

LABOR AND EMPLOYMENT PRACTICE CASE BULLETIN

EMOTIONAL DAMAGE AWARD IS NOT SUBJECT TO INCOME TAX

Murphy v. United States

The U.S. Court of Appeals for the D.C. Circuit recently changed a 10-year law on the taxation of damage awards and settlements. In 1996, Congress amended §104(a)(2) of the Internal Revenue Code to allow taxation of damages for emotional distress. Under that amendment, to be excluded from income, damage awards or settlements for “personal injuries or sickness” must arise from physical injuries or physical sickness (as opposed to non-physical, or emotional, damages). Thus, for the last ten years, damages for physical injuries were not taxable; damages for emotional injuries were. During that time, plaintiffs have been seeking larger damage and settlement amounts to compensate them for the tax consequences.

In Murphy v. United States, 98 AFTR 2d 2006-6088 (D.C. Cir. 2006), the court held the 1996 amendment unconstitutional. The plaintiff had sued her former employer for violation of various whistle-blower statutes, claiming that the employer had black-listed her and provided unfavorable references to potential employers after she complained to state authorities of environmental hazards on her employer's property. The Secretary of Labor found unlawful discrimination and retaliation and awarded Murphy \$45,000 for emotional distress and \$25,000 for injury to professional reputation. No part of the award was for lost wages or diminished earning capacity. The IRS taxed Murphy on the full compensatory award of \$70,000, and she sued for a refund.

The D.C. Circuit determined that §104(a)(2) is unconstitutional under the Sixteenth Amendment, which is Congress’ authority to tax income. The court agreed that an award of

damages for emotional injury and loss of reputation was not “income” within the meaning of the Sixteenth Amendment. The court found the damages were to make Murphy emotionally and reputationally “whole,” and not to compensate her for lost wages or taxable earnings of any kind.

As a result, the IRS may no longer tax damage awards for emotional distress or injury to reputation even if they are unrelated to physical damages or lost wages or earnings. This decision changes the tax consequence that has applied during the last decade to awards and settlements in labor and employment cases.

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