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Viewpoint

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SECTION 104 CASES CONTINUE TO MERIT ATTENTION.

Robert W. Wood reviews the latest cases involving the section 104 damages exclusion.

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by Robert W. Wood

[1] Most readers of Tax Notes are well aware that the Small Business Job Protection Act of 1996 (H.R. 3448) radically changed section 104. Its ramifications have sent a shockwave through a significant segment of the litigation community and its various participants. Big companies, litigators, and tax professionals have all been affected.

[2] But after all of the theatrics of the amendments to section 104, the line drawn between physical injuries and personal (but not physical) injuries seems destined not to work quite as well as Congress might have anticipated. Let me return to this subject of the post-August 20, 1996, law in a few minutes. On pending audits, pending appeals and pending tax litigation, most tax practitioners are understandably still dealing with cases that were settled (or proceeded to judgment) under "old" law (that is, the law in effect prior to August 20, 1996), albeit winnowed down by Schleier and all of the other cases that have narrowed the tort exclusion. Let's look at a pair of recent cases decided under that old law.

Every Body Needs Milk

[3] If anyone needed confirmation that section 104 (at least before August 20, 1996) had substantial vitality even in the wake of harsh Supreme Court announcements such as Burke and Schleier, that confirmation is readily apparent in the case of George Knevelbaard, et ux. v. Commissioner, T.C. Memo. 1997-330, Doc 97-21376 (29 pages). The Tax Court there held that payments received by a group of dairy farmers in settlement of a lawsuit against several banks were excludable from their gross income under section 104. The case arose out of Mr. and Mrs. Knevelbaard and six other couples (who were also dairy farmers), all of whom sold raw milk to Knudsen Dairy. Under long-term agreements, the milk producers were required to ship milk to Knudsen, and Knudsen was to pay for the milk twice per month.

[4] When Knudsen failed to pay the milk producers in July 1986, the milk producers were unexpectedly faced with financial difficulties, had to borrow money, depleted savings, and even faced possible bankruptcy. Although Knudsen got back on track, it never made the back payments and Knudsen ultimately filed for bankruptcy.

[5] In 1989, the Knevelbaards and the six other couples joined nearly 1,000 other milk producers in filing a suit [P. 984] against several banks, alleging that the banks made risky but secured loans to Knudsen knowing that Knudsen was highly leveraged and vulnerable. The suit also contended that the banks gave false assurances of Knudsen's solvency, thus inducing the dairy farmers to continue to supply the milk. The complaint contained 12 causes of action sounding in tort, and sought damages for mental suffering and emotional distress.

[6] In 1990, the banks and milk producers orally agreed to a settlement under which the banks would pay $20 million in full payment of the plaintiffs' claims for negligent infliction of emotional distress. The settlement agreement as finally written allocated $19.3 million to that tort action, and $700,000 to negligent interference with contractual relationships. The banks had consistently contended that they were not liable for claims arising out of the contract between Knudsen and the milk producers.

Burke Case Has Vitality

[7] Predictably, the IRS disagreed with this allocation, arguing that the proceeds represented damages for lost milk under these contracts. The Tax Court, however, disagreed with the IRS. Citing United States v. Burke, 504 U.S. 229, 92 TNT 110-1 (1992), Judge Parr of the Tax Court concluded that the milk producers' action against the banks was based on tort or tort-like rights. The court noted that the action had sought damages for mental suffering and emotional distress, that the milk producers' claim against the bank was separate and apart from their contractual claim against Knudsen, and that the origin of their claim against the bank was the bank's behavior.

[8] It must be remembered, that the Supreme Court in Burke focused on the remedial provisions of the statute the Court was considering (Title VII of the Civil Rights Act of 1964). The majority of the Justices in Burke felt that the remedial provisions of the statute would determine whether or not it was tort-like. Although Justice Scalia issued a concurring opinion (that seemed to want to repeal section 104 altogether!), there was a vigorous dissent by Justice O'Connor in which Justice Thomas joined. The dissent referred to the tort-like inquiry that is required under the IRS's own regulations (not to mention decades of case law).

