Oral argument set for April 23, 2007

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 05-5139

MARRITA MURPHY and DANIEL J. LEVEILLE,

Appellants,

v.

INTERNAL REVENUE SERVICE AND
UNITED STATES OF AMERICA,

Appellees.

On Appeal from the United States District Court
for the District of Columbia

District Court No. 03CV02414

BRIEF OF *AMICI CURIAE* URGING REVERSAL

In Support of Appellants

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CERTIFICATE OF *AMICI CURIAE* AS TO PARTIES, RULINGS, AND RELATED CASES UNDER CIRCUIT RULES 26.1 and 28(a)(1)

Pursuant to Rules 26.1 and 28 (a)(1) of this Court, *amici curiae* certify as follows:

A. Parties and *Amici*: Except for *amici curiae* No-FEAR Coalition, National Employment Lawyers Association, Andrew Jackson Society, National Taxpayers Union, Liberty Coalition and the Innocence Project, all parties, intervenors, and *amici* appearing before the District Court and in this Court are listed in the Appellant's brief on rehearing. The amici are all private non-profit associations and none have parent companies.

B. Ruling under Review: Reference to the rulings under review is set forth in Appellants' brief on rehearing.

C. Related Cases: Reference to related cases is set forth listed in the Appellants' brief on rehearing.

Dated: January 29, 2007

Respectfully submitted,

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Richard R. Renner
Attorney for Amici Curiae

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I. INTEREST OF *AMICI CURIAE* AND INTRODUCTION

A. No FEAR Coalition

The **No FEAR Coalition** is comprised of more than 20 organizations dedicated to eliminating discrimination and worker abuse in federal agencies. It was founded by Dr. Marsha Coleman-Adebayo, whose successful civil rights lawsuit against the U.S. Environmental Protection Agency (*Coleman-Adebayo v. Browner*) galvanized Congress and led to the passage of the Notification of Federal Employees Anti-Discrimination and Retaliation ("NO FEAR") Act of 2002. The No FEAR Coalition Members include the following groups and organizations: African American Environmentalist Association; EPA Victims Against Racial Discrimination; The National Whistleblower Center; Southern Christian Leadership Conference; Congress Against Racism & Corruption in Law Enforcement; Customs Employees Against Discrimination; Government Accountability Project; NAN; AARP; US Chamber of Commerce; EPA-NTEU Chapter #280; EPA Chapter AFGE; Society for Human Resource Management; Religious Action Committee on Reform Judaism; National Council of Churches in Christ, USA; Seventh Day Adventist Church; and the No Fear Institute.

The Notification of Federal Employees Anti-Discrimination and Retaliation ("NO FEAR") Act of 2002 was the first civil rights act of the 21st century. See, P.L. 107-174 (H.R. 169), 116 Stat 566 (May 15, 2002). The No FEAR law was signed by President Bush on May 15, 2002. When federal agencies are found liable for retaliation prohibited by federal discrimination and whistleblower laws, the NO FEAR Act requires them to pay the full cost of their liability from their own budget.

Additionally, the No FEAR Coalition strongly believes that violation of Title VII of the 1964 Civil Rights Act undermines our credibility as a democracy and that we cannot allow federal agencies to violate the civil and human rights and remain silent. Members of the No FEAR Coalition have a strong interest in assuring that victims of unlawful retaliation receive the full measure of compensation due to them. The No FEAR Coalition submits this brief urging the strongest enforcement of the constitutional limitation on taxation, limiting it to income, and excluding "make whole" compensatory damages. Taxation of compensatory damages would undercut the effectiveness of the No FEAR Act which was intended to restore accountability to government agencies through full and direct compensation of victims.

B. National Employment Lawyers Association

The **National Employment Lawyers Association (NELA)** is the only professional membership organization in the country comprised of lawyers who represent employees in labor, employment and civil rights disputes. NELA and its 67 state and local affiliates have a membership of over 3,000 attorneys who are committed to working on behalf of those who have been treated illegally in the workplace. NELA strives to protect the rights of its members' clients, and regularly supports precedent-setting litigation affecting the rights of individuals in the workplace. NELA seeks to eradicate inequality and injustice in the workplace by advocating for employee rights and assisting the lawyers who represent them.

As an organization focused on protecting the interests of workers who are treated illegally, NELA has an abiding interest in the practical effect and

impact the decision in this case may have on remedies for people who have been unlawfully treated in the workplace.

NELA also has an interest in this case to avoid precedents that deter whistleblowers from reporting frauds against the government. Taxation of compensatory damage awards will have a deterrent effect. When taxes are imposed on compensatory awards, such as one for fraud against the government, then the taxes hinder the public policy of providing such compensation and may have a chilling effect on potentially important whistleblowing activity.

C. Andrew Jackson Society

The Andrew Jackson Society is a First Amendment association of lawyers and professionals working together to ensure adherence to the Constitution and the rule of law in taxation, banking and other financial matters. Its mission is to foster the pursuit of liberty through limited government and greater personal autonomy, responsibility and accountability. Its members and their clients are directly affected by the tax on compensatory damages.

