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Amos