Tax-Free Damages: *Murphy*'s Law Opens Floodgates

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (http://www.woodporter.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. Tax Institute 2005 with 2006 update), available at http://www.damageawards.org. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Most tax lawyers only dimly remember constitutional law. I took constitutional law 30 years ago at the University of Chicago, and it was taught by a German, Prof. Gerhard Casper. As he went on to bigger and better things (such as serving as president of Stanford), I wondered why I kept saying ''*Marbury v. Madison*'' with a German accent and, more broadly, just how the U.S. Constitution was relevant to federal income tax. Now I know — at least about the latter point. I just filed a Tax Court petition arguing unconstitutionality for the first time, feeling oddly like Lawrence Tribe.

I was able to file the petition because on August 22, 2006, the U.S. Court of Appeals for the District of Columbia Circuit decided *Marrita Murphy v. IRS*.[1] Whether you read this case with a German accent or not, it is a whopping decision. In many ways, it is a garden-variety tax case, involving a taxpayer who received a recovery (arising out of a whistle-blower action). Marrita Murphy argued that her recovery was excludable, and those arguments usually fail in court. However, they can often be favorably resolved administratively.

In any event, this opinion is momentous both in its interpretation of section 104(a)(2) (the oft-maligned personal physical injury exclusion), and even more so in its interpretation of the Sixteenth Amendment and its correspondingly restrictive view of Congress's power to levy taxes.

In short, this case is a big deal.

Pedestrian Background

This tax case arose out of a whistle-blower case. Murphy alleged that her former employer, the New York Air National Guard, blacklisted her and provided unfavorable references after she complained about environmental hazards. Although her claim was about blacklisting, in an administrative hearing she submitted evidence of mental and physical injuries as a result of the blacklisting. A physician testified that she had ''somatic'' and ''emotional'' injuries. One of those was bruxism (teeth grinding usually associated with stress that can cause permanent tooth damage). The administrative law judge determined that she had other physical manifestations of

[1](No. 05-5139), slip opinion, *Doc 2006-15916, 2006 TNT 163-6* (D.C. Cir. Aug. 22, 2006).

stress too, including anxiety attacks, shortness of breath, and dizziness. The ALJ recommended compensatory damages of $70,000 — $45,000 of which was for ''emotional distress or mental anguish'' and $25,000 for ''injury to professional reputation.''

Significantly, none of her award was for lost wages or diminished earning capacity. Note the exact wording of the awards because, in the subsequent tax case, it was important exactly how the award was worded. The award was affirmed by a Department of Labor Administrative Review Board, so Murphy got her money. She included the entire $70,000 in her 2000 gross income, paying $20,665 in taxes. Later, she filed an amended return claiming that it was excludable from her income. The IRS denied her refund claim, and Murphy sued in district court.

She argued that her recovery was for personal physical injuries, and therefore excludable under section 104(a)(2). Alternatively, she claimed section 104(a)(2) as applied to her award was unconstitutional because the award was not income within the meaning of the Sixteenth Amendment. The IRS raised various objections, and the district court granted summary judgment to the government.[2] Appealing to the D.C. Circuit, Murphy argued both the section 104 point and the constitutional point.

The One-Two Punch

Whatever happens with the subsequent history of the *Murphy* case (more about a U.S. Supreme Court bid later), for years there will be discussion about *Murphy* and its treatment of section 104. Murphy was quite right to argue that section 104(a)(2) could cover her injuries, since bruxism is physical, and since somatic is defined in the dictionary as ''relating to or affecting the body, especially as distinguished from a body part, the mind or the environment.''[3] Cleverly, Murphy also argued that the dental records she submitted showed that the bruxism resulted in permanent damage to her teeth.

The D.C. Circuit addressed both the statutory section 104 argument and the more metaphysical ''what is income?'' question, noting that summary judgment is appropriate only if there is no genuine issue regarding any material fact and if the moving party is entitled to judgment as a matter of law.

Before we discuss how the three-judge panel of the D.C. Circuit treated the statutory and constitutional arguments, it's worth foreshadowing the conclusion. It was easy to tell early on in the opinion which way the wind was blowing. The court seemed sweet on the taxpayer and harsh in its rejections of government contentions. For that matter, although the court came out in favor of the government on the statutory issue, the judges seemed inclined to listen to the taxpayer's physical injury arguments as well. More about the significance of that below.

What is worth reiterating here, particularly to aficionados of procedure, is that the case went to the D.C. Circuit after the government won in the district court on a motion for summary judgment. Because of that, I was expecting (once I tested the wind) for the case to be remanded, and for the summary judgment the IRS had achieved to be vacated. Given that summary judgment is a pretrial motion to obviate trial, I was also expecting the remand to direct the district court to proceed with a trial of the case.

Instead, after concluding that section 104 was unconstitutional, at least as applied to this taxpayer, the appellate court concluded its opinion with:

> We remand this case to the district court to enter an order and judgment instructing the Government to refund the taxes Murphy paid on her award plus applicable interest.[4]

That was surprising, at least to me. Perhaps the explanation lies in the overwhelmingly dispositive nature of a constitutionality finding. The statutory argument (which the district court and court of appeals both resolved in favor of the IRS) falls by the wayside. After all, how can it matter what section 104(a)(2) actually says, when the second holding is that it is unconstitutional as applied to this taxpayer?

Section 104 in the Limelight

Many people may read the *Murphy* case and gloss over the statutory discussion. After all, when you have a howitzer, why worry about a BB gun? Yet, long after the constitutional debate has subsided (and in whatever later courts that constitutional debate takes place), I believe that section 104(a)(2) will still be with us and that we tax advisers will still be interpreting it. That makes the section 104 discussion in *Murphy* the sleeper part of the decision.

Indeed, I would argue that this aspect of the case may in time overshadow the more flamboyant constitutionality holding. The statutory argument is nothing new, although the lawyers in *Murphy* presented it with unusual flare. Basically, Murphy experienced both mental and physical problems. According to the testimony she submitted in her underlying administrative proceeding, her former employer's blacklisting resulted in somatic and emotional injuries. She suffered bruxism, anxiety attacks, shortness of breath, and dizziness.

