'Murphy' Won't Ease Settling Employment Claims Involving Emotional Distress

By Deborah Rothman

By now, most employment lawyers have heard the drumbeat of optimism resulting from the Aug. 22, 2006, decision of the U.S. Court of Appeals for the District of Columbia Circuit, *Murphy v. Internal Revenue Service*, 05-5139, in which the court held that emotional-distress damages for nonphysical injuries may be excluded from income. But before they start dancing to the beat, they should understand just what the decision probably won't do, especially in the context of settling employment cases.

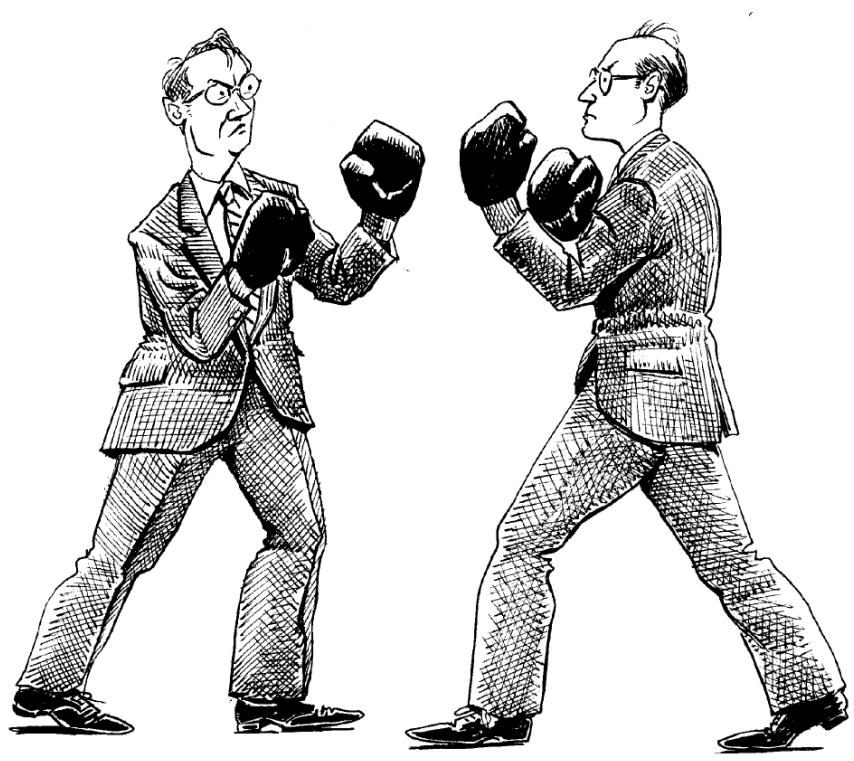
An administrative law judge had awarded Murphy compensatory damages of $45,000 for "emotional distress or mental anguish" and $25,000 for "injury to professional reputation," on account of retaliation by her former employer for her whistle-blowing activities. She received no damages for her demonstrated permanent physical injuries and none for lost wages. The Department of Labor Administrative Review Board affirmed the findings and award. When Murphy filed her 2000 tax return consistent with Internal Revenue Code Section 104(a)(2), she included the $70,000 damages in gross income and paid $20,665 in taxes. She later filed an amended return seeking a refund of the $20,665, which the IRS, not surprisingly, denied.

Murphy sued the IRS in District Court using two alternative theories: first, that her compensatory award was in fact for physical injury, in which case it was excludable from gross income under Internal Revenue Code Section 213(b)(6); and second, that taxing compensatory damages as income violated the 16th Amendment.

The District Court granted the IRS' motion for summary judgment on all claims. On appeal, the court upheld the dismissal of her claim that her compensatory damages should be excludable from gross income, because her compensatory damages were awarded on account of her emotional distress and reputational loss, not specifically on account of physical harm.

The court held unconstitutional, however, Internal Revenue Code Section 104(a)(2). The rationale is that the 16th Amendment permits taxation only of increases in wealth, such as capital gains or wages, not of restorations of capital, whether financial or human.

Attorneys are cautiously optimistic that



Murphy will make employment cases involving allegations of emotional distress stemming from nonphysical torts easier to settle. The theory is that, if the plaintiff does not have to pay income tax on a portion of the settlement, the defense's settlement money will go further — a classic win/win. Though on its surface such optimism is certainly warranted, here are the top 10 reasons why *Murphy* arguably will not make settlement of employment claims involving emotional distress any easier in the short term, if ever:

(10) *Murphy* was decided by the District of Columbia Circuit, so it is not binding authority in the 9th or any other circuit.

