, of the Constitution (Govt. Pet., pp. 1, 4-6, and 14) was never raised on appeal before the panel and, thus, has been waived. *United States ex rel. Totten v. Bombadier Corp.*, 380 F.3d 488, 497 (D.C. Cir. 2004) ("arguments that parties do not make on appeal are deemed to have been waived."); *Ark Las Vegas Rest. Corp. v. NLRB*, 334 F.3d 99. 108 n. 4 (D.C.Cir. 2003) (argument waived because not raised in the party's brief); *Whately v. District of Columbia*, 447 F.3d 814, 821 (D.C. Cir. 2006). Notably, the Government chose not to argue on appeal whether the income tax was a direct or indirect tax, or argue that the 16th Amendment does not apply in this case.[4] Indeed, the Government did not even cite to *Brushaber v. Union*

[4] *Also see, District of Columbia v. Air Florida, Inc.*, 750 F.2d 1077, 1084 (D.C. Cir. 1984) (it is "well-settled" that "issues and legal theories not asserted at the District Court level ordinarily will not be heard on appeal"). Appellees also did not press in the District Court the argument that the income tax is not a direct tax that is outside the scope of the 16th Amendment. These issues are now waived because in response to Murphy's 16th Amendment claim the Government argued

Pac. RR. Co., 240 U.S. 1 (1916), in its brief to the panel.[5] A party's failure to raise an issue before a panel, whether deliberately or otherwise, does not justify a rehearing *en banc.*

On appeal, the Government exclusively argued that Congress based its definition of gross income in the modern tax code "upon the 16th Amendment and the word 'income' is used" in 26 U.S.C. §61(a) "in its constitutional sense," and further stated that ever since the 16th Amendment was enacted in 1913 Congress has defined gross income as "income derived from any source whatever," which is also based on the 16th Amendment.[6] It is obvious why the Government conceded before the panel that the definition of income is based on the 16th Amendment. There is no merit to the contradictory contentions being raised now. *See also* § C, *infra.*

After the 16th Amendment became law, the courts began defining the meaning of the term "income" as used in that amendment and the tax codes enacted thereunder. *Doyle,* 235 F. at 688 (monies paid to compensate for losses in a fire are not income).[7] The *Doyle* precedent has not

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below that Murphy's awards for emotional distress and injury to reputation ***"constitute 'income' under the Sixteenth Amendment."*** Def. Opp. To Pltf. Mtn. for Partial Summary Judgment, pp. 4-5 (Oct. 25, 2004) (emphasis added), citing *Glenshaw Glass,* 348 U.S. at 431-432 & n. 11. These issues, belatedly raised in the Government's petition, are without merit. *See* § C, *infra.*

[5] Nor did the Government cite in its brief to the panel any of the authorities on pages 4-6 and 14 of the Government's petition for rehearing for the propositions cited therein. In addition to not citing *Brushaber,* the Government failed to cite the following cases in its brief to the panel: *Steward Mach Co. v. Davis,* 301 U.S. 548 (1937); *Hylton v. United States,* 3 U.S. 171 (1796); *Knowlton v. Moore,* 178 U.S. 41 (1900); *United States v. Mfrs. Nat'l. Bank of Detroit,* 363 U.S. 194 (1960); *Penn Mut. Indem. Co. v. Commissioner,* 277 F.2d 16 (3d Cir. 1960); *Simmons v. United States,* 308 F.2d 160 (4th Cir. 1962). Curiously, Appellees attack the panel for failing to analyze these cases or arguments that were never even raised by the Appellees before the panel.

[6] *See* Appellees' Br., pp. 19-20 (Dec. 21, 2005), citing U.S. Const. amend. XVI; Revenue Act of 1913, §II(B), 38 Stat. 167; 26 U.S.C. §61(a); H.R. Rep. No. 1337, 83d Cong., 2d Sess. at A18 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. At 168 (1954).

