ORAL ARGUMENT SCHEDULED FOR APRIL 23, 2007

No. 05-5139

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

MARRITA MURPHY, *et al.*,

Plaintiffs/Appellants,

v.

INTERNAL REVENUE SERVICE, *et al.*,

Defendants/Appellees,

On appeal from the United States District Court
for the District of Columbia

REPLY BRIEF OF APPELLANTS

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REPLY BRIEF OF THE APPELANTS

Marrita Murphy, by and through counsel, hereby submit this reply brief and also adopts the arguments raised in the brief of Amici Curiae, submitted on January 29, 2007.

REPLY TO JURISDICTIONAL STATEMENT

In footnote 2 of Appellees' brief, the Government contends only the United States of America was a properly named defendant, that the plaintiffs' request for non-monetary relief was barred and the Administrative Procedure Act did not allow plaintiffs to sue the Internal Revenue Service ("IRS"). That issue, however, was separately raised by the IRS in a motion to dismiss, which was denied by the district court. By failing to file a cross-appeal from the denial of its motion to dismiss, the IRS waived this issue and it should not be the subject of this appeal. *See* Fed. R. App. 4(a)(3).

SUMMARY OF ARGUMENT

The "make whole" damages awarded to Marrita Murphy are not "income" under either 26 U.S.C. §61(a), or the Sixteenth Amendment to the U.S. Constitution. Leaving aside the constitutional issue, under the rules of statutory construction that apply to tax levying statutes the failure of Congress to enact a specific provision to tax non-physical personal injury damage awards renders Murphy's award not subject to any tax passed by Congress. The 1996 change in 26 U.S.C. §104(a)(2) did not automatically make Murphy's damages subject to tax, because there is no tax levying statute that imposes a tax on such damages. Applying the Supreme Court's well-recognized rule of statutory construction in *Gould v. Gould,* a tax on Murphy's damages cannot be sustained because it does not fall within the scope of Section 61(a), the tax levying statute at issue here.

In response, the Government simply says that *Gould* is an old case and it has not been

cited by the Supreme Court since *Glenshaw Glass.* However, the rule of statutory construction in *Gould* was not even an issue in *Glenshaw Glass.* More importantly, *Gould* has never been reversed or reconsidered by the Supreme Court, and it has been followed in this Circuit, and by other circuits as recently as 2005.

The conclusion that "make whole" damages for emotional distress and reputation are not income is consistent with a long line of administrative rulings including the Treasury Department's 1922 ruling that non-physical compensatory damages are not income under the Sixteenth Amendment and the tax code. As the Supreme Court noted after reviewing this history, the courts held a number of times after the Sixteenth Amendment was enacted that "a restoration of capital was not income; hence it fell outside the definition of 'income'…" *O'Gilvie*, 519 U.S. at 84. The Government has not provided any reason to justify a departure from this reasoning.

The Government has not reconciled its "accession to wealth" theory with the facts of this case. *Glenshaw Glass* simply does not support the Government's argument that Murphy's "make whole" compensatory damages award is somehow an "accession to wealth." Conspicuously absent from the Government's brief is any discussion of the common dictionary meaning of "accession", "income" and "income tax." None of these definitions support the Government's theory, so the Government ignored them altogether.

Murphy raised the human capital analogy that was adopted by the Treasury Department, not to pursue a deduction but instead to further demonstrate that her "make whole" damages are not an "accession to wealth." The Government cannot escape, and has not contested, that Murphy's damages were awarded as a matter of law to fully restore her loss. The Government's attempt to argue that because Murphy cannot avail herself of 26 U.S.C. §1001, and other statutes

generally applicable to business deductions, is inapposite.

Murphy's compensatory damages also fall within the statutory exclusion of Section 104(a)(2), as amended. The uncontested summary judgment record demonstrates that Murphy's physical problem was more than a mere "symptom," it was a "long continued" physical injury constituting bodily harm and included permanent damage to her teeth. Additionally, under amended §104(a)(2) there is a distinction between "physical injuries or physical sickness" and the term "physical symptoms" as used in the legislative history and relied upon by the district court. Neither the district court nor the IRS addressed this critical issue.

The Government concedes that the Sixteenth Amendment governs Section 61(a)'s catchall provision, which is the sole means by which the Government attempts to tax Murphy. For this and other reasons, the Court need not determine whether a tax on Murphy's damages is a direct or indirect tax. Alternatively, if a tax on Murphy's damages is not an income tax, the tax cannot be sustained because it is a direct tax.

ARGUMENT

I. THE DISTRICT COURT ERRED BY HOLDING THAT MURPHY'S DAMAGES AWARD IS INCOME UNDER 26 U.S.C. §61(a), AND THAT IT IS NOT EXCLUDED FROM INCOME UNDER 26 U.S.C. §104(a)(2).