D. National Taxpayers Union

The 350,000 member **National Taxpayers Union** (NTU) is a non-partisan citizen group founded in 1969 to advocate for lower taxes, smaller government, and more accountable elected officials at all levels of government. NTU has prepared and participated in numerous past *amicus curiae* briefs, owing to its staff members' considerable experience with issues ranging from state and local tax and expenditure limitations to the retroactive application of tax increases. In this case NTU and its members believe that simple considerations of equity demand that compensatory

damages making an individual whole again should not be defined as income subject to federal tax. In addition, taxing such damages could exert a chilling effect on vital whistleblowing activity that has heretofore uncovered tens of billions of dollars in waste, fraud, and abuse among government programs.

E. Liberty Coalition

The Liberty Coalition is a transpartisan public policy organization that works for activities related to civil liberties and basic human rights. Its interests include preserving the Bill of Rights, personal autonomy and individual privacy. The Coalition[1] has a working group to protect government whistleblowers who report waste, fraud and abuse from retaliation. Therefore, it has a keen interest in the victims' recovery of make whole remedies and participates here to prevent the chilling effect taxation of such remedies would have on whistleblowing.

F. Innocence Project

The Innocence Project was created by Barry C. Scheck and Peter J. Neufeld at the Benjamin N. Cardozo School of Law in 1992. It is a non-profit legal clinic and handles cases where post-conviction DNA testing of evidence can yield conclusive proof of innocence. The Innocence Project has contributed to the exoneration of many convicted persons by sponsoring the use of such post-conviction DNA testing. Once an individual is exonerated, federal and state statutes may provide causes of action that allow the individual to sue for monetary damages. These monetary damages are intended to make the exonerated individual whole. It is in the interest of the

[1] A list of the organizations that participate in the Coalition's network of partner groups is available at http://libertycoalition.net/about-liberty-coalition.

Innocence Project to ensure that such monetary damages are not taxed so that the exonerated individual may be made whole.

II. SUMMARY OF ARGUMENT

The decision of the district court below seriously undercuts the effectiveness of our civil rights and environmental laws. Particularly when the district court seeks to "decrease" enforcement litigation, it is contrary to public policy.

Section 61 of the Internal Revenue Code of 1986, as amended, provides that taxable income means all "income" from whatever source derived. Income is generally viewed as an increase in a person's wealth. Payments that compensate a person for costs incurred as a result of injuries of a non-physical nature do not increase wealth, but rather return the person to the position held prior to the injury. To hold otherwise is to hold that such tort damages are essentially windfalls rather than replacement for the damaged asset, that is human well-being.

This Court should reject the IRS's position that human well-being is not an asset that can be replaced with monetary value. Instead, amici ask this Court to adopt the human capital rationale. The Treasury Department and courts have enforced this rationale for more than 75 years, and it was previously relied upon by this panel. There is no gain realized by a "make whole" damages recovery intended to restore a loss of human capital. Therefore, it is not taxable income. Tort liability is designed to make the victim of the tort whole. If law could make a victim suffering from emotional distress whole through specific performance, that would be the preferred solution. Specific performance in replacing the emotional well-being would not create "income" under the tax law because wealth has not increased. Similarly, because monetary compensation is in substitution for

specific performance in tort damages, such compensation is not income within the meaning of Section 61. In the alternative, one could view the amount of the taxpayer's actual "make whole" damages as the taxpayer's basis in the underlying tort claim – it is the same as the compensatory damages awarded to the taxpayer. Thus, the taxpayer has no net gain in a transaction in which the chose of action is relinquished for the payment of "make whole" compensatory damages.

The 1996 amendment to 26 U.S.C. § 104(a)(2) ("Section 104(a)(2)") established different treatment for physical and emotional damages. This distinction should be viewed with suspicion since it reflects the prevalent prejudice against people with mental injuries. There is no compelling or even rational basis to tax people who are compensated for their emotional distress and not those compensated for physical injuries. The 1996 amendment is contrary to the public policy that rejects discrimination between physical and mental injuries without a rational basis for such discrimination.

The original panel decision in this case was correct when it held that Section 104(a)(2) "is unconstitutional as applied to [Murphy's] award because compensation for a non-physical personal injury is not income under the Sixteenth Amendment if, as here, it is unrelated to lost wages or earnings." This panel should reach the same result previously reached by holding that regardless of the lack of an express exemption in Section 104, Murphy's "make whole" damages are not income within the plain meaning of Section 61(a). This Court can avoid the constitutional question.

Compensatory damages compensate a party for a loss and are intended to make a victim whole. Therefore, awards of such damages are not income within the statutory or constitutional definition of income. Finally,

the taxation of such awards becomes a direct tax prohibited by Article I of the Constitution.

