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Top 10 Reasons 'Murphy' Is My Favorite Tax Case

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The U.S. Court of Appeals for the D.C. Circuit Aug. 22, in *Murphy v. IRS*,[1] shocked the tax world by holding Section 104 of the Internal Revenue Code unconstitutional to the extent it taxes non-wage settlement proceeds for loss of reputation and mental distress.

At this writing, it is not yet clear if *Murphy* will face scrutiny from the U.S. Supreme Court. Whatever happens in the coming months or years, there is good reason to think it will reshape at least some of the tax law, and alter the behavior of a variety of constituents in the tax world.

I have 10 reasons why *Murphy* is momentous. They are:

1. *Murphy* confirms that Section 104 still has legs.
2. *Murphy* will encourage IRS to issue Section 104 guidance.
3. *Murphy* will cause defendants to re-examine their policies on Section 104 and Forms 1099.
4. *Murphy* will encourage settlement.
5. *Murphy* will encourage lawyers and judges to focus on exact wording.
6. *Murphy* will prompt refund claims.
7. *Murphy* will encourage forum shopping by taxpayers.
8. *Murphy* will encourage debate about what kinds of payments should and should not be taxable.
9. *Murphy* is (probably) substantial authority.
10. *Murphy* will facilitate more structured settlements.

Before I explain my top 10 reasons why *Murphy* is preeminent, let us look at the basics.

Just the Facts

Marrita Murphy alleged that her former employer blacklisted her and provided unfavorable references after she complained of environmental hazards. She submitted evidence of mental and physical injuries due to the blacklisting in an administrative hearing. A physician testified she had somatic and emotional injuries, including bruxism (teeth grinding usually associated with stress).

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The administrative law judge determined she also had other physical manifestations of stress, including anxiety attacks, shortness of breath, and dizziness. The administrative law judge recommended compensatory damages of $70,000, $45,000 of which was for "emotional distress or mental anguish," with $25,000 for "injury to professional reputation." Significantly, none of her award was for lost wages or diminished earning capacity.

The award was affirmed by a Department of Labor Administrative Review Board.

[1] (No. 05-5139), slip opinion (D.C. Cir. 8/22/06).

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Murphy paid tax on her award, but later filed an amended return claiming that it was excludable. IRS denied her refund claim, and Murphy sued in federal district court, arguing that her recovery was for personal physical injuries excludable under Section 104(a)(2). Alternatively, she claimed that Section 104(a)(2) was unconstitutional as applied to her award because the award was not income within the meaning of the Constitution's 16th Amendment.

Concluding that Section 104 did not allow Murphy to exclude her damages since her award was not for ''physical'' injuries, the D.C. Circuit addressed whether that is constitutional. The D.C. Circuit refers to *Helvering v. Clifford*,[2] which held that the word ''incomes'' in the 16th Amendment and ''gross income'' in Section 61(a) of the Internal Revenue Code are coextensive. This recovery was to make Murphy reputationally whole, so the court found it not to be income at all.

Top 10

Different people will find different things about *Murphy* remarkable. Here are my top 10 reasons *Murphy* is a bellwether of change.

'Murphy' Confirms Section 104 Still Has Legs. Long after the constitutional debate over *Murphy* has subsided (and in whatever subsequent courts that debate takes place), I believe Section 104(a)(2) will still be with us, and we will still be interpreting it. That makes Section 104 the real sleeper part of the decision, overshadowing the more flamboyant (un)constitutional holding.

The statutory argument is nothing new, although the lawyers in *Murphy* presented it with unusual flare.

Murphy experienced both mental and physical problems, including bruxism, anxiety attacks, shortness of breath, and dizziness. Persuaded by this evidence, the administrative law judge awarded her $45,000 for ''emotional distress or mental anguish,'' and $25,000 for ''injury to professional reputation'' due to the blacklisting. The administrative law judge's findings turned out to be critical to the tax result. The court stressed that none of Murphy's award was for lost wages or diminished earning capacity.

That directly fed into the constitutional notion that these amounts were truly not income, since they compensated Murphy for something (her well-being and reputation) not taxable in the first place. The wording of the order was critical from another perspective. The fact that the administrative law judge used the fateful phrases, ''emotional distress or mental anguish'' and ''injury to professional reputation'' foreclosed the argument that Section 104(a)(2) applied by its terms.

Notwithstanding this language, Murphy argued that her award did compensate her for personal physical injuries. There was no question that Murphy's claim was based upon tort or tort-type rights under the applicable whistleblower statutes. IRS did not challenge the existence of tort or tort-type rights, but disputed whether her injuries were ''physical.''

Before a taxpayer can exclude compensatory damages from gross income under Section 104(a)(2), *Commissioner v. Schleier*[3] says he must demonstrate that:

- the underlying cause of action giving rise to the recovery was based upon tort or tort-type rights; and
- the damages were awarded on account of personal physical injuries or sickness.

IRS has been slow in issuing regulations to define physical injury. The statute was changed in 1996 to require physical injury or physical sickness, rather than merely personal injury or sickness.