[9] The dissent in Burke then turned to the nature of the rights protected (those rights being purely personal in the case of Title VII) rather than the nature of the remedy provided. Focusing on the nature of the remedy, asserted the dissent, could not possibly be controlling in determining the appropriate tax character of the recovery, given that the IRS's own regulations require an examination of the type of rights protected. Unfortunately, with Commissioner v. Schleier, 115 S.Ct. 2159, 95 TNT 116-8 (1995), holding that age discrimination recoveries under the ADEA constitute taxable income, virtually everyone forgot about the Burke decision.

[10] The Schleier decision was careful to say that it did not formulate the only test for 104 excludability. Yet, for quite a while now people have been relying upon the Schleier two-pronged approach in analyzing whether a recovery could qualify as excludable from income. In Schleier, the Supreme Court said that section 104 could operate to exclude a recovery from income when it is both: (1) received through prosecution or settlement of an action based on tort or tort-type rights; and (2) received on account of personal injuries or sickness.

[11] Burke, it should be recalled, found that Title VII recoveries (under the pre-1991 version of Title VII) were taxable, but strongly implied that post-1991 Title VII recoveries would be excludable. In fact, the Supreme Court implied this so strongly that the Internal Revenue Service soon issued a revenue ruling so holding (Rev. Rul. 93-88). The IRS then suspended and then revoked this ruling after a seemingly more harsh Supreme Court decided Schleier in 1995.

Back to Knevelbaard

[12] Against the lofty Supreme Court authority of Burke and Schleier, let's go back to our milk farmer case. Judge Parr of the Tax Court had to reconcile how the recovery against the bank by the Knevelbaards and the other couples arising out of their dairy contracts really stood up to the tort injury standard of section 104.

[13] Judge Parr, referring to the key phrase in section 104, concluded that the settlement proceeds were received "on account of" personal injuries. The Tax Court specifically rejected the IRS's argument that the settlement was paid on account of Knudsen's default. While the milk producers undoubtedly suffered emotional harm from Knudsen's default in its contractual obligations, wrote the court, the milk producers alleged additional and separate harm caused by the violation of duties owed to them by the banks. The court was convinced by the taxpayers' testimony that their experience produced serious and prolonged stress.

[14] Interestingly, the court referred not only to Burke, but to several other important decisions from the recent past. The Tax Court in Knevelbaard also cited Threlkeld v. Commissioner, 87 T.C. 1294, 86 TNT 243-70 (1986), aff'd 848 F.2d 81 (6th Cir. 1988). In Schleier, the Supreme Court held age discrimination recoveries under the ADEA were taxable. Of course, in 1996 Congress passed the Small Business Job Protection Act of 1996, tightening the section 104 exclusion even further by requiring a physical injury or physical sickness, generally effective for recoveries after August 20, 1996.

[15] In Knevelbaard, the Tax Court even noted specifically that the fact that the settlement distribution was made pro rata to the milk producers was not improper, nor did it somehow indicate that the settlement represented lost profits. The court considered the fact the $20 million payment was distributed in proportion to the amount of the defaulted milk payments to be simply a practical and common sensical solution, given the nearly 1,000 dairy farmers who were involved. It seems that there might have been better planning from the [P. 985] lawyers involved in the settlement, but the pro rata nature of the payout to the Knevelbaards and their fellow plaintiffs was not enough to tax their creamy recovery into skimmed milk.

Knevelbaard: To Sum Up

[16] George Knevelbaard, et ux. v. Commissioner is one of the more favorable cases to come along in this area in the last couple of years. After all, the Tax Court:

1. Endorsed the Burke standard for the scope of section 104 (which is considerably broader than the Schleier standard).

[17] Given that many courts since the Schleier decision have repeated the Schleier two-part standard for section 104 excludability, it is significant that the broader Burke test may be re-emerging. Just how much impact this could have for post-August 20, 1996, cases is not entirely clear, since a physical injury or physical illness would still be required. However, even for post- August 20, 1996, cases, there could be some impact to the scope of section 104 merely by applying the Burke rather than Schleier test. In any event, the impact for pre-August 20, 1996, cases could be huge.