III. ARGUMENT

A. Taxation of compensatory damages will undercut the effectiveness of civil rights laws.

Simply stated, the taxation of "make whole" compensatory damages awards is directly at odds with, and undermines the purpose of, Title VII of the Civil Rights Act of 1964 ("Title VII") and the 1991 amendments to the Civil Rights Act ("the 1991 amendments") "to make persons whole for injuries suffered on account of unlawful discrimination." *Faragher v. City of Boca Raton*, 524 U.S. 775, 805-806, 118 S.Ct. 2275, 2292 (1998), citing *Albermarle Paper Co. v. Moody*, 422 U.S. 405, 418, 95 S.Ct. 2362, 2372 (1975). This is true whether such awards are received on account of physical injuries or physical sickness.

Title VII makes it an unlawful employment practice for an employer "to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1). The 1991 amendments to Title VII expressly authorize the recovery of compensatory damages. 42 U.S.C. § 1981a(b)(2) and (3). Under the 1991 amendments, victims of intentional discrimination are entitled to a jury trial, at which they may recover compensatory damages for "future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses." 42 U.S.C. § 1981a(b)(3). In addition, the 1991 amendments limit the amount of compensatory damages that are recoverable in cases of intentional discrimination in Title VII cases by capping the amount of damages based on the size of the

employer. *Id.* Significantly, the 1991 amendments expressly exclude "back pay" or "interest on back pay" from the definition of recoverable compensatory damages. 42 U.S.C. § 1981a(b)(2). Any award of such damages, therefore, is not income.

Unquestionably, the purpose of the 1991 amendments was to expand civil rights protections and remedies for federal and private sector employees to provide for compensatory damages. Such awards were to make whole the victims of discrimination on the basis of race, sex and national origin. *See, e.g.,* H.R.Rep. No. 102-40, pt. 1, pp. 64-65 (1991), U.S.Code Cong. & Admin.News 1991, pp. 549, 602, 603 (Report of Committee on Education and Labor) ("Monetary damages also are necessary to *make discrimination victims whole* for the terrible injury to their careers, to their mental and emotional health, and to their self-respect and dignity.")(Emphasis added). Certainly unlawful discrimination "is a fundamental injury to the individual rights of a person," *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987), that causes grave harm to its victims. *United States v. Burke*, 504 U.S. 229, 238 (1992). Congress enacted the federal civil rights statutes not only to make those victims whole, but also with "the central statutory purposes of eradicating discrimination throughout the economy." *Albemarle Paper Co. v. Moody,* 422 U.S. 405, 420-421 (1975); *United States v. Burke*, 504 U.S. 229, 250 (1992) (O'Connor, J., dissenting). Individual lawsuits serve as "the chosen instrument of Congress to vindicate 'a policy that Congress considered of the highest priority.'" *Christiansburg Garment Co. v. EEOC,* 434 U.S. 412, 418 (1978), quoting *Newman v. Piggie Park Enterprises Inc.*, 390 U.S. 400, 402 (1968).

Prior to 1991, Title VII only provided plaintiffs with the right to seek limited forms of equitable relief, which included back pay. *Id.*, pt. 2, p. 25

(Report of Committee on the Judiciary) ("The limitation of relief under Title VII to equitable remedies often means that victims of intentional discrimination may not recover for the very real effects of the discrimination."). Solely as a result of the lack of a "make whole" compensatory damages provision in the pre-1991 version of Title VII, the Supreme Court held that that version did not provide for recovery of "personal injury" damages for the violation of "tort or tort type rights," and therefore such monetary recoveries for back pay under the pre-1991 version were not excludable from gross income under IRC Section 104(a)(2). *U.S. v. Burke*, 504 U.S. 229, 238-242, 112 S.Ct. 1867, 1872-1874 (1992).

It is clear under the reasoning of *Burke,* that recoveries under the compensatory damages provision in the 1991 amendments for Title VII claimants who prove intentional discrimination by their employers are damages for "personal injuries" for the violation of "tort or tort type rights." *Id*. They are not "gains" or "accessions to wealth" that would be taxable under the 16th Amendment. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430-31 (1955).[2] When Congress passed the 1991 amendments to provide for compensatory damages, it was obvious that such damages for non-physical personal injuries fell within the exclusion from gross income under Section 104(a)(2). *Cf., Burke, supra.* Consequently, if the 1996 amendment to Section 104(a)(2) applied to narrow the exclusion to damages

[2]In *Glenshaw Glass*, the parties stipulated, and the court accepted, that the adjudication would turn on statutory interpretation of I.R.C. § 61(a), not on constitutional issues. Indeed, the Court here could reach the same outcome for Ms. Murphy on this statutory basis.

for "personal physical injuries and physical sickness," the effect would be that successful Title VII claimants were made less than "whole."

