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Federal Taxation

by Suellen M. Wolfe*
and
Jennifer N. Moore**

I. INTRODUCTION

The Eleventh Circuit Court of Appeals examined prominent and controversial tax issues during 2000. The technically difficult concept of cancellation of indebtedness income as it relates to the basis of a Subchapter S shareholder's interest was examined just prior to the United States Supreme Court's interpretation of this tax concept. The Supreme Court agreed with the interpretation of Internal Revenue Code ("I.R.C.") section 1366 espoused by the Eleventh Circuit. The Eleventh Circuit also examined an issue that the Supreme Court may soon consider when the circuit court followed the lead of an early 2000 Tax Court case examining the tax consequences of a corporate stock redemption incident to a divorce. Though the Eleventh Circuit characterizes the transaction as a tax free sale to the nonredeeming spouse under the provisions of I.R.C. section 1041, disagreement among the circuits and split decisions of the lower courts insure further examination of the Eleventh Circuit's position. The Eleventh Circuit also determined that an amount received for damages to business reputation received before the amendment to I.R.C. section 104(a)(2) on August 20, 1996, is excluded from tax. In that case, the court was required to revisit the concepts articulated by the United States Supreme Court in *Commissioner v. Schleier*[1] and *United States v.*

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1. 515 U.S. 323 (1995).

Burke.[2] A case involving a procedural issue examined whether the action of a tax matters partner ("TMP") is binding on the partners and whether the partners were informed of administrative and judicial proceedings occurring on the partnership level. In addition, common tax transactions causing disagreement over the appropriate legal standard to be applied were also reviewed. The Eleventh Circuit denied a payor spouse an income tax deduction for a payment required by a divorce agreement. The payment was held to constitute child support because it was deemed to be fixed by a divorce instrument. Another case involving reimbursed traveling expenses reversed the grant of a summary judgment to the government.

II. JURISDICTION OF TAX COURT TO DENY LEAVE TO FILE MOTION TO VACATE ASSESSMENT OF TAX LIABILITY OF PARTNERSHIP FILED BY TMP

In *Davenport Recycling Associates v. Commissioner*,[3] the Eleventh Circuit affirmed the Tax Court's decision denying leave to file a motion to vacate its order upholding a tax assessment against a limited partnership.[4] Respondent Davenport Recycling Associates ("Davenport") was a limited partnership. Davenport's general partner and its TMP[5] was Sam Winer. Ernest and Marion Karras and DL Associates ("DL") were limited partners.[6]

Davenport and its partners were audited for the years 1982 through 1985. On February 18, 1986, Winer was enjoined from marketing certain partnership interests and from serving as TMP. Davenport's limited partners were notified of Winer's removal as Davenport's TMP. DL served as TMP until it was determined that, as a limited partner, it was ineligible to serve. The Internal Revenue Service ("IRS") and Winer obtained a court order permitting Winer to serve again as Davenport's TMP performing administrative services.[7]

Winer, as TMP, signed extensions to the statute of limitations for the audits for Davenport. An assessment of taxes was eventually issued by the IRS for the years 1982-1985. After notifying the Davenport partners, Winer appealed the assessment to the tax court. No partner

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2. 504 U.S. 229 (1992).
3. 220 F.3d 1255 (11th Cir. 2000).
4. *Id.* at 1256.
5. The tax management partner is empowered to act as an agent on behalf of the partners in connection with a partnership audit including ensuing judicial proceedings. I.R.C. § 6231(a)(7) (2000).
6. 220 F.3d at 1256.
7. *Id.* at 1257-58.

of Davenport filed a motion at the Tax Court or moved to participate in the appeal. Winer, acting as TMP, eventually conceded to the adjustments, and the tax court entered the order on February 23, 1994. Winer failed to serve various documents about the case's disposition to the partners as required by tax court rules.[8]

The Karrases sought leave to file a motion to vacate on January 23, 1996, contending that Winer did not have authority to represent Davenport before the tax court because of the injunction prohibiting his service. They also contended that the IRS's failure to inform the tax court of the injunction constituted fraud. After an evidentiary hearing, the tax court denied the leave to file the motion.[9]

The Eleventh Circuit examined whether the tax court abused its discretion in denying the leave to file the motion.[10] Typically, the tax court lacks jurisdiction to vacate a decision once it becomes final.[11] However, the court has some discretion to extend the stated thirty-day limitation that is imposed after its order is entered.[12] The extension can be granted only when (1) the decision is shown to be void or a legal nullity for lack of jurisdiction over either the subject matter or the party; (2) there has been fraud on the court; or (3) the decision was based on mutual mistake.[13] The Karrases premised their argument before the Eleventh Circuit on the first two contentions.[14]