Persuaded by that evidence, the ALJ awarded her $45,000 for ''emotional distress or mental anguish,'' and $25,000 for ''injury to professional reputation'' due to the blacklisting. Those ALJ findings turned out to be critical to the tax result. I say that because the court stressed that none of her award was for lost wages or diminished earning capacity. That directly fed into the constitutional notion that the amounts were truly not income because they were compensating Murphy for something that was not taxable in the first place (her well-being and reputation).

The wording of the order was also critical from another perspective. Because the ALJ entered the fateful

[2] *Marrita Murphy v. IRS*, 362 F. Supp.2d 206, *Doc 2005-6167*, *2005 TNT 58-5* (D.D.C. 2005).

[3] *See American Heritage Dictionary* (4th Ed. 2000).

[4] Slip op. at p. 24.

phrases ''emotional distress or mental anguish'' and ''injury to professional reputation,'' the argument was foreclosed that section 104(a)(2) applied by its terms. Despite that language, Murphy argued that her award did compensate her for personal physical injuries. There was no question that Murphy's claim was based on tort or tort-type rights in the applicable whistle-blower statutes. The IRS did not challenge the tort or tort-type rights basis, but disputed whether her injuries were physical.

Any student of this area will recall that the Supreme Court laid down a two-part test for excludability in *Commissioner v. Schleier*.[5] Before a taxpayer can exclude compensatory damages from gross income under section 104(a)(2), *Schleier* says he must demonstrate that: (1) the underlying cause of action giving rise to the recovery was based on tort or tort-type rights and (2) the damages were awarded on account of personal physical injuries or physical sickness. The latter element, debated in *Murphy*, may not be the linchpin of the case in light of its unconstitutionality holding. Despite that, it is vitally important.

Getting Physical?

Just what *is* physical injury, anyway? The IRS has not been speedy in writing regulations to define it. We all know the statute was changed in 1996 to require *physical* injury or physical sickness, rather than merely *personal* injury or sickness. We also all know that administratively (in private letter rulings, for example), the IRS has suggested its view that the injury must be visible.[6] One can see broken bones and bruising, but many injuries or illnesses are not apparent to the naked eye. (Of course, I'm not even sure the naked eye is all that matters here; maybe ''observable'' would include viewing it with a microscope?)

For 10 years now, taxpayers have grappled in the dark with the question of which injuries are physical and which are not.[7] Are ulcers? The *Vincent*[8] case suggests that ulcers are indeed physical, although Nancy Vincent did not qualify for an exclusion because the Tax Court concluded that the jury in her underlying case was never asked to consider her physical problems. Thus, quite literally, the *Vincent* jury is still out on the ulcer question.

What about migraines, cluster headaches, or strokes? The oft-quoted legislative history to the 1996 act states that mere symptoms of emotional distress do not constitute physical injuries. The cited examples include headaches, stomachaches, and insomnia.[9] The famous footnote enumerating those three items was allegedly written by House Ways and Means Committee staffer Tim Hanford, now a Washington lobbyist. Hanford says that he believes the list was not meant to be exclusive.

But even for the items on the list, exactly what is a stomachache? Does a bleeding ulcer qualify, or is it, despite its physical situs, beyond a mere stomachache, and therefore more than a symptom of emotional distress? If headaches are not sufficient to constitute physical injuries, what about cluster headaches or migraines? What about an aneurysm? Questions of degree abound.

Murphy argued cogently that the legislative history to the 1996 change surely attempts to separate transitory symptoms from serious and permanent physical injuries and physical sickness. Hers were not comparatively minor, transitory symptoms of emotional distress like headaches, upset stomach, and sleeplessness.

That broaches the territory of one of the great unspoken phrases of the tax law: physical sickness. 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.[10] If one cannot draw a bright line between physical injuries on one hand and mere symptoms of emotional distress on the other, I submit that the grains of sand are even more intermingled when it comes to physical sickness and symptoms of emotional distress. However, section 104(a)(2) — whether it is constitutional or not — clearly excludes from income damages for physical sickness.

If the IRS will not define the term ''physical'' in regulations (as so far it doesn't seem inclined to do), then should taxpayers be able to resort to a dictionary? Murphy thought so.[11] She pointed 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 the IRS, proving that she had suffered permanent damage to her teeth. Are those not physical?

The word ''physical'' comes from medieval Latin and was first recorded in English in the 14th century.[12] It means bodily or corporeal, as distinguished from spiritual.[13] Synonyms for physical include carnal, corporal,

---

[5]515 U.S. 323, *Doc 95-5972, 95 TNT 116-8* (1995).

[6]*See* LTR 200041022, *Doc 2000-26382, 2000 TNT 201-10*. *See also* Wood, ''The Case for Excluding Discrimination, Harassment Recoveries Under Section 104,'' 78 *Daily Tax Report* (BNA) (Apr. 25, 2005), p. J-1.

[7]*See* Wood, ''Post-1996 Act Section 104 Cases: Where Are We Eight Years Later,'' *Tax Notes*, Oct. 4, 2004, p. 68. *See also* Wood, ''Damage Awards: Sickness, Causation, and More,'' *Tax Notes,* June 12, 2006, p. 1233.

[8]*See Vincent v. Commissioner*, T.C. Memo. 2005-95, *Doc 2005-9343*, *2005 TNT 85-6*. *See also* Wood, ''Ulcers and the Physical Injury/Physical Sickness Exclusion,'' *Tax Notes,* June 20, 2005, p. 1529.

[9]*See* Conference Committee Report 104-737, p. 300.

[10]*See* Wood, ''Physical Sickness and the Section 104 Exclusion,'' *Tax Notes,* Jan. 3, 2005, p. 121.

[11]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.

[12]*See* Adrian Room, *Cassell's Dictionary of Word Histories*, p. 462, (Cassell 2002).

[13]*Id.*

corporeal, material, and somatic.[14] Quite apart from rudimentary sources like a dictionary, what about nontax 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* considered physical injuries or physical sickness. Those aren't tax cases, of course, but they are cases in which the physical manifestations of emotional distress were regarded as physical injuries. For example, in *Walters v. Mintec/International*[15] 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 for damages to be available.