The appellee's position is also at odds with the purpose of the federal whistleblower laws under which appellants in this case sued and were awarded non-wage compensatory damages. *See, e.g., Passaic Valley Sewerage Commissioners v. Dept. of Labor,* 922 F.2d 474, 479 (3rd Cir. 1993); *Blackburn v. Martin,* 982 F.2d 125,129-32 (4th Cir. 1992) (award of compensatory damages is "*in addition to* remedies designed to restore any financial losses that the victim of discrimination suffered.")(emphasis added); *DeFord v. Secretary of Labor,* 700 F.2d 281, 288 (6th Cir. 1983).

Not only will the taxation of such compensatory damages undermine the legislative purpose of discrimination and whistleblower laws in general, it will have a "chilling effect" on the filing of such claims which will also defeat the legislative purpose behind these remedial laws. In this case, the district court held that one of the primary purposes behind the 1996 amendment to Section 104(a)(2) limiting the exclusion to physical injuries or physical sickness was to "*decrease* litigation." *Murphy v. IRS,* 362 F.Supp.2d 206, 218 (D.D.C. 2005) (emphasis added). That purpose, however, directly conflicts with the underlying purpose of Title VII. Our civil rights laws depend for their enforcement on private actions to vindicate individual rights. If victims of discrimination are to be made "whole," it is completely inappropriate to discourage legitimate claims by taxing compensatory damages to "decrease" litigation. Put another way, the government's position would convert emotional well-being and good reputation into taxable commodities. Such a conversion is contrary both to the remedial purposes of civil rights and whistleblower laws, and to the

traditional concepts of income under Section 61 as well as the Sixteenth Amendment.

B. The compensatory nature of a "make whole" award may also be analogized to the taxpayer's basis which would be the same as the award itself.

Amici support the "human capital" rationale for analogizing the recovery of "make whole" personal injury damages to the payment of damages for the return of capital or restoration of capital loss in the business setting. There is no reason the courts should treat the taxation of damages for payment of capital and human capital differently. This issue was resolved during the early years following the passage of the Sixteenth Amendment when the federal administration and the courts determined, based on the human capital rationale, that make whole damages for personal injuries were not income within the meaning of the revenue statutes or the constitution. The human capital rationale remained in full force following its inception during the 1918-1922 time frame, and the courts, as well as the IRS, relied on that approach to conclude that payments for "make whole" personal injury damages are not income and, therefore, are not taxable. *Hawkins v. Commissioner,* 6 B.T.A. 1023, 1024-25 (U.S. Bd. Tax. App. 1927) ("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"); *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"). The purpose of tort liability is to put the victim in the same position as before the tort occurred. If law could return emotional well-

being, it would. It cannot. Therefore, compensation is in the form of money. However, that money no more increases the victim's wealth than a replacement of emotional stability would. The victim is damaged, the court determines the amount of the damage, and the money is intended to replace the loss. Wealth was not increased. Income was not earned. There is simply no cause for taxation.

A similar rationale applies to individuals who are wrongly incarcerated, later exonerated, and paid damages to compensate for the deprivation of freedom. When an individual receives money for such erroneous imprisonment, that monetary compensation is acting as a proxy for the freedom that the government wrongfully took. While such freedom can never be replaced, providing monetary compensation is an attempt to make the individual whole again. If it were possible to provide specific performance and replace the freedom of which the wrongfully incarcerated individual was deprived, the restoration of that would not be income. Similarly, monetary compensation that is a proxy for such freedom is not income.

However, even if the tax basis approach is taken for human capital recoveries of "make whole" compensatory damages, the proper treatment of such awards is to consider them a return of capital and not as income. Not all payments and recoveries are income, and if money is classified as a capital asset, or return of capital, or restoration of a loss of capital, it is not considered income. The proper adjustment for recovery of capital expenditures occurs through an offset to the selling price, rather than deduction. *Woodward v. Commissioner,* 397 U.S. 572, 574-75 (1970).

A vested cause of action is, of course, "a species of property." *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 428 (1982); *Martinez v. California*,

444 U.S. 277, 281 (1980). A cause of action created by law can be viewed as a bundle of rights. *Penn Central Transp. Co. v. City of New York*, 438 U.S. 104 (1978). The Code classifies a cause of action, or "chose in action," as "intangible personal property." As the Internal Revenue Manual explains:

> Intangible personal property includes "choses in action." . . . A chose in action is a personal right not reduced to possession and recoverable by a suit at law. A plaintiff's cause of action in tort against a defendant is an example of a chose in action.
> I.R.M 5.17.2.4.3.4 – Intangible Property (2000).