The Karrases' subject matter jurisdiction argument was based on the assertion that Winer had no authority to consent to the extensions of the statute to assess Davenport and its partners.[15] The Eleventh Circuit agreed with the tax court's holding that the statute of limitations is an affirmative defense that has to be raised by the partnership.[16] It does not involve the subject matter jurisdiction of the tax court.[17] The failure of the Karrases to file a timely petition to vacate the tax court's order precluded them from asserting that Winer, acting as TMP, had a conflict of interest thereby nullifying his action binding Davenport.[18]

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8. *Id.*
9. *Id.* at 1258.
10. *Id.*
11. *Id.* at 1259 (citing Arkansas Oil & Gas, Inc. v. Commissioner, 114 F.3d 795, 798 (8th Cir. 1997)).
12. *Id.* (citing Billingsley v. Commissioner, 868 F.2d 1081, 1084-85 (9th Cir. 1989)).
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.* at 1260.

The Karrases also argued that the tax court lacked jurisdiction over the parties because Winer had no authority to appear before the tax court on behalf of Davenport.[19] The Eleventh Circuit held that the doctrine of implied ratification, recognized and as interpreted by New York, was properly applied by the tax court.[20] The Eleventh Circuit also concluded that the tax court did not abuse its discretion when it held that the Karrases accepted the benefit of Winer's authority, were properly notified, and impliedly ratified Winer's actions.[21]

The Karrases' final argument, that the order of the tax court was procured by fraud, had to be strictly construed. It is applied only when the ability of the court to render an impartial decision is compromised.[22] The Eleventh Circuit held that no fraud had been committed on the tax court and affirmed the tax court's denial of leave to file a motion to vacate its order.[23]

III. UNITED STATES SUPREME COURT AFFIRMS STRICT STATUTORY CONSTRUCTION OF I.R.C. SECTION 1366 PERMITTING THE BASIS OF S CORPORATION SHAREHOLDER'S STOCK TO BE INCREASED BY THE AMOUNT OF CANCELLATION OF INDEBTEDNESS

In *Gitlitz v. Commissioner*,[24] the United States Supreme Court sanctioned the taxing concepts articulated by the Eleventh Circuit in *Pugh v. Commissioner*.[25] In *Pugh* the Eleventh Circuit held that cancellation of debt ("COD") income, tax exempt because of the insolvency of the S corporation, is an item of income that passes through to the shareholders increasing their tax basis in the S corporation.[26] The tax benefit for the taxpayers in *Gitlitz* and *Pugh* differs because of their respective tax positions. However, the second principle articulated by the Supreme Court, that the pass through of amounts occurs before the reduction of the S corporation's tax attributes,[27] makes the taxpayer's position in *Pugh* stronger.

The income of an S corporation is not taxed at the corporate level because the shareholders of the corporation determine their tax liability by reporting their pro rata share of the S corporation's items of income.

19. *Id.* at 1261.
20. *Id.*
21. *Id.* at 1262.
22. *Id.*
23. *Id.*
24. 531 U.S. 206 (2001).
25. 213 F.3d 1324 (11th Cir. 2000).
26. *Id.* at 1324-25.
27. *See Gitlitz*, 531 U.S. at __.

I.R.C. section 1366[28] specifically states that items of income include tax exempt income.[29] The character of items of income "shall be determined as if such item were realized directly from the source from which realized by the corporation, or occurred in the same manner as incurred by the corporation."[30]

Appellant Pugh was a shareholder in Epoch Capital Corporation ("Epoch"), an S corporation. In 1990 Epoch, then insolvent, had $661,357 in debt forgiven. The corporation liquidated, and Pugh did not receive any liquidating distribution.[31]

Pugh's appeal was brought to determine the amount of loss in his investment in Epoch. Because there was no amount realized by Pugh on the liquidation of Epoch, his basis in the stock would determine the amount of loss he was entitled to recognize. Pugh sought to increase his basis in order to increase his reportable loss.[32]

Cancellation of indebtedness generally constitutes income to the debtor.[33] Because Epoch was insolvent, the cancellation of debt income was excluded from the income of the S corporation at the corporate level.[34] An S corporation determines its income in the year of discharge, but to the extent that its COD income is excluded, it is required to reduce its favorable tax attributes.[35] In most cases the amount of COD income excluded offsets net operating losses or capital loss carryovers. However, Epoch had no tax attributes to offset.[36]

The separate treatment of an item of income could affect the tax liability of a shareholder. Despite the fact that the COD income was excluded on the S corporation level and did not reduce any tax attributes of Epoch, Pugh treated the COD income as an item of income passing through to him that, though tax exempt, increased the basis of his stock in Epoch.[37]

The Commissioner asserted deficiencies against Pugh contending that he was not entitled to increase the basis in his Epoch stock by the amount of the COD income. Pugh appealed to the tax court, which held for the government.[38] Pugh then appealed to the Eleventh Circuit,

