**Murphy v. IRS: Taxation Of Personal Injury Awards**

ATTORNEYS WITH CLIENTS WHO HAVE SUFFERED personal injuries should understand how related damages or settlement proceeds (generally referred to as “damages”) will be taxed. The tax treatment will largely depend on the nature of the underlying claim, and attorneys should, therefore, ask the following questions: Will damages (if any) be awarded on account of personal physical injury or sickness? Will damages be awarded on account of nonphysical injury such as emotional distress or damage to reputation? The answers to these questions will have a dramatic effect on the amounts ultimately received and should be carefully considered when structuring both complaints and settlement agreements.

The District of Columbia Circuit Court of Appeals (the “D.C. Circuit”) recently addressed the taxation of personal injury awards in *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006) (“Murphy I”) and *Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007) (“Murphy II”). In particular, the D.C. Circuit focused on the distinction in tax law between damages received on account of personal physical injuries and damages received on account of nonphysical injuries. Although the D.C. Circuit clearly struggled with the

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practical application of certain fundamental tax concepts (even holding a provision of the Code to be unconstitutional before reversing its own ruling), the Murphy I and Murphy II opinions are instructive for practitioners seeking to understand how damages awarded to their clients will be taxed.

**BACKGROUND** • Marrita Leveille (now “Murphy”) received compensatory damages of $70,000 after winning a complaint against her former employer for a violation of whistle-blower statutes. The award was divided as follows: $45,000 represented damages for emotional distress or mental anguish and $25,000 represented damages for injury to professional reputation.

Murphy included the $70,000 in gross income on her 2000 tax return and paid $20,665 of related taxes. She later sought a refund of the $20,665. The IRS denied the request for a refund, and Murphy brought a suit against the IRS in the U.S. District Court for the District of Columbia, which granted summary judgment for the IRS. On appeal to the D.C. Circuit, Murphy contended that her receipt of damages on account of personal injuries (including nonphysical personal injuries) was analogous to a tax-free return of capital (i.e., human capital) and was, therefore, not subject to taxation.

In determining whether the damages received by Murphy were subject to federal income tax, the D.C. Circuit focused on the congressional authority to tax, the concept of gross income, and statutory exclusions from gross income. The following brief discussion will introduce these tax concepts, which are fundamental to an understanding of how personal injury awards are taxed.

**CONGRESSIONAL AUTHORITY TO TAX** • The Constitution empowers Congress to lay and collect taxes, duties, imposts and excises. The scope of this taxing authority, however, is limited by the requirement that all direct taxes must be apportioned.

The Supreme Court held in *Pollock v. Farmer’s Loan & Trust Company*, 158 U.S. 601 (1895), that taxes on income from real or personal property were direct taxes subject to the apportionment requirement. Because the income tax disputed in *Pollock* was not subject to apportionment, the Court held the entire income tax system to be constitutionally invalid. *Id.* at 637.

After the Supreme Court’s decision in *Pollock*, the states ratified the 16th Amendment to the Constitution, authorizing Congress to impose income taxes without regard to either apportionment or the source of income. Specifically, the Sixteenth Amendment provides: “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” The Sixteenth Amendment, however, does not define “incomes” for purposes of the congressional taxing power. The scope of the federal income tax has, therefore, been determined primarily by statute.

**THE CONCEPTS OF GROSS INCOME AND TAX BASIS** • The Code provides an extensive definition of “gross income,” which serves as the starting point for computing the taxpayer’s federal income tax liability. Section 61(a) broadly defines “gross income” as all income from whatever source derived unless otherwise provided and then lists several examples, including compensation for services, gains derived from dealings in property, etc. (All Section references are to the Internal Revenue Code, as amended.) According to the Supreme Court, Congress broadly defined gross income in this manner in order to exert the full measure of its taxing power. *Helvering v. Clifford*, 309 U.S. 331, 334 (1940).

Although the judiciary has generally accepted this broad statutory definition, courts have articulated certain limits on the scope of gross income. For instance, in *Commissioner v. Glenshaw Glass Co.*, 348
U.S. 426 (1955), the Supreme Court suggested that a payment must represent a clearly realized accession to wealth in order to constitute gross income.

A taxpayer's recovery of amounts previously invested in property does not represent an accession to wealth and, accordingly, is not treated as gross income. While section 61(a) provides that gross income includes gains derived from dealings in property, section 1001(a) defines “gain from the sale or other disposition of property” as the excess of the amount realized (the amount of money and fair market value of property received) over the adjusted basis of the property. Consequently, only the amount realized by the taxpayer on the disposition of property in excess of the property's adjusted basis (sometimes referred to as the tax basis) is income for purposes of the federal income tax.

Generally, the taxpayer’s “adjusted basis” is the cost of the property (as increased for related non-deductible costs incurred by the taxpayer after acquiring the property and reduced for deductions allowed with respect to the property). In other words, the taxpayer’s basis in property equals his or her investment of previously taxed (or exempt) income. The Code uses this tax basis mechanism to prevent double taxation. Thus, a taxpayer who sells property may recover his investment in the property tax-free because the taxpayer was already taxed on the invested income (or such income was exempt). Such a recovery is often referred to as a “return of capital.”

Similarly, in the context of litigation, damages awarded for damage to the recipient’s property generally represent a tax-free “return of capital” to the extent of the recipient’s basis in the property. See Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944). The IRS explained this return of capital concept in Rev. Rul. 81-277, 1981-2 C.B.14 (citations omitted):

If the recovery represents damages for lost profits, it is taxed as ordinary income. If, however, the recovery is treated as a replacement of capital the damages received from the lawsuit are treated as a return of capital and are not taxable as income. Payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross income because there is no economic gain.

For example, suppose that X invests $10 in certain capital assets (and takes a $10 cost basis). Y subsequently harms the assets and is required to pay damages to X in the amount of $5 for injury to the property. The $5 recovery constitutes a tax-free return of capital and is, therefore, not included in X’s gross income.

**STATUTORY EXCLUSIONS FROM GROSS INCOME—SECTION 104(A)(2) •** Sections 101 through 140 of the Code set forth rules specifically excluding items from gross income. The dispute in Murphy I and Murphy II relates to the application of section 104(a)(2), which excludes from gross income certain damages related to personal injuries. Specifically, section 104(a)(2) provides that gross income does not include “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....” Section 104 further provides that emotional distress shall not be treated as a physical injury or physical sickness. Thus, under section 104(a)(2), a taxpayer may generally exclude from gross income damages received on account of physical personal injuries or sickness, but may not exclude punitive damages or damages received on account of emotional distress.

**Murphy I**

In Murphy I, the D.C. Circuit sought to determine whether damages received by Murphy were income for purposes of the Sixteenth Amendment by considering whether the damages represented a substitute for a normally untaxed personal quality, good, or asset. The court determined that the damages were awarded to make Murphy “emotionally...