A taxpayer's cause of action is also a capital asset under the Code. Under Section 1221, intangible personal property falls within the definition of a capital asset unless it is excluded as being property used in the taxpayer's trade or business that is subject to the allowance for depreciation. Payment of a settlement or judgment that releases the defendant from liability constitutes a sale, exchange or "other disposition" of property under Section 1001. *Herbert's Estate v. Commissioner,* 139 F.2d 756, 758 (3rd Cir. 1943) (finding that the claims against a corporation held by an estate resulted in "a chose in action, property, which it got rid of or relinquished upon payment" and the payment of that claim held by the estate "was a 'disposition' of the claim..."); *Commissioner v. Golonsky,* 200 F.2d 72, 74 (3rd Cir. 1953) ("no longer open to doubt" that choses in action are intangible property and that the release of such a right falls within the broad definition of a sale or exchange of property); *Ray v. Commissioner,* 18 T.C. No. 52 (1952) (lessee's release to lessor of a restrictive covenant held to be a sale of a capital asset); *Benedum v. Granger,* 180 F.2d 564, 566 (3rd Cir. 1950) ("Benedum having held 'property,' a chose in action, exchanged it for other less valuable property. The transaction clearly constitutes an exchange

of capital assets"). *Also see, Jeffrey v. United States,* 261 B.R. 396, 401 (2001) (taxpayer's unliquidated medical malpractice cause of action held to be intangible personal property).

Upon recognizing that the taxpayer's cause of action is a capital asset, the determination of the basis is obvious -- it is the amount of actual "make whole" damages the taxpayer suffered that gave rise to the chose of action. The value of this basis is the subject of the adjudication of damages. In this case, it is the value determined by the Department of Labor, the court of competent jurisdiction, setting the value of Murphy's "make whole" damages for loss of reputation, emotional distress and related damages. Once that amount is determined, it fixes the amount of the taxpayer's basis as well. As the taxpayer's basis in the chose of action is the same as the amount awarded in "make whole" compensatory damages, the taxpayer can experience no gain from the transaction in which the chose of action is relinquished for the payment of compensatory damages. As is the case under the human capital analogy, there is no gain because the amount of damages are purely remedial in nature to compensate for a loss to make the taxpayer "whole."

C. IRC Section 104(a)(2) discriminates against mental and emotional illness and damages.

In *Olmstead v. L.C.*, 527 U.S. 581 (1999), the Supreme Court held that the Americans with Disabilities Act ("ADA") not only prohibits discrimination between the disabled and non-disabled, but it also prohibits discrimination between individuals with different types of disabilities. The Court recognized the value to public policy of giving mental illnesses and injuries parity with physical illnesses and injuries.

Federal courts have had difficulty applying this policy in the context of determining insurance coverage. Compare *EEOC v. Staten Island*

Savings Bank, 207 F.3d 144, 148 (2nd Cir. 2000) ("Title I of the ADA does not bar [employers] from offering" long-term disability benefit plans that provide less coverage for mental and emotion disabilities than for physical disabilities); *EEOC v. CNA Insurance Cos*., 96 F.3d 1039 (7th Cir. 1996) (ADA does not regulate the contents of insurance policies, allowing insurers to limit benefits); *Weyer v. Twentieth Century Fox Film Corp*., 198 F.3d 1104 (9th Cir. 2000) (same); with *Phillips v. Lincoln National Life Insurance Co.*, 978 F.2d 302 (7th Cir. 1992) (holding that determination of whether mental illness is covered by insurance policy turned on determination of whether it had an organic cause); *Kunin v. Benefit Trust Life Insurance Co.*, 910 F.2d 534 (9th Cir. 1990) (autism covered because evidence showed it had an organic cause); *Car Parts Distribution Center v. Automotive Wholesaler's Ass'n*, 37 F.3d 12, 17 (1st Cir. 1994) (insurer may be sued under the employment discrimination title of the ADA if it functions as an employer or acts on behalf of the employer in providing or administering employment benefits such as insurance). *See also Iwata v. Intel Corp*., 349 F.Supp.2d 135 (D.Mass. 2004). In *Brewer v. Lincoln National Life Insurance Co.*, 921 F.2d 150 (8th Cir. 1990), cert. denied 501 U.S. 1238 (1991), the Court refused to distinguish between organic and functional mental illnesses. What makes these cases so difficult is that even the fundamental text of the mental health profession notes in its introduction:

> [T]he term mental disorder unfortunately implies a distinction between 'mental' disorders and 'physical' disorders that is a reductionistic anachronism of mind/body dualism. A compelling literature documents that there is much 'physical' in 'mental' disorders and much 'mental' in 'physical' disorders. The problem raised by the term 'mental' disorders has been much clearer than its solution, and, unfortunately, the term persists in the title of DSM-IV

> because we have not found an appropriate substitute. Moreover, although this manual provides a classification of mental disorders, it must be admitted that no definition adequately specifies precise boundaries for the concept of 'mental disorders.'
> Diagnostic and Statistical Manual of Mental Disorders, Fourth Edition (DSM-IV).

The public policy of eradicating prejudice against mental illness and injury will be advanced by eliminating the discriminatory effect of the 1996 amendment to Section 104(a)(2).

D. Section 104(a)(2) has no effect on the Sixteenth Amendment's limitation on Congress' power to tax or the statutory definition of "income."