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28. I.R.C. § 1366 (2000).
29. *Id.*
30. *Id.* § 1366(b).
31. 213 F.3d at 1325.
32. *Id.*
33. I.R.C. § 108 (2000).
34. 213 F.3d at 1327.
35. I.R.C. §§ 108(b)(1), (b)(2)(A), (b)(2)(D).
36. 213 F.3d at 1330.
37. *Id.* at 1325.
38. *Id.*

which held that I.R.C. section 1366(a)(1) clearly specifies COD income as an item of income that passes through to the shareholder.[39] Pugh was permitted to increase the basis of his stock under I.R.C. section 1367, thus increasing the loss he reported.[40]

A. *Character of Tax Exempt Income*

In *Pugh* the IRS argued that the COD income does not pass through to the shareholder because it is not an item of income. It continued that if the S corporation does not use the COD income to reduce its tax attribute, it has no further tax effect. The IRS also contended that an S corporation shareholder will ultimately include the tax exempt amount in his income when it is actually distributed. At distribution, there is a corresponding reduction in his basis. The IRS asserted that I.R.C. section 108 income is never actually distributed because it is constructive income and the described taxing mechanism typical to tax exempt income never occurs. Therefore, COD income is an atypical type of tax exempt income that should be treated differently. The Commissioner also argued that if COD income reduces tax attributes, then it is technically not tax exempt.[41]

The Eleventh Circuit first examined the nature of COD income.[42] Typically, COD income passes through to an S corporation's shareholders.[43] The court noted that I.R.C. section 108 provides for the exclusion of this income by an insolvent taxpayer.[44] However, I.R.C. section 108(d)(7)(A) also provides that the corporation must reduce its tax attributes at the corporate level as a result of nontaxable COD.[45] The Eleventh Circuit held that the I.R.C. does not preclude the COD income from affecting tax at the shareholder level.[46] The Eleventh Circuit further held that I.R.C. section 1366 specifically provides that all items of corporate income that could affect a shareholder's tax liability pass through to him as if "incurred in the same manner as incurred by the corporation."[47]

An S corporation shareholder is required to carry over losses that exceed his adjusted basis in the stock.[48] Eventually the suspended

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39. *Id.* at 1326.
40. *Id.* at 1331.
41. *Id.* at 1327-31.
42. *Id.* at 1326-27.
43. *Id.* at 1327.
44. *Id.*
45. *Id.*
46. *Id.*
47. *Id.* at 1328 (quoting I.R.C. §§ 1366(a)(1)(A), (b) (2000)).
48. I.R.C. § 1366(d)(2).

losses can affect a shareholder's tax liability. If a shareholder has suspended losses, the receipt of COD income, as an item of income, may decrease the amount of suspended losses. Pugh's individual tax position made his tax effect unique because he had no suspended losses and Epoch liquidated. Therefore, the COD income would never directly affect his tax liability.[49]

Even though Pugh had no suspended losses and the COD income could not affect Pugh's tax liability, the Eleventh Circuit determined that the item still passed through to Pugh.[50] The Eleventh Circuit noted that tax exempt income constitutes a pass through item even though it did not affect the taxpayer's tax liability.[51] Comparing COD income to tax exempt income (which passes through to the shareholder pursuant to I.R.C. section 1366(a)(1)(A)), the Eleventh Circuit held that COD income is a type of excluded income.[52] I.R.C. section 108 is not distinguishable from other receipts defined in Part III Subchapter B of the tax code or "Items Specifically Excluded from Gross Income."[53]

B. Increase in Basis

The Eleventh Circuit further held that an S corporation's COD income passes through pro rata to its shareholders under I.R.C. section 1366(a)(1) in all instances.[54] Therefore, pursuant to I.R.C. section 1367, Pugh was entitled to increase his basis by the amount of COD income that flowed through to him from Epoch.[55]

The Eleventh Circuit recognized that economics of the transaction may warrant a different conclusion, but it was convinced that the language of the Code is clear.[56] A technical correction of the tax code is the province of Congress. Though a distributive share of the income of an S corporation's shareholder did not include cancellation of indebtedness income because the partnership was insolvent, the shareholder's basis increased by his share of the COD income. Pugh was permitted to recognize a loss calculated by a basis that was increased by the amount of COD income that passed through to him.[57]

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49. 213 F.3d at 1328-29.
50. *Id.* at 1329.
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.* at 1328-30.
55. *Id.* at 1330-31.
56. *Id.* at 1331.
57. *Id.* at 1330-31.

