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Recommended Citation
Stuart G. Lazar, *To Tax or Not to Tax, That is the Question: The State of Section 104(a)(2) Following Murphy v. Internal Revenue Service*, Laches 9 (2007).
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To Tax or Not To Tax, That is the Question:

The State of Section 104(a)(2) Following *Murphy v. Internal Revenue Service*

by Stuart G. Lazar

Damages awards, as a general rule, are taxed in the same manner as the underlying item that they are substituting for would have been taxed. The leading case in this area, *Raytheon Products Corp. v. Commissioner*,[1] holds that the relevant inquiry is, "In lieu of what were the damages awarded?" Thus, in the business context, absent any specific exclusion, damages awarded in lieu of lost profits would be includible in income. Similarly, damages awarded to compensate for property damage would be includible in income (as gain) to the extent that the amount recovered exceeds the taxpayer's basis in such property (or would be treated as a loss to the extent the taxpayer recovered less than its basis in the property damaged).

When it comes to damages awards for injury and sickness, Section 104(a)(2) of the Internal Revenue Code provides an exclusion from gross income for the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness. Sound simple? Based on the plethora of case law that has developed over the years, the answer is, resoundingly, "No." In addition, a recent DC Court of Appeals case, *Murphy v. Internal Revenue Service*,[2] found Section 104(a)(2) to be unconstitutional, which adds more uncertainty than clarity to an already confusing area of tax law. This article discusses the history behind Section 104(a)(2), including prior case law interpreting the section, leading up to an analysis of the *Murphy* decision and its effect on the future.

Historical Background

Initially, Treasury regulations promulgated under the Revenue Acts of 1916 and 1917 stated that an "[a]mount received as the result of a suit or compromise for personal injury, being similar to the proceeds of accident insurance, is to be accounted for as income." On the heels of these regulations, in 1918 the Attorney General issued an opinion that held that accident proceeds were not includible in income as they were a substitute for human capital that is the source for future earnings, and that such proceeds replace capital in human ability that is destroyed by an accident.[3] Subsequently, the Treasury Department reversed its position[4] based on the Attorney General's opinion, and the result was codified by Congress in Section 213(b)(6), which excluded from gross income "[a]mounts received, through accident or health insurance or under workmen'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." The legislative history to Section 213(b)(6) states that:

"Under the present law it is doubtful whether amounts received through accident or health insurance, or under workman'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. The proposed bill provides that such amounts shall not be included in gross income."[5]

Following the enactment of Section 213(b)(6), the question arose as to whether this provision excluded only damages for *physical* injuries or whether non-physical *personal* injuries were excludible as well. In a pair of Solicitor's Memoranda, the Service, relying on the legislative history to Section 213(b)(6), held that damages awards received by a lawyer for injury to his professional reputation and by a husband for alienation of his wife's affections could not be excluded from gross income.[6] The Service's conclusion was based in part on the legislative history's comparison of damage awards to payments under accident and health insurance policies and worker's compensation laws, and was based in part on the belief that since non-physical injuries did not involve conversion of human capital, damages for such injuries were not an excludible return of capital.

The Service was again forced to reverse its position, this time on the taxability of non-physical personal injuries, following the Supreme Court decision of *Eisner v. Macomber*.[7] In *Eisner v. Macomber*, the Court defined gross income as "the gain from capital, from labor, or from both combined..." Based on this decision, the Service determined that there was no distinction between physical and non-physical personal injuries and that Solicitor's

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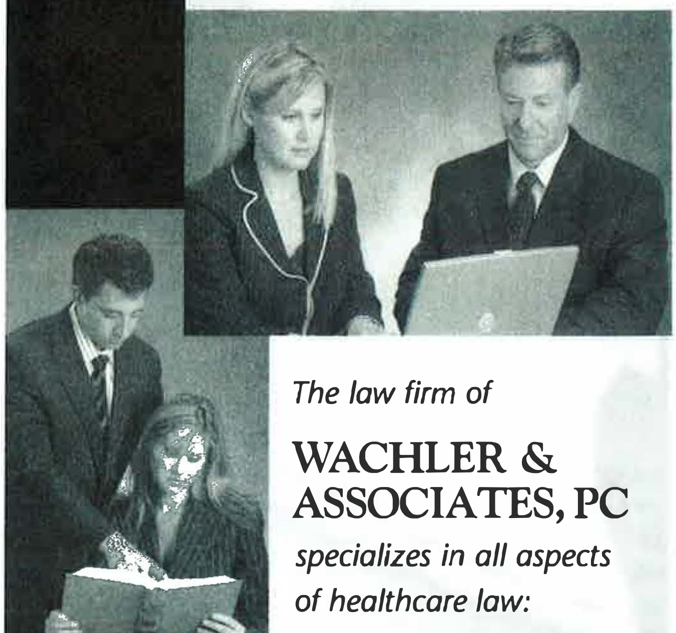