Although admittedly not occurring in the context of an income tax dispute, the *Walters* case squarely presents the question of 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.[16]

Murphy relied on another nontax case, *Payne v. General Motors Corp*,[17] involving an employee who sued an employer under Title VII of the Civil Rights Act of 1964 and section 1981 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 those nontax cases, Murphy argued that neither section 104 nor its regulations limit the physical injury exclusion to an injury occurring by physical stimulus. In fact, Murphy understandably pointed out that the Treasury regulations under section 104 track the pre-1996 version of section 104, before the "physical" modifier was added. The D.C. Circuit stops short of criticizing the IRS for failing to change its regulations 10 years after the statute was amended.

More than a few readers of *Murphy* will discern that the appellate court was none too happy with the IRS or the Treasury Department, let alone with Congress. Nevertheless, the court acknowledged that the old section 104 regulations and the current 1996 act version 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 the IRS, the court said the statute controlled.

The 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. The IRS argued that Murphy had to demonstrate that she was awarded her damages "because of" her physical injuries. The IRS claimed that she did not do that, and in fact, that the ALJ finding had been expressly to the contrary. Again, here is where language truly matters. It was of no moment, said the IRS, that Murphy suffered from bruxism or other physical manifestations of stress.

After all, the labor board ruling was quite explicit that her damages were expressly for "mental pain and anguish" and "injury to professional reputation." Those, said the IRS, are nonphysical injuries. Ultimately, the D.C. Circuit agreed with the government that Murphy failed to carry her burden on that point. Although Murphy argued valiantly 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) does not permit Murphy to exclude her award from her gross income.

'On Account Of' Haiku

Before turning to the constitutional argument that is the headliner of this case, it is worth examining what the "on account of" relationship suggests. If the ALJ order had in fact mentioned bruxism (or the other physical symptoms) as the reason for an award, would not Murphy have satisfied the "on account of" test? I think so.

Moreover, given that the vast majority of cases do not go to a verdict or administrative ruling, but rather are settled, what does that suggest about the settlement process? In most cases, there is an explicit allocation among various amounts paid by a defendant to a plaintiff. In a whistle-blower case, there might be wage and nonwage categories. Although the 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 nonwage recoveries even if there is a wage element in the case.

Further, this case may portend a more thorough application of the "on account of" enigma. What if the evidence showed that the ALJ 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"?

---

[14] *See* Ehrlich, *The Highly Selective Thesaurus for the Extraordinarily Literate*, p. 124 (Harper 1994).

[15] 758 F.2d 73 (3d Cir. 1985).

[16] *See Restatement (2d) 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.

[17] 731 F. Supp. 1465, 1474-1475 (D. Kan. 1990).

My point is that the award for emotional distress and the 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 the physical injury and the emotional distress truly are the same thing. It was clear long before *Murphy* that the wording of the court order (or here, the administrative order) was crucial.

Since the court in *Murphy* ultimately concluded (almost reluctantly) that Murphy did not carry her burden of showing that her recovery really was ''on account of'' the 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. The IRS has long taken the position that it is not bound by characterizations in court orders or settlement agreements.[18] Surely that rule should work both ways.

Before turning to the U.S. Constitution, let's belabor the ''on account of'' link, for much depends on those three little words. In fact, I believe they will continue to be important, despite the current constitutional hiatus *Murphy* has imposed. The starting point must be section 104 itself, which excludes ''damages . . . received . . . on account of personal physical injuries or physical sickness.'' The relevant nexus is between the damages received and the injury; the statute does not require a relationship between the tortious act and physical injuries or sickness for which damages are received. The ''on account of'' language originates from a statute enacted in 1918,[19] and the same language appeared in the 1939, 1954, and 1986 codes.

In 1996 Congress amended section 104(a)(2) to exclude punitive damages from the statute and to require that the personal injury or sickness be physical. Significantly, the 1996 amendments did not alter the ''on account of'' language. According to the legislative history:

> If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) *that flow therefrom* are treated as payments received on account of physical injury or physical sickness *whether or not the recipient of the damages is the injured party*. (Emphasis added.)[20]

There are two crucial points here. First, the relevant ''on account of'' nexus is between damages and a physical injury or sickness (that is, all damages that ''flow therefrom''). The action must have its *origin* in a physical injury or sickness, but there need not be any causal nexus between the tort and the injury.

Second, the recipient need not be the one who suffers physical injuries. A payment can be ''on account of'' physical injury or sickness even if the plaintiff is not injured, but recovers on behalf of an injured party (for example, recoveries for loss of consortium).

The Supreme Court analyzed the ''on account of'' language in three decisions over the last 15 years: *United States v. Burke*,[21] *Schleier*,[22] and *O'Gilvie v. United States*,[23] although the *Murphy* court addressed only *O'Gilvie*. In *Burke*, the Court ruled that section 104(a)(2) is not satisfied when the underlying claim does not provide for tort-like remedies (that is, a broad range of damages, including for pain, suffering, and emotional distress). In *Schleier*, the Court said that to fall within section 104(a)(2), each item of damages must be proximately connected to the physical injury. The *Schleier* Court used the direct-connection approach, demonstrably stopping short of proximate cause between the cause of action and the damages.[24] The relevant nexus is between recovery and injury, *not* between tortious act and injury.

In *O'Gilvie*, the issue was whether punitive damages were received ''on account of'' a personal injury. The Court adopts a stringent ''on account of'' standard, holding that ''on account of'' requires that damages be awarded ''by reason of, or because of'' the personal injury.[25] The *O'Gilvie* Court noted that the original aim of the statute was to exclude damages intended to substitute for physical or personal well-being — ''personal assets that the Government does not tax and would not have taxed had the victim not lost them.''[26] Applying that reasoning, the Court found that punitive damages were not received ''on account of'' personal injury or sickness because they do not compensate for any type of loss.