[7] Shortly after *Doyle,* the Supreme Court defined "income" as a "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber,* 252 U.S. 189, 207 (1920). Justice Brandeis dissented out of concern that the definition of income did not include various means for which

been questioned by the IRS. In a 1924 case, Justice Brandeis was very clear that the term "income" limited Congress' taxing authority as Congress "cannot make a thing income which is not so in fact." *Burk-Waggoner Oil*, 269 U.S. at 114 (Brandeis, J., writing for unanimous Court). Justice Brandeis' opinion is also notable because, although he dissented in *Eisner*, he still firmly acknowledged the limiting authority of the term "income" as set forth in the 16th Amendment, and as subsequently codified by Congress.

In *Glenshaw Glass*, the Court's use of the term "accession to wealth" was sensitive to Justice Brandeis' concern that an overly broad definition of "income" could not be used by Congress to "make a thing income which is not so in fact." *Burk-Waggoner Oil, supra.* "Accessions," as understood by the courts, was an addition to wealth or property. It was not an all-encompassing term which would include monetary payments for restoration of a loss – be that a loss to a house or a hand.

Before the panel, the Government boldly set forth its position that the definition of income is based on the 16th Amendment by arguing:

> Moreover, in *Glenshaw Glass*, the Court … further made clear that it understood ***the broad definition of income in I.R.C. § 61 to be based upon the Sixteenth Amendment and that the term "income" was used in its constitutional sense***.

Appellees' Br., p. 21 (Dec. 21, 2005) (emphasis added), citing *Glenshaw Glass*, at 431 n. 11.

The Government's belated argument that Murphy's claim is outside the scope of the 16th Amendment (Govt. Pet 1, 4-6, 14) is also at odds with a long line of cases and Departmental rulings issued both before and after *Glenshaw Glass.* In 1922, the Treasury Department stated that money received for alienation for affection or for lost reputation "***does not constitute***

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persons could obtain income which were not directly related to a gain from capital or labor. For example, what about earnings from gambling, gifts or inheritance? *Eisner*, 252 U.S. at 226 (Brandeis, J., dissenting). However, Justice Brandeis did not dispute the *Doyle* holding and did not contend that monies obtained to compensate a person for a loss was income.

income within the meaning of the sixteenth amendment and the statutes enacted thereunder." Sol. Op. 132, 1-1 C.B. 92, 03 (1922) (emphasis added).[8] This ruling was based on Supreme Court decisions interpreting the definition of income under the 16th Amendment and remained in full force after *Glenshaw Glass* was decided. *Id.*, citing *Stratton's Independence v. Howbert*, 231 U.S. 399; *Eisner*, 252 U.S. at 207. *Also see Hawkins, supra.* This principle was extended long after *Glenshaw Glass* was decided to declare that compensation to victims of Nazi persecution and prisoners of war was not income.[9] Accord., *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962) ("Damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights – because, in effect, they restore a loss to capital.").

The panel clearly recognized the expansive power of Congress to tax income. Op. 10, 16. However, the panel also properly followed 80 years of Supreme Court cases and Departmental rulings requiring that monies taxed actually be a realized gain or accession to wealth of some sort.[10] This is hardly earth-shattering. Indeed, the panel followed the very basic

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[8] *Also see* Op. 23, citing Sol. Op. 132. The position in Sol. Op. 132 was formally stated in a Revenue Ruling in 1974. *See* Rev. Rul. 77-74 , 1974-1 C.B. 33, 1974 WL 34538 (IRS RRU) ("amounts received … for alienation of affections … ***are not income***.") (emphasis added).

[9] Rev. Rul. 56-518, 1956-2 CB 25; Rev. Rul. 57-505, 1957-2 CB 50; Rev. Rul. 58-500, 1955-2 CB 21; Rev. Rul. 58-370, 1958-2 CB 14; Rev. Rul 69-212, 1969-1 CB 34; Rev. Rul. 55-132, 1955-1 CB 213; Rev. Rul. 56-462, 1956-2 CB 20.