Administratively (in private letter rulings, for example), IRS has suggested that you really must be able to see the injury.[4] One can see broken bones and bruising, but many injuries or illnesses are not apparent to the naked eye.

Taxpayers have grappled for 10 years now with the question of what injuries are physical and what are not.[5] *Vincent v. Commissioner* suggests that ulcers are physical, although Vincent did not qualify for an exclusion because the jury in her underlying case was never asked to consider her physical problems.[6] Migraines, cluster headaches, and strokes are also in no-man's land. The oft-quoted legislative history to the 1996 law that changed the wording of the tax code states that mere symptoms of emotional distress do not constitute physical injuries. The cited examples include headaches, stomachaches, and insomnia.[7]

Yet, even for the items it enumerates, exactly what is a stomachache? Does a bleeding ulcer qualify, or is that something beyond a mere stomachache, and therefore not merely a symptom of emotional distress? If headaches are not sufficient to constitute physical injuries, what about cluster headaches or migraines? What about an aneurism?

Although such questions of degree still abound, *Murphy* suggests that Section 104 is a broader exclusion than IRS thinks it is.

'Murphy' Will Encourage IRS to Issue Section 104 Guidance. Whatever else it may be, *Murphy* is a wake-up call to IRS to issue guidance under Section 104, preferably in the form of regulations. Although it may not be able to embark on this course while the constitutional issues remain in play, I believe, one way or another, that we will still be dealing with the confines of Section 104 in the future.

The Treasury regulations under Section 104 still track the pre-1996 version of Section 104, before the ''physical'' modifier was added. The D.C. Circuit stops short of criticizing IRS for failing to change its regulations 10 years after the statute was amended. Yet more than a few readers of *Murphy* will discern that the appellate court was not happy with the service or the Treasury Department, let alone with Congress.

Nevertheless, the court acknowledged that the old Section 104 regulations and the current 1996 act ver-

[2] 309 U.S. 331 (1940).
[3] 515 U.S. 323 (1995).

[4] See Private Letter Ruling 200041022. See also Wood, *The Case for Excluding Discrimination, Harassment Recoveries Under Section 104*, 78 Daily Tax Report (BNA) (April 25, 2005), page J-1.
[5] See Wood, *Post-1996 Act Section 104 Cases: Where Are We Eight Years Later*, Vol. 105, No. 1, Tax Notes (October 4, 2001), p. 68. See also Wood, *Damage Awards: Sickness, Causation and More*, Vol. 111, No. 11, Tax Notes (June 12, 2006), p. 1233.
[6] See *Vincent v. Commissioner*, T.C. Memo. 2005-95. See also Wood, *Ulcers and the Physical Injury/Physical Sickness Exclusion*, Vol. 107, No. 12, Tax Notes (June 20, 2005), p. 1529.
[7] See Conference Committee Report 104-737, p. 300.

  DTR ISSN 0092-6884

sion of Section 104 were not in sync, the language of the regulations being at odds with the more explicit language of the statute. In what turned out to be a pyrrhic victory for IRS, the court said the statute controlled. IRS diverts attention from the word ''physical,'' and instead, focuses on the ''on account of'' nexus.

Section 104 provides an exclusion only for amounts paid ''on account of'' physical injury or physical sickness. IRS argued that Murphy had to demonstrate that she was awarded her damages ''because of'' her physical injuries. IRS claimed that she did not do that, and in fact, that the administrative law judge finding had been expressly to the contrary.

Language truly matters. It was of no moment, said IRS, that Murphy suffered from bruxism or other physical manifestations of stress, because the labor board ruling said her damages were for ''mental pain and anguish'' and ''injury to professional reputation.'' Those, said IRS, are nonphysical injuries.

Ultimately, the D.C. Circuit agreed with the government that Murphy failed to carry her burden on this point. Although Murphy argued that she suffered ''physical'' injuries, she could not rebut the ''on account of'' argument. As a result, the D.C. Circuit concluded that, on its face, Section 104(a)(2) did not permit Murphy to exclude her award from her gross income.

I believe the service will suffer a chilling effect on attacks under Section 104. Every taxpayer will come (to audits, appeals conferences, etc.) armed with constitutional invective, and many IRS employees at many different levels may see this. Even before *Murphy*, I have seen IRS employees put their own gloss on Section 104, often according a more liberal view than I believe the National Office espouses. (This may be yet another unintended backfire achieved by the service in not issuing regulations under Section 104.)

I believe the service will suffer a chilling effect on attacks under Section 104. Every taxpayer will come (to audits, appeals conferences, etc.) armed with constitutional invective.

I expect this trend will become more pronounced. If the service has any hope of damage control, it will need to give firm and fast internal guidance to the field about how to address these issues. Even if the service gives such guidance, the tide of exclusions may become Katrina-like. If IRS will not define the term ''physical'' in regulations (as so far they do not seem inclined to do), then should taxpayers be able to resort to a dictionary?