Section 104(a)(2) merely provides several exemptions to the definition of income in Section 61(a). It does not purport to include categories of income into Section 61(a). That emotional damages are excluded from Section 104(a)(2)'s exemption is, therefore, meaningless. The Sixteenth Amendment and Section 61 define what is actually taxable under an income tax. Congress did not seek to alter this in its 1996 amendment to Section 104. Compensatory damages for "make whole" relief are not income under Section 61 or the Sixteenth Amendment and cannot be taxed, irrespective of the exclusion for physical injuries under Section 104(a)(2). To hold otherwise would allow Congress to amend Section 61 and the Sixteenth Amendment by negative inference. Because such amounts are not excluded by Section 104(a)(2) does not evince a congressional intention to include such amounts as "income."

Even if Congress did intend to include emotional damages as income by such negative inference, such inclusion is not valid. The plain meaning of "income" in the Sixteenth Amendment is an increase in wealth, which is

not present when a payment is made as compensation of injuries. It is certainly convenient when Congress undertakes the task of establishing by law that which the Constitution requires. However, when Congress misstates the constitutional limits, it is solely the courts' responsibility to reassert those limits. In *City of Boerne* v. *Flores,* 521 U.S. 507, 536 (1997), for example, the Supreme Court preserved for itself the responsibility of establishing the limits of religious freedom. The Religious Freedom Restoration Act was passed by Congress in response to a Supreme Court decision. *Employment Div., Dept. of Human Resources of Ore. v. Smith,* 494 U.S. 872 (1990) (affirming the denial of unemployment benefits to Native American Church members who lost their jobs after using peyote). The Religious Freedom Restoration Act reinstated the Court's *Sherbert* test by prohibiting the substantial burdening of a person's religious practice absent a compelling government interest and proof that the statute is using the "least restrictive means" available. This Act was meant to apply to state and local laws and was passed pursuant to Congress' right to "enforce . . . by appropriate legislation" the protections of the Fourteenth Amendment (the First Amendment right to free exercise of religion is enforced, in part, through the Fourteenth Amendment).

Justice Kennedy begins his *Boerne* majority opinion by emphasizing that our government is one of limited and enumerated powers. The Fourteenth Amendment's Enforcement Clause has, Justice Kennedy insists, never been understood to grant Congress anything approaching unrestrained legislative authority. Instead, laws passed pursuant to the Enforcement Clause, though always given some measure of deference by the Court, are limited by the requirement that they be only "remedial" in nature. *South Carolina v. Katzenbach*, 383 U.S. 301, 326 (1966). Remedial congressional

acts may be "preventive," but Congress may not act to *substantively* create or change the Fourteenth Amendment's restrictions on the States. *Boerne*, 521 U.S. at 524.

Similarly, as argued by the appellant, Congress cannot change the Sixteenth Amendment. The original panel decision, Slip Op. at 15, recognized this limit:

> The Sixteenth Amendment simply does not authorize the Congress to tax as "incomes" every sort of revenue a taxpayer may receive. As the Supreme Court noted long ago, the "Congress cannot make a thing income which is not so in fact." *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925). Indeed, because the "the power to tax involves the power to destroy," *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819), it would not be consistent with our constitutional government, and the sanctity of property in our system, merely to rely upon the legislature to decide what constitutes income.

In this case, the statute enacted by Congress defining what is gross income, 26 U.S.C. §61, does not even include compensatory "make whole" damages for personal injury as income. Moreover, the Treasury Regulations support the understanding that Section 61 is not intended to tax "make whole" payments. Treasury Regulation §1.61-14 states that windfall type litigation proceeds such as punitive damages and treble damages under the anti-trust laws are taxable income, but is silent on "make whole" damages. Punitive damages do not replace lost capital, but actually increase wealth and are rightfully taxed. It may be inferred from this regulation that litigation awards that are not of a windfall nature do not increase wealth and therefore are not income.

Section 61 was enacted by Congress pursuant to the constitutional limits on its taxing authority and Congress expressly recognized that the

definition of income in Section 61 "'is based upon the 16th Amendment and the word 'income' is used in its constitutional sense.'" *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432-433 n. 11 (1955), quoting H.R.Rep.No.1337, supra, note 10, at A18. "Make whole" compensatory damages awards are not a gain or other accession to wealth, and therefore they are not taxable under the statute enacted by Congress to define taxable income pursuant to its constitutional limits. Such awards are also not taxable because in 1996 Congress did not pass a law taxing them and by simply changing the scope of the exemption in Section 104 Congress did not separately authorize a tax on such damages. Nor given the express constitutional limitations of Section 61 could such damages be considered income. Not only is Congress without constitutional authority to tax such damages as income, Congress has not even enacted a statute to tax them. Accordingly, this panel should reach the same result in this case and the Court could avoid declaring Section 104 unconstitutional[3] by holding that the "make whole" damages received by Murphy are not income under the tax code as well as the constitution.