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Memoranda 957 and 1384, discussed above, were incorrect since the damages awarded in those situations for defamation of professional reputation and alienation of affection were not gain under the *Eisner* Court's definition of income.[8] Although the definition of gross income as stated in *Eisner* has been expanded as a result of the Supreme Court's decision in *Commissioner v. Glenshaw Glass Co.*,[9] the reasoning was adopted by the courts in *Hawkins v. Commissioner.*[10] Moreover, in 1992, the Supreme Court had held that Section 104(a)(2) applied to both physical and non-physical personal injuries in *United States v. Burke.*[11] In addition, in Revenue Ruling 77-74, the Service determined that an amount received for alienation of affection was not included in income – following the precedent of Solicitor's Opinion 132 rather than citing to the statutory exclusion of Section 104(a)(2).[12] Courts have frequently found that the dividing line between those damages that were taxable and those excluded from gross income was not between physical and non-physical injuries, but instead turned on whether the damages were received for personal or non-personal injuries. In *Threlkeld v. Commissioner*,[13] the Tax Court held that the term "personal injury" included "any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."

The *Threlkeld* court's definition of "personal injury" excludible from gross income was extremely broad. Cases following *Threlkeld* applied such definition to traditional non-physical injuries (such as defamation of character) and to a number of cases where the taxpayer recovered damages in employment-related actions for discrimination based on age, sex, race and national origin, as well as retaliatory discharge from employment and the denial of First Amendment rights. Moreover, according to the court in *Threlkeld*, not only were damages for non-economic losses excluded from income but damages for economic losses were excludible as well. The court stated that:

> "Whether the damages received are paid on account of 'personal injuries' should be the beginning and the end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim ... and not to the consequences that result from the injury."

The court noted that for physical injuries, which by definition are personal in nature, "the entire award is excluded from income even if all or a part of the recovery is determined with reference to the income lost because of the injury." And with regard to awards for non-physical injuries the same result would be achieved since the court would not scrutinize the award "to determine whether the components of the injuries for which the award (is) made are personal or professional."

Limiting Excludability

In the late 1980s and the 1990s, congressional and judicial actions limited the scope of Section 104(a)(2). First, Congress enacted the Omnibus Budget Reconciliation Act of 1989 ("OBRA"). OBRA amended Section 104(a)(2) so that it would not apply to punitive damages in cases not involving physical injury or sickness. At that time, Congress had attempted to limit the scope of Section 104(a)(2) to damages awarded only on account of physical injury or sickness. While the House bill contained such a provision, the Senate version did not.

Second, in 1992, the United States Supreme Court, in *United States v. Burke*,[14] held that an award of back pay for sex discrimination under Title VII of the Civil Rights Act of 1964 was not excludable from gross income under Section 104(a)(2). In the first Supreme Court decision interpreting Section 104(a)(2), the Court reasoned that Title VII did not redress "a tort or tort-like injury" because its remedies (i.e., back pay, injunctions and equitable relief) were inconsistent with the traditional tort-type remedies such as compensatory damages for pain and suffering, emotional distress, injury to reputation and punitive damages. Though Title VII was amended in 1991 to provide a broader range of remedies, the *Burke* decision is still extremely relevant in the analysis of whether a damage award is excludable under Section 104(a)(2).

Third, in 1995, in *Commissioner v. Schleier*, the Supreme Court held that an award of back pay and liquidated damages under the Age Discrimination in Employment Act of 1967 ("ADEA") was not "on account of" a personal injury, and was thus not excluded from income. The Court, expanding on its decision in *Burke*, determined that for a damage award to be excluded from gross income under Section 104(a)(2) it had to 1) redress a tort or tort-like injury and 2) it had to be "on account of" (i.e., actually compensate for) such personal injury. Because the award in *Schleier* satisfied neither part of this test, the award was includable in the taxpayer's gross income. Although the Court in *Schleier* did not directly address the issue of punitive damages, the Court noted that liquidated damages awarded under ADEA were punitive in nature and, accordingly, not excludable from income.

Following *Burke* and *Schleier*, Congress again amended Section 104(a)(2). The amendments in the Small Business Job Protection Act of 1996 ("SBJPA") had two main purposes: first, to limit the exclusion for damages to those received on account of physical injury or physical sickness; and second, to eliminate the exclusion for punitive damages, whether received on account of a physical injury or a non-physical, personal injury. In addition, the SBJPA amendments to Section 104(a)(2) explicitly stated that emotional distress (and the physical manifestations therefrom) would not be treated as a physical injury unless the claims of emotional distress themselves arose out of a physical injury. In explaining the new physical injury requirement, the House Committee Report focused on the "origin of the claim" and the proximity of the physical injury to the wrongful act:

"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... The bill also specifically provides that emotional distress is not considered a physical injury or physical sickness... Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness."

In the decade since the passage of SBJPA, neither the Treasury Department (through regulations) nor the Service (through a revenue ruling) has – save a single private letter ruling – issued guidance on what constitutes a physical injury. In that ruling,[15] the Service states that "direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under Section 104(a)(2)." However, in the same ruling, the Service declined to rule as to whether a physical contact that does not result in a cut, bruise or other similar bodily harm would constitute a physical injury.