Murphy thought so.[8] She pointed both to her physician's testimony that she had experienced ''somatic'' and ''body'' injuries ''as a result of [the defendant's] blacklisting.'' She also pointed to the *American Heritage Dictionary*, which defines ''somatic'' as ''relating to, or affecting the body, especially as distinguished from a body part, the mind or the environment.'' Murphy also submitted her dental records to IRS, proving that she had suffered permanent damage to her teeth. That sure sounds physical.

Quite apart from rudimentary sources like dictionaries, what about non-tax case law defining the term? Cleverly, Murphy cited several federal court decisions showing that, for various purposes, substantial physical problems caused by emotional distress are indeed considered physical injuries or physical sickness. These are not tax cases, mind you, but they are cases in which the physical manifestations of emotional distress were regarded as physical injuries.

For example, in *Walters v. Mintec/International*,[9] the Third Circuit held that a plaintiff could recover for physical harm caused by the emotional disturbance of an accident. The court based its decision on the Restatement of Torts, which requires physical harm in order for damages to be available. Although not occurring in the context of an income tax dispute, the *Walters* case squarely presents the question whether an injury resulting from emotional disturbance can be ''physical'' harm. Concluding that it can, the Third Circuit quotes from the comments to the Restatement of Torts:

> The fact that [emotional disturbance is] accompanied by transitory, non-recurring phenomena, harmless in themselves, such as dizziness, vomiting, and the like, does not make the actor liable where such phenomena are in themselves inconsequential and do not amount to any substantial bodily harm. On the other hand, long continued nausea or headaches may amount to physical illness, which is bodily harm; and even long continued mental disturbance . . . may be classified by the courts as illness, notwithstanding their mental character.[10]

Murphy also relied on *Payne v. General Motors Corp.*,[11] another non-tax case, where an employee sued an employer under Title VII of the Civil Rights Act of 1964 and Section 1981, and for negligent infliction of emotional distress. The employee suffered from constant exhaustion and fatigue, diagnosed by a psychologist as resulting from the employee's depression. The employee's depression, in turn, was allegedly caused by the employer's discrimination.

The court held the problems constituted ''physical injuries,'' which were a prerequisite to maintain an action for negligent infliction of emotional distress under Kansas law.

Against the background of such non-tax cases, Murphy argued that neither Section 104 of the tax code nor its regulations limit the physical injury exclusion to an injury occurring by physical stimulus. Whatever happens to *Murphy*, this kind of discussion should light a fire under the service to issue guidance.

'Murphy' Will Cause Defendants to Re-Examine Their Policies on Section 104 and Forms 1099. Although plaintiffs' lawyers are already attempting to educate themselves and their clients what this will mean, corporate America must also respond. Corporate defendants will face requests not to issue Forms 1099 for non-wage

[8] Not only did Murphy use the dictionary in her statutory argument, but she also did so in her constitutional attack. She used several dictionary definitions of ''accession to wealth'' to show that she had not received one.

[9] 758 F.2d 73 (3rd Cir. 1985).

[10] See Restatement (2nd) of Torts Section 436A, Comment C (1965), quoted in *Walters v. Mintec/International*, 758 F.2d 73 at 1985 U.S. App. Lexis 29782, p. 6.

[11] 731 F. Supp. 1465, 1474-75 (D. Kan. 1990).

settlements. If a payment is excludable under Section 104, it should not be the subject of an IRS Form 1099.[12] Taxpayers know this. Plaintiffs' lawyers know this. Defendants know this.

There are often debates at settlement time, and there are often mistakes made and arguments voiced over 1099 issues. Yet, when the lawyers involved in settling cases consider these issues at settlement time, they usually get worked out. There is often give and take at arm's length between plaintiffs and defendants, with plaintiffs not asking for too much and defendants not yielding too much. In the main, this leads to equitable results.

Now, plaintiffs are going to become much more aggressive, and defendants will need to know how to respond. In the D.C. Circuit, this may be easy. Elsewhere, it will not be.

'Murphy' Will Encourage Settlement. Pragmatists will readily note that *Murphy* was a tax refund case. Potential Form 1099 mismatch issues aside, had Murphy not reported her recovery on her initial return, she likely would have avoided a fight. A fight avoided is often a fight won.

Of course, *Murphy* also was a case that went to judgment, or at least its administrative equivalent. The vast majority of cases settle, and the tax flexibility a settlement generally offers should not be ignored. Everyone knows that the time to address such issues is before settlement documents are signed.

Quite apart from litigation risks, concerns about publicity, the high cost of lawyers' fees, and other factors that auger toward settlement, I am convinced that many cases settle as much for tax reasons as for any of these seemingly more dispositive reasons.

Congress amended Section 104 in 1996 to require that injuries must be ''physical'' to give rise to an exclusion. Murphy argued cogently that the legislative history to this 1996 change attempts to separate transitory symptoms from serious and permanent physical injuries and physical sickness. Hers were not minor and transitory symptoms of emotional distress like headaches, upset stomach, and sleeplessness, which are not permanent in nature and which go away after a period of time. This broaches the territory of one of the great unspoken phrases of the tax law: ''physical sickness.''

