Section 104 Viability: Still Alive and Kicking

By Robert W. Wood

A recent appellate court decision may shed further light on the proper scope of the section 104 exclusion for payments for personal injury and/or illnesses in the wake of past Supreme Court decisions. The Eleventh Circuit's decision in *Fabry* potentially heralds a more flexible approach.

The section 104 exclusion for physical injury/physical illness has been in the law in its current guise since August 20, 1996, and it was in the law in an earlier version in the 1954 code. Authority dealing with the 1996 act's physical injury requirement, however, has been relatively sparse. No regulations, no rulings, and no cases expressly explain the scope of the exclusion since it was modified in 1996, and whether there must be a physical touching. The 1996 legislative history is less than illuminating, even though it is fairly long. The fact that legislative history is generally unenlightening is a sad commentary about our legislative process.

Nevertheless, there has been much authority under the pre-1996 act version of section 104 that required only "personal" injuries or illnesses, without the physical modifier. These cases have been decided in the wake of many Supreme Court decisions, and there is still raging controversy about various aspects of even the old law. The tax treatment of attorneys' fees has also engendered intense debate. This discussion has generated a severe split in the circuit courts that may lead either to a Supreme Court case, corrective legislation, or both.

In the meantime, the cases decided under the pre-1996 act version of section 104 can be very helpful not only in planning if one is litigating a case involving a pre-1996 act recovery, but also in planning the treatment of post-1996 act recoveries. If an amount is held to be excludable under the pre-1996 act version of section 104, there may be guidance that will be helpful in treating the post-1996 recovery. Apart from the designation, the knowledge and understanding of the Supreme Court's decisions in *United States v. Burke*, 504 U.S. 229, *92 TNT 110-1* (1992), and *Commissioner v. Schleier*, 515 U.S. 323, *Doc 95-5972 (27 pages), 95 TNT 116-8* (1995), remain the same.

Fabry Sheds New Light on Section 104

In *Carl J. Fabry, et ux. v. Commissioner*, 86 AFTR2d Par. 2000-5171, *Doc 2000-21891 (23 original pages), 2000 TNT 164-4* (11th Cir. Aug. 23, 2000), the Eleventh Circuit embarked on a case remarkable in result and analysis. The appeals court cogently explained the *Burke* and *Schleier* tests and how they should be applied. It then proceeded to hold that an injury to reputation could result in an excludable award. This decision by the Eleventh Circuit should be useful not only for those dealing with pre-August 20, 1996 recoveries, but also for those planning litigation settlements and judgments in 2000 and beyond.

The *Fabry* case involved a couple's action in state court seeking monetary damages under tort theories of

negligence and strict liability. Carl and Patricia Fabry operated a nursery as a sole proprietorship and successfully raised ornamental plants and citrus trees. The couple developed a reputation for growing quality plants and business boomed. However, they started using a fungicide purchased from E.I. du Pont De Nemours and Co., which ultimately led to the plants dying, customer complaints, and the erosion and eventual closing of their business. The lawsuit alleged that the fungicide had contaminated their plants. The Fabrys sought damages for lost profits, lost going concern value, and damage to their business reputation.

Discussions regarding a settlement began right away. Part of the couple's initial settlement demand included a claim for $500,000 for damages to business reputation. Eventually, after mediation, the suit was resolved with the chemical company paying $3.8 million for a general release. This released du Pont from all claims related to the fungicide except for claims for damages to crops planted in the future.

General Release?

On their 1992 federal income tax return, the Fabrys included most of their recovery in income, but excluded the $500,000 that they believed resulted from their claims for damage to business reputation. Their argument was that this was excludable under section 104(a)(2) as being received on account of personal injuries. The IRS disagreed, assessing deficiencies, penalties, and interest. Ultimately, the matter wound up in Tax Court. In *Carl J. Fabry, et ux. v. Commissioner,* 111 T.C. 305, *Doc 98-37065 (15 pages), 98 TNT 242-3* (1998), the Tax Court had an easy time finding for the commissioner and the Fabrys went to the Eleventh Circuit.

Since so many cases of this sort seem to be decided for the commissioner by the Tax Court, it is worth noting that the Eleventh Circuit (as all good appellate courts do) started with its standard of review. The appeals court stated that the interpretation and application by the Tax Court of a statutory section of the code was a question of law that it would review *de novo*.

The appellate court then went into an extensive discussion of the pre-1992 law, including such classic harm to reputation cases as *Roemer v. Commissioner,* 79 T.C. 398 (1982), *rev'd* 716 F.2d 693 (9th Cir. 1983). That case held that whether personal reputation or business reputation, an injury to reputation was a personal injury subject to exclusion under section 104. Despite the origin of the tort of defamation in old English law, the IRS objected mightily, to no avail.

Subsequently, the *Roemer* line of cases was followed by the IRS clarifying in Rev. Rul. 85-143, 1985-2 C.B. 55, that it would not follow the Ninth Circuit's opinion in *Roemer*. Then, in *Threlkeld v. Commissioner,* 87 T.C. 1294, *86 TNT 243-70* (1986), *aff'd* 848 F.2d 81, *88 TNT 119-7* (6th Cir. 1988), a malicious prosecution action resulted in a recovery that the Sixth Circuit found to be excludable despite the fact that there were no personal injuries. In that case, the appeals court explained that the personal nature of the injuries should not be defined by its effect.