Other courts have applied *O'Gilvie* to require a causal connection between the injury and the damages (not between the tortious act and the injury). For example, in *Barnes v. Commissioner*[27] the court held that ''on account of'' requires a ''strong causal connection'' between the injury and the damages. In *Brabson v. United States*,[28] the Tenth Circuit held that ''on account of'' requires ''a direct link between the injury and the remedial relief.''[29] In *Fabry v. Commissioner*,[30] the Eleventh Circuit ruled that ''on account of'' requires a ''direct causal link'' between the elements of the tort and the elements of damages.[31]

Even the IRS has sometimes agreed, although it has had trouble maintaining consistency. In LTR 200121031, a taxpayer was awarded damages for her husband's death from a ''physical disease'' — lung cancer associated with

---

[18] *See Robinson v. Commissioner*, 102 T.C. 116, *Doc 94-1439, 94 TNT 23-18* (1994), *aff'd in part, rev'd in part*, 70 F.3d 34, *Doc 95-10932, 95 TNT 238-7* (5th Cir. 1995); *McKay v. Commissioner*, 102 T.C. 465, *Doc 94-3399, 94 TNT 60-9* (1994), *vacated on other grounds*, 84 F.3d 433, *Doc 96-13888, 96 TNT 92-7* (5th Cir. 1996); *Brown v. United States*, 890 F.2d 1329, 1342 (5th Cir. 1989).

[19] *See* Revenue Act of 1918, ch. 18, section 213(b)(6).

[20] H.R. Conf. Rep. No. 104-737, at 300 (1996).

[21] 112 S.Ct. 1867 (1992).

[22] *Supra* note 5.

[23] 519 U.S. 79, *Doc 96-31894, 96 TNT 240-1* (1996).

[24] *Schleier*, 515 U.S. at 330.

[25] *O'Gilvie*, 519 U.S. at 454.

[26] *Id.* at 456.

[27] T.C. Memo. 1997-25, *Doc 97-1505, 97 TNT 11-13*.

[28] 73 F.3d 1040, *Doc 96-3551, 96 TNT 25-24* (10th Cir. 1996).

[29] *Id.* at 1047.

[30] 223 F.3d 1261, 1270, *Doc 2000-21891, 2000 TNT 164-4* (11th Cir. 2000).

[31] *See also Gregg v. Commissioner,* T.C. Memo. 1999-10, *Doc 1999-3623, 1999 TNT 15-7* (holding that ''on account of'' requires damages be paid by reason of a personal injury or sickness); *Thompson v. Commissioner*, T.C. Memo. 1998-214, *Doc 98-19631, 98 TNT 117-8* (''The question is for what was the amount paid.'').

the husband's inhalation of asbestos. Allowing the wife to exclude the recovery from asbestos manufacturers under section 104(a)(2), the IRS reasoned that the husband contracted a physical disease from exposure to asbestos and that the ''diseases were the proximate cause of the *circumstances* giving rise to'' the taxpayer's claims. The IRS ruled: ''Because there exists a direct link between the *physical injury suffered* and the *damages recovered*, Taxpayer may exclude from gross income any economic damages compensating for such injury.''[32]

Returning to *Murphy*, what does ''on account of'' mean? The phrase continues to have a Kafkaesque quality, and given its manifest importance, that itself is troubling. The *Murphy* court says *O'Gilvie* makes the exclusion available only for personal injury damages awarded by reason of, or because of, the personal injuries. However, the court again cites *O'Gilvie* for the notion that something stronger than but-for causation is required.

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

Constitutional Argument

Having concluded that section 104 did not allow Murphy to exclude her damages from income, the D.C. Circuit went on to address whether that is constitutional. That's a curious turn of events because section 104(a)(2) is manifestly an exclusionary provision. Is it the constitutionality of section 104 or of section 61 that the court is evaluating? The court invariably refers to section 104(a)(2), but more than a few technicians will doubtless wonder whether the more appropriate attack would have been on section 61.

Those niceties aside, the attack is a powerful one in both its verbiage and in its historical moment. Plus, not too many tax decisions cite those hoary and hallowed decisions of yore. The D.C. Circuit refers to *Helvering v. Clifford*,[33] which held that the word ''incomes'' in the Sixteenth Amendment and the phrase ''gross income'' in section 61(a) are coextensive. From there, the court goes on to construct the statute, as the Supreme Court did in *Eisner v. Macomber*.[34]

Speaking of *Eisner* takes me back to my first tax class,[35] and I suspect many other tax lawyers have a similar memory. In *Eisner* (no, not Michael Eisner, but generations earlier), the Supreme Court held that the taxing power extended to any ''gain derived from capital, from labor, or from both combined.'' Refining that concept in *Commissioner v. Glenshaw Glass Co.*,[36] the Supreme Court said that Congress was able to tax all gains or accessions to wealth.

In addition to asking what constitutes ''physical'' injuries, or what ''on account of'' means, we also have to ask just what is a gain? What is an accession to wealth? Tax advisers rarely consider such esoterica. I know I don't.

Plucky Ms. Murphy, however, argued that restorations of capital are not income. Accordingly, she argued that her damage award for personal injuries, including nonphysical injuries, was simply not income but rather a restoration of capital — human capital, that is. For that proposition, Murphy cited — as did the D.C. Circuit — Nobel Laureate Gary Becker.[37] Murphy argued that the concept of human capital was read into the IRC by the Supreme Court in *Glenshaw Glass*.

That's a mouthful, but there it is. Bear in mind that *Glenshaw Glass* was a case in which the Supreme Court sought to determine the tax treatment of punitive damages. Not only that, but *Glenshaw Glass* was a case in which the Court said the damages *were* taxable. As you chew on that, note that the court in *Murphy* quotes from the *Glenshaw Glass* opinion:

> The long history of . . . holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property . . . damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.[38]

Murphy argued that the Supreme Court in *Glenshaw Glass* made clear that a recovery of compensatory damages for a personal injury — of whatever type — is analogous to a return of capital and therefore is not income under the code or the Sixteenth Amendment. (Another more unadorned reading of *Glenshaw Glass* might have been that ''punitive damages *are* income.'')

In any event, historical analysis then blossomed. Murphy went on to argue that the code was drafted shortly after the 1913 passage of the Sixteenth Amendment. Murphy focused on three sources that the Supreme Court quoted 80 years later in *O'Gilvie*. It is worth repeating those sources because Murphy's argument — accepted by the D.C. Circuit — was that those timely musings indicated the contemporaneous common understanding of the word ''income.'' This is fundamental stuff.

Pages of History

First, in an opinion rendered to the secretary of Treasury on whether proceeds from an accident insurance policy were income (under the code as it existed before the 1918 act), the attorney general stated:

---

[32]LTR 200121031, *Doc 2001-15011, 2001 TNT 103-10* (emphasis added).

[33]309 U.S. 331 (1940).

[34]252 U.S. 189 (1920).