A. Murphy's Damages Award Is Not Income Under §61 and the Sixteenth Amendment.

In a long line of cases, the Supreme Court and the U.S. Courts of Appeals have drawn a sharp distinction between monetary awards which constitute a taxable "accession to wealth" and awards that make a person "whole" for restoring a personal loss.[1] Applying the consistent and

[1] *See, e.g., Doyle v. Mitchell Bros.*, 235 F. 686, 688 (6th Cir. 1916) (monies paid to compensate for losses in a fire are not income); *Southern Pacific Co. v. Lowe*, 247 U.S. 330, 335 (1918) (return of capital not income under the tax code or 16th Amendment); *Burk-Waggoner Oil v. Hopkins*, 269 U.S. 110, 114 (1925) (Brandeis, J.) (neither Congress nor the Courts are permitted

unbroken line of cases interpreting the meaning of "income" under the Sixteenth Amendment, the history surrounding its passage, and the commonly understood meaning of "income" under the tax codes passed under the Sixteenth Amendment, requires a finding that Murphy's compensatory damages award for an actual loss of reputation and damage to her emotional or physical well being is not income.

The Government concedes that Congress based its definition of gross income in §61(a) upon the Sixteenth Amendment, and the Government further states that ever since the Sixteenth Amendment was enacted in 1913, "[t]hat definition" of income "has remained substantially unchanged," except for a slight change in the wording in 1954 to more closely mirror the language of the Sixteenth Amendment. *See* Appellees' Br., pp. 18-19. This concession supports Murphy's statutory construction argument that her damages are not subject to tax because Congress failed to enact a tax levying statute to tax non-physical compensatory damages. Simply revoking an exemption does not automatically result in a tax if that matter does not fall within the scope of the existing tax levying statute, or if Congress fails to enact a separate tax provision. A tax on Murphy's damages does not fall within the definition of income used in the catchall phrase of §61(a), and it is therefore not income within the statutory meaning of income

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to "make a thing income which is not so in fact"); *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 432, n. 8 (1955) (personal injury recoveries are "by definition compensatory only" and nontaxable as contrasted with punitive damages); *U.S. v. Kaiser*. 363 U.S. 299, 311 (1960) (Frankfurter, J., concurring) (Strike benefits not income and stating, "The principle at work here is that payment which compensates for a loss of something which would not itself have been an item of gross income is not a taxable payment"); *O'Gilvie v. United States*, 519 U.S. 79, 84-86 (1996) ("a restoration of capital [is] not income; hence it [falls] outside the definition of 'income' upon which the law impose[s] a tax"); *Hawkins v. Commissioner*, 6 B.T.A. 1023, 1024-25 (U.S. Bd. Tax. App. 1927) ("compensation for injury to [plaintiff's] personal reputation" was not income because it was "an attempt to make the plaintiff whole as before the injury."); *Dotson v. U.S.*, 87 F.3d 682, 685 (5th Cir. 1996) (personal injuries for physical or emotional well-being nontaxable as a "return of human capital").

or the Sixteenth Amendment upon which §61(a)'s catch-all definition is based.

In *Gould,* a statutory construction problem arose when the government attempted to tax alimony which could not be legally taxed until Congress actually passed a tax levying statute, 26 U.S.C. §71, and amended §61(a) to add alimony to the list of items included in gross income, to expressly tax alimony.[2] When a taxpayer challenges whether the levying statute applies in the first instance it must be construed strictly and all doubts must be resolved in favor of the taxpayer. *See* Appellants' Br., p. 14.[3] Notably, the Revenue Act of 1913, which was at issue in *Gould v. Gould,* 245 U.S. 151, 153 (1917), when the issue of alimony was considered, also contained a catchall provision. *See* Revenue Act of 1913, §II(B), 38 Stat. 167 (defining gross income as "income derived from any source whatever."). *Also see,* Appellees Br., p. 18. However, the Supreme Court held in *Gould* that alimony could not be taxed under the Revenue Act of 1913 because it did not fall within the scope of the statutory definition of income, including the catchall provision.

In response to this argument, the Government simply says that *Gould* is an old case and was rendered meaningless by *Glenshaw Glass.* However, *Gould* has never been overruled and

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[2] *See e.g.,* IRS General Counsel Memorandum (June 15, 1978), GCM 37571, 1978 WL 43529 (IRS GCM), describing the enactment of specific tax levying statutes to include alimony payments under certain circumstances as an item of gross income under section 22(k) of the 1939 Code, and later as part of Section 61(a) and Section 71(a) of the modern tax code. These specific tax levying statutes were in response to the *Gould* decision and *Douglas v. Wilcuts,* 296 U.S. 1 (1935), in which "[a]mounts paid to a divorced wife under a decree for alimony are not regarded as income to the wife but are paid in discharge of a general obligation to support, which is made specific in the decree."