After all, Section 104 excludes from gross income damages for physical injuries and physical sickness, yet the latter receives no attention in the literature, the case law or anywhere else.[13]

If one cannot draw a bright line between physical injuries on the one hand and mere symptoms of emotional distress on the other, I submit that the line is even fuzzier when it comes to physical sickness and symptoms of emotional distress. Yet Section 104(a)(2)—whether it is constitutional or not—clearly excludes from income damages for physical sickness too.

After 1996, plaintiffs' lawyers became more aware of tax issues, and of the effects of including battery claims when the facts support it. In the wake of *Murphy*, clients will become more savvy, and lawyers will too.

'Murphy' Will Encourage Lawyers and Judges to Focus on Exact Wording. Lawyers got a wake-up call from the D.C. Circuit. They got a lesson about how (from a tax perspective, which often means from a plain old economic perspective), a settlement is almost always better than a verdict. Exact wording may be more important than the intent of the payor and other traditional indica.

Plaintiffs' lawyers often draft court orders for judges to sign. Although this change will not happen overnight, I believe plaintiffs' lawyers will become even more sensitized to tax linguistics. Plaintiffs' lawyers already want to include battery claims in employment cases on appropriate facts, a plain (if not immediate) reaction to the ''physical'' adjective now in Section 104.[14] In short, they will learn.

Quite apart from court orders, settlement documents—already a fertile field for tax considerations—will plainly become more so. The vast, vast, vast majority of cases settle. Given that the vast majority of cases do not go to a verdict or administrative ruling, but rather are settled, what does this suggest about the settlement process?

In a majority of cases, there is an explicit allocation between various amounts paid by a defendant to a plaintiff. In a whistleblower case, there might be wage and non-wage categories. Although IRS might seek to limit the holding of *Murphy* to cases in which wages are not an element (as they were not in *Murphy*), I believe the analysis of the *Murphy* court should apply to many non-wage recoveries, even if there is also a wage element in the case. The wage element should be treated as wages, but the rest may qualify for *Murphy*'s law.

Although IRS might seek to limit the holding of *Murphy* to cases in which wages are not an element, I believe the analysis of the *Murphy* court should apply to many non-wage recoveries, even if there is also a wage element in the case.

Furthermore, the *Murphy* case may portend a more thorough application of the ''on account of'' enigma. What if the evidence showed that the administrative law judge awarded the money to Murphy because of her bruxism, and acknowledged that the bruxism was caused by the emotional distress, which was caused by the defendants? What if the judge's order so states, or if there is a transcript in which the judge's reasoning is clear, even though the judge ultimately states in his order that the payment is ''for emotional distress''?

My point is that an award ''for emotional distress'' and an award for bruxism may not be all that different. If one accepts the notion that the physical injury (or sickness?) results from emotional distress, and that the defendant caused it, then perhaps they truly are the same thing. It was clear long before *Murphy* that the

[12] See Instructions to IRS Form 1099-MISC. In the context of attorneys' fees, see also the recently issued attorney payee regulations, T.D. 9270 (July 12, 2006).

[13] See Wood, *Physical Sickness and the Section 104 Exclusion,* Vol. 106, No. 1, Tax Notes (Jan. 3, 2005), p. 121.

[14] Perhaps a paraphrase of the *Murphy* court's holding is that to be constitutional, Section 104(a)(2) must now be read without the word ''physical.''

  DTR ISSN 0092-6884

wording of the court order (or as in this case, the administrative order) was key.

Since the court in *Murphy* ultimately concludes (almost reluctantly) that Murphy did not carry her burden of showing that her recovery really was ''on account of'' physical injury/sickness, it is worth asking what would have worked. Notes? Pleadings? A transcript? Surely the language of the order itself cannot be the only reference point. After all, the service has long taken the position that it is not bound by characterizations in court orders or settlement agreements.[15] Surely that rule should work both ways.

The ''on account of'' phrase continues to have a Kafka-esque quality, and given its manifest importance, that itself is troubling. The *Murphy* court says *O'Gilvie*[16] makes the exclusion available only for personal injury damages awarded by reason of, or because of, the personal injuries. Yet, the court again cites *O'Gilvie* for the notion that something stronger than but–for causation is required.

I find these gradations of ''why'' a payment is made troubling. I believe the service does too. Notwithstanding the constitutional reach of *Murphy*, and notwithstanding multiple Supreme Court cases that attempt to explicate the nebulous ''on account of'' haiku, even *Murphy* with its sweeping convictions fails to clean this one up.

'Murphy' Will Prompt Refund Claims. Refund claims may pile up like the letters to Santa in *Miracle on 34th Street*. Moreover, this will not only occur from and after the Aug. 22 date of the *Murphy* case, but retroactively for taxpayers who have settled their cases earlier in 2006, or indeed, in 2005, 2004, and 2003. For some taxpayers, 2002 will still be open.