[35]That was in 1976, with the University of Chicago's Walter J. Blum, who inspired me to become a tax lawyer.

[36]348 U.S. 426 (1955).

[37]*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).

[38]*See Glenshaw Glass*, 348 U.S. at 432, note 8.

> Without affirming that the human body is in a technical sense the ''capital'' invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore ''capital'' as distinguished from ''income'' receipts.[39]

Not long thereafter, Treasury reasoned in a revenue ruling that:

> Upon similar principles . . . an amount received by an individual as the result of a suit or compromise for personal injuries sustained . . . through accident is not income [that is] taxable.[40]

The third quote came from the House report on what became the Revenue Act of 1918:

> Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income.[41]

When Congress passed the Revenue Act of 1918, it included a provision to exclude from gross income ''amounts received, through accident or health insurance or under workman's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.''[42]

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. She noted that in *Dotson v. United States*,[43] the court concluded (on the basis of that House report) that ''Congress first enacted the personal injury compensation exclusion . . . when such payments were considered the return of human capital, and thus not constitutionally taxable 'income' under the 16th amendment.''[44]

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

It is easy to imagine IRS (and Justice Department) blood boiling over the mere mention of those arguments, let alone imagine that a court would take them seriously. After all, how many Supreme Court cases have upheld the taxation of nonwage recoveries? Wasn't that all vetted many times over the years, most recently when Congress amended section 104 to explicitly tax nonphysical injuries? Surely Congress had the power to do that, didn't it?

With considerable verve, the government advanced many arguments, some general and some specific, about why Murphy's constitutional argument should fail. Despite that valiant effort, the court rejected every government argument. The government (understandably) argued that there is a presumption that Congress enacts laws within its constitutional limits.[45] It argued that as recently as *Commissioner v. Banks*,[46] the Supreme Court underscored Congress's power to tax income, affirming that the power ''extends broadly to all economic gains.''[47] That Congress historically chose in its discretion (and maybe even generosity) to exclude some personal injury recoveries did not mean that the Sixteenth Amendment mandated that exclusion, the government noted.

Indeed — although that argument plainly did not play well to the D.C. Circuit — the IRS stated flatly that Congress could repeal section 104 *entirely*, and that doing so would plainly not violate the Sixteenth Amendment! Taking issue with Murphy's ''human capital'' theory, the IRS even attempted to explain the corollary concept of ''financial capital,'' citing concepts such as basis under section 1012, how one adjusts basis, and so forth. That got messy and inelegant.

The IRS argued that people do not pay cash or cash equivalents to acquire their own well-being, so they have no basis in it. When they have gain or loss on the realization of compensatory damages, that means they have no basis on which to calculate that gain or loss. Those arguments somehow did the government more harm than good here.

All Things Great and Small

Just as Murphy made some obscure points (like footnote 8 in the *Glenshaw Glass* opinion), the government found itself relying on dicta from the Ninth Circuit opinion in *Roemer v. Commissioner*.[48] In *Roemer*, a defamation recovery was held excludable under the old version of section 104. The dicta relied on by the government in *Murphy* suggests that since there is no tax basis in a person's health and personal interests, money received for an injury to those interests might be considered a realized accession to wealth.[49] Maybe relying on that obscurity was a mistake.

In any event, nothing went well for the government in this case. After lining up the arguments, the D.C. Circuit flatly said, ''we reject the government's breathtakingly expansive claim of congressional power under the Sixteenth Amendment.''[50] Take that!

The D.C. Circuit then went on to say that when the Sixteenth Amendment was drafted, the word ''incomes''

---

[39]31 Op. Att'y Gen. 304, 308 (1918).
[40]T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).
[41]H.R. Rep. No. 65-767, at 9-10 (1918).
[42]40 Stat. 1057, 1066 (1919), enacting section 213(b)(6).
[43]87 F.3d 682, *Doc 96-20921*, *96 TNT 144-9* (5th Cir. 1996).
[44]*Id.* at 685.
[45]*See Rust v. Sullivan*, 500 U.S. 173 (1991).
[46]543 U.S. 426, *Doc 2005-1418, 2005 TNT 15-10* (2005).
[47]*See Banks,* 543 U.S. at 433.
[48]716 F.2d 693 (1983).
[49]*See Roemer*, 716 F.2d at 696 n.2.
[50]Slip op. at 5.

had well-understood limits. A return of capital is just not income.[51] Turning away from the return of capital point, the circuit court then said that the question in this case was not about return of capital — ''except insofar as Murphy analogizes human capital to physical or financial capital.''[52] The question, said the D.C. Circuit, is fundamental: Was the compensation she received for her injuries income?

In an appropriate attempt at harmonization among the circuits, the *Murphy* court launched its ''is it income?'' analysis by saying, ''We join our sister circuits by asking: 'in lieu of what were the damages awarded?'''[53] For that fundamental query, the court cites *Raytheon Products Corp. v. Commissioner*[54] and other cases. Finding significant support for the ''in lieu of'' test in case law (referring to both *O'Gilvie* and *Glenshaw Glass*), the court said that if Murphy received the money in lieu of something that is normally untaxed, her compensation is not income under the Sixteenth Amendment.

Simply and elegantly, the court then said that the record was clear that the damages Murphy received were to make her emotionally and reputationally whole, not to compensate her for lost wages or taxable earnings of any kind. Her emotional well-being and good reputation — before they were diminished by her former employer — were not taxable as income. Therefore, said the court, the compensation she received in lieu of what she lost cannot be considered income.

Showing a moment of reticence, the circuit court proffered that ''it would appear'' that the Sixteenth Amendment does not empower Congress to tax Murphy's award. However, the court noted that ''our conclusion at this point is tentative because the Supreme Court has also instructed that, in defining 'incomes,' we should rely on 'the commonly understood meaning of the term which must have been in the minds of the people when they adopted the 16th Amendment.'''[55] Citing from *Myers v. United States*,[56] and again from *Eisner v. Macomber*,[57] the court went on to discuss the Revenue Act of 1918, and generally agreed with Murphy's view of the more or less contemporaneous writings suggesting that the term ''incomes'' as used in the Sixteenth Amendment does not extend to moneys received 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 Sixteenth Amendment was adopted. That fact supported the view that compensation for those 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 Sixteenth Amendment, nor by the state legislatures that ratified it. By 1913, 39 of the then 48 states and the District of Columbia included the concept in their tort law that compensatory damages for ''mental suffering'' were recoverable in the same manner as compensatory damages for physical harms.