IV. EXPENSE REIMBURSEMENT SCHEME AS AN ACCOUNTABLE PER DIEM ALLOWANCE

In *Trucks, Inc. v. United States*,[58] the Eleventh Circuit reversed the grant of the Government's motion for summary judgment.[59] It held that whether an employer had a reasonable expectation that traveling expenses it reimbursed to some of its employees would be incurred is a question of fact for the jury.[60]

Appellant Trucks, Inc. ("Trucks"), operates a trucking company in Texas and in the southern and eastern coastal states. Expenses incurred by the drivers for food, lodging, and incidental costs were reimbursed by Trucks on a per diem rate based on load revenue. The drivers were required to submit documentation of their trip. Trucks then paid the drivers fourteen percent of load revenue as wages and an additional six percent of load revenue as reimbursement of expenses incurred while traveling.[61]

Believing that it reasonably anticipated and calculated its drivers' expenses, Trucks asserted that the reimbursement was not considered wages to the drivers. The company did not withhold employment taxes on the portion of the payment to the drivers representing the travel expense reimbursement. The IRS determined these payments were wages and assessed Trucks's employment taxes, penalties, and interest. Trucks partially paid the amount of the assessment and sued for a refund and abatement of all other IRS assessments.[62]

A deduction from adjusted gross income of an employer is permitted for reimbursed expenses of employees.[63] The law has very strict substantiation requirements for reimbursed expenses. An employer must have a reimbursement or other expense allowance arrangement. An employer's reimbursement of its employees' expenses may be exempt from employment taxes if payment is made from an accountable plan.[64] A plan is accountable when (1) it covers only expenses with a business connection; (2) all expenses are substantiated to the employer; and (3) the employee is required to return to the employer any amount paid in excess of the substantiated expenses.[65]

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58. 234 F.3d 1340 (2000).
59. *Id.* at 1341.
60. *Id.* at 1343-44.
61. *Id.* at 1341.
62. *Id.* at 1341-42.
63. *Id.* at 1342 (quoting I.R.C. § 62(a)(2)(A) (2000)).
64. *Id.* (quoting I.R.C. Reg. 1.62-2(c)(2)(i)).
65. *Id.* at 1342-43 (citing I.R.C. Reg. 1.62-2(d), (e), (f)).

The district judge found that Truck's method of reimbursement of expenses violated the first requirement of an accountable plan and granted a summary judgment to the government. Trucks appealed the award of the summary judgment.[66] The Eleventh Circuit reviewed the case de novo and applied the standards of the district court applicable to an award of summary judgment.[67] The Eleventh Circuit found that Trucks presented sufficient evidence to create a factual question as to its state of mind.[68] Based on *American Airlines, Inc. v. United States*,[69] Trucks had met its initial burden of proof, precluding a summary judgment for the Government.[70]

Trucks's purported "accountable plan" was analyzed by the Eleventh Circuit in the context of the three prongs of the test articulated by the regulations.[71] The deposition of Trucks' owner was examined to ascertain if the first requirement, that the reimbursed expenses had a business purpose, was satisfied. A reimbursement has a business connection if it is "'paid or incurred by the employee in connection with the performance of services as an employee of the employer.'"[72] The payment also must be made only for expenses the employee would be reasonably expected to incur.[73]

Some of Trucks' drivers paid for lodging, and some slept in the sleeping compartment of their trucks. Regardless of where the drivers rested, Trucks' paid them a per diem flat rate. The district court found that the lack of record keeping and an affidavit filed by Trucks' owner stating that she did not know how many nights the drivers actually incurred lodging expenses violate the business connection requirement.[74]

The deposition of the owner described her investigation into standard business practices of the trucking industry, which she used in establishing Trucks' reimbursement plan.[75] The Eleventh Circuit concluded that whether Trucks could have reasonably expected its drivers to incur expenses that were standard within its industry was a question of fact.[76]

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66. *Id.* at 1343.
67. *Id.* at 1342 (citing Mays v. United States, 763 F.2d 1295, 1296 (11th Cir. 1995) (per curiam)).
68. *Id.* at 1344.
69. 204 F.3d 1103 (Fed. Cir. 2000).
70. 234 F.3d at 1343.
71. *Id.* at 1343-45.
72. *Id.* at 1343 (quoting Treas. Reg. § 1.62-2(d)(1)).
73. *Id.* (citing Treas. Reg. § 1.62-2(d)(3)(i)).
74. *Id.*
75. *Id.*
76. *Id.* at 1343-44.