2. Upheld express allocation language in a settlement agreement.

[18] This is a familiar tune. Everyone should know by now that express language in the settlement agreement is far more likely to be upheld than if the parties leave the matter to fate. There have been some case law suggestions that there needs to be an adverse interest among the parties, and some indication that there was bargaining over the tax allocation. Whether a particular court will require just that much detail or not, it is certainly appropriate to expressly state intended tax consequences, to expressly state how the amounts will be reported (W-2, 1099, or not at all), and to expressly require consistent reporting and treatment on tax returns by all parties.

3. Found that testimony by settling litigants as to their stress and emotional distress was convincing.

[19] While it is very helpful that the Tax Court found the testimony of the litigants helpful and found the stress to be genuine, no one likes to take the witness stand in defense of a tax allocation. The fact that the allocation withstood scrutiny in Knevelbaard is significant, but one has to assume that there really was serious stress present. These taxpayers were good witnesses. However, it does raise the larger question of what other evidence besides testimony might have been convincing. At the audit or appeals stage, perhaps a diary, medical records, psychiatric records, etc., could all help to reach the same result at an earlier (and therefore less expensive) stage.

4. Found it unimportant that the distributions of settlement monies to the 1,000 litigants were proportional to what could be described as their contract damages.

[20] Perhaps this is merely a variation of paragraph 2 above (about express allocations in settlement agreements). However, it does seem significant that there was strong enough evidence of tort claims and tort injuries here that the Tax Court was not at all bothered by the fact that distributions were made proportionate to amounts the plaintiffs lost on what can only be described as an economic contract. Although the Tax Court may have found this a sensible basis upon which to make the distributions, the IRS certainly did have a point that this might have been viewed as contradicting the tort character of the payments.

Excludable Damages vs. Taxable Punitives

[21] If the Knevelbaard decision does not breathe new life into at least some practitioners' views of the section 104 exclusion (again, under pre-August 20, 1996, law), then perhaps they will be impressed with Hughes A. Bagley, et ux. v. Commissioner, No. 96-1768, Doc 97- 23130 (9 pages) (8th Cir., Aug. 6, 1997). That case is doubly interesting, in that it deals not only with the tort exclusion, but more significantly, deals with the tax treatment of punitive damages. Even before O'Gilvie v. U.S., 117 S.Ct. 452 (1996), was decided by the Supreme Court, and even before the H.R. 3448 change to section 104 to make punitive damages taxable, the prevailing holding in the courts was that punitives would be taxable in all circumstances. How then should an allocated settlement be dealt with?

[22] Hughes A. Bagley had settled his tort actions against his prior employer. Bagley was vice president of Iowa Beef Processors when it terminated his employment. Shortly thereafter, Bagley testified before a congressional subcommittee investigating the meat packing industry and focusing in part on Iowa Beef Processors' activities. Bagley's testimony was responded to by the then president of his former employer, and Bagley's former employer ultimately wrote a letter attacking Bagley's character and veracity. The letter was circulated widely and even reported to the media. In the face of this scandal, Bagley's new employer terminated him.

[23] Bagley sued Iowa Beef Processors, alleging tortious interference with his current and future employment, libel, and invasion of privacy. A jury awarded him $1.5 million in actual damages and $7.25 million in punitive damages. There were various motions, including for judgment notwithstanding the verdict. In particular, the trial court reversed the libel claim (on which the $1 million in compensatory damages and $5,000 in punitive damages had been awarded) and remanded for a new trial.