Moreover, in 34 of those states, there were reported cases involving defamation and other reputational injuries. The *Murphy* court dropped a four-page footnote string citing state law cases to prove it. On top of that, in at least five other states, an action for alienation of affections (also a nonphysical injury) was allowed. All in all, the court found no meaningful distinction between Murphy's award and the kinds of damages recoverable for personal injury when the Sixteenth Amendment was adopted. Completing its argument, the court said:

> Because, as we have seen, the term ''incomes,'' as understood in 1913, clearly did not include damages received in compensation for a physical personal injury, we infer that it likewise did not include damages received for a nonphysical injury and unrelated to lost wages or earning capacity.[58]

The court referred to early IRS authority making clear that the Service (then) drew no distinction between nonphysical and physical personal injuries. Concluding that compensation for loss of personal attributes is not received in lieu of income, and that the framers of the Sixteenth Amendment would not have understood compensation for a personal injury — including a nonphysical injury — to be income, the court was done:

> 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.[59]

As noted above, the *Murphy* court does not remand the case to district court for trial, but rather directs the district court to issue an order and judgment instructing the government to refund Murphy's taxes, plus interest. In the same paragraph, the court quotes Albert Einstein saying that ''the hardest thing in the world to understand is the income tax,''[60] but the court says plainly that ''it is not hard to understand that not all receipts of money are income.''[61] Deftly, the D.C. Circuit just wiped away volumes of tax case law and decades of jurisprudence, and dramatically threw into disarray the post-1996 law of section 104.

Where to From Here?

It is not hyperbole to say that *Murphy* is nothing short of amazing. Many tax lawyers (myself included, I confess) are dusting off their copies of the Constitution and referring to constitutional arguments in their pleadings. Except perhaps for state and local tax lawyers who argue about sales tax, nexus, and points of that ilk, constitutional arguments have generally been relegated to tax

---

[51] *See Doyle*, 247 U.S. at 187; *Southern Pacific Company*, 247 U.S. at 335.

[52] Slip op. at p. 16.

[53] *Id.*

[54] 144 F.2d 110 (1st Cir. 1944).

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

[56] 272 U.S. 52 (1926).

[57] 252 U.S. 189 (1920).

[58] Slip op. at 22-23.

[59] Slip op. at 23.

[60] *See id.* at 24, *quoting The Macmillan Book of Business and Economic Quotations* 195 (Michael Jackman ed., 1984).

[61] Slip op. at 24.

protesters. No more. As I noted at the outset, I just made my first constitutional argument in a Tax Court petition, and I have never represented a tax protester.

Whether or not one agrees with the opinion and its reasoning, the D.C. Circuit can hardly be dismissed as flaky. The three judges on the *Murphy* panel are notable circuit court judges — Chief Judge Douglas H. Ginsburg plus Judges Judith Ann Wilson Rogers and Janice Rogers Brown — and they are to be reckoned with. But exactly how will they be reckoned with? The IRS has multiple choices.

It can petition the D.C. Circuit for a rehearing. I would suppose that would be done here, although I somehow doubt that a rehearing, even if requested and granted, is likely to result in a sea change. Court watchers may have statistics on the number of times a case is reversed in a rehearing. This case is of such enormous impact that the oddsmakers may start to weigh in.

Second, the 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. Again, there will be oddsmakers and statistics. Maybe on such a fundamental constitutional question the High Court will have no choice.

But remember the multiple times the Supreme Court refused to resolve the attorney fee question, denying certiorari despite a vehement split among the circuits? Like Julius Caesar, who, according to Mark Anthony's funeral oration, thrice refused a kingly crown, the High Court kept denying certiorari before it finally took on *Banks*.[62] If the IRS seeks certiorari, as I hope it will, it is possible the Supreme Court will step sideways. (Incidentally, look what ended up happening to Caesar.)

Third, the IRS could do nothing. 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 that 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, the IRS could acquiesce in the *Murphy* decision and then apply its rationale nationwide. That seems as unlikely as Bob Dole marrying Britney Spears. Finally, whether or not the IRS attempts to push this case into the Supreme Court, the Service could continue to litigate nonphysical injury cases across the country, seeking appropriate litigation vehicles in other circuits. That seems likely.

Categories of Cases to Which This Will Apply

Leaving aside the situs questions *Murphy* raises about the reach of a D.C. Circuit case across the country, although we'll return to that topic shortly, what kinds of cases may be affected by *Murphy*? In addition to whistleblower cases that do not involve wages (similar to the *Murphy* fact pattern), I suggest that the following types of cases may be affected:

- defamation;
- intentional and negligent infliction of emotional distress;
- false imprisonment;
- malicious prosecution; and
- invasion of privacy.

Of course, there may be many others. The $64,000 question may be *Murphy's* effect on employment cases. The IRS may argue that *Murphy* should apply only to cases not arising in the employment context (that is, cases in which there are no wages). However, that seems difficult to argue.

After all, *Murphy* did *arise* in the employment context. Whether or not Murphy received an award attributable to wages, the rest of the decision should not be affected. Although one might argue that the wage vs. nonwage dichotomy might lead to abuses, with taxpayers having even greater reasons to push an allocation further away from wages, that dichotomy has always existed.

Short Circuit?

In the D.C. Circuit, *Murphy* now represents the law of the land. I believe that means the IRS is bound by the decision until someone says otherwise. 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 unmarred by the decision) cannot now be used by the IRS to contradict the *Murphy* holding. Plainly, taxpayers in the D.C. Circuit are not going to report their emotional distress and other nonwage and nonphysical injury settlements. That means taxpayers in the D.C. Circuit will be back to pre-1996 act law, when section 104(a)(2) did not use the word ''physical.''

Moreover, that will occur not only from the August 22, 2006, date of *Murphy*, but retroactively for taxpayers who settled their cases earlier in 2006 or, indeed, in 2005, 2004, and 2003. For some taxpayers, 2002 will still be open. Some taxpayers will file amended returns. From first-hand experience, I can tell you that taxpayers are already planning those maneuvers.

