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D.C. Circuit Reverses Course In *Murphy* Redux

By Jeremiah Coder — jcoder@tax.org

After vacating its prior holding in *Murphy v. IRS* in December, the D.C. Circuit Court last week affirmed the district court's opinion, holding that an award of compensatory damages for emotional distress constitutes taxable gross income. (For the opinion, see *Doc 2007-15777* or *2007 TNT 129-4*.)

In August 2006 a unanimous appellate court panel had ruled that the damages, while not exempt from taxation under section 104(a)(2), did not constitute income within the meaning of the 16th Amendment and so were not subject to tax. (For the court's initial decision, see *Doc 2006-15916* or *2006 TNT 163-6*.)

Marrita Murphy was awarded damages resulting from discrimination by her employer for her whistle-blowing activities. She included the $70,000 award in her 2000 gross income and paid the resulting taxes but then filed an amended return seeking a refund. The IRS denied her refund claim, so Murphy sued in district court.

Murphy claimed that her award was attributable to ''physical personal injuries'' — testimony showed that she suffered from bruxism, anxiety attacks, and dizziness — and thus should be excluded from gross income under section 104(a)(2). Alternatively, Murphy asserted the damages did not constitute gross income within the meaning of the 16th Amendment, so it was unconstitutional for the IRS to tax them. The district court granted the IRS summary judgment in the case.

On appeal to the D.C. Circuit, the court denied Murphy's claim that her award was excludable under section 104(a)(2), but it agreed with her that it was unconstitutional for the IRS to tax nonphysical compensatory damages. After an outpouring of academic and legal criticism regarding its decision, the court vacated its judgment *sua sponte* and reheard the case after a full rebriefing of the issues.

The court portrayed its actions as balancing the ''considerations of judicial orderliness and efficiency against the need for the greatest possible accuracy in judicial decisionmaking.'' To do so, the court focused on the IRS's new argument at rehearing that a tax on the award was an excise tax rather than a direct tax; and therefore is constitutional because it was a uniform excise tax not subject to the apportionment restrictions outlined for direct taxes in Article I, section 9 of the Constitution.

Addressing the subject of section 104(a)(2)'s applicability to Murphy's case, the appeals court held that the record clearly showed that only nonphysical injuries were taken into account in determining the amount of the award. Following the Supreme Court's decision in *O'Gilvie v. United States*, 519 U.S. 79 (1996), *Doc 96-31894*, *96 TNT 240-1*, the panel said that Murphy was required to show a stronger causal connection between her personal injuries and the damages awarded than a ''but for'' relationship, which she failed to do. Hence, Murphy's award was not excludable under section 104(a)(2), the court said.

Disappointed

''I'm disappointed,'' said Robert Wood of Wood & Porter in San Francisco. ''As a practical matter, the focus on 'on account of' is unfortunate — that's not what section 104 is all about. Both the government and taxpayers struggle with the language, but the court's focus on the 'on account of' link rather than the physical will often leave taxpayers in the lurch.''

> ***'The court's acceptance of a forced sale strains credulity,' Colapinto said.***

David Colapinto, who represented Murphy, also criticized the result reached by the court. ''The court's acceptance of a forced sale strains credulity,'' he said. ''There's no precedent for applying these concepts. It ignores the concept of make-whole relief.''

In construing section 61, the court this time sidestepped the question of whether Murphy experienced an ''accession to her wealth'' and instead focused on whether the damages fit into the code's broad definition of gross income: ''all income from whatever source derived.'' The court looked to Congress's 1996 amendment to section 104(a) — which narrowed the exclusion to physical injuries — as evidence that section 61 specifically contemplated the inclusion of nonphysical injuries. Unlike in its original opinion, the court did not delve into a contemporaneous understanding of what the word ''income'' meant when the 16th Amendment was ratified.

Colapinto panned the court's analysis. ''In order to reach the result it did, the court had to make up a tax that doesn't exist. The court said Congress is amending section 61 by implication — they're implying a tax not passed by Congress,'' he said.

The court's constitutional analysis in the new opinion questioned how to characterize Murphy's award — as a tax based on property ownership (a direct tax) or as a tax on the use of property, a privilege, or activity (an excise tax). Its conclusion was that ''Murphy's situation seems akin to an involuntary conversion of assets; she was forced to surrender some part of her mental health and reputation in return for monetary damages.'' Because Murphy received monies vindicating a statutory right, the transaction was a '''privilege' taxable by excise.'' As long as a tax on a nonphysical personal injury is implemented uniformly throughout the nation, it is a valid excise tax under Article I, section 8, the court said.

In a press release, the National Whistleblower Center called the decision a ''terrible setback'' and said that ''the Court's reversal stands reality on its head.'' (For the release, see *Doc 2007-15825* or *2007 TNT 129-18*.)

But others praised the court for being willing to correct its previous mistakes in legal analysis. Lisa Zarlenga of Steptoe & Johnson credited the court with a reasoned outcome. ''I wasn't that surprised about the reversal — the court seems to have bowed to public pressure,'' she said. ''The court took a safer route that the IRS offered up the second time around, and analyzed the tax as an excise tax on a compensatory damage award rather than deal with the more troubling question of whether one may be taxed on the ownership of human capital.''

However, Colapinto warned that ''if you're a litigant, you better not get hurt, because you won't be made whole.'' He said Murphy will seek further review of her case. ■

House, Senate Energy Bills Feature Some Similar Provisions

By Heidi Glenn — hglenn@tax.org

Lawmakers return to work this week after a short break and are expected to consider several tax-related bills before the August recess. Among the issues vying for congressional attention in July is energy reform: House taxwriters last month approved about $15 billion in incentives, and Senate taxwriters drafted a bill that is more than twice that amount. Leaders will have to clear several hurdles before the packages can head to a House-Senate conference.

The House Ways and Means Committee bill (H.R. 2776) focuses mainly on tax breaks for renewable and alternative energy sources and is offset primarily through denying the section 199 domestic production activities deduction for oil and gas companies. The Senate Finance Committee-passed bill also denies the section 199 deduction for oil and gas companies and includes an outer continental shelf excise tax. While the Senate Finance bill offers incentives for renewable and alternative energy sources, it would also provide domestic fuel security provisions.

Before Congress left for the July 4 recess, House Speaker Nancy Pelosi, D-Calif., said lawmakers would soon begin considering a ''declaration of energy independence'' that includes the House taxwriters' bill.

The Senate, however, has yet to approve the Finance Committee's bill, and leaders will no doubt be looking for ways to get the tax package to conference. Last month after the Senate failed to attach the tax legislation to a larger energy bill, Democrats promised to keep the tax bill alive either as part of another bill or as stand-alone legislation.

On the next page is a side-by-side comparison of some of the provisions in the two bills. (The Senate Finance Committee approved amendments not reflected in the table. Amendments include a proposal affecting the expatriate mark-to-market tax; a tightening of the sale-in, lease-out provisions; and a proposal to require liquid coal facilities to decrease greenhouse emissions by 20 percent over a life cycle before qualifying for the alternative fuel credit.)

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