[3] *Also see, e.g., White v. Aronson,* 302 U.S. 16, 20, 58 S.Ct. 95 (1937); *Andrus v. Burnet,* 50 F.2d 332, 333 (D.C. Cir. 1931); *Princess Cruises, Inc. v. United States,* 397 F.3d 1358, 1362 (Fed. Cir. 2005); *Ocean Drilling & Exploration Co. v. United States,* 988 F.2d 1135, 1156 (Fed. Cir. 1993); *Estate of Renick v. United States,* 687 F.2d 371, 376 (Ct. Cl. 1982); *America Online, Inc. v. United States,* 64 Fed. Cl. 571, 576 (Ct.Cl. 2005).

was not even discussed by the *Glenshaw Glass* Court. Moreover, *Gould* has been repeatedly followed by the federal courts, as recently as 2005, and it has been followed in this Circuit. In 1978, the IRS, itself, recognized "the continued viability of *Gould."*[4] The Government failed to address this mandatory rule of statutory construction and did not respond to Murphy's arguments on this point. *See* Appellants' Br., pp.14-17. To the extent the Government attempts to distinguish *Gould,* it also has failed.[5]

Accordingly, under the circumstances presented here, §61(a) must be construed strictly against the Government and this Court should find that Murphy's "make whole" compensatory damages are not subject to tax under this statute.

B. Murphy's "Make Whole" Damages Are Not Taxable Income.

After the Sixteenth Amendment became law, the courts began defining the meaning of the term "income" as used in that amendment and the tax codes enacted thereunder. *Doyle*, 235 F. at 688 (monies paid to compensate for losses in a fire are not income).[6] The *Doyle* precedent

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[4] *See* GCM 37571, 1978 WL 43529, at p. 6 ("We emphasize, however, that our conclusion regarding the includibility of the payments in the wife's gross income under section 61(a) is totally dependent upon the fact that the husband's legal obligation to support the wife has ceased. If payments are made by the husband in satisfaction of a valid support obligation, *we believe the holding of Gould v. Gould would bar* the includibility of these payments under section 71. While Congress, by enacting section 71 and its predecessor, section 22(k) of the 1939 Code, intended to overrule the holding of *Gould* in the circumstances described in those sections, *it showed no intention of rendering this holding inapplicable to a situation which was not so specifically described. Moreover, contemporary decisions have recognized the continued viability* of *Gould* in situations not covered under section 71.") (emphasis added).

[5] None of the cases cited by the Government for the proposition that taxing statutes can be construed broadly presented a challenge to the applicability of the statute in the first instance. Appellees' Br., pp. 23-26.

[6] Shortly after *Doyle,* the Supreme Court defined "income" as a "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber,* 252 U.S. 189, 207 (1920). Justice Brandeis dissented out of concern that the definition of income did not include various means for which persons could obtain income which were not directly related to a gain from capital or labor.

has not been questioned by the IRS, and this Court has previously state that *Doyle* and other cases set forth what was "'believed to be the commonly understood meaning of the term [income] which must have been in the minds of the people when they adopted the Sixteenth Amendment…'" *Burnet v. John F. Campbell Co.*, 50 F.2d 487, 488 (D.C. Cir. 1931), citing *Merchants' L. & T. Co. v. Smietanka*, 255 U.S. 519, 41 S.Ct. 386, 389 (1921).[7]

The Government's argument is also at odds with a long line of cases and Departmental rulings issued both before and after *Glenshaw Glass.* In 1922, the Treasury Department stated that money received for alienation for affection or for lost reputation "***does not constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder.***" Sol. Op. 132, 1-1 C.B. 92, 03 (1922) (emphasis added).[8] This ruling was based on Supreme Court decisions interpreting the definition of income under the Sixteenth Amendment and remained in full force after *Glenshaw Glass* was decided. *Id.*, citing *Stratton's Independence v. Howbert*, 231 U.S. 399; *Eisner*, 252 U.S. at 207. *Also see Doyle, supra; Hawkins, supra.*[9] In

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Eisner, 252 U.S. at 226 (Brandeis, J., dissenting). However, Justice Brandeis did not dispute the *Doyle* holding and did not contend that monies obtained to compensate a person for a loss was income.

[7] Justice Brandeis' opinion in *Burk-Waggoner Oil*, that the term "income" limited Congress' taxing authority as Congress "cannot make a thing income which is not so in fact," is also notable because, although he dissented in *Eisner,* he still firmly acknowledged the limiting authority of the term "income" as set forth in the Sixteenth Amendment.

[8] The position in Sol. Op. 132 was formally stated in a Revenue Ruling in 1974. *See* Rev. Rul. 74-77, 1974-1 C.B. 33, 1974 WL 34538 (IRS RRU) (amounts received for alienation of affections "***are not income.***") (emphasis added).

[9] The Government's reliance on a plurality opinion in *Lukhard v. Reed*, 481 U.S. 368 (1987), is entirely misguided. The issue there was what "income or resources" a state could rely upon in determining eligibility for AFDC welfare benefits. While permitting Virginia to include awards obtained for personal injury (including for "lost wages") in the determination for eligibility, this result was based on Justice Blackmun's concurrence in the judgment only, but he expressly did not join the plurality opinion cited by the Government here. *Lukhard*, 481 U.S. at 383-84 (J.

regards to the extension of this principle after *Glenshaw Glass*, the Government ignores entirely *Starrels v. Commissioner,* 304 F.2d 574, 576 (9th Cir. 1962), in which the court expressly held that damages "for personal injuries … make the taxpayer whole from a previous loss of personal rights – because, in effect, they restore a loss to capital."