Alternatively, the tax on Murphy's compensatory damages is an unconstitutional direct tax. Article I, section 2, provides that, "Representatives and direct Taxes shall be apportioned among the several

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[3] "[I]t is a cardinal principle" of statutory interpretation that when an Act of Congress raises "a serious doubt" as to its constitutionality, the Supreme Court "will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided." *Crowell v. Benson*, 285 U.S. 22, 62 (1932); see also *United States v. X-Citement Video, Inc.*, 513 U.S. 64, 78 (1994); *United States v. Jin Fuey Moy*, 241 U.S. 394, 401 (1916); cf. *Almendarez-Torres v. United States*, 523 U.S. 224, 238 (1998) (construction of statute that avoids invalidation best reflects congressional will).

States . . . according to their respective Numbers." In Constitutional analysis, no wording is considered careless, inadvertent, or redundant. It is therefore instructive to consider what Representatives and direct taxes have in common that caused the Framers to link them.

Under the unamended Constitution, Representatives were the only federal officials elected directly by the people. The parallel thought was that direct taxes are those imposed directly upon the People:

> . . . Albert Gallatin[] in his "Sketch of the Finances of the United States," published in November, 1796, said: "The most generally received opinion, however, is, that by direct taxes in the Constitution, those are meant which are raised on the capital or revenue of the people; by indirect, such as are raised on their expense. . . ." He then quotes from Smith's Wealth of Nations, and continues: "[There is] little doubt that the framers . . . by direct taxes, meant those paid directly from and falling immediately on the revenue; and by indirect, those which are paid indirectly out of the revenue by falling immediately upon the expense." 3 Gallatin's Writings, (Adamis's ed.) 74, 75. [*Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 ["*Pollock I*"], 569-70 (1895), vacated on rehearing 158 U.S. 601 [*Pollock II"]*(1895).]

In the Framers' view, the linkage of direct taxes and Representatives minimized the risk of controversy over taxation:

> It is not considered that the number of people in each State ought not to be the standard for regulating the proportion of those who are to represent the people of each State. The establishment of the same rule for the apportionment of taxes will probably be as little contested; thought the rule itself, in this case, is by no means founded on the same principle. In the former case, the rule is understood to refer to the personal rights of the people. In the latter, it has reference to the proportion of wealth of which it is by no means a precise measure, and in ordinary cases a very unfit one. But notwithstanding the imperfection of the rule as applied to the relative wealth and contributions of the States,

> it is evidently the least exceptionable among the practicable rules, and had too recently obtained the general sanction of America not to have found a ready preference with the convention. [The Federalist Papers, No. 54 (Madison), pp. 336-7 (Mentor ed. 1961).]

The Framers divided the tax world into two parts: direct taxes and indirect taxes. Moreover, they defined indirect taxes as consumption taxes:

> The taxes intended to be comprised under the general denomination of internal taxes may be subdivided into those of the *direct* **and those of the *indirect* kind . . . by which must be understood duties and excises on articles of consumption**. [The Federalist Papers, No. 36 (Hamilton), p. 219 (Mentor ed. 1961); bold-face added; italics in the original.]

Indirect taxes – the imposts, duties, and excises stated in Article I, Section 9 – are thus taxes on articles of consumption that are collected indirectly as part of the purchase price of goods. The Federalist makes clear the practical difficulties of collecting direct taxes in Federalist Papers, No. 12 (Hamilton), pp. 92-3 (Mentor ed. 1961). Moreover, the Framers saw an important political benefit in the self-regulatory nature of indirect taxes:

> Imposts, excises, and, in general, all duties upon articles of consumption, may be compared to a fluid, which will in time find its level with the means of paying them. . . .
> It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. . . . If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them.
> Impositions of this kind usually fall under the denomination of indirect taxes, and must for a long time constitute the chief part of the revenue raised in this country. . . . [The

> Federalist Papers, No. 21 (Hamilton), pp. 142-3 (Mentor ed. 1961).]

On the other hand, the Framers saw direct taxes as, by nature, unregulated and therefore in need of apportionment to prevent overreaching by the political majority:

> *In a branch of taxation where no limits are to be found in the nature of the thing*, the establishment of a fixed rule, not incompatible with the end, may be attended with fewer inconveniences than to leave that discretion altogether at large. [The Federalist Papers, No. 21 (Hamilton), p. 143 (Mentor ed. 1961); emphasis added.]
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> * * *
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> The apportionment of taxes on the various descriptions of property is an act that seems to require the most exact impartiality; yet there is, perhaps, no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice. Every shilling with which they overburden the inferior number is a shilling saved to their own pockets. [The Federalist Papers, No. 10 (Madison), p. 80 (Mentor ed. 1961).]

