

Analysis & Perspective

Taxation

Tax Practitioner Wood Offers Top 10 Reasons Why His Favorite Case Is D.C. Circuit's *Murphy*

The U.S. Court of Appeals for the District of Columbia Circuit shocked the tax world Aug. 22 by holding in *Murphy v. IRS* that Section 104 of the Internal Revenue Code is unconstitutional to the extent that it taxes non-wage settlement proceeds for loss of reputation and mental distress, San Francisco attorney Robert W. Wood writes in an exclusive article for BNA.

It is not yet clear if *Murphy* will face scrutiny from the U.S. Supreme Court. But whatever happens in the coming months or years, Wood says that 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," including employment law.

In *Murphy*, a unanimous panel reversed a lower court and held that an Air National Guard employee who successfully sued for emotional distress and injury to her professional reputation stemming from whistleblower retaliation was entitled to a refund of the federal income tax she paid on her \$70,000 compensatory damages award (27 EDR 311, 9/13/06).

In his BNA article, excerpted here, Wood offers 10 reasons *Murphy* is "momentous." They are:

1. *Murphy* confirms that § 104 still has legs.
2. *Murphy* will encourage the IRS to issue § 104 guidance.
3. *Murphy* will cause defendants to re-examine their policies on § 104 and Form 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.

Practical Implications of Ruling. "It is not hyperbole to say that *Murphy* is nothing short of amazing," Wood, who practices with Wood & Porter, says. Many tax lawyers are dusting off their copies of the U.S. Constitution and starting to refer to constitutional arguments in their pleadings, he says. 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 protestors, he adds.

"No more. I just made my first constitutional argument in a Tax Court petition, and I have never represented a tax protestor," Wood says. Whether one agrees with the opinion and its reasoning, the D.C. Circuit panel can hardly be dismissed as flaky, he adds, noting that Chief Judge Douglas H. Ginsburg and Judges Judith W. Rogers and Janice Rogers Brown are "notable" and "to be reckoned with."

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The IRS still can petition the D.C. Circuit for rehearing. It also can petition the Supreme Court for certiorari review, and Wood suspects 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 justices to take the case or not. On such a fundamental constitutional question, perhaps the top court will have no choice but to grant certiorari, he says. He cautions, however, with a reminder of the multiple times the justices refused to resolve the issue of the taxation of attorneys' fees in employment and other cases, denying certiorari despite a split among the circuits.

The IRS also could do nothing, Wood adds. "Tacticians will readily appreciate that despite the undoubted conviction the IRS must have that *Murphy* is overwhelmingly wrong (if not downright blasphemous), the IRS 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," he writes.

The IRS also could acquiesce in the *Murphy* decision and then apply its rationale nationwide but that seems "highly, highly" unlikely, Wood notes. Finally, whether or not the IRS attempts to push the case into the Supreme Court, it could continue to litigate nonphysical injury cases across the country, seeking appropriate litigation vehicles in other circuits.

From whatever perspective you view *Murphy*, "it is epochal," Wood writes. Even if the Supreme Court hears the case and reverses, he says, some of *Murphy*'s 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," he concludes.

Full text of Wood's 8-page BNA article. "Top 10 Reasons *Murphy* Is My Favorite Tax Case," is available at <http://op.bna.com/eg.nsf/r?Open=pdon-6u7t9d>.