This question was settled by the Treasury Department in 1922 when it held that non-physical damages were not income within the meaning of the Sixteenth Amendment or any of the tax laws. *See* Sol. Op. 132, 1-1 C.B. 92, 03 (1922) ("the question is really more fundamental, namely, whether such damages are within the legal definition of income."). Other Treasury Decisions and administrative authorities cited by the Government were expressly revoked or overruled before Congress passed the first personal injury exemption in 1918. *Cf.,* Appellees' Br., pp. 34-35, with 31 Op. Att'y Gen. 304 (1918) and T.D. 2747, 20 Treas. Dec. 457 (1918). The Government's reliance on other overruled administrative authorities is without moment (*see* Appellees' Br., pp. 36-37) does not make personal injury damages either an "accession to wealth" or income. Those administrative rulings were expressly overruled in 1922. Sol. Op. 132, 1-1 C.B. 92, 03 (1922). Based on the controlling Departmental rulings and Supreme Court cases, compensation for non-physical injuries was treated the same as compensation for physical injuries under the definition of income required by the Sixteenth Amendment, and the Government has given no reason why this Court should depart from the Treasury Department's own substantive reasoning. Additionally, this Court should accord *Skidmore* deference to Sol. Op. 132 and Rev. Rul. 74-77, another argument ignored by the Government. *See* Appellants' Br., pp. 24-26.

Given the controlling authorities as well as the common dictionary meanings of "income"

Blackmun, concurring in judgment). However, the policies underlying AFDC and welfare benefits determination are completely inapposite and have no bearing on interpretation of taxes.

and "income tax" which have remained virtually unchanged since 1913, it cannot be said "that the term 'income' as commonly understood" at the time of adoption of the Sixteenth Amendment applies to "make whole" compensatory damages, such as those awarded to Murphy. *Burnet,* 50 F.2d at 488.

That gross income might now include some items that allegedly were not taxed when the Sixteenth Amendment was drafted likewise does not make nonphysical compensatory damages income. Each of the examples raised by the Government constitute a gain or "accession to wealth" that would be taxable income under the statutory and constitutional definition of income adopted under the Sixteenth Amendment, and most every example cited by the Government was expressly taxed through enactment of a specific tax levying statute. *Cf.* Appellees' Br., pp. 37-38.

Moreover, a conclusion that Murphy's "make whole" damages are not income under the code or the Constitution does not conflict with the Supreme Court's rulings in *Schleier, Burke, Banks* or *O'Gilvie.* In none of those cases was the issue of taxing non-physical "make whole" compensatory damages before the Court. The question before the Court in those cases was not whether the monies taxed were income in the first instance, but whether damages awarded for back pay or liquidated damages under statutes not providing for compensatory damages, [10] or whether punitive damages and attorneys fees, fell within the scope of Section 104, the statutory personal injury exemption that was in effect before 1996.[11] Once it was held in those cases that

[10] The starting point to answer whether Murphy's damages are taxable is an examination of the nature of the damages awarded under the specific statutes or laws at issue. In this case, the Government does not even cite the federal environmental whistleblower statutes under which Murphy was awarded damages, but the Government does not dispute that those statutes provided her an award of "make whole" compensatory damages for her personal injury losses.

[11] In *United States v. Burke,* 504 U.S. 229 (1992), the Court examined only whether back pay

the monies received were not on account of personal injuries the awards had to be taxable as income by default. However, in this case, the Government is taxing monies awarded for personal injuries, thus requiring an analysis of the more fundamental question as to whether the award is income in the first instance.

This Court should apply the "In lieu of what were the damages awarded?" test that had been developed in various circuits.[12] Applying this test unquestionably demonstrates that Murphy's compensatory damages award is nontaxable. Murphy's damages were strictly designed to make her physically and emotionally "whole," and did not "reach beyond those damages that, making up for a loss, seek to make a victim whole, or … 'return the victim's personal or financial capital.'" *O'Gilvie*, 519 U.S. at 86. In *O'Gilvie,* the Supreme Court asked whether the award being taxed is a "substitute for [a] normally untaxed personal … quality, good or 'asset.'" *Id.*. The Government has not advanced any argument to avoid that threshold question raised by Justice Breyer.

The Government's circular argument that Murphy is better off financially after receiving

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damages awarded under Title VII of the Civil Rights Act of 1964 (which at the time did not provide for an award of compensatory damages) were on account of personal injuries or for back pay. The Court held the back pay award was not for personal injuries as it was not based on "tort or tort type rights." In *Commissioner v. Schleier,* 515 U.S. 323 (1995), the Court only analyzed whether liquidated damages awarded under the Age Discrimination in Employment Act were on account of personal injuries. In *O'Gilvie v. United States,* 519 U.S. 79 (1996), the sole issue was whether punitive damages were received "on account of" personal injuries. The Court held that punitive damages were not the same as compensatory damages because punitive damages do not "compensate for loss" or make the plaintiff whole. In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Court held that when a litigant's recovery constitutes taxable income, such income includes the portion of recovery paid to a litigant's attorney under a contingent fee agreement. The only issue in *Banks* was whether the plaintiff could assign a portion of a taxable recovery to an attorney without incurring tax; however, whether the damages recovered were taxable income or for personal injuries was not even before the Court.