Supreme Court Authorities

The *Fabry* opinion gets very interesting when it goes through an exhaustive and persuasive analysis of the Supreme Court's decision in *United States v. Burke* and its tort-like personal injury formula. The appeals court describes what needs to be found for the recovery to be excludable under *Burke*. Then, the appellate court discusses the *Schleier* case, with its own formulation of what constitutes a payment made "on account of a personal injury or sickness."

The Eleventh Circuit tried to synthesize the *Burke* and *Schleier* cases, which is not a simple task. In doing so, the appellate court attempted to provide guidance about what everyone is doing after this mishmash of Supreme Court authority. As the Eleventh Circuit in *Fabry* succinctly put it:

> *Burke* holds that payment received because of a Title VII violation is not excludable because violation of Title VII does not provide for personal injury losses. *Schleier* holds that the consequences of reaching sixty years of age are not consequences of personal injury. . . . We must look elsewhere for guidance.

The appellate court then noted that few courts have examined or used the second prong in *Schleier*.

The Eleventh Circuit cited as helpful the Sixth Circuit's decision in *Daniel C. Greer v. United States*, 207 F.3d 322, *Doc 2000-15424 (21 original pages), 2000 TNT 106-2* (6th Cir. 2000). That case involved claims for wrongful termination and injury to reputation, stress, humiliation, mental anguish, and emotional pain. The district court agreed with the taxpayer that the recovery was excludable. On appeal, the Sixth Circuit held that under *Schleier*, the taxpayer must demonstrate that:

> (1) there was an underlying claim sounding in tort;
>
> (2) the claim existed at the time of settlement;
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> (3) the claim encompassed personal injuries; and
>
> (4) the agreement was executed in lieu of the prosecution of the tort claim on account of the personal injury, rendering it a settlement rather than a mere severance agreement.

Thus, the Sixth Circuit in *Greer* took the two-part test of *Schleier* and effectively expanded it into a four-part test. The Eleventh Circuit in *Fabry* now assents to this construction.

In *Fabry*, the Eleventh Circuit also found other cases helpful. One of the cases cited was *Noel v. Commissioner,* 73 T.C.M. 2178, *Doc 97-6452 (26 pages), 97 TNT 44-16* (1997). In that case, the Tax Court found that two-thirds of the settlement proceeds were allocable to the release of contract claims. That left the remaining one-third allocable to tortious interference with contractual rights and prospective business advantage. This interference caused emotional distress and damage to business reputation through adverse publicity, so the Tax Court found it was paid "on account of personal injury" and therefore it was excludable under section 104. The *Fabry* court also cited *Knevelbaard v. Commissioner,* 74 T.C.M. 161, *Doc 97-21376 (29 pages), 97 TNT 140-4* (1997), in which the Tax Court ruled that a settlement arising from a patently commercial dispute involving dairy farmers who sued for breach of fiduciary duty and emotional distress was excludable under section 104.

So What About the Fabrys?

At trial, the IRS had stipulated that the $500,000 payment was properly allocable to damage for business reputation of the Fabrys. Perhaps this turned out to be a mistake. With this stipulation, the Tax Court found that notwithstanding the general release, which did not specifically allocate the $500,000 payment to this element of damages, the amount was excludable. The Eleventh Circuit examined the complaint, the mediation process, the settlement negotiations, and supporting documents. Unlike the Tax Court, the appellate court found that the $500,000 payment qualified for an exclusion under section 104.

The Eleventh Circuit reviewed the Tax Court's due diligence and expressed its disagreement. The appeals court said that the Tax Court's "method of merely perusing the record, looking for the presence of the magic words, 'personal injury,' either in the complaint, release, mediation correspondence or settlement documents, is incorrect." In *Fabry*, the court went on to specifically address intangible injuries, such as damage to business reputation, in light of *Schleier* and following cases.

What the Eleventh Circuit found most significant was that in *Fabry* there appeared to be a cause and effect relationship between the tort, the resulting personal injury, and the amount received in the settlement. Obviously, this is not an exact science. The causal link, however, is what convinced the court that the *Schleier* standards would be satisfied. At the end of one section, the *Fabry* court queries:

> Is damage to one's business reputation a personal injury? Did the negligent or wrongful conduct of du Pont amount to a tort resulting in personal injury to the Fabrys, culminating in an injury to their business reputation, which injury in turn caused them to suffer damages, personal to them? Did the injury justify the $500,000 amount of damages recovered? . . . For the following reasons we conclude that it did.

Conclusion

On its own, the Eleventh Circuit's decision in *Fabry* is not going to revolutionize section 104 authority. Nonetheless, every professional who practices in this area should read it, and read it carefully. It indicates a fundamental attempt (and a valiant attempt at that) to get the Supreme Court's opinions in *Burke* and *Schleier* to jibe, and to apply them in a practical way. That this is not the only case to take a liberal (or is it more conservative?) approach to section 104 is amply illustrated by some Tax Court cases, including *Knevelbaard*.

Despite this very favorable development, we will all be struggling with this area for some years to come. In the meantime, the *Fabry* case will be of material assistance to taxpayers.

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