The Framers provided Constitutional requirements of fairness for each type of tax. Indirect taxes are required by Article I, Section 8 to be "uniform throughout the United States." Protection with regard to the imposition of direct taxes is provided in Article I, Section 9, by requiring that direct taxes be apportioned among the States on the basis of population:

> Let it be recollected that the proportion of these taxes[] is not to be left to the discretion of the national legislature, but is to be determined by the numbers of each State, as described in the second section of the first article. An actual census or enumeration of the people must furnish the rule, a circumstance which effectively shuts the door to partiality or oppression. The abuse of this power of taxation seems to have been provided against with guarded circumspection. In addition to the precaution just mentioned, there is a provision that "all duties, imposts, and excises shall be

> UNIFORM throughout the United States." [The Federalist Papers, No. 36 (Hamilton), p. 221 (Mentor ed. 1961).]

It is significant that the Framers thus imposed a lesser level of protection with regard to indirect taxes, requiring only that they be "uniform throughout the United States." Their reasoning is clear. Indirect taxes are self-regulating, and therefore inherently safe. The Federalist No. 21, quoted *supra*. They were likely to be the nation's principal source of revenue for the then-foreseeable future. The Federalist No. 12, quoted *supra*. They were accepted by the public. The Federalist No. 54, quoted *supra*. The Framers left no room under the Constitution for any tax that is neither a consumption tax nor a direct tax, since any such tax would escape the Constitutional requirements of fairness and uniformity. The Framers believed that compared to taxation, there is "no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice." They clearly did not intend any such escape. It follows that any tax that is not a consumption tax is a direct tax.

Only a few of the Supreme Court decisions attempting to construe the meaning of "direct Tax[es]" (and none since the Nineteenth Century) has undertaken any reference to The Federalist. Only one – *Pollock II* – has done so with sufficient rigor. *Pollock v. Farmers Loan & Trust Co.*, 158 U.S. 601 (1895). *Pollock II* held that a tax on income from real estate was an invalid direct tax. This was correct. The tax was not a consumption tax and was therefore a direct tax. Moreover, *Pollock II* based its holding squarely on The Federalist No. 36 (Hamilton):

> [T]hirty-sixth number says: "The taxes intended to be comprised under the general denomination of internal taxes, may be subdivided into those of the *direct* and those of the *indirect* kind. . . . As to the latter, *by which must be understood duties and excises on articles of consumption*,

> one is at a loss to conceive, what can be the nature of the difficulties apprehended." Thus we find Mr. Hamilton, while writing to induce the adoption of the Constitution, *first*, dividing the power of taxation into *external* and *internal*, putting into the former the power of imposing duties on imported articles and into the latter all remaining powers; and, *second*, dividing the latter into *direct* and *indirect*, putting into the latter, duties and excises on articles of consumption.
>
> It seems to us to inevitably follow that in Mr. Hamilton's judgment at that time all internal taxes, except duties and excises on articles of consumption, fell into the category of direct taxes. [158 U.S. at 1121; emphasis in original.]

Since *Pollock*, the Supreme Court has not returned to this study of The Federalist's explanation. The result has been, in the words of Justice Harlan in *Spreckles Sugar Refining Co. v. McClain*, 192 U.S. 397, 413 (1904), a series of cases making "distinctions, often very difficult to be expressed in words, between taxes that are direct and those which are to be regarded simply as excises."

In *Union Elec. Co. v. United States*, 363 F.3d 1292, 1302 (Fed Cir. 2004), cert. denied, 543 U.S. 821 (2004), the Court agreed with the reasoning in *Pollock*, and relied upon The Federalist Nos. 36 and 21 in upholding, as an indirect consumption tax, a tax on enriched uranium. The Court found it to be a "consumable commodity." Perhaps most importantly, the Court noted that *Pollock* has never been overruled, and it was bound to follow it:

> We agree that *Pollock* has never been overruled, though its reasoning appears to have been discredited. Nonetheless, we are obligated to follow *Pollock* until it is explicitly overruled by the Supreme Court. *Agostini v. Felton*, 521 U.S. 203, 237,[] 138 L. Ed. 2d 391, 117 S. Ct. 1997 (1997). [*Id.* at 1300; footnote omitted.]

On the authority of The Federalist, *Pollock II*, and *Union Elec. Co.*, Ms. Murphy's damage award is a Constitutionally invalid direct tax.

IV. CONCLUSION

The amici ask this Court to reissue its prior decision and reverse the district court's order granting defendants' motion for summary judgment. Instead, it is the plaintiffs' motion for partial summary judgment must be granted. The *amici* ask this Court to remand this case to the district court to enter an order instructing the Government to refund the taxes Murphy paid on her award plus applicable interest.

Respectfully Submitted by:

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RULE 32(a)(7)(C) CERTIFICATE

I HEREBY CERTIFY that the foregoing Brief for *Amici Curiae* complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B). The Brief is composed in a 14-point proportional typeface, Times New Roman, and the contents of the Brief (exclusive of those parts permitted to be excluded under FRAP and the local rules of this court) contain 6,991 words.

Respectfully submitted by:
Tate & Renner

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Richard R. Renner

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on January 29, 2007, I caused two copies of the foregoing Brief of *Amici Curiae* Urging Reversal, in support of Appellants, to be served by express delivery service, postage prepaid, upon:

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