[10] Simply because Murphy received $70,000 in payment for her "make whole" award does not mean that she realized a gain. *See* Sol. Op. 132, 1-1 C.B. 92, 03 (1922) ("the Supreme court has repeatedly held that gross income does not include everything that comes in."), citing *Lynch v. Turrish*, 247 U.S. 211 (1918); *Eisner, supra.; Stratton's Independence, supra. Also see, Bowers v. Kerbaugh-Empire*, 271 U.S. 170 (1926) (savings on liquidation of debt through drop in foreign exchange not income). "Make whole" compensatory damages to restore a loss are not a gain or accession to wealth by definition. *Hawkins*, 6 B.T.A. at 1025 ("Such compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury.").

concepts of tax law urged by Appellees to conclude that Murphy's damages are analogous to a basis in capital, or for restoration of capital or a loss, are not a realized gain and are not income.

2. The panel correctly determined that damages for nonphysical personal injuries were not considered income under 16th Amendment. In fact, this question was settled by the IRS in 1922 when it held, based on Supreme Court precedent, that non-physical damages were not income within the meaning of the 16th Amendment or any of the tax laws. *See* Sol. Op. 132, 1-1 C.B. 92, 03 (1922) ("the question is really more fundamental, namely, whether such damages are within the legal definition of income."). The Government agrees that the constitutional term "income" is relevant to whether the statutory reference to "income" in 26 U.S.C. § 61 covers Murphy's damages award. Govt. Pet. 6 n. 6. However, the Government ignores the exclusive argument it raised to the panel that the meaning of income in § 61 and the 16th Amendment are coextensive.[11] The panel agreed and held "that damages received solely in compensation for a personal injury are not income within the meaning of the Sixteenth Amendment." Op. 10, 23.

Two Treasury Decisions and proposed Treasury regulations, cited by the Government for the first time in its request for rehearing *en banc* (Govt. Pet. 6-7), were expressly revoked or overruled in 1918 before Congress passed the first personal injury exemption in 1918. 31 Op. Att'y Gen. 304 (1918); T.D. 2747, 20 Treas. Dec. 457 (1918). Both separately concluded that damages for personal injuries were not income and not subject to tax. *Id.* Appellees' reliance on overruled authority does not make personal injury damages income.

[11] The Government also misrepresents the record because Murphy did, in fact, challenge the taxing of her damages under both the 16th Amendment and § 61. Appellant's Br., Statement of Issues, pp. 1-2 ("Whether Congress has the authority under the U.S. Constitution, Sixteenth Amendment, or any cognizable definition of gain or income under the tax code, to tax "make whole" emotional distress personal injury or sickness compensatory damage awards when such a tax would be on compensation for a loss (or restoration of human capital) as opposed to income or any accession to wealth?").

The Government's further reliance on two subsequent Solicitor Memorandums (also cited for the first time in the petition for rehearing *en banc*) finding that non-physical damages were taxable does not help the Government's argument either. Those two rulings were expressly overruled in 1922 because nonphysical damages for personal injuries are not income under the 16th Amendment or the tax codes enacted thereunder. Sol. Op. 132, 1-1 C.B. 92, 03 (1922). Accordingly, the panel correctly concluded, based on the controlling Departmental rulings and Supreme Court cases, that compensation for non-physical injuries was treated the same as compensation for physical injuries under the definition of income required by the 16th Amendment. This issue was settled, as the Treasury Department itself acknowledged, by 1922.[12]

B. The Panel Properly Applied *O'Gilvie v. United States* and Correctly Determined that the Damages Here Are Not Income.

1. The panel's interpretation of the meaning of income is not "unjustifiably narrow," but rather is fully consistent with the "coextensive" definition of income provided by Congress in the tax code itself (26 U.S.C. § 61) that is based on the 16th Amendment and which is used in its "constitutional sense." *Glenshaw Glass*, 348 U.S. at 431-432 and n. 11, citing H.Rep.No. 1337, 83d Cong., 2d Sess. A 18; S.Rep.No. 1622, 83d Cong., 2d Sess. 168.

