


August 30, 2006

TAX REPORT

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Court Ruling in Damages Case Deals Big Setback to the IRS

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A recent court ruling saying a woman doesn't owe taxes on an award from her former employer for "a nonphysical personal injury" represents a significant setback for the IRS. Even though the decision was handed down only last week, lawyers are already urging taxpayers in similar cases to take action to save taxes on their awards.

At issue in the case was whether a \$70,000 payment that a woman received from her former employer for "emotional distress" and "loss of reputation" was taxable. The woman had paid \$20,665 in income taxes on that award. In a decision that is sparking intense debate among lawyers, the U.S. Court of Appeals for the District of Columbia Circuit said the \$70,000 award didn't represent "income" -- and thus wasn't taxable.

"Albert Einstein may have been correct that 'the hardest thing in the world to understand is the income tax,'" Chief Judge Douglas Ginsburg wrote. But "it is not hard to understand that not all receipts of money are income."

The three-judge panel's decision is binding on the Internal Revenue Service in cases involving taxpayers in Washington, D.C., but not other parts of the country. However, the decision is likely to have "immense implications" for many other people around the nation who expect to receive damages for "nonphysical personal injuries" -- or who have received damages in recent years, says Todd A. Kraft, a tax lawyer in Dallas at Meadows, Owens, Collier, Reed, Cousins & Blau.

For example, the decision could affect the way numerous settlement agreements are drafted in the future, Mr. Kraft says. Furthermore, lawyers are recommending that taxpayers who received similar awards in the past few years and paid taxes on them should consider filing amended returns seeking refunds. (Generally, taxpayers have to file a refund claim within three years from the date they filed the original return, or within two years after the date they paid the tax, whichever is later, the IRS says.)

"The likely immediate effect of this case will be to trigger thousands of refund claims," says Mary B. Hevener, a Washington lawyer at Baker & McKenzie.

An IRS spokeswoman referred questions to the Justice Department, where a spokesman says the government hasn't decided on its next step.

The winner in the appeals court decision is Marrita Murphy, who was represented by David Colapinto, a Washington lawyer at Kohn, Kohn & Colapinto. According to the appeals court opinion, she filed a complaint in 1994 with the U.S. Labor Department alleging that her former employer, the New York Air National Guard, in violation of various whistle-blower statutes, had "blacklisted" her and given unfavorable references to potential employers after she complained to state authorities of environmental hazards at a New York Air National Guard air base.

The department said Ms. Murphy should get \$70,000 in compensatory damages, of which \$45,000 was for "emotional distress or mental anguish" and \$25,000 for "injury to professional reputation" from having been blacklisted. None of the award was for lost wages or diminished earning capacity, the court said.

Ms. Murphy paid taxes on the award and later filed an amended return seeking a refund. The IRS said no. She lost her case at the district-court level. The appeals court rejected her argument that the award was for "physical personal injuries" -- but decided that the award didn't fall within the meaning of the term "incomes" as used in the 16th Amendment, which was ratified in 1913 and authorized Congress to collect an income tax. The court called a 1996 tax-law change "unconstitutional" insofar as it permitted taxation of damage awards for mental distress and loss of reputation.

"It's been a long, hard, uphill battle," Ms. Murphy said yesterday. "The personal cost is extremely high. It affects every area of your life. But it's going to help other people."

Some lawyers, including Donald Alexander, a former IRS commissioner, think the decision will be overturned. Meanwhile, the subject remains murky. "If Einstein was confused before Murphy, he'd be a whole lot more confused now," says Ms. Hevener of Baker & McKenzie.

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Taxpayers will have more choices for direct deposit of their refunds next year.

Starting in January, taxpayers will be able to split their federal income-tax refunds for 2006 among up to three financial accounts, the IRS said. An "account" can include an individual retirement account.

The IRS has posted a draft of Form 8888 on its Web site (irs.gov).

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Briefs: The Senate Finance Committee plans a Sept. 6 hearing called "Executive Compensation: Backdating to the Future." Among the issues: backdating of stock options.

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