Although many taxpayers will file amended returns, can they go back to years closed by the statute of limitations? My first reaction is that the statute of limitations is an absolute bar, and that taxpayers cannot go back and amend returns for years prior to the applicable statute.

There may be differences of opinion about the ''nonwage'' lynchpin of the case. *Murphy* arose in an employment context, even though no wages were awarded. I do not see an appropriate line being drawn between nonemployment cases on the one hand (such as defamation cases, false imprisonment, intentional or negligent infliction of emotional distress, etc.) and employment cases on the other. Although *Murphy* does not apply to wage recoveries, where someone recovers $200,000 in wages and $300,000 in non-wage nonphysical personal injury damages, I see no credible basis on which to argue that the *Murphy* holding does not apply to the $300,000.

Plainly, there may be questions about the appropriateness of allocations between wage and non-wage, but the wage versus non-wage issue has always been there. *Murphy's* non-wage focus could have the curious effect of making recoveries in the nonemployment field (garden-variety intentional infliction of emotional distress cases, for example) more attractive from a tax perspective than a similar case in the employment arena. The taint of wages will clearly be stronger in the employment context. That is a reversal of the position that exists with respect to attorneys' fees, where the new above-the-line deduction in employment cases makes employment cases taxed more favorably than nonemployment ones (when it comes to attorneys' fees).[17]

Given that the vast majority of cases settle, and it is a rare employment case where all amounts are treated as wages, *Murphy* may impact many employment cases. Many refund cases will be filed.

'Murphy' Will Encourage Forum Shopping by Taxpayers. The *Murphy* case binds IRS, at least in the D.C. Circuit. The *Murphy* case strikes down Section 104(a)(2) as it is applied to a taxpayer like Murphy. Plus, it is probably within the spirit of the case that Section 61 (which is quite literally unmarred by the decision) cannot now be used by IRS to contradict the *Murphy* holding. Many taxpayers in the D.C. Circuit are not going to report their emotional distress and other nonwage and nonphysical injury settlements.

That means taxpayers living in the D.C. Circuit will be back to pre-1996 law, when Section 104(a)(2) did not use the word ''physical.'' The presence of a split in the circuits on such issues is daunting.

Many litigators and tax practitioners will remember the split in the circuits on attorneys' fees issues that existed before the Supreme Court decided *Banks* in 2005.[18] A split in the circuits tends to encourage manipulative behavior. Will taxpayers attempt to somehow import D.C. Circuit court law to their cases occurring in other states and other circuits? Will taxpayers actually move to the D.C. Circuit? If so, will they need to move before their case is resolved, before they receive the money, or only move to the D.C. Circuit in time to file their Tax Court petition (if they even have to fight about it)?[19]

Tax procedure aficionados will start thinking about the *Golsen*[20] rule, which indicates the applicable law when a Tax Court case is filed. Taxpayers and practitioners will be scrambling.

The larger questions relate to *Murphy*'s impact throughout the country without any maneuverings. What if there are no conflicting circuit court cases in other jurisdictions? The *Murphy* court positions itself as following the ''in lieu of'' test of all of its ''sister circuits.'' The impact of Tax Court Rule 143 also may be debated.

In general, that rule provides that trials in the Tax Court are to be conducted under the rules of evidence applicable to trials without jury in the U.S. District

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[15] See *Robinson v. Commissioner*, 102 T.C. 116 (1994), *aff'd in part rev'd in part*, 70 F.3d 34 (5th Cir. 1995); *McKay v. Commissioner*, 102 T.C. 465 (1994), *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996); *Brown v. U.S.*, 890 F.2d 1329, 1342 (5th Cir. 1989).

[16] 519 U.S. at 454.

[17] See Wood, *Will the IRS Pursue Attorneys' Fees Post-Banks?* Vol. 108, No. 4, Tax Notes (July 18, 2005), p. 319. See also Wood, *Supreme Court Attorney Fee Decision Leaves Much Unresolved,* Vol. 106, No. 7, Tax Notes (Feb. 14, 2005), p. 792.

[18] For full details, see Wood, *Taxation of Attorneys' Fees Altered by the Jobs Act and the Supreme Court*, Ch. 4, No. 1, 57th Annual Tax Institute, USC Law School, 2005 Tax Institute.

[19] See Wood, *More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies*, Vol. 20, No. 21, BNA Employment Discrimination Report (May 21, 2003), p. 701.

[20] See *Golsen v. Commissioner*, 54 T.C. 742, 747 (1970), *aff'd on other issue*, 445 F.2d 985 (10th Cir. 1971).

Court for the District of Columbia.[21] Before you get too excited, this ''D.C.-trumps-the-rest-of-the-U.S.'' rule is limited to the rules of evidence, not extending to substantive interpretations of tax law. Still, some have argued that this makes (some) tax cases coming out of the D.C. District or Circuit court more important than in any other circuit.