Can taxpayers 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 before the applicable statute. But perhaps someone will think of a way to do even that.

Although I see the reach of *Murphy* as quite far, there may be differences of opinion about the ''nonwage'' linchpin of the case. *Murphy* did arise in an employment context, even though no wages were awarded. As noted above, I don't see an appropriate line being drawn

[62]The Supreme Court denied certiorari five times before *Banks*. *See O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963); *Benci-Woodward v. Commissioner*, 219 F.3d 941, *Doc 2000-20007*, *2000 TNT 144-8* (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766*, *2000 TNT 117-9* (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455*, *2001 TNT 247-75* (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002).

between nonemployment cases on one hand (such as defamation cases, false imprisonment, intentional or negligent infliction of emotional distress, and so on) and employment cases on the other.

It is a foregone conclusion that the reasoning of *Murphy* does not apply to wage recoveries. But, in a case in which someone recovers $200,000 in wages and $300,000 in nonwage 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 the allocation between wage and nonwage, but that strikes me as the only ground for debate. Of course, the wage vs. nonwage issue has always been there. It will surely remain present.

Murphy's nonwage 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's a reversal of the position that exists regarding attorney fees, in which the new above-the-line deduction in employment cases makes employment cases taxed more favorably than nonemployment ones (when it comes to attorney fees).[63] Given that the vast majority of cases settle, and it is a rare employment case in which all amounts are treated as wages, *Murphy* will surely affect many employment cases.

The effect of Tax Court Rule 143 may also 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 Court for the District of Columbia.[64] Before you get too excited, the "D.C. trumps the rest of the U.S." rule is limited to the rules of evidence and does not extend 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 tax cases in any other circuit. If you are a taxpayer and, like most taxpayers, your court of choice is the Tax Court (where, notably, you don't have to pay your tax before you dispute it), you may agree. Yet, it seems unlikely that anything in the *Murphy* case can be made out to be a ruling on evidence.

Still, it is a ruling of an important circuit court — not an allegedly wacko one, as some have labeled the Ninth Circuit, or an allegedly agrarian one, as some have labeled the Tenth. The D.C. Circuit is right up there with the Second Circuit, the former home of Learned Hand, whose ruminations on tax law still feature prominently in tax jurisprudence, particularly in tax shelter litigation and other economic substance debates.

[63]*See* Wood, "Will the IRS Pursue Attorney Fees Post-*Banks*?" *Tax Notes*, July 18, 2005, p. 319. *See also* Wood, "Supreme Court Attorney Fee Decision Leaves Much Unresolved," *Tax Notes*, Feb. 14, 2005, p. 792.

[64]*See* section 7453.

Other Circuits

The presence of a split in the circuits on those issues is daunting. Many litigators and tax practitioners will remember the split in the circuits on attorney fee issues that existed before the Supreme Court decided *Banks* in 2005.[65] A split in the circuits tends to encourage manipulative behavior, although it is certainly understandable why it does.

Will taxpayers attempt to somehow import D.C. Circuit law to their cases in other states and other circuits? Will taxpayers actually move to the D.C. Circuit? To take advantage of the circuit's law, must they move before their case is resolved, before they receive the money, or only in time to file their Tax Court petition (if they even have to fight about it)?[66] Tax procedure aficionados will start thinking about the *Golsen*[67] rule, which indicates the applicable law when a Tax Court case is filed.

That I am raising those questions does not mean I have all the answers. I am not even certain those are all the right questions. Taxpayers and practitioners will be scrambling. Moreover, the far larger and more amorphous questions concern *Murphy's* effect 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 its sister circuits. Will the IRS treat *Murphy* as substantial authority throughout the United States? Whether the answer to that question is yes or no, many taxpayers will doubtlessly adopt the view of the *Murphy* court. Whether they are in Kansas or California, Louisiana or Maine, many, I imagine, will take the position that a nonphysical injury recovery (for emotional distress, defamation, and so forth) is simply not income.

Is *Murphy* Substantial Authority?

Given that many taxpayers may take filing positions based on *Murphy* (new filing and amended filing), it is appropriate to question whether the IRS could impose penalties on taxpayers should those 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.[68] Just what is and what is not substantial authority isn't always clear. The regulations tell us that the weight of authorities supporting the tax treatment claimed must be

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

[66]*See* Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies," *BNA Employment Discrimination Report* (May 21, 2003), vol. 21, no. 1, p. 701.

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

[68]*See* reg. section 1.6662-4(d)(2).

''substantial'' in relation to the authorities' supporting contrary positions.[69] That sounds circular. If it is substantial, then it's substantial?

The weight of an authority depends on its relevance, its persuasiveness, and the type of document providing the authority. The regulations mention revenue rulings, private letter rulings, technical advice memorandums, and so on. Age is relevant too, and some documents more than 10 years old are generally given very little weight.[70] That's a curious reference point, although surely it is not meant to suggest that recent authority 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.[71] I take that to mean that 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're relying on *Murphy* even though you live in the Ninth Circuit — that doesn't necessarily mean you do not have substantial authority.

In *Wise v. Commissioner*,[72] the Tax Court (interpreting former reg. section 1.6661-3(b)(1), the predecessor to reg. section 1.6662-4(d)(3)) held that the taxpayer's reliance on a single Eleventh Circuit case supporting his position was substantial authority, even though the 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*,[73] the Tax Court found substantial authority (again, declining to impose the former section 6661 penalty) when 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 are apparently golden. 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),[74] how persuasive its logic is, just how much other adverse authority there is that contradicts it, and so forth. From what I can tell so far (although I stress I've not yet made a study of this point), a case like *Murphy* has little to contradict it. If I'm right, that 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.

Company Reactions

It is not only plaintiffs who will react. Plaintiffs' lawyers are already attempting to educate themselves and their clients about what this will mean. There will be many misguided efforts and a great deal of misinformation. Corporate America must also respond. Corporate defendants will face requests to not issue IRS Forms 1099 for nonwage settlements. If a payment is excludable under section 104, it should not be the subject of a Form 1099.[75] Taxpayers know that. Plaintiffs' lawyers know that. Defendants know that.

True, there are often debates at settlement time, and there are often mistakes made and blood spilled over Form 1099 issues. However, when the lawyers involved in settling a case consider the issue at settlement time, those issues usually get worked out. In my experience, there is 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, that leads to equitable results.