(9) *Murphy* is certain to be appealed or otherwise challenged by the IRS. The service will appeal the case to the Supreme Court or re-litigate it in another circuit. The state of the law thus is likely to be uncertain for quite some time.

(8) In *Murphy*, the former employee introduced substantial evidence that she had suffered permanent physical injury to her teeth due to bruxism, or tooth-grinding — occasioned by job-related stress. The administrative law judge, however, made no award for emotional distress arising from physical injury. Had he linked the award for emotional distress and reputational injury with the permanent damage to her teeth, Murphy would not have had to include her damages in gross income on her return at all, and she would not have had to ask the IRS for a refund. The case would not have been filed. On the other hand, when parties are negotiating the settlement of an employment claim, they have considerable latitude in determining how settlement sums will be treated by the IRS, unlike a taxpayer who must rely on the wording of a litigated award. The trick is to spell out in the settlement agreement what portion of the settlement amount is attributable to physical injury arising out of the alleged tort.

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(7) Murphy's case arose from her attempt to persuade the service to refund income taxes she had paid. Common sense tells us that the IRS is unlikely to refund money paid. When a settlement is negotiated, the plaintiff has time to work with his or her personal accountant to determine how best to characterize each component of the settlement. When the plaintiff's return is filed, it arrives with millions of other tax returns and is likely to receive much less scrutiny than a refund request.

(6) Employment defense attorneys and their clients traditionally been have reluctant to agree to characterize as excludable from income, that is, as non-1099-able, emotional distress damages arising from a physical ailment such as an ulcer, when the root cause, and indeed the basis for the lawsuit, is an employment tort such as discrimination or wrongful termination. However, *Murphy* did not make new law when it noted that emotional distress resulting from physical injury or illness, even if the physical injury is the result of an employment tort, is still excludable from gross income, and thus from income tax. If anything, *Murphy* should reassure management lawyers and their clients that the law provides that exclusion from gross income of damages paid for physical injuries applies to physical ailments such as migraines and low-back pain arising out of employment torts.

(5) Even without *Murphy*, counsel often compromise on the tax issue. They agree that the employer will not treat a reasonable portion of the settlement amount as back pay or other wages but instead simply will issue a 1099 for the negotiated sum, on condition that the employee indemnify and hold harmless the defendant from any taxes and/or penalties imposed because of the employee's treatment of the settlement amount on his or her tax return. This compromise gives the employer the reassurance that, as long as the negotiated portion of the settlement can be demonstrated not to be wages, the filing of a 1099 will withstand IRS scrutiny.

(4) Most psychologists agree that emotional injuries tend to be somatized, meaning they often manifest themselves in the physical body. As long as the plaintiff's counsel alleges that the emotional distress caused by the employment tort caused physical injury or sickness, defense counsel should be comfortable characterizing some or all of the settlement as excludable from gross income. Again, *Murphy* need not be adopted by the 9th Circuit for employment settlements to go more smoothly in this regard.

(3) The tax treatment of settlement amounts is not a top point of contention in employment mediations. The gross number of dollars seems to be the key issue. It is only after a settlement figure has been agreed to, or is on the horizon, that tax treatment is negotiated, if at all.

(2) In cases in which tax treatment is an irresolvable issue, sometimes the parties "agree to disagree" by agreeing that the defendant will pay the entire settlement amount, and send a 1099, to the plaintiff's counsel's client trust account. The defense is satisfied because it does not risk being second-guessed by the IRS for under-reporting on its returns the amount paid in settlement. The plaintiff is satisfied because he or she is not going to receive a 1099 from the employer or former employer and because this procedure may help the plaintiff avoid the Alternative Minimum Tax.

(1) And the No. 1 reason I believe that the adoption of the *Murphy* rule in the 9th Circuit would not facilitate more employment settlements is that the parties would fight over who should get the benefit of the extra dollars available because of the exclusion. The employer undoubtedly will argue that the settlement amount should be discounted because the employee will be paying less tax. The employee will respond that the employer would be receiving a windfall if it were permitted to pay a smaller settlement amount on account of the ruling.

It is certainly possible that the *Murphy* ruling, should it be adopted by the 9th Circuit, would only introduce one more point of contention between the parties, and thus one more avenue for creating, rather than eliminating, impasses.

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