The Eleventh Circuit also examined the final two prongs of an accountable plan: substantiation and return of excess reimbursement.[77] Generally, an employee must substantiate the payment of expenses to his employer. However, the IRS will accept reimbursement of a flat rate per diem without the typical substantiation if certain requirements are met.[78] Trucks claimed that its policy met the requirements of a per diem allowance.[79] The Eleventh Circuit found that Trucks produced some evidence its plan was reasonable as to calculations and assumptions, and this evidence should be examined by a jury for its reasonableness.[80]

The third prong of a plan requires an employee return the excess amount for days of travel not substantiated.[81] An exception (similar to the per diem exception for the substantiation requirement) is applicable to the return of excess requirement.[82] Trucks asserted it satisfied this exception because it knew how many days its drivers incurred expenses.[83] The Eleventh Circuit also identified Truck's reasonable anticipation of expenses as a jury question.[84]

In concluding its analysis, the Eleventh Circuit held that Trucks produced sufficient evidence to show genuine factual dispute over the reasonableness of its decision that expense reimbursements were paid under an accountable per diem allowance.[85]

V. FIXED PAYMENTS UNDER SECTION 71(C)

In *Preston v. Commissioner*,[86] the Eleventh Circuit affirmed a tax court decision holding that certain payments made by Mr. Preston were not deductible as alimony under I.R.C. section 215 because the payments were child support under I.R.C. section 71(c).[87] The Eleventh Circuit found that a payment is fixed within the meaning of section 71(c) if the payment is earmarked by a temporary or final order for specific expenses of the spouse's children.[88]

77. *Id.* at 1344-45.
78. *Id.* at 1344.
79. *Id.*
80. *Id.*
81. *Id.* at 1344-45.
82. *Id.* at 1344.
83. *Id.* at 1345.
84. *Id.*
85. *Id.*
86. 209 F.3d 1281 (11th Cir. 2000).
87. *Id.* at 1282.
88. *Id.* at 1284.

Forest Preston and Diane Sowell married in 1974 and thereafter had two children. Sowell filed for divorce in 1992, and the Superior Court of Muscogee County issued a temporary order detailing Preston's financial responsibilities to his family. Preston was to pay the medical, dental, and prescription drug expenses incurred by his wife and children; school tuition and expenses for his children; both his wife's and children's clothing costs; as well as monthly payments totaling $1,500 to his wife. When the final order was entered in 1993, Preston was required to pay his son's private school tuition and his daughter's car insurance. In addition, he was to pay $1,600 per month in child support.[89]

In 1992 and 1993 Preston claimed alimony deductions for payments he made to Sowell and other deductions for expenses he incurred on behalf of his children pursuant to the temporary order. In 1992 the deducted expenses included a doctor's bill and dentist's bill, as well as a payment for his daughter's school tuition. In 1993 the deducted expenses included amounts he paid pursuant to the final order for his son's tuition and daughter's car insurance. The tax court ruled that the payments were nondeductible child support and thus denied the deductions.[90]

Payments for alimony are included in the income of the spouse receiving the payments and are deductible to the spouse making the payments.[91] However, I.R.C. section 71(c) specifically excludes from this rule "that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse."[92] At issue in *Preston* was whether, under I.R.C. section 71(c), the payments Preston was required to make were "'fix[ed] (in terms of an amount of money or a part of the payment)' by the temporary or final order" as payments made for the support of his children.[93] If the payments were fixed as a sum payable for the children by the temporary or final order, Preston could not take the deductions. Preston relied on *Commissioner v. Lester*[94] even though the ultimate holding of the case had been statutorily overruled by I.R.C. section 71(c)(2).[95] Preston argued that the reasoning in *Lester* should persuade the court in this case that the payments he made were alimony

89. *Id.* at 1283-84.
90. *Id.* at 1284.
91. I.R.C. § 71(a) (2000).
92. *Id.* § 71(c)(1).
93. 209 F.3d at 1284 (quoting I.R.C. § 71(c)(1)).
94. 366 U.S. 299 (1961).
95. 209 F.3d at 1284.

because the payments required by the temporary or final order were not a specific fixed amount and thus were "general support payments."[96]

However, the court found that the payments required by the temporary or final order were fixed in the sense that they were "earmarked . . . for the specific expenses of the children as they arose."[97] The court reasoned that because the temporary and final orders fixed each of the individual payments of the children's expenses as payable exclusively for the support of the children, "each payment was fixed at 100% by the applicable order."[98] Therefore, Preston was not entitled to deduct the payments from his income.[99]

VI. ADOPTION OF *READ V. COMMISSIONER* TO DETERMINE MEANING OF "ON BEHALF OF" UNDER I.R.C. SECTION 1041

In *Craven v. United States*,[100] the Eleventh Circuit adopted the tax court's decision in *Read v. Commissioner*[101] and held that the redemption of a former wife's stock in a closely-held corporation pursuant to the divorce settlement agreement was a transfer on behalf of her former husband incident to divorce and therefore qualified for nonrecognition under I.R.C. section 1041.[102]