If you are a taxpayer and, like most taxpayers, your court of choice is the Tax Court (where notably, you do not have to pay your tax before you dispute it), you may agree. It seems unlikely that anything in the *Murphy* case can be made out to be a ruling on evidence. Still, *Murphy* seems likely to encourage some bootstraps.

'Murphy' Will Encourage Debate About What Kinds of Payments Should and Should Not Be Taxable. Like the question of what constitutes ''physical'' injuries, or what ''on account of'' means, just what is a gain? What is an accession to wealth? While tax advisers rarely consider such esoterica, plucky Ms. Murphy argued that her damage award for personal injuries—including non-physical injuries—was simply not income but rather a restoration of capital—human capital, that is.

For this proposition, Murphy cited Nobel Laureate Gary Becker, and the D.C. Circuit did too.[22]

Murphy argued that the concept of human capital was read into the Internal Revenue Code by *Glenshaw Glass*. In *Glenshaw Glass*, the court made clear that a recovery of compensatory damages for a personal injury is analogous to a return of capital, and therefore is not income under the tax code or the 16th Amendment. Murphy went on to argue that the Internal Revenue Code was drafted shortly after the 1913 passage of the 16th Amendment.

Murphy focused on three sources that the Supreme Court quoted 80 years later in *O'Gilvie*. Murphy's argument was that these timely musings indicated the contemporaneous common understanding of the word ''income.'' Because the 1918 act followed soon after ratification of the Sixteenth Amendment, Murphy argued that the statute reflected the meaning of the amendment as it would have been understood by those who framed, adopted, and ratified it.

Constitutional arguments in tax cases generally do not fare well. Murphy had winnowed her arguments significantly by the time her case reached the D.C. Circuit Court of Appeals. In the district court she also had argued that the 1996 amendments to Section 104 resulted in an unconstitutional retroactive application of law violating the due process and takings clauses of the Fifth Amendment. The district court rejected these arguments, and Murphy dropped them on appeal.

The collective IRS (and Justice Department) blood must boil over the mere mention of such arguments. The government advanced a slew of arguments in return, some general and some specific, as to why Murphy's constitutional argument should fall.

The government (understandably) argued that there is a presumption that Congress enacts laws within its constitutional limits.[23] As recently as *Commissioner v. Banks*,[24] the Supreme Court underscored Congress's power to tax income, affirming that such power ''extends broadly to all economic gains.''[25]

The government noted that the mere fact that Congress historically chose in its discretion to exclude certain personal injury recoveries did not mean the 16th Amendment mandated such an exclusion. Indeed—although this argument plainly did not play well to the D.C. Circuit—IRS stated flatly that Congress could repeal Section 104 entirely. These arguments did the government more harm than good. In fact, nothing went well for the government.

After lining up the arguments, the D.C. Circuit flatly said that ''we reject the government's breathtakingly expansive claim of congressional power under the Sixteenth Amendment.''[26] In an attempt at harmonization among the circuits, the court in *Murphy* launched its ''is it income?'' analysis by saying ''we join our sister circuits by asking: 'in lieu of what were the damages awarded?' ''[27] For this fundamental query, the court cites *Raytheon Products Corp. v. Commissioner*.[28]

Finding significant support for the ''in lieu of'' test in the case law, the court said that if Murphy received this money in lieu of something that is normally untaxed, then her compensation is not income under the 16th Amendment. The damages Murphy received were to make her emotionally and reputationally whole, not to compensate her for lost wages or taxable earnings. Her emotional well-being and good reputation before they were diminished by her former employer were not taxable as income, so the compensation she received in lieu of what she lost should not be considered income either.

Even so, the court acknowledged that the Supreme Court has also instructed that in defining ''incomes'' we should rely upon ''the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment.''[29]

The court generally agreed with Murphy's view of the contemporaneous writings, which suggested that the term ''incomes'' as used in the 16th Amendment did not extend to moneys solely in compensation for a personal injury, and unrelated to lost wages or earnings. The court then stated that emotional distress and loss of reputation were both actionable in tort when the 16th Amendment was adopted. That fact supported the view that compensation for nonphysical injuries was not regarded differently than compensation for physical injuries.

Therefore, said the court, it was not considered income by the framers of the 16th Amendment, nor by the state legislatures that ratified it. Concluding that compensation for loss of personal attributes is not received in lieu of income, and that the framers of the 16th Amendment would not have understood compensation for a personal injury—including a nonphysical injury—to be income, the court said:

[21] See Internal Revenue Code Section 7453.

[22] See Gary S. Becker, *Human Capital* (1st Ed. 1964); see also Gary S. Becker, ''The Economic Way of Looking at Life,'' 43-45 (Nobel Lecture, Dec. 9, 1992).

[23] See *Rust v. Sullivan*, 500 U.S. 173 (1991).

[24] 543 U.S. 426 (2005).

[25] See *Banks*, 543 U.S. at p. 433.

[26] Slip Opinion at p. 15.

[27] Slip Opinion at p. 16.