How that will change with *Murphy* I don't know. Plaintiffs will become much more aggressive, and defendants must know how to respond. In the D.C. Circuit, that may be easy. Elsewhere, it will not be.

Settle Your Case!

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 not have faced a tax dispute. A fight avoided is often a fight won.

Of course, *Murphy* was also 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 cannot be gainsaid. Just look at the mutual fund and brokerage industry settlements[76] and, more recently, Boeing's settlement tax antics.[77]

Everyone knows — or should know — that the time to address those issues is *before* settlement documents are signed. I am convinced that, quite apart from litigation risks, concerns about publicity, the high cost of lawyers'

---

[69] *Id.*

[70] Reg. section 1.6662-4(d)(3)(ii).

[71] *See* reg. section 1.6662-4(d)(3)(iv)(B).

[72] T.C. Memo. 1997-135, *Doc 97-7584, 97 TNT 52-12*.

[73] T.C. Memo. 1990-15.

[74] In fairness, the staleness comment in the regulations appears to refer only to private letter rulings, TAMs, 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.

[75] *See* Instructions to IRS Form 1099-MISC. Regarding attorney fees, see also the recently issued attorney payee regulations, T.D. 9270 (July 12, 2006).

[76] *See* Wood, ''Should the Securities Industry Settlement Be Deductible?'' *Tax Notes*, Apr. 7, 2003, p. 101.

[77] *See* Wood, '''It's Deductible': Sharp Pencils and Boeing's Imbroglio,'' forthcoming in *Tax Notes.*

fees, and other factors that auger toward settlement, many cases settle as much for tax reasons as for any of those seemingly more dispositive reasons.

IRS Guidance

Whatever else it may be, *Murphy* is a wake-up call to the IRS to issue guidance under section 104, preferably in the form of regulations. Although it may not be able to embark on that course until it attempts to clear the air of the constitutional gauntlet now in play, I believe that in the future we will still be dealing with the confines of section 104 in one way or another.

I also believe the IRS will suffer a chilling affect on attacks under section 104. Every taxpayer will now come (to audits, appeals conferences, and so forth) armed with constitutional invective, and IRS employees at many different levels may see that. Even before *Murphy*, I saw IRS employees put their own gloss on section 104, often according a more liberal view than I believe the National Office espouses. (That is yet another unintended backfire the IRS achieved by not issuing regulations under section 104.)

Now, I expect that trend will be more pronounced. If the IRS has any hope of damage control, it must give firm and fast internal guidance to the field about how to address those issues. Even if the IRS gives this guidance, the tide of exclusions may become Katrina-like. Napoleon had his Waterloo. Like the Federal Emergency Management Agency, the IRS may have its New Orleans.

Scrabble Game

Speaking of wake-up calls, lawyers got one too. Yes, they got a subtle lesson about how settlement is almost always better than a verdict, but they also got some pointers in tax lingua franca. If ''on account of'' means what it seems to mean, exact wording may be more important than the intent of the payer and other traditional indicia.

Plaintiffs' lawyers often *draft* court orders for judges to sign. Although that change will not happen overnight, I believe plaintiffs' lawyers will become even more sensitized to tax linguistics. I note that 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.[78] 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. You do the math.

Structured Settlements

Murphy may also affect the structured settlement industry, the 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, even though (under traditional annuity principles) one might view a portion of each payment as constituting interest.

Section 104 may be the reason the structured settlement industry exists, but section 130 is its linchpin. Under section 130, a qualified assignee has no income on receipt of an assignment from a defendant, as long as the qualified assignee purchases a qualified funding annuity and 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. Those 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 United States, 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 use of structured settlements in employment cases, and in many other nonpersonal physical injury suits.[79]

How does *Murphy* affect that? It's not clear. Some have argued that if a payment is not excludable under section 104(a)(2) — because under *Murphy* the payment is not income at all — section 130 cannot apply either. That technical point is an interesting one, and arguably important given the billions of dollars flowing into structured settlement annuities every year.

It is hard for me to imagine that logic being applied; however, one of the principal effects of *Murphy* will be a reexamination of what is and is not excludable. Practitioners won't care if it is section 104 or the Constitution that exempts a settlement or judgment from tax.

However, because *Murphy* strikes down section 104(a)(2) only ''as applied'' to some 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 gray *Murphy* area are now those that are nonwage and nonphysical. That would include defamation, intentional and negligent infliction of emotional distress, and so forth. Today (or at least pre-*Murphy*), those cases are treated by the structured settlement industry as nonqualified, not relying on section 130.

If tomorrow the industry were to suddenly start treating, based on *Murphy*, all those recoveries as excludable, using ostensibly ''qualified assignments'' for those cases, there may be a problem. However, it is hard to imagine the structured settlement industry treating all

[78]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.''

[79]*See* Wood, ''Structured Settlements in Non-Physical-Injury Cases: Tax Risks?'' *Tax Notes,* Aug. 2, 2004, p. 511.

those nonwage nonphysical injury cases as excludable — at least until some of *Murphy*'s dust settles. Even if the industry were to start doing that, I'm not convinced that the distinction between gross income excludable under section 104(a)(2) and amounts that are not gross income at all would be drawn by the IRS, which surely has bigger fish to fry. But it's a risk, and an interesting technical point.

Conclusion

It is too soon to say which of my predictions about *Murphy* will come true. Yet, from whatever perspective you view this case, it is epochal. Even if the D.C. Circuit changes its mind on rehearing, or the U.S. Supreme Court hears the case and reverses it, some teachings of the case will remain, and may help generations of taxpayers.

But I should hardly talk as if a reversal of *Murphy* is a foregone conclusion. Clearly, many taxpayers (not to mention employment lawyers) nationwide are dancing jigs, hoping that the Supreme Court will do nothing — or if the Court does take the case, that Murphy's superb lawyering will carry the day a second time.

The IRS and Justice Department must be scrambling. For them, *Murphy* merits a veritable slough of metaphors and allusions. Truly, this is the IRS's worst nightmare — salt in a wound; snakes on a plane; the IRS's own bridge of sighs; the Gordian knot. However you cast it, it has to be one of the most devastating and potentially far-reaching of losses for the IRS.