[24] Before a new trial began on the libel claim, though, the parties agreed to a settlement of $1.5 million. Bagley was paid, and excluded the entire $1.5 million from his income. The IRS came along, determining that $1.3 million of the $1.5 million constituted punitive damages, and was thus not excludable from his income.

[25] The Tax Court, however, ruled that only $500,000 represented punitive damages, finding that if the litigation had continued, it would have been reasonable to assume that Iowa Beef Processors would have paid the entire $1 million as compensatory damages. The court [P. 986] did agree that the $500,000 in punitive damages paid as such was taxable.

Be Reasonable in Your Allocations

[26] There seem to be several lessons contained within the Hughes A. Bagley opinion. (Let's see: "Choose Wisely," "Don't Be a Pig," "Know When to Hold and When to Fold," etc.) Mr. Bagley was still arguing even on appeal about how no part of the settlement payment represented punitive damages, and he should receive it all tax-free. The court said that accepting his argument would require the court to believe that this potential liability did not affect the size of the settlement at all, and thus that Iowa Beef Processors paid nothing to Bagley to secure the release from this sizable exposure. The court did acknowledge that the settlement agreement contained no reference to punitive damages, but pointed out that the agreement did not explicitly state that punitive damages were not part of the agreement either. (Another Lesson: "Be explicit in the settlement agreement!")

[27] What seems to be called for here is a little bit of realism. Everyone would know that the punitive award would influence the amount of the ultimate settlement. The appellate court judge could not say that $500,000 was not the proper amount to allocate to punitives. After all, the court noted that the Bagleys did not suggest an alternative amount (except zero), and the court found that the $500,000 allocated to punitives gave the Bagleys the benefit of the largest amount the jury had awarded in compensatory damages. Thus, said the court, this was the largest amount that could plausibly be allocated to compensatory damages.

[28] Ultimately, Mr. Bagley did not come off too badly. Out of the $1.5 million settlement, $500,000 was allocated to punitives. This, keep in mind, was after a jury verdict in which Bagley had been awarded $1.5 million in actual damages and $7.25 million in punitive damages.

Bigger Lessons

[29] Perhaps to a greater extent than the decision in Knevelbaard, the decision in Hughes A. Bagley ought to provide continuing guidance to litigants going forward in these disputes. With punitive damages now having the universal smell of taxability, it is my belief that most punitive damage awards in the future will be paid in settlements in which no one will admit any liability for punitive damages. If one takes the figures in the Hughes A. Bagley case, he received a jury verdict of $1.5 million in actual damages, and $7.2 million in punitive damages, ultimately settling the case lock, stock, and barrel for $1.5 million. With a little attention to detail, it might have been possible to treat all of the recovery as actual damages and no portion as punitives. After all, his original actual damages verdict was for $1.5 million. Nonetheless, it was also not a terrible result to have $500,000 treated as taxable, with the other $1 million treated as excludable under section 104.

[30] Interestingly, the court in Hughes A. Bagley mentioned McKay v. Commissioner, 102 T.C. 465, 94 TNT 60-9 (1994), distinguishing that case because the parties involved there were settling the case and were genuinely adverse in doing so on the issue of whether the settlement included punitive damages. Furthermore, said the Bagley court, the agreement in the case specified that it did not include punitive damages, and that the settlement was less than the jury had awarded in compensatory damages. All tax practitioners (plus the various litigators out there that think they don't need tax practitioners) should take note of the court's comment.

[31] If the settlement agreement was so important in reaching this tax decision, and if the case was settling for less than the total amount of actual damages awarded by the jury, that might have made a difference. Would Bagley's case have been resolved differently (either in the Tax Court and/or Eighth Circuit Court of Appeals) if Bagley had taken not $1.5 million in total settlement of his case, but $1.4 million? That would have been less, after all, than the $1.5 million in actual damages that he was awarded by the jury. If Bagley had taken the full $1.5 million but the parties had expressly allocated $100,000 to any punitives claim he had, would that have worked?