Moreover, the panel's decision does not conflict with the Supreme Court's rulings in *Schleier, Burke, Banks* or *O'Gilvie.* Govt. Pet. 9-10. In none of those cases was the issue of taxing non-physical "make whole" compensatory damages before the Court. The question

[12] That gross income might now include some items that allegedly were not taxed when the 16th Amendment was drafted likewise does not make nonphysical damages income under the 16th Amendment, or otherwise. Each of the examples raised by the Government could constitute a gain that would be taxable income under the statutory and constitutional definition of income adopted under the 16th Amendment. *Cf.* Govt. Pet. 8. The panel did not declare that the meaning of income was static for all purposes. Rather, the panel simply held that based on approximately 80 years of Departmental rulings and Supreme Court cases, the "make whole" damages at issue here were not a realized gain or an accession to wealth that fall within the "coextensive" statutory and constitutional definition of income that governs personal injury damages.

before the Court in those cases was not whether the monies taxed were income in the first instance, but whether damages awarded for back pay or liquidated damages under statutes not providing for compensatory damages, or whether punitive damages and attorneys fees, were for personal injuries[13] within the scope of Section 104, the statutory personal injury exemption that was in effect before 1996. Once it was held in those cases that the monies received were not on account of personal injuries the awards had to be taxable as income by default. However, in this case, the Government is taxing monies awarded for personal injuries, thus requiring an analysis of the more fundamental question as to whether the award is income in the first instance.

The panel correctly applied the "In lieu of what were the damages awarded?" test that had been developed in various circuits, joined by the panel in this case and not challenged in the Government's petition. The panel properly concluded that Murphy did not realize either a gain or an accession to wealth. Op. 16-17.[14] Applying this test unquestionably demonstrates that Murphy's compensatory damages award is nontaxable. The "nature" of the payments awarded

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[13] In *United States v. Burke*, 504 U.S. 229 (1992), the Court examined only whether back pay damages awarded under Title VII of the Civil Rights Act of 1964 (which at the time did not provide for an award of compensatory damages) were on account of personal injuries or for back pay. The Court held the back pay award was not for personal injuries as it was not based on "tort or tort type rights." Likewise, in *Commissioner v. Schleier*, 515 U.S. 323 (1995), the Court only analyzed whether liquidated damages awarded under the Age Discrimination in Employment Act were on account of personal injuries. In *O'Gilvie v. United States*, 519 U.S. 79 (1996), the sole issue was whether punitive damages were received "on account of" personal injuries. The Court held that punitive damages were not the same as compensatory damages because punitive damages do not "compensate for loss" or make the plaintiff whole. In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Court held that when a litigant's recovery constitutes taxable income, such income includes the portion of recovery paid to a litigant's attorney under a contingent fee agreement. The only issue in *Banks* was whether the plaintiff could assign a portion of a taxable recovery to an attorney without incurring tax. However, the issue of whether the damages recovered were taxable income or for personal injuries was not even before the Court.

[14] Op. 16-17, citing *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944); *Francisco v. United States*, 267 F.3d 303, 319 (3d Cir. 2001); *Tribune Publ'g Co. v. United States*, 836 F.2d 1176, 1178 (9th Cir. 1988); *Gilbertz v. U.S.*, 808 F.2d 1374, 1378 (10th Cir. 1987).

were "intended to compensate" Murphy for her tort-type losses and they were not payments intended to assist her in some form of accession to wealth. *Gilbertz v. U.S.*, 808 F.2d 1374, 1378 (10th Cir. 1987). Murphy's damages were strictly designed to make her physically and emotionally "whole," and did not "reach beyond those damages that, making up for a loss, seek to make a victim whole, or … 'return the victim's personal or financial capital.'" *O'Gilvie*, 519 U.S. at 86.[15]

