

D.C. CIRCUIT STRIKES DOWN TAX ON EMOTIONAL DAMAGES

Decision Based on the 16th Amendment Is Significant, Employment Lawyers Say

BY DAVID L. HUDSON JR.

In a surprising decision, the U.S. Court of Appeals for the D.C. Circuit has ruled that the federal government may not tax damage awards for emotional distress unrelated to lost wages or earnings.

A three-judge panel ruled Aug. 22 that the federal law allowing the taxing of such awards was unconstitutional because such awards are not income within the meaning of the 16th Amendment. [*Murphy v. United States*](#), No. 05-5139.

"This is one of the most important employment law decisions of the last decade," says Stamford, Conn.-based employment lawyer Gary Phelan. Employment lawyers on both sides praised the ruling as one that will encourage settlement of such cases.

The case began when Marrita Murphy sued the Department of Labor in 1994 alleging that her former employer, the New York Air National Guard, had blacklisted her and provided unfavorable job references because she blew the whistle on environmental hazards at an airbase. An administrative law judge recommended Murphy receive \$70,000 in compensatory damages—\$45,000 for emotional distress and \$25,000 for injury to her professional reputation. The Department of Labor Administrative Review Board affirmed the findings and recommendations.

Murphy included the \$70,000 award on her 2000 federal income tax return, then filed an amended return seeking a refund of more than \$20,000, the amount of taxes paid on the \$70,000 award. The Internal Revenue Service denied her request. Murphy then sued the IRS and the United States in federal district court. In 2005, the federal district court rejected her claims and granted summary judgment to the government defendants.

On appeal, the D.C. Circuit reversed. The panel agreed Murphy could not prevail based on federal law 26 U.S.C. § 104(a)(2), which was amended in 1996 to prohibit the exclusion of emotional distress damages (as opposed to physical injuries) from gross income calculations. Federal law provides that damages for personal injuries and sickness are not taxable; physical injuries are based in tort and not subject to calculation as gross income.

For years, employment lawyers sought to treat employment discrimination awards the same as personal-injury tort claims—as not taxable. However, in 1996, Congress amended the law to provide that awards from personal injuries or sickness can only be excluded from gross income if they arise from physical sickness or injuries. Based on the statutory language, the panel concluded that "section 104(a)(2) does not permit Murphy to exclude her award from gross income."

However, the panel determined that section 104(a)(2) is unconstitutional under the 16th Amendment, which provides: "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."

The panel agreed with Murphy that her \$70,000 award for emotional injury and loss of reputation was not income within the meaning of the 16th Amendment. "As we have seen, it is clear from the record that the damages were awarded to make Murphy emotionally and reputationally 'whole,' and not to compensate her for lost wages or taxable earnings of any kind," Chief Judge Douglas H. Ginsburg wrote for the panel. "Under this analysis, therefore, the compensation she received in lieu of what she lost cannot be considered income and, hence, it would appear the 16th Amendment does not empower the Congress to tax her award."

The panel then examined the original intent of the framers of the 16th Amendment to determine the definition of "incomes" within the language of the amendment. The panel explained that it sought to examine materials from the time period near 1913, when the amendment was ratified. According to the panel, an attorney general opinion and Treasury Department ruling from 1918 "strongly suggest that the term 'incomes' as used in the 16th Amendment does not extend to monies received solely in compensation for a personal injury and unrelated to lost wages or earnings."

"In sum, every indication is that damages received solely in compensation for a personal injury are not income within the meaning of that term in the 16th Amendment," the panel concluded.

Stephen M. Kohn, one of Murphy's attorneys and president of the National Whistleblower Center in Washington, D.C., says, "In terms of any victim who has suffered a mental injury or emotional distress, this will have a significant impact. This is a major victory for victims' rights."

"Between 1918 and 1996, emotional distress and loss of reputation were not taxed," Kohn says. "In 1996, when Congress passed a minimum wage law, a provision was inserted without debate that said emotional distress damages were taxable."

Charles Miller, a spokesman for the Department of Justice, says the matter is under review, and no determination has been made as to the government's next step.

Employment law practitioners on both sides praised the ruling and hailed it as very significant.

"The decision is positive for both sides because most cases are settled, and the cost of settlement goes up when bigger chunks of settlements go to the government," explains Ann Elizabeth Reesman, general counsel for the pro-employer Equal Employment Advisory Council. "The plaintiff needs less money, and there is less taken out of the employer's pocket."

"It could dramatically affect employment cases because after the 1996 amendments, which made emotional distress damages taxable, it became much more difficult to settle cases," says Phelan, who represents employees in all types of discrimination cases. "This is one of the few areas where the plaintiffs and defense bar have been in agreement."

The decision is important not only to the employment law community but also to those in the tax law field. Erik Jensen, a tax law professor at Case Western Reserve University in Cleveland who has written about the 16th Amendment, says, "For many years, it has been assumed that Congress can define income as it wishes," he says. "I like the idea of a court taking the language of the 16th Amendment seriously."

Jensen finds the ruling defensible, but says the court should have "at least considered the threshold indirect/direct tax issue. It is conceivable that a court could treat a tax like that in *Murphy* as an indirect tax instead of a direct tax. If it is an indirect tax, then the only constitutional concern is the uniformity rule, which requires that the tax must be uniform in its application across the United States."

But Jensen agrees with the court on its original intent analysis: "To the extent that original intent is relevant, I am skeptical that the drafters and ratifiers of the 16th Amendment would have thought that emotional distress damages would be considered income."

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