[12] *Raytheon Prod. Corp. v. Commissioner,* 144 F.2d 110, 113 (1st Cir. 1944); *Francisco v. United States,* 267 F.3d 303, 319 (3d Cir. 2001); *Tribune Publ'g Co. v. United States,* 836 F.2d 1176, 1178 (9th Cir. 1988); *Gilbertz v. U.S.,* 808 F.2d 1374, 1378 (10th Cir. 1987).

the damages award than prior to receiving the award and therefore it must be income also misses the fundamental point that Murphy's damages are not income in the first instance. First, the Government misconstrues the holding of *Glenshaw Glass*, which expressly distinguished punitive damages from "make whole" compensatory damages for personal injury. *Glenshaw Glass*, 348 U.S. at 433 n. 8. Since personal injury damages were not the subject of the tax it is highly misleading for the Government to claim that *Glenshaw Glass* requires the conclusion that damages received on account of personal injury are an accession to wealth. "Accessions," as understood by the courts and not challenged by the Government here, was an addition to wealth or property. It was not an all-encompassing term which would include monetary payments for restoration of a loss – be that a loss to a house or a hand. Indeed, *Glenshaw Glass* did not disturb the "long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital…." *Id.*

The fundamental principle set forth in Sol. Op. 132 holding that such damages for personal injuries were not income was steadfastly followed by the IRS and the courts from 1922 and never overruled. This undermines and contradicts the Government's no basis theory. The Government still cannot show that "make whole" damages for personal injury are a taxable accession to wealth in light of the "long history" of authorities which concluded that there is not "any gain or profit" derived from an award of such damages.[13] *Cf.* Sol. Op. 132; *Hawkins,* 6

[13] The Government's reliance on Treas. Reg. 1.61-14(a), stating that punitive damages and treasure trove are examples of items not specifically enumerated in Section 61(a), does not help the Government. Rather, treasure trove and punitive damages are clearly distinguishable from "make whole" compensatory damages for personal injury. *Glenshaw Glass, supra.* These examples are accessions to wealth whereas "make whole" compensatory damages are not. Moreover, the cross-reference in Treas. Reg. 1.61-14(b) to Section 104 and its regulations does not imply the inclusion of personal injury damages in gross income as those regulations were enacted in 1970 and the IRS did not promulgate any regulations to interpret Section 104 since it was amended in 1996. *See* 26 C.F.R. §1.104-1 (1970); Treas. Reg. 1.61-14 (1993). Indeed,

B.T.A. at 1025 ("Such compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury.").

It has long been held that not everything that is paid to an individual is income. Simply because Murphy received $70,000 in payment for her "make whole" award does not mean that she realized an accession to wealth. *See* Sol. Op. 132, 1-1 C.B. 92, 03 (1922) ("the Supreme court has repeatedly held that gross income does not include everything that comes in."), citing *Lynch v. Turrish*, 247 U.S. 211 (1918); *Eisner, supra.; Stratton's Independence, supra. Also see, Bowers v. Kerbaugh-Empire,* 271 U.S. 170 (1926) (savings on liquidation of debt through drop in foreign exchange not income).

The Government's reliance on 26 U.S.C. §1001, and other similar provisions that generally apply to business deductions is a red-herring.[14] In *Polone v. Commissioner,* 449 F.3d 1041, 1045 (9th Cir. 2006), amended and superceded by *Polone v. Commissioner,* __F.3d__, 2007WL725736 (9th Cir. March 12, 2007), the court only held that §1001 does not apply to personal injury damages on the basis of state law, and that case expressly did not concern the definition of "income" under either the Sixteenth Amendment or §61(a). *Id.,* 2007WL725736, *4 n.3. In *Roemer v. Commissioner,* 716 F.2d 693, 696 n. 2 (9th Cir. 1983), the court held that personal injury damages at issue there were not taxable, and the portions of *Roemer* selectively cited by the Government are dicta. Moreover, the "sale of blood" case cited by the Government

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the IRS administrative regulations on whether personal injury damages for non-physical injuries were enacted in 1922 and adopted in part in 1974, specifically state that these kinds of damages are not income. *See* Sol. Op. 132 and Rev. Rul. 74-77.

[14] *Raytheon* does not support the Government's basis argument because the issue there was whether the anti-trust business damages were for damage to business goodwill (a capital asset) or lost profits (income). *Raytheon,* 144 F.2d at 113-14.

is inapposite and also undermines the Government's position as the sale of blood is not a personal injury, does not involve "make whole" damages analogous to the return of human capital, and involves the sale of a replenishable part of the body for a profit. *Cf. Lary v. United States,* 787 F.2d 1538, 1540-41 (11th Cir. 1986).