The Government's circular argument that Murphy is better off financially after receiving the damages award than prior to receiving the award and therefore it must be income also misses the fundamental point that Murphy's damages are not income in the first instance. First, the Government misconstrues the holding of *Glenshaw Glass*, which expressly distinguished punitive damages from "make whole" compensatory damages for personal injury. *Glenshaw Glass*, 348 U.S. at 433 n. 8. Since personal injury damages were not the subject of the tax it is highly misleading for the Government to claim that *Glenshaw Glass* requires the conclusion that damages received on account of personal injury are an accession to wealth resulting in an economic gain. Indeed, *Glenshaw Glass* did not disturb the "long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital…." *Id.* Included in that "history of departmental rulings" is Sol. Op. 132 which expressly held that nonphysical damages for alienation of affections and lost reputation were not income under the 16th Amendment or the tax codes enacted thereunder, and they could not be considered a gain or profit, but rather were analogous to a return of capital. Thus, these

[15] Nor did the panel misconstrue *O'Gilvie*, which distinguished punitive damages from personal injury damages awarded to restore a loss or return human capital, by asking whether the award being taxed is a "substitute for [a] normally untaxed personal … quality, good or 'asset.'" Op. 16, quoting *O'Gilvie*, 519 U.S. at 86. The Government has not advanced any argument to avoid that threshold question raised by Justice Breyer in *O'Gilvie*.

fundamental principles set forth in Sol. Op. 132 holding that such damages for personal injuries were not income were steadfastly followed by the IRS and the courts from 1922 and were never overruled. Second, it has long been held that not everything that is paid to an individual is income. *See* Footnote 10, *supra.*

2. The "return of human capital" analogy (Op. 10-11) was not created by either Murphy or the panel. It was expressly adopted by the IRS in 1918, in 1922, and in 1974, and was acknowledged by the Supreme Court in *Glenshaw Glass* and *O'Gilvie*. *See Glenshaw Glass*, 348 U.S. at 433 n. 8; *O'Gilvie*, 519 U.S. at 84-84; 31 Op. Att'y Gen. 304 (1918); T.D. 2747, 20 Treas. Dec. 457 (1918); Sol. Op. 132, 1-1 C.B. 92, 03 (1922). *Also see* Rev. Rul. 77-74, 1974-1 C.B. 33, 1974 WL 34538 (IRS RRU) (adopting Sol. Op. 132 and agreeing that such non-physical personal injury damages "are not income").[16]

The panel correctly interpreted Sol. Op. 132 (*see* Op. 23), noting that the IRS also concluded in 1922 that non-physical personal injury damages are "not income" under the 16th Amendment or the tax statutes enacted under the 16th Amendment. Sol. Op. 132, also states:

> ***If an individual is possessed of a personal right*** that is not assignable and ***not susceptible of any appraisal in relation to market values***, and thereafter receives either damages or payment in compromise for an invasion of that right, ***it can not be held that he thereby derives any gain or profit.***

Sol. Op. 132, 1-1 C.B. 92, 03 (1922) (emphasis added).

This binding authority of the IRS completely undermines and contradicts the Government's theory postulating that because Murphy "does not have a basis in her 'human capital,' all damages received on account of an injury thereto are an accession to wealth" and a taxable gain. Govt. Pet. 11-12. The IRS concluded in 1922, there is "no gain or profit" realized

[16] *Accord., Dotson,* 87 F.3d at 685 (Because "human capital lost through injury" was understood to be nontaxable, the drafters of the 1918 tax code incorporated into that code a statutory exemption for compensation for personal injury).

by an individual who receives non-physical personal injury damages and such compensation is not income at all. Op. 23, citing Sol. Op. 132. The Government still fails to explain how its unsupported theory that "make whole" damages for personal injury can be turned into a taxable accession to wealth or gain in light of the binding "long history" of Departmental authorities which concluded that there is not "any gain or profit" derived from an award of such damages.[17]