[28] 144 F.2d 110 (1st Cir. 1944).

[29] Slip Opinion at 17, citing *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509 at 519 (1921).

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''Therefore, we hold § 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.''[30]

'Murphy' Is (Probably) Substantial Authority. Is the *Murphy* case substantial authority throughout the United States? Whether the answer is yes or no (or maybe), many taxpayers will adopt the view of the *Murphy* court. Whether they are in Kansas or California, Louisiana or Maine, I imagine many will take the position that a nonphysical injury recovery (for emotional distress, defamation, etc.) is simply not income.

Given that many taxpayers may take (new or amended) filing positions based on *Murphy*, it is appropriate to question whether IRS could impose penalties on taxpayers should such positions not be sustained.

Generally speaking, penalties should not be imposed on a taxpayer even if the taxpayer ultimately loses a tax case, as long as the taxpayer had ''substantial authority'' for the position. The substantial authority standard is objective, involving an analysis of the law, and an application of the law to the facts. The substantial authority standard is less stringent than the ''more likely than not'' standard, but more stringent than the ''reasonable basis'' standard.[31]

Just what is and what is not substantial authority is not always clear. The regulations tell us that the weight of authorities supporting the tax treatment claimed must be ''substantial'' in relation to the authorities supporting contrary positions.[32] That sounds circular. If it is substantial, then it is substantial?

The substantial authority standard is less stringent than the "more likely than not" standard, but more stringent than the "reasonable basis" standard.

The weight of an authority depends on its relevance, persuasiveness, and the type of document providing the authority. The regulations mention revenue rulings, private letter rulings, technical advice memorandums, etc. Age is relevant too, and certain documents more than 10 years old are generally given very little weight.[33] That is a curious reference point, although surely it is not meant to suggest that authority that is recent is entitled to heavy weight.

When it comes to court cases, the regulations state that the applicability of a court case to a particular taxpayer by reason of the taxpayer's residence in a particular jurisdiction generally is not taken into account in determining whether there is substantial authority for the position. However, substantial authority does exist when the tax treatment of the item is supported by controlling precedent of the circuit court of appeals to which the taxpayer has a right of appeal.[34] If you have controlling precedent in your circuit, where your Tax Court case would be appealed, you do have substantial authority.

Conversely, if you are relying on another circuit's precedent—say you are relying on *Murphy* even though you live in the Ninth Circuit—that does not necessarily mean you do not have substantial authority. In *Wise v. Commissioner*,[35] the Tax Court (interpreting former Regs. Section 1.6661-3(b)(1), the predecessor to Section 1.6662-4(d)(3)) held that the taxpayer's reliance on a single 11th Circuit case supporting his position was substantial authority, despite the fact that IRS's position was supported by opinions of the Fourth, Fifth, Sixth and Eighth circuits, as well as several Tax Court opinions.

In *Unger v. Commissioner*,[36] the Tax Court found substantial authority (again, declining to impose the former Section 6661 penalty) where the taxpayer was able to present some cases in support of a ''novel'' legal argument.

In other words, if you have a good case in your own circuit, you clearly should have substantial authority. If you have a good case somewhere else, whether you have substantial authority is likely to depend on how recent it is (evidently something hot off the press is better than something 60 years old[37]), how persuasive is its logic, just how much other adverse authority there is that contradicts it, etc.

From what I can tell so far (though I stress I have not yet made a study of this point), a case like *Murphy* has little to contradict it. If I am right, this may mean that taxpayers on similar facts throughout the United States may have substantial authority to exclude that which the 1996 act sought to tax with its addition of the ''physical'' qualifier.

However, the regulations suggest that a return position that is arguable but fairly unlikely to prevail in court does not meet the substantial authority standard. Many tax lawyers might say that a repeat of the *Murphy* case, involving another unconstitutional finding by any other circuit court, or by the U.S. Supreme Court, is quite unlikely. That may suggest caution, but I do not believe many taxpayers will be cautious in light of the sweeping taxpayer victory *Murphy* presents.

'Murphy' Will Facilitate More Structured Settlements. The *Murphy* case probably will impact the structured settlement industry, that arm of the life insurance business that implements periodic payment settlements to plaintiffs. Section 104 makes clear that payments on account of physical injuries or physical sickness are excludable regardless of whether they are made in a lump sum or via periodic payments. A structured settlement enables the plaintiff to receive a stream of payments, with the entirety of each payment being excludable from income, notwithstanding the fact that (under traditional annuity principles) one might view a portion of each payment as constituting interest.