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Finally, in *O'Gilvie v. United States*, the Supreme Court held that punitive damages received in a tort action by the spouse and children of a woman who had died of toxic shock syndrome were not received "on account of" personal injuries (under the pre-OBRA Section 104(a)(2)). Although the taxpayers argued that Section 104(a)(2) required only that they establish a "but for" connection between the punitive damages recovered and the personal injuries sustained, the Court (relying on *Schleier*) agreed with the government that the words "on account of" require a stronger causal connection and that Section 104(a)(2) is applicable only to damages awarded "by reason of, or because of, the personal injuries." The Court rejected the taxpayer's position because it "would thereby bring virtually all personal injury lawsuit damages within the scope of the provision, since 'but for the personal injury, there would be no lawsuit, and but for the lawsuit, there would be no damages.'" The Court, following *Schleier*, held that to be excludable under Section 104(a)(2), the damages received must be designed to compensate the victim for the personal injuries sustained. Punitive damages, on the other hand, are awarded on account of a jury's desire to punish and deter future misconduct of the defendant. Since *O'Gilvie* analyzed Section 104(a)(2) prior to the 1989 amendments, presumably the case stands for the proposition that punitive damages (regardless of whether for physical or non-physical injuries) had never been excludible from gross income.

Murphy: Where Do We Go from Here?

Although after 1996, the law regarding the taxation of personal injury damage awards appeared to be significantly narrowed, a recent D.C. Circuit Court of Appeals case creates a great deal of uncertainty for taxpayers and tax practitioners. In *Murphy v. Internal Revenue Service*, a three-judge panel unanimously held that Section 104(a)(2) was unconstitutional to the extent that it permits the taxation of a personal injury (such as mental distress or loss of reputation) unrelated to compensation or lost wages.

The taxpayer, Murphy, had, in a prior administrative proceeding, been awarded compensatory damages of $70,000 – $45,000 of which was for emotional distress or mental anguish and $25,000 was for injury to professional reputation in an action against her former employer under whistle-blower statutes for reporting environmental hazards on her former employer's property to state authorities. Murphy included the award in income, though she later filed a claim for refund claiming that such amounts were excluded from income under Section 104(a)(2).

Although the court agreed with the government that the damages received by Murphy were not "on account of" a physical injury, and were thus not excludable under Section 104(a)(2), the court then considered whether this result was constitutional. The court determined that the relevant issue was whether such amounts were income under the Sixteenth Amendment. That analysis required the court to ask "in lieu of" what were the damages awarded. In *Murphy*, where the damages were awarded to make the taxpayer "whole" (emotionally and reputationally) and not to provide compensation for lost wages or taxable earnings, the court held that such amounts received were not income. Looking to determine whether, when the Sixteenth Amendment was adopted, the people or Congress would have understood compensatory damages for a non-physical injury to be income, the court determined that there was no distinction between a physical personal injury and a non-physical injury unrelated to lost wages or earning capacity.

On December 22, 2006, the same three-judge panel that heard *Murphy* vacated its decision and ordered that the parties submit briefs for a rehearing. The rehearing is scheduled to occur on April 23, 2007. While it is unclear how these judges will re-decide the case, it is unusual for a panel to vacate its own decision. Although the judges are empowered to affirm their original decision, the act of vacating that decision leads one to believe that a majority of the panel has serious doubts about its validity.

Regardless of whether the *Murphy* decision is reinstated, it is clear that punitive damages (whether for physical or non-physical injuries) are includable in income. *Murphy* does not provide any grounds for a taxpayer to argue that such amount are "on account" of physical or non-physical personal injuries.

Stuart G. Lazar is an associate professor at the **Thomas M. Cooley Law School**. Prior to coming to Cooley, Professor Lazar was a partner at the law firm of Edwards & Angell, LLP based in Providence, Rhode Island. In his spare time, Professor Lazar is an aspiring stand-up comic and, although he finds humor in the tax law, his comedic act contains no references to the Internal Revenue Code, the Internal Revenue Service or any Treasury regulation.

Footnotes

1 114 F.2d 110 (1st Cir. 1944).
2 460 F.3d 79 (D.C. Cir. 2006).
3 31 Op. Att'y Gen. 304, 308 (1918).
4 T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).
5 H.R. Rep. No. 65-767, at 9-10 (1918), reprinted in 1939-1 (Part 2) C.B. 86, 92.
6 *See* Solicitor's Memorandum 957, 1 C.B. 65 (1919); Solicitor's Memorandum 1384, 2 C.B. 71 (1920).
7 252 U.S. 189 (1920).
8 *See* Solicitor's Opinion 132, I-1 C.B. 92, 93 (1922).
9 348 U.S. 426 (1955).
10 6 B.T.A. 1023 (1927).
11 504 U.S. 229 (1992).
12 *See* Revenue Ruling 77-74, 1974-1 C.B. 33.
13 87 T.C. 1294 (1986), aff'd. 848 F.2d 81 (6th Cir. 1988).
14 504 U.S. 229 (1992).
15 *See* Private Letter Ruling 200041022 (July 17, 2000).