Fabry v. Commissioner, 111 T. C. 305 (1998)

Damages received for injury to business reputation are not automatically excludable from gross income as personal injury damages under section 104(a)(2) of the Internal Revenue Code; it is a fact-specific determination.

Summary

In Fabry v. Commissioner, the petitioners, Carl and Patricia Fabry, sought to exclude $500,000 from their gross income, which they received in settlement of a lawsuit against E. I. du Pont de Nemours and Co. for damages related to the use of a contaminated agricultural chemical. The Fabrys argued that the portion of the settlement allocated to business reputation damages should be excluded as personal injury under section 104(a)(2). The Tax Court held that whether damages for business reputation qualify as personal injury is a question of fact, not law, and the Fabrys failed to prove that the settlement payment was for personal injuries. Consequently, the court sustained the deficiency determination for the inclusion of the $500,000 in their taxable income.

Facts

The Fabrys operated Patsy's Nursery, where they used Benlate, a fungicide manufactured by du Pont. From 1988 to 1991, they suffered significant plant damage, which they attributed to Benlate's contamination. In 1991, they sued du Pont, alleging strict liability in tort and negligence, and claimed damages for plant loss, lost income, business value, and damage to their business reputation. The case was settled in 1992 for $3,800,000, with $500,000 allocated to business reputation damages. The Fabrys excluded this amount from their 1992 federal income tax return, claiming it as a personal injury under section 104(a)(2).

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency in 1996, asserting that the $500,000 payment should be included in the Fabrys' gross income. The Fabrys petitioned the U. S. Tax Court, which heard the case and issued its opinion on December 16, 1998, holding that the $500,000 payment was not excludable as personal injury damages.

Issue(s)

1. Whether the $500,000 received by petitioners in settlement of a lawsuit alleging injury to business reputation is excludable from their gross income under section 104(a)(2) as damages received on account of personal injuries.

Holding

1. No, because the petitioners failed to prove that the $500,000 payment was

received on account of personal injuries within the meaning of section 104(a)(2).

Court's Reasoning

The court emphasized that the determination of whether damages for business reputation constitute personal injury is fact-specific and requires examining the nature of the claim and the intent of the payor. The Fabrys' lawsuit was based on strict liability and negligence for plant damage and business losses, not personal injury. The court found no evidence in the complaint, mediation statements, or settlement negotiations that the Fabrys claimed personal injuries as defined under section 104(a)(2). The court cited previous cases to support its view that business reputation damages are not automatically considered personal injury and rejected the Fabrys' argument that such damages are excludable as a matter of law. The court also noted that the settlement agreement did not allocate any portion of the payment to personal injury claims, and the stipulation explicitly excepted personal injury from its coverage.

Practical Implications

This decision clarifies that taxpayers cannot automatically exclude damages received for injury to business reputation as personal injury under section 104(a)(2). Practitioners must carefully analyze the facts and circumstances of each case, including the nature of the underlying claims and the intent of the payor, to determine the tax treatment of settlement payments. The ruling may impact how settlement agreements are structured and documented, requiring explicit allocations to personal injury if such treatment is sought. It also affects how attorneys advise clients on the tax implications of settlements, especially in cases involving business reputation damages. Subsequent cases have applied this fact-specific approach, reinforcing the need for clear evidence of personal injury claims to support exclusion under section 104(a)(2).