The Cravens (Billy Joe and Linda) married in 1966 and started their own pottery business in 1971. In 1975 Billy Joe incorporated the business as Craven Pottery, Inc., with Billy Joe owning fifty-one percent of the company stock, Linda owning forty-seven percent of the stock, and the remaining two percent owned by the Cravens' two children. When the Cravens' marriage turned sour, Linda stopped working at the corporation. The Cravens separated in 1988, and a divorce decree was entered into in 1991. The decree contained a settlement agreement under which Linda agreed to sell, and the corporation agreed to buy, her stock in Craven Pottery, Inc.[103]

As payment for the stock, the corporation gave Linda a $4.8 million promissory note, with Billy Joe guaranteeing the note with an express acknowledgment that the note's terms were of direct interest and benefit to him. The note was to be paid in 120 equal monthly payments beginning July 2000. Lump sum payments on the note of $1 million

96. *Id.*
97. *Id.*
98. *Id.*
99. *Id.* at 1284-85.
100. 215 F.3d 1201 (11th Cir. 2000).
101. 114 T.C. 14 (2000).
102. 215 F.3d at 1207.
103. *Id.* at 1202.

each were also to be made in June 2000, 2005, and 2010, but the corporation could pay any amount due under the note before its due date by paying its then present value. Any prepayments were to be applied against the lump sum payments beginning with the one due in 2010, then against the 2005 payment, then the 2000 payment. In 1991 Billy Joe made a prepayment on the note, and the corporation made the remaining three prepayments in 1992, 1993, and 1998.[104]

On her tax returns for 1992, 1993, and 1994, Linda did not report capital gains from the redemption of her stock in the corporation. However, she did take the position (in disclosure statements) that the redemption qualified for nonrecognition under I.R.C. section 1041. The IRS disagreed and determined that Linda had capital gains based on the principal of the prepayments on the note. Linda paid the tax and interest due, filed a claim for a refund, and when the claim was denied, sued for a refund in district court.[105]

The district court found that Linda's redemption fell under I.R.C. section 1041 because it was within the confines of a Treasury Department Temporary Regulation, Temp. Treas. Reg. section 1.1041-1T(c) (Q&A 9).[106] The regulation states that in certain circumstances transfers of property to a third party on behalf of a spouse or former spouse may qualify under I.R.C. section 1041.[107] Because Billy Joe was obligated under Georgia law to divide equitably all marital assets, the district court found that the corporation's redemption of Linda's stock was on behalf of Billy Joe. Also persuasive to the district court were Billy Joe's guarantee of the note and the fact that Billy Joe had, in effect, complete control of the corporation after the redemption.[108] Also, the district court found that *Arnes v. United States*[109] (*Arnes I*) was applicable to this case. *Arnes I* contains a similar fact pattern: The divorcing spouses in *Arnes I* each owned fifty percent of a McDonald's franchise. Per McDonald's policy, when spouses divorced, ownership of the entire franchise had to be transferred to one spouse. Therefore, the wife sold her fifty percent interest to the corporation with her husband guaranteeing payment to the wife. The transfer was made pursuant to the divorce decree.[110] The Ninth Circuit found that I.R.C. section 1041

104. *Id.* at 1202-03.
105. *Id.* at 1203.
106. *Id.*
107. Temp. Treas. Reg. § 1.1041-1T(c) (1984).
108. 215 F.3d at 1203.
109. 981 F.2d 456 (9th Cir. 1992).
110. *Id.* at 457.

applied to the transfer because the redemption relieved the husband of his obligation to purchase his wife's stock.[111]

If I.R.C. section 1041 did not apply to the redemption of Linda's stock, the redemption would be treated as a sale under I.R.C. sections 302(a) and (b)(3).[112] Linda would have gain in the amount the proceeds from the redemption exceeded her basis in the stock.[113] The IRS determined that Linda had capital gains on the principal of the prepayments in the amounts of $187,922 in 1992, and $285,709 in 1993.[114] If I.R.C. section 1041 applied to Linda's redemption, Linda would not be required to recognize gain on the principal of the prepayments because property received in an I.R.C. section 1041 transfer is excluded from the recipient's gross income.[115]

To decide the issue in this case, the Eleventh Circuit relied on a Treasury Department Temporary Regulation, the Ninth Question of Temp. Treas. Reg. § 1.1041 - 1T(c).[116] The answer to the Ninth Question describes three situations in which a transfer to a third party "'on behalf of a spouse (or former spouse) [would] qualify under I.R.C. § 1041.'"[117] Linda argued that her redemption fell under the first situation: "'where the transfer to the third party is required by a divorce or separation instrument.'"[118]

