



In “Bombshell” Case, D.C. Appeals Court Says Taxing Emotional Distress Damages Is Unconstitutional

In an August 22, 2006 decision (*Murphy v. Internal Revenue Service*, 2006 U.S. App. LEXIS 21401 (D.C. Cir. 2006)), the D.C. Circuit Court of Appeals held that the 16th Amendment does not permit the federal government to levy income tax on damages awarded for non-physical, work-related injuries. The decision, if upheld, has significant potential consequences for awards and settlements in the field of employment law.

In 1994, Marrita Murphy (née Leveille) filed suit against her former employer, the New York Air National Guard, claiming that it had violated several whistle-blower statutes by “blacklisting” her and providing unfavorable references to prospective employers after she made complaints to state authorities about environmental hazards on a New York Air National Guard airbase. In 1999, she was awarded \$70,000 in compensatory damages for emotional distress and loss of reputation.

Payments for damages are considered income and therefore subject to tax, unless they are awarded “on account of personal physical injuries or physical sickness;” if so, they may be excluded from income under I.R.C. §104(a)(2). Section 104(a)(2) was amended in 1996 to clarify that damages for nonphysical injuries, such as emotional distress, may not be excluded. Murphy included the \$70,000 in her gross income on her 2000 tax return, but subsequently sued for a refund. She made two principal arguments.

First, because her emotional distress had physical manifestations (including teeth grinding, anxiety attacks, shortness of breath, and dizziness), she argued that §104(a)(2) should be interpreted to permit the exclusion of her award. Second, she argued, in the alternative, that 104(a)(2) is unconstitutional because her award should not be considered “income” within the meaning of the 16th Amendment.

The district court rejected Murphy’s arguments and she appealed. The D.C. Circuit Court of Appeals agreed with the lower court that her damages did not fit under 104(a)(2)

because they were not received “on account of physical injuries.” However, the Court of Appeals found that not excluding such an award from income was unconstitutional under the 16th Amendment. The Court relied on historical documents (case law, a House Committee report, and an opinion by the U.S. Attorney General) indicating that such an award would not have been considered income at the time of passage of the Amendment. In addition, the Court noted that the award was not “in lieu of” wages or other taxable income (an analysis taken from *O’Gilvie v. United States*, 519 U.S. 79 (1996)).

The decision, should it stand, would have significant implications for employment judgments and settlements. For example, lawyers for plaintiffs would be likely to seek characterization of damages as compensation for emotional or physical distress, rather than as punitive damages or a replacement for wages. Employers, on the other hand, might try to bargain for smaller settlements.

However, employers outside of the D.C. Circuit should be cautious of attempts by plaintiffs’ counsel to characterize payments as emotional distress damages and therefore not subject to taxation. The decision is only binding in the D.C. Circuit and any reliance on it would be premature. At least two other circuits (the 8th and the 9th) have issued contradictory rulings with respect to the taxability of such awards. Also, the decision may prompt the IRS to subject settlement agreements to a greater level of scrutiny, especially in cases where the plaintiff initially sought, at least in part, the award of back and/or front pay in the demand for relief. Employers outside the D.C. Circuit, therefore, should continue to treat such payments as taxable and should report such payments on a 1099 Form.

Further, the potential consequences of this case indicate that the government is likely to appeal or seek a rehearing in the same court. Because the misallocation of the tax treatment of an award or settlement could subject employers to penalties, such as additional taxes and interest, employers should seek guidance from both employment and tax counsel as this case progresses.

This Advisory is for informational purposes only and is not intended as legal advice. For more information on Hughes Hubbard’s Employment and Tax practices, please contact any of the following attorneys:

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|-----------------------------|-----------------------|-----------------------------------|
| <i>Ned H. Bassen</i> | <i>(212) 837-6090</i> | <i>bassen@hugheshubbard.com</i> |
| <i>Spencer L. Harrison</i> | <i>(212) 837-6858</i> | <i>harrison@hugheshubbard.com</i> |
| <i>Andrew H. Braiterman</i> | <i>(212) 837-6315</i> | <i>braiterm@hugheshubbard.com</i> |
| <i>Jodi E. Divak</i> | <i>(212) 837-6841</i> | <i>divak@hugheshubbard.com</i> |