C. If The Award Is Not Income, It Cannot Be Taxed Constitutionally Or Otherwise.

First, the argument that even if Murphy's damages are not income they can still be constitutionally taxed has been waived. *See* §A, *supra.* Second, the Government has conceded that gross income as defined in §61 is based on the 16th Amendment. *Glenshaw Glass,* 348 U.S. at 432-433 n. 11. Third, there is no merit to the direct/indirect tax argument. Congress did not enact a special tax on compensatory damages for non-physical personal injuries in 1996, and the removal of the exemption for non-physical injuries results in a tax pursuant to the same § 61 that is based on, and defines income according to, the 16th Amendment.[18] Fourth, there is no

[17] The Government's reliance on 26 U.S.C. § 1001 is unavailing because that provision does not apply to claims raised by individuals. More significantly, the Government's citing § 1001, and cases for the proposition that there is "no basis" in human capital, are in conflict with the binding "long history" of Departmental authorities and Supreme Court cases cited above. In *Polone v. Commissioner,* 449 F.3d 1041, 1045 (9th Cir. 2006), the court only held that §1001 does not apply to personal injury damages, and did not concern the definition of "income" under either the 16th Amendment or § 61. In *dicta,* the *Polone* court noted that damages for loss of reputation effectively "restore a loss to capital" and treating such damages as a "gain" "would be at odds with the basic concept of tort law," as these were payments to "make" the taxpayer "whole." In *Roemer v. Commissioner,* 716 F.2d 693, 696 n. 2 (9th Cir. 1983), the court held that personal injury damages at issue there were not taxable, and the portions of *Roemer* selectively cited by the Government are dicta. Moreover, the "sale of blood" cases were also cited for the first time in the petition for rehearing *en banc,* and the argument based on those cases is waived. Govt. Pet. 12. Indeed, the "sale of blood" cases are not personal injury cases, do not involve damages analogous to the return of human capital, and do not support granting rehearing *en banc*.

[18] When the Supreme Court invalidated the entire income tax in 1895 it was deemed to be a direct tax. *Pollock v. Farmer's Loan & Trust Co.,* 157 U.S. 429 (1895) (striking down a tax on incomes over $4,000 as an unconstitutional direct tax requiring apportionment). This resulted in

threshold requirement that a court determine whether an income tax is direct or indirect for the 16th Amendment to apply.[19] Fifth, even if such a requirement existed, an income tax on damages to compensate for a loss of human capital is a direct tax on the source and more direct than the tax declared to be invalid in *Pollock.* There is no point to granting rehearing *en banc* on this issue, not raised on appeal, and which would not change the result of the panel's decision.

CONCLUSION

For the foregoing reasons, Appellees' petition for rehearing *en banc* should be denied. The Government's petition does not justify disturbing a well-reasoned and supported panel decision and does not provide any support that an unspecified "parade of horribles" would result. Indeed, not all tax experts agree with the views cited by Appellees.[20] For over 78 years, the IRS

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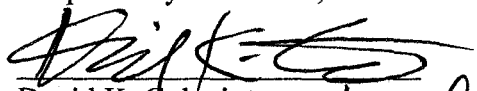
the enactment of the 16th Amendment. *Johnson v. Commissioner,* T.C. Memo. 1978-32, 1978 WL 2739 (U.S. Tax Court 1978) ("since ratification of the Sixteenth Amendment it is immaterial, with respect to income taxes, whether the tax is a direct or indirect tax."). *Also see Eisner,* 252 U.S. at 220 (Holmes, J., dissenting) (One of the reasons for enacting the 16th Amendment was "to get rid of nice questions as to what might be direct taxes."). Consequently, all modern income taxes fall within the scope of the 16th Amendment as all subsequent versions of the federal income tax were enacted under that amendment and Congress expressly adopted the definition of income contained in the 16th Amendment when it passed § 61. *Glenshaw Glass,* 348 U.S. at 432-433 n. 11.