The court found that the central question in this case was whether Linda's transfer of her stock to the corporation was made on behalf of Billy Joe.[119] After noting the district court's reliance on *Arnes I* and the questions and problems *Arnes I* raised, the court turned its attention to *Read* and adopted its reasoning.[120] In *Read* the tax court resolved the issues raised in *Arnes I* that were not addressed by the Ninth Circuit or were in conflict with subsequent decisions.[121] The facts of *Read* are even more similar to this case than the *Arnes I* facts. The husband and wife in *Read* were the sole owners of the voting stock and sole owners of almost all of the nonvoting stock of the corporation. The divorce decree required that the husband buy out the wife's shares in the corporation by having the corporation purchase the wife's stock and issuing a

111. *Id.* at 459.
112. I.R.C. §§ 302(a), (b)(3) (2000).
113. *Id.* § 1001(a).
114. 215 F.3d at 1204.
115. I.R.C. § 1041 (2000).
116. 215 F.3d at 1207.
117. *Id.* at 1205 (quoting Temp. Treas. Reg. § 1.1041-1T(c)).
118. *Id.* (quoting Temp. Treas. Reg. § 1.1041-1T(c)).
119. *Id.*
120. *Id.* at 1206.
121. *Id.*

promissory note to the wife for the balance of the purchase price. The husband in *Read* individually guaranteed the corporation's payments to the wife.[122]

The issue in *Read* was whether the temporary regulation allowed the wife to exclude the gain on the transfer of her stock to the corporation.[123] The tax court found that the phrase "on behalf" did not require that the husband have a "primary-and-unconditional-obligation" to purchase the stock.[124] The "primary-and-unconditional-obligation" standard applies when the corporation pays a debt for the husband. The payment is then deemed a dividend to the husband.[125] Instead, the tax court determined that the plain meaning of "on behalf" should apply in cases like *Read*, and therefore the transfer must be "in the interest of" the husband or "as a representative of" the husband.[126] Thus, the wife's transfer in *Read* fell under I.R.C. section 1041 because the corporation was acting on behalf of the husband.[127]

The Eleventh Circuit found that three facts place Linda within the *Read* analysis: "(1) she was redeeming her stock pursuant to the divorce settlement; (2) Billy Joe guaranteed the note; and (3) in that note Billy Joe acknowledged that its terms were of 'direct interest, benefit and advantage' to him."[128] The court found that the first fact alone qualified the transaction under I.R.C. section 1041 and that the other two strengthened the conclusion.[129] Therefore, the court held that the proceeds of Linda's transfer qualified for nonrecognition under I.R.C. section 1041.[130]

VII. EXCLUDABILITY OF DAMAGES RECEIVED FOR A NONPHYSICAL INJURY IN A TORT ACTION

During the 2000 survey period, the Eleventh Circuit examined an issue that arose prior to the amendment of I.R.C. section 104(a)(2) by the Small Business Job Protection Act of 1996.[131] The amendment dealt with damages received for a nonphysical injury in a tort action.[132] After August 20, 1996, these damages are not excludable from gross

122. *Id.*
123. 114 T.C. at 27-28.
124. *Id.*
125. *Id.* at 34-35.
126. *Id.* at 36.
127. *Id.* at 38.
128. 215 F.3d at 1207.
129. *Id.*
130. *Id.*
131. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.
132. Fabry v. Commissioner, 223 F.3d 1261, 1262 n.1 (11th Cir. 2000).

income.[133] In *Fabry v. Commissioner*,[134] the amendment did not apply because the damages award received by the taxpayers was paid in 1992.[135]

Mr. and Mrs. Fabry owned a very successful nursery specializing in ornamental plants and citrus trees. When the Fabrys began using a fungicide manufactured by E.I. du Pont de Nemours and Co. in 1988, their business and reputation took a sharp downturn. The fungicide caused the Fabrys' plants to yellow and their growth to be stunted. Many of the plants died. When previously sold plants began to develop defects, the Fabrys were forced to close their business. They sued du Pont, seeking damages for lost profits, lost going concern value, and damage to business reputation. Among other things, the Fabrys sought $500,000 in damages for their lost business reputation when settlement discussions commenced. Following mediation in 1992, du Pont paid the Fabrys $38 million in full settlement of their claims against the company. However, the Fabrys, on their 1992 returns, did not include as income the $500,000 they received from du Pont that was attributable to damage to their business reputation. The Commissioner of the IRS assessed a tax deficiency of $201,054 plus $40,211 in penalty against the Fabrys, who argued that I.R.C. section 104(a)(2) did not require them to report the $500,000 as taxable income. The tax court agreed with the Commissioner, and the Fabrys appealed.[136]

While the tax court acknowledged during trial that the Fabrys' case presented a question of law, it used a facts and circumstances approach in its analysis, focusing on the nature of the Fabrys' claims against du Pont. The tax court did not find specific language in the Fabrys' release with du Pont to indicate the $500,000 in question was received on account of personal injuries. The tax court also looked for specific language asserting personal injuries in the Fabrys' first amended complaint as well as in the mediation process, the settlement negotiations, and supporting documents.[137] Finding none, the tax court found "insufficient evidence of a claim for personal injury presented during the lawsuit sufficient to support a conclusion that the Fabrys' $500,000 claim for damages to business reputation was on account of personal injuries."[138]

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133. *Id.* at 1262 n.1.
134. 223 F.3d 1261 (11th Cir. 2000).
135. *Id.* at 1262.
136. *Id.* at 1262-63.
137. *Id.* at 1269.
138. *Id.* (internal quotations omitted).

