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Neil E. Harl
Iowa State University

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Taxing Recoveries That Are Not “Personal Physical Injuries or Physical Sickness”

-by Neil E. Harl*

With a pair of U.S. Supreme Court decisions in 2005 on handling litigation costs including contingent attorney’s fees¹ and an attempt by Congress to resolve the controversy for such fees and expenses in 2004² with respect to costs associated with discrimination in employment and enforcement of civil rights,³ many thought the taxation of settlements and court judgments involving “personal physical injuries or physical sickness” was, at long last, settling down and taxpayers and tax practitioners could expect a modicum of certainty for a few years. However, the recently decided case of Murphy v. United States⁴ changed all of that. That decision held unconstitutional the provisions of I.R.C. § 104(a)(2) excluding from gross income –

“The amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.”

The statutory history

The current version of the statute was last amended in 1996 and, until August 20, 1996, the effective date of the provision in the Small Business Job Protection Act of 1996,⁵ stated –

“The amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.”

The 1996 enactment made it clear that punitive damages were includible in gross income as were damages not attributable to physical injury or physical sickness.⁶ The cases that followed were in agreement that the narrowing of the exclusion provision made recoveries relating to breach of contract and defamation charges, for example, taxable⁷ along with punitive damages.⁸

Murphy v. United States

The 2006 case of Murphy v. United States⁹ found the distinction drawn in the 1996 enactment unconstitutional as a violation of the Sixteenth Amendment to the United States Constitution. The Murphy case involved an employee of the New York Air National Guard who had made complaints about environmental hazards at a New York Air National Guard airbase. As a result of the complaints, her employer retaliated and Murphy was “blacklisted” and unfavorable references were provided to potential employers. Murphy charged that the retaliatory action resulted in emotional distress and injury to her professional reputation from her “whistle-blower” activity. She sued and recovered a substantial amount, approximately

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* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
$70,000, in damages of which $45,000 was for “emotional distress or mental anguish” and $25,000 was for “injury to professional reputation.”

The District Court held that the damages were not excludable under I.R.C. § 104(a)(1) but, on appeal, the Court of Appeals for the District of Columbia, reversed, agreeing with Murphy that the treatment she had received was unconstitutional.

The appellate court focused heavily on the notion that payments for the restoration of capital are not income, and making a person whole is viewed as a restoration of human capital and looked to three authorities in support of that point of view – (1) an opinion of the United States Attorney General; (2) a statement by the Internal Revenue Service and the Department of the Treasury; and (3) a passage in a Congressional Committee Report (which was viewed as ambiguous and was given less weight). All three statements had preceded the enactment of I.R.C. § 104(a)(2) and all had taken the position that recoveries to restore capital are not income.

The Office of the United States Attorney General, in an opinion rendered to the Secretary of the Treasury as to whether the proceeds from an accident insurance policy were income under the Internal Revenue Code as it stood prior to the 1918 Act, had stated –

“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 not 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.”

The Department of the Treasury had made a similar statement in a revenue ruling –

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

The House Ways and Means Committee of the U.S. House of Representatives on the bill that became the Revenue Act of 1918 had said –

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.

The Court of Appeals concluded that to draw a distinction between recoveries that were made “by reason of” or “because of” personal physical injury or physical sickness and those failing to meet that test was unconstitutional. Essentially, the taxpayer argued that I.R.C. § 104(a)(2) made her recovery taxable when the recovery should not have been taxable under the Sixteenth Amendment. Thus, the court’s holding meant that her recovery for emotional distress and injury to her professional reputation was a restoration of her “capital” and, therefore, was not taxable. As the court stated, “. . . damages received solely in compensation for a personal injury are not income within the meaning of that term in the Sixteenth Amendment. First, as compensation for the loss of a personal attribute, such as wellbeing or a good reputation, the damages are not received in lieu of income. Second, the framers of the Sixteenth Amendment would not have understood compensation for a personal injury – including a nonphysical injury – to be income.” Accordingly, the court held I.R.C. § 104(a)(2) unconstitutional insofar as it “. . . permits the taxation of an award of damages for mental distress and loss of reputation.”

Impact of the decision

It is likely that the decision will be appealed to the United States Supreme Court. If so, and if the court agrees with the appellate decision, or certiorari is denied, the ball will be in the Congressional court. The Congress would have little choice but to go along with allowing recoveries from non-physical injuries and non-physical sickness to be excludable from gross income. If the appellate court is reversed by the United States Supreme Court, and the distinction in taxation of damages is held constitutional and the high court is unimpressed with the argument that such damages should not be considered to be income, the state of the law would be returned to where it has been since 1996.

Footnotes

5 Pub. L. No. 104-188, § 1605(a).
6 I.R.C. § 104(a)(2).
7 E.g., Polone v. Comm’r, T.C. Memo. 2003-339 (payment before the 1996 enactment became effective).
8 Green v. Comm’r, T.C. Memo. 2005-250 (punitive damages and interest).
10 Id.