Yet, while Section 104 may be the reason the structured settlement industry exists, Section 130 is its

[30] Slip Opinion at p. 23.
[31] See Regulations Section 1.6662-4(d)(2).
[32] *Id.*
[33] Reg. Section 1.6662-4(d)(3)(ii).
[34] See Reg. Section1.6662-4(d)(3)(iv)(B).
[35] T.C. Memo. 1997-135.
[36] T.C. Memo. 1990-15.
[37] In fairness, the staleness comment in the regulations appears to refer only to private letter rulings, technical advice memorandums, general counsel memorandums, and actions on decision. Still, the regulations do refer in general terms to the age of documents, noting that age should be taken into account, along with subsequent developments.

lynchpin. Under Section 130, a qualified assignee has no income upon receipt of an assignment from a defendant, provided that the qualified assignee purchases a qualified funding annuity, and provided that the periodic payments are excludable from the claimant's gross income under Section 104(a)(2). The qualified assignee is the owner of the annuity. It has income when the annuity issuer makes payments under the annuity, and then has a corresponding deduction in the same amount when the payment is received by the claimant. These are the basics of qualified assignments.

The structured settlement industry has adapted to the linkage between Section 130 and Section 104 by using ''nonqualified'' assignments for any case that falls outside Section 104, and thus outside the protection of Section 130. By employing an assignment company that is not subject to tax in the U.S., the industry avoids the mismatch between the one-time assignment from the defendant with its lump sum payment and the corollary stream of payments to the claimant over time. Interestingly, the nonqualified side of the industry is growing tremendously, fueled by the increased usage of structured settlements in employment cases, and in many other non-personal physical injury suits.[38]

How *Murphy* will impact this is not clear. If a payment is not excludable under Section 104(a)(2)—because under *Murphy* the payment is not income at all—then perhaps Section 130 also cannot apply. This is an interesting technical point, and arguably important given the billions of dollars flowing into structured settlement annuities every year. One of the principal effects of *Murphy* will be a re-examination of what is and is not excludable.

Of course, practitioners will not care if it is Section 104 or the Constitution that exempts a settlement or judgment from tax. However, since *Murphy* strikes down Section 104(a)(2) only ''as applied'' to certain cases, it should have no effect on most Section 130 assignments. Traditionally, Section 130 assignments are only for true physical injury tort cases.

The cases in the grey *Murphy* area are now those that are non-wage and non-physical. That would include defamation, intentional and negligent infliction of emotional distress, etc. Today (or at least pre-*Murphy*), such cases are treated by the structured settlement industry as nonqualified, not relying on Section 130.

If the industry were to suddenly start treating all such recoveries as excludable, and use ostensibly ''qualified assignments'' for these cases, then there may be a problem. Of course, it is hard to imagine the structured settlement industry treating all such non-wage, nonphysical injury cases as excludable until some of *Murphy*'s dust settles.

[38] See Wood, *Structured Settlements in Non-Physical Injury Cases: Tax Risks?* Vol. 104, No. 5, *Tax Notes* (Aug. 2, 2004), p. 511.

Even if the industry were to start doing this, I am not convinced that the ''excludable under Section 104(a)(2) versus not gross income at all'' distinction would be drawn by the service, which surely has bigger fish to fry. Yet, it is a risk, and an interesting technical point.

Conclusion: Where Do We Go From Here?

It is not hyperbole to say that *Murphy* is nothing short of amazing. Many tax lawyers are dusting off their copies of the Constitution and starting to refer to constitutional arguments in their pleadings. Except perhaps for state and local tax lawyers who often argue about interstate commerce, nexus, and points of that ilk, constitutional arguments have generally been relegated to tax protesters.

No more. I just made my first constitutional argument in a Tax Court petition, and I have never represented a tax protester. Whether one agrees with the opinion and its reasoning, the D.C. Circuit can hardly be dismissed as flaky. These are three notable circuit court judges, Chief Judge Ginsburg and Judges Rogers and Brown, and they are to be reckoned with.

At this writing, IRS could still petition the D.C. Circuit for a rehearing. Second, IRS can petition the U.S. Supreme Court for certiorari. I suspect that is likely to occur. Despite the constitutional holding in the case, there is no right to appeal, but only a discretionary power in the Supreme Court to take the case or not.

On such a fundamental constitutional question, perhaps the high court will have no choice but to take the case. However, remember the multiple times the Supreme Court refused to resolve the attorneys' fee question, denying certiorari despite a vehement split among the circuits?

Third, IRS could do nothing. Tacticians will readily appreciate that despite the undoubted conviction IRS must have that *Murphy* is overwhelmingly wrong (if not downright blasphemous), the service might not wish to risk a far greater loss in the Supreme Court.

I hope this caution does not prevail. Indeed, until we know whether *Murphy* is the law of the land, this entire area will be thrown into disarray.

Fourth, IRS could acquiesce in the *Murphy* decision and then apply its rationale nationwide. That seems highly, highly unlikely. Finally, whether or not the service attempts to push this case into the Supreme Court, IRS could continue to litigate nonphysical injury cases across the country, seeking appropriate litigation vehicles in other circuits.

From whichever perspective you view *Murphy*, it is epochal. Even if the U.S. Supreme Court hears the case and reverses it, some of its teachings may help generations of taxpayers. Yet many taxpayers (not to mention employment lawyers) are hoping that the Supreme Court will do nothing, or that if the court does take the case, that *Murphy*'s superb lawyering will carry the day a second time.

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