On appeal the Eleventh Circuit scrutinized the meaning of "personal injuries" in I.R.C. section 104(a)(2), which provides that judgment or settlement damages received for personal injuries or sickness are excludable from gross income.[139] Looking to the regulations first, the court noted that the regulations equate the term "personal injuries" with violation of tort or tort-type rights.[140] Next, after laying the groundwork for its decision by describing inconsistent case law among the circuits in this area, the court turned its attention to Supreme Court decisions decided in 1992 and after that addressed the application of I.R.C. section 104(a)(2).[141] The court noted that *Commissioner v. Schleier*[142] and *United States v. Burke*[143] were the two cases most pertinent to its decision.[144] In *Burke* the Supreme Court applied I.R.C. section 104(a)(2) to deny exclusion unless the underlying law or statute provided for personal injury losses.[145] In *Schleier* the Court established a two-prong test under which the taxpayer must meet two independent requirements for the damages associated with tort-like personal injuries to qualify under I.R.C. section 104(a)(2) for exclusion: "First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is based upon tort or tort type rights; and second, the taxpayer must show that the damages were received on account of personal injuries or sickness."[146] Noting that *Burke* and *Schleier* do not address the precise issue before it in the Fabrys' case, the Eleventh Circuit looked to other circuits for application of those cases.[147] The court found a Sixth Circuit decision, *Greer v. United States*,[148] helpful in interpreting the second prong of the *Schleier* test.[149] *Greer* involved a taxpayer who was discharged with a severance package of $331,968, $280,968 of which he claimed was in settlement of his potential wrongful discharge claim and was therefore excludable from gross income. Greer argued that his termination "diminished his personal and professional reputation, and inflicted stress, humiliation, mental anguish, self doubt and emotional pain" upon

139. *Id.* at 1264.
140. *Id.*
141. *Id.* at 1265-67.
142. 515 U.S. 323 (1995).
143. 504 U.S. 229 (1992).
144. 223 F.3d at 1265.
145. 504 U.S. at 237.
146. 515 U.S. at 337 (internal quotations omitted).
147. 223 F.3d at 1267.
148. 207 F.3d 322 (6th Cir. 2000).
149. 223 F.3d at 1267.

him.[150] The district court agreed with Greer.[151] On appeal the Sixth Circuit separated the two-prong test from *Schleier* into four elements:

> (1) there was an underlying claim sounding in tort; (2) the claim existed at the time of settlement; (3) the claim encompassed personal injuries; and (4) the agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" the personal injury, rendering it a settlement rather than a mere severance agreement.[152]

Applying this four-prong test, the Sixth Circuit found that claims of nonphysical injuries could still be proven to be excludable.[153]

In its own analysis, the Eleventh Circuit first took issue with the facts and circumstances approach taken by the tax court.[154] The Eleventh Circuit disagreed with the tax court, finding its method of looking to the record for the words "personal injury" to be not only insufficient, but also incorrect.[155] The court next determined that to satisfy the two-prong *Schleier* test, a causal link between the tort and the intangible element of the injury must exist.[156] If that link exists, the court noted, *Schleier* would appear to be satisfied, and payments received for the personal injury damages would be excludable under I.R.C. section 104(a)(2).[157]

Turning to the issue of whether damage to the Fabrys' business reputation could be a personal injury, the court found that it was.[158] Specifically, the court concluded that the $500,000 recovered by the Fabrys was justified; that damage to one's business reputation was a personal injury; and that du Pont's negligence or wrongful conduct resulted in a personal injury to the Fabrys that injured their business reputation.[159] However, the court emphasized "the unique facts of this case," focusing on the Fabrys' sole proprietorship of their business and that the Fabrys' nursery business was "part and parcel of their persona."[160] The court stated, "Their business reputation was their personal reputation."[161] Thus, the court's holding in this case appears to be as fact-sensitive as the tax court's.

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150. 207 F.3d at 325.
151. *Id.*
152. *Id.* at 327.
153. *Id.* at 328.
154. 223 F.3d at 1268-69.
155. *Id.* at 1269.
156. *Id.* at 1269-70.
157. *Id.* at 1270.
158. *Id.*
159. *Id.* at 1271.
160. *Id.* at 1270-71.
161. *Id.* at 1270.