Significantly, the Government's citing § 1001 and other authorities to argue that there is "no basis" in human capital, and thus no value to human life, does not change the binding "long history" of Departmental rulings and cases cited above. The Government's tax basis argument misses the point and diverts attention from the central holding of *Glenshaw Glass,* that in order to tax Murphy's damages the Government must show that her damages award was an "accession to wealth." This the Government has not done. Rather, Murphy raised the human capital analogy, that was relied on by the Treasury Department in 1918 and 1922, as a means to demonstrate that her "make whole" compensatory damages are not an "accession to wealth," and therefore do not fall within the definition of income under §61(a) and the Sixteenth Amendment.

The Government cannot escape, and has not contested, that Murphy's damages were intended to fully compensate for her loss. The Government's attempt to argue that because Murphy cannot avail herself of §1001, and other statutes generally applicable to business deductions, is inapposite and does not mean that Murphy has realized an "accession to wealth" under *Glenshaw Glass.*

C. Even If the Damages Award Is Income Under Section 61(a) It Must Be Excluded Under Section 104(a)(2).

The Government never contested plaintiff's statement of material facts in the district court, so it is not a matter of factual dispute that the conduct found illegal by DOL: (1) caused Murphy to sustain ***both*** "somatic" and "emotional" injuries, including the teeth grinding condition; (2) More than 10 years after the DOL took testimony at the only evidentiary hearing

held on Murphy's claims, she still "continues to experience pain and tooth damage…"; and (3) Murphy suffered from other physical manifestations of stress. *Murphy v. IRS*, 362 F.Supp.2d at 211. The DOL specifically cited that portion of Murphy's expert, Dr. Edwin Carter, who testified unequivocally that Murphy sustained panic attacks and physical manifestations of stress as well as "somatic references and body references."[15] Because the DOL expressly cited to and relied on that portion of Dr. Carter's expert testimony about Murphy's physical injuries when the DOL justified the amount of Murphy's compensatory damages, Murphy did, in fact, receive damages "on account of" physical injuries or physical sickness. *See Commissioner v. Schleier*, 515 U.S. 323, 336-37, 115 S.Ct. 2159 (1995).

Notably, the DOL's labeling of the award as for "emotional distress" is not dispositive of the issue and the cases cited by Murphy in her opening brief on this point were not even discussed by the Government. *See* Appellants' Br., pp. 47-48.

The district court also utilized Dr. Carter's expert testimony about Murphy's physical injuries. Thus, there a direct causal connection exists between the physical injury or physical sickness and the damages awarded to Murphy.

Section 104(a), as amended, distinguishes between "physical injuries or physical sickness" and "emotional distress." 26 U.S.C. §104(a). If the amended statute is to have any meaningful purpose, there must be a distinction between "physical injuries or physical sickness" and the term "physical symptoms" as used in the legislative history. However, the district court

[15] The ALJ's recommended decision on damages that was adopted by the ARB specifically cited to and relied on Dr. Carter's testimony about Murphy's physical or somatic injuries to justify the amount of the award of compensatory damages for emotional distress. *Cf.* Docket #15, Pl. Stmt. of Facts, ¶¶ 13, 17, citing Transcript, pages 148-149, of Dr. Carter's July 18, 1994 testimony before the DOL *with Leveille v. New York Air National Guard,* ALJ Case Nos. 94-TSC-4 and 94-TSC-4, Recommended Decision and Order, at pp. 4-7 (Feb. 9, 1998), citing Transcript pages, 148-149, 165, of Dr. Carter's testimony.

did not come to grips with this problem of statutory construction concerning the meaning of the 1996 amendments to §104(a). *See* Appellants' Br., pp. 34-48, and authorities cited therein. *Also see, Walters v. Mintec/International,* 758 F.2d 73, 77-78, citing *Restatement (Second) of Torts,* §§ 7, 402A, and 436A. There is a difference long recognized in the law distinguishing between "transitory" symptoms such as "dizziness" or nausea, and other "long continued" physical problems that "may amount to a physical illness" and which, in themselves, constitute "bodily harm." *Restatement (Second) of Torts*, § 436A. The district court simply concluded that because Murphy's "physical problem, bruxism… was only a symptom of her emotional distress, not the source of her claim." *Murphy,* 362 F.Supp.2d at 215. However, the uncontested summary judgment record demonstrated that Murphy's physical problem was more than a mere "symptom," it was a "long continued" physical injury constituting bodily harm in and of itself and permanent damage to her teeth. *See* J.A. 40-41, Carter Aff., ¶¶ 10-16; J.A. 44-45, Kurzer Aff., ¶¶ 8-15.

II. EVEN IF MURPHY'S DAMAGES ARE NOT INCOME THEY CANNOT BE TAXED.

A. Where the Power to Tax Is Based On the Sixteenth Amendment There Is No Need to Determine Whether the Tax Is Direct Or Indirect.