[32] There is another side to all of this, of course. Anyone who has been in discussions with the IRS is aware that the IRS might like to prorate the relative amounts awarded by a court or jury. In the case of Bagley, who was awarded $1.5 million at trial for actual damages and $7.25 million at trial for punitive damages, an IRS pro rata allocation would result in the lion's share of the amount being treated as punitive damages. Such a pro rata allocation seems highly inappropriate, of course, but that is hardly likely to stop the IRS from trying.

Post-August 20, 1996, Law

[33] Keep in mind that, unlike Knevelbaard, Hughes A. Bagley seems totally applicable under current (post-August 20, 1996) law. The big issue in taxing punitives is not going to be a court-ordered payment of punitive damages that actually gets paid. The big issue is going to be just what constitutes punitives when cases settle before trial (surely no punitives!), or especially, when cases settle on appeal. The settlement agreement, the facts, and the law surrounding the particular settlement and the intent of the parties should all

be relevant in determining the tax treatment of the payment.

[34] Since punitive damages deserve discussion for recoveries after August 20, 1996, perhaps the fitting way to conclude this brief review of a couple of recent cases is to note in a more general way what I perceive to be occurring in post-August 20, 1996, settlements. [P. 987] Assuming that the parties are well informed (an assumption that unfortunately is often not reasonable to make), then they will have considered the tax impact prior to the last-ditch frantic days of settlement. In the frantic pace to get the case settled, often on the eve of trial, the parties may agree on a dollar amount, a confidentiality clause, and all those other provisions in a settlement agreement that need attention. But the tax issues (admittedly all important to me) seem to languish.

[35] The principal tax issues I see raised in most litigation today include:

- Is there any argument for a section 104 exclusion (medical expenses, some physical consequence that might bring at least part of the recovery into the territory of tax nirvana)?
- What amount should be treated as wages and subject to full wage withholding, including FICA, FUTA, and federal income tax withholding?
- Will there be any pension or other employee plan ramifications of the above "wages" determination?
- What portion should be treated as damages not in the nature of wages, but something reported to someone in gross on a Form 1099? It may even be the employers who are most interested in this allocation, since they may be saving substantial FICA dollars. Are there state tax consequences (i.e., for moving taxpayers) to this allocation?
- How should the attorneys' fees be treated? This issue can be one of the most nettlesome of them all, since practice varies so widely. It is a separate subject unto itself. (For discussion about the Alexander case and its impact on so- called netting of attorneys' fees, see Wood, "Attorneys' Fees Held to be Below the Line Deduction," Tax Notes, Feb. 26, 1996, p. 1279.) Recently, I have found more concern on the part of the government and taxpayers alike with getting this issue resolved. Considering that the recovery in the typical litigated case (outside the purely physical P.I. field) will now largely or wholly be taxable, a deduction of attorneys' fees (as a miscellaneous itemized deduction) is not very helpful. Attorneys ought to be sure they know what their fee agreements say, and to the maximum extent possible, seek to distinguish the Alexander facts when a real attorneys' fee award is made.
- I should not leave out the enormous number of ordinary vs. capital distinctions that are raised in the settlement context. The fundamental issues have not changed too much over the years. For example, there are large numbers of business disputes where lost profits vs. harm to goodwill dichotomies are hotly debated. However, the ordinary vs. capital debate has changed radically in scope over the last few years by virtue of the Supreme Court's INDOPCO decision and its cancer- like growth into virtually all areas of federal tax practice. The deduct vs. capitalize fork in the road is especially tempting in the field of environmental litigation and compliance. Right now, I'm not sure whether taxpayers or the government are "taking the road less traveled by."
- Finally, fine or penalty issues still occasionally arise. Although we all know that fines and penalties are nondeductible under section 162(f), it certainly bears examining whether a fine or penalty is truly that or is rather some remediation expense that is merely bearing the wrong moniker. The case law has been relatively generous when a remedial purpose can be shown, even though the name "fine or penalty" may be attached to it. Thus, don't give up on the deduction until it is truly time.

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