[19] The cases cited by Appellees do not impose such a rule. For example, in *Simmons,* 308 F.2d at 165-168, the plaintiff contended that the tax under challenge was a direct tax that was not an income tax, and therefore the plaintiff argued the tax was outside the scope of the 16th Amendment's exclusion of income taxes from the apportionment requirement for direct taxes. Notably, the *Simmons* court did not hold that the 16th Amendment only applies to direct income taxes. *Id.,* 308 F.2d at 168 (noting the 16th Amendment and statutory provisions "are closely related" and taxes on income under § 61 "are authorized by the 16th Amendment."). Also, in *Penn Mutual Indemnity Co.,* 277 F.2d at 19-20, the court rejected the taxpayer's argument that a tax on mutual insurance companies was not a direct tax on property that must be apportioned, but was an income tax that would fall within the scope of the 16th Amendment.

[20] *Cf.*, Robert W. Wood, "Top Ten Reasons Why 'Murphy' Is My Favorite Tax Case," Vol. 190, No. 1, *Daily Tax Report* (BNA Oct. 2, 2006) (*Murphy's* "teachings may help generations of taxpayers."); David L. Hudson, Jr., "D.C. Circuit Strikes Down Tax On Emotional Damages," 35 A.B.A.J. E-Report 1, 1 (Sept. 1, 2006).

did not tax non-physical "make whole" awards for emotional distress and loss of reputation and there was no "damage" to the nation or the administration of collecting revenues. Indeed, the panel clarifies that personal injury damages are not taxable as income, just as the courts and the government itself so stated for more than seven decades following the enactment of the 16th Amendment and the modern tax code, and the panel decision is in line with one of the most basic tax concepts, that restoration of capital or a loss is not a gain, and is not income. Unquestionably, this is an overwhelmingly positive development that is welcomed by both sides of the employment bar[21] (a remarkable development in and of itself) and resolves the uncertainties about whether personal injury damages are taxable in a manner consistent with over 80 years of case law and other authority.

Respectfully submitted,



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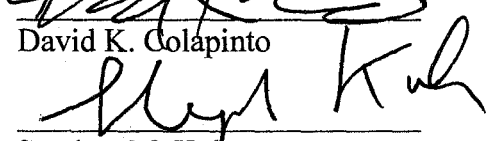

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October 31, 2006

[21] *See* Hudson, 35 A.B.A.J. E-Report 1, 1, *supra.* (noting the agreement amongst plaintiffs and defendants employment attorneys that the decision is "positive" for both employers and employees and it that will promote settlement in employment cases).

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

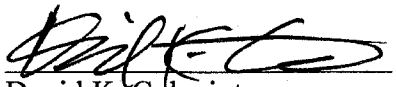
Pursuant to D.C. Circuit Rule 27(a)(4) and 28(a)(1), Appellants' counsel makes the following certification as to parties, rulings and related cases.

(A) Parties and Amici: The following is a list of all parties who have appeared before the district court and in this court: (1) Marrita Murphy and Daniel J. Leveille, Plaintiffs-Appellants; (2) Internal Revenue Service and United States of America, Defendants-Appellees; and (3) The NO FEAR Coalition was admitted as amicus curiae on appeal.

(B) Rulings Under Review: The rulings under review are: (1) the Order, dated March 22, 2005, granting defendants' motion for summary judgment [Record ("R.") 24.]; (2) the Memorandum Opinion, dated March 22, 2005 [R. 23.]. Both the Memorandum Opinion and Order under review in this case are unpublished. *Murphy v. I.R.S.,* 362 F. Supp.2d 206 (D.D.C. 2005).

(C) Related Cases: Counsel is not aware of any related cases as that term is defined in D.C. Circuit Rule 28(a)(1)(C), and this case was not previously before this Court or any court other than the district court below.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing was served on this 31st day of October, 2006, by first class mail, postage prepaid, upon:

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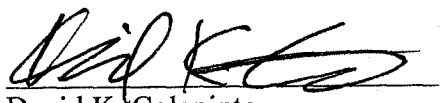
By: 
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