When seeking rehearing en banc, Appellees argued that because the power to tax is found in Article I, Section 8, cl. 1, of the Constitution, which provides for the power to impose indirect excise taxes, etc., and not under the Sixteenth Amendment. However, in their merits brief on rehearing the Government concedes that the Sixteenth Amendment is the source for the definition of income contained in the catchall provision of Section 61(a), which is the sole means by which the IRS justifies the tax on Murphy's compensatory damages award. *See* Appellees' Br., p. 11 ("Gross income includes 'all income from whatever source derived.' I.R.C. § 61(a).

Congress purposely modeled this definition upon the language of the Sixteenth Amendment …"); *Id.*, pp. 18-19 and 22.

Where, as here, the Government relies solely on the catchall provision of Section 61(a) as the tax levying statute then the court must determine whether the item to be taxed is income under the Sixteenth Amendment. See Dodge, Joseph M., "The Constitutionality of Federal Taxes and Federal Tax Provisions," pp. 8-9 (November 12, 2006). Florida State University College of Law, Public Law Research Paper No. 226, Available at SSRN: http://ssrn.com/abstract=943014 ("if an item is potentially taxable *only* under the catch-all clause of section 61(a), then it *must* pass the income test [under the Sixteenth Amendment], and it cannot be bootstrapped into validity as being potentially the subject of a hypothetical (but non-existent) provision that would be valid as an indirect tax."). As previously noted, Congress did not enact a separate tax on compensatory damages for non-physical personal injuries in 1996, as it had previously done for alimony, and the removal of the exemption for non-physical injuries from Section 104 does not result in a tax pursuant to the catchall provision in §61 that is based on the Sixteenth Amendment. Requiring Congress to enact a specific tax on compensatory damages would not be "an empty formality." *Id.*, pp. 9-10 ("If no Code provision specifically includes the item in income (or otherwise requires it to be taxed), its inclusion rests on whether the item is 'income' with the catch-all clause of section 61, with the latter (in turn) being limited by the 16th Amendment meaning of 'income.'").

A finding that Murphy's damages are not income within the scope of the catchall provision in §61 or the Sixteenth Amendment, or that Congress has not enacted a specific tax on non-physical compensatory damages, renders moot the issue whether the tax is direct or indirect

and it would be an advisory opinion to rule on the direct/indirect question.[16] If no Code provision specifically includes non-physical compensatory damages as an item of income, or it is not income under the catchall provision of Section 61(a), then the Court would be issuing an advisory opinion based on a hypothetical because Congress has not actually passed a tax, and there would be no live case or controversy, that can be judicially reviewed.

Nor is there a requirement that a court determine whether an income tax is direct or indirect for the Sixteenth Amendment to apply.

B. The Tax On Murphy Is a "Capitation" or Other Direct Tax.

Alternatively, the tax on Murphy is a direct tax on the source and more direct than the tax declared to be invalid in *Pollock.*[17] The Government makes many errors in its effort to counter *Amici's* argument, joined by Murphy, that the tax on Murphy's damages is a direct tax subject to apportionment under the Constitution.

1. The Federalist has a great deal to say about the nature of direct and indirect taxes, all of it unfavorable to the Government's case. The Government's response is to ignore the Federalist completely.

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[16] *See, e.g., Public Utilities Commission of the State of California v. FERC*, 236 F.3d 708, 713-716 (D.C. Cir. 2001) (citations omitted) (Article III, Section 2 of the Constitution restricts federal courts to resolving actual, ongoing controversies, rather than issuing advisory opinions or deciding questions that cannot affect the rights of litigants in the case before them).

[17] The Supreme Court invalidated the entire income tax in 1895 when it was deemed to be a direct tax. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), vacated on rehearing 158 U.S. 601 (1895). Murphy joins *Amici* in their views on *Pollock* and *Union Elec. Co. v. United States*, 363 F.3d 1292 (Fed Cir. 2004), *cert. denied*, 543 U.S. 821 (2004). Accord., *Brushaber v. Union Pac. R.R.*, 240 U.S. 1, 19 (1916) (the Sixteenth Amendment "contains nothing repudiating or challenging the ruling in the *Pollock Case* that the word direct had a broader significance …" and "the purpose was not to change the existing interpretation…"). *Also see*, Jensen, Erik M., "The Apportionment of 'Direct Taxes': Are Consumption Taxes Constitutional?" 97 *Columbia Law Review*, 2334, 2342-2345, 2366-2375 (1997).

The Government draws from a secondary source its sole reference to a primary source: a passage from James Madison's notes of The Debates in the Federal Convention on August 20, 1787.[18] Madison records that Rufus King asked the convention "what was the meaning of direct taxation" and that "[n]o one answd." Appellees' Br., pp. 59-60. The Government implies that the other delegates were baffled by the question and had no answer. This is both disingenuous and illustrates the folly of attempting Constitutional analysis without reference to The Federalist. It is obvious the delegates already had clear ideas about the meaning of direct and indirect taxation.[19] *Madison himself*, as one of the three authors of The Federalist, wrote specifically in No. 54, about "direct taxes" and their relationship to apportionment of representatives. The Federalist Papers, No. 54 (Madison), pp. 336-7 (Mentor ed. 1961). It is overwhelmingly likely that the future President, knowledgeable and attentive, simply joined the others in ignoring King whose comment came close to the end of a hot August Monday in Philadelphia during a discussion of apportionment of taxes among the states pending an initial census. King was likely ignored because the delegates wanted to get on with the issue at hand, not because they didn't know what was meant by "direct taxation." "No one answd" was thus essentially equivalent to "No one bothered to answer."

2. The Government overlooks that the tax it seeks to impose upon Murphy is in fact a capitation tax or other direct tax. Contemporaneous authoritative explanation of the term "capitation" shows that the term was meant to encompass, among others, income taxes. Albert Gallatin, Secretary of the Treasury under Presidents Jefferson and Madison, May 14, 1801 to February 9, 1814, thus wrote as to the meaning of the term:

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[18] Available online at www.yale.edu/lawweb/avalon/debates/820.htm.

[19] *See, e.g.*, Jensen, 97 *Columbia Law Review* at 2337-2338 and 2377-2389.

> The remarkable coincidence of the clause of the Constitution with this passage [in Adam Smith's "Wealth of Nations"] in using the word 'capitation' as a generic expression, including the different species of direct taxes, in acceptation of the word peculiar, it is believed, to Dr. Smith, leaves little doubt that the framers of the [Constitution] had [Adam Smith] in view at the time, and that they, as well as he, by direct taxes, meant those paid directly from and falling immediately on the revenue ..." 3 Gallatin's Writings, (Adamis's ed.) 74, 75. [Quoted in *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429, 570 (1895), vacated on rehearing 158 U.S. 601 (1895).]

Of course, direct taxes in the Constitution are not limited to capitation taxes. *See* Article I, § 9, cl. 4 ("No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."). *Also see*, Jensen, 97 *Columbia Law Review* at 2389-2397. A definition of direct taxes based on the historical record is: "Direct taxes are taxes that are not indirect taxes and that are imposed by the national government directly on individuals, generally without the states' serving as filters of the national power." *Id.*, at 2402. On the basis of this definition, a tax on Murphy's damages is a direct tax. It was Murphy who paid the tax now at issue. The tax was both measured by the amount of Murphy's damages to make her whole for personal injury loss and clearly fell, directly, upon her. As a result, the tax the Government seeks to impose is thus clearly and inescapably direct.

3. The Government's heavy reliance on *Hylton v. United States*, 3 U.S. 171 (1796), is both over-stated and misplaced. First, in fact, only two of the justices – William Patterson and James Wilson – not four, were delegates to the Constitutional Convention.[20] The lead opinion in *Hylton* was written by Samuel Chase, who was not a delegate. Second, there no reason to prefer the personal recollections of Messrs. Patterson and Wilson to the extent reflected in *Hylton* over the more immediate ones set forth in The Federalist – rather the reverse. Third, Mr. Justice Chase's theory of direct and indirect taxation corresponds neatly to the principles set forth in The

[20] *See* the rosters of delegates at www.answers.com/topic/philadelphia-convention and www.law.umkc.edu/faculty/projects/ftrials/conlaw/marryff.html.

Federalist and Gallatin's Writings – that direct taxes are measured by the taxpayer's revenue and indirect (consumption) taxes by the taxpayer's expenses:

> I think an annual tax on carriages for the conveyance of persons, may be considered as within the power granted to Congress to lay duties. The term duty, is the most comprehensive next to the generical term tax; and practically in Great Britain, (whence we take our general ideas of taxes, duties, imposts, excises, customs, &c.) embraces taxes on stamps, tolls for passage, &c. &c. and is not confined to taxes on importation only.
>
> It seems to me, that a tax on expence is an indirect tax; and I think, an annual tax on a carriage for the conveyance of persons, is of that kind; because a carriage is a consumeable commodity; and such annual tax on it, is on the expence of the owner. [3 U.S. at 175.]

Mr. Justice Patterson's views in *Hylton* are drawn even more directly from The Federalist and Gallatin, and cites to Adam Smith's *Wealth of Nations,* 3 Vol. pp. 331 and 341 (1776), which likewise supports that the tax on Murphy's damages are direct. *Hylton.*, 3 U.S. at 180-81. *Hylton* thus supports Murphy's position in the instant case.

CONCLUSION

For the foregoing reasons, and for the reasons previously raised by Murphy and Amici Curiae, the district court should be reversed.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I hereby certify that the foregoing corrected reply brief complies with the type-volume limitation set forth in FRAP 32(a)(7)(B)(i), and that it contains 6,988 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii), and Circuit Rule 32(a)(2). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and Circuit Rule 32(a)(1) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface (Times New Roman, 12 point font) using Microsoft Word 2002.

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing Corrected Reply Brief was served on this 15th day of March, 2007, by first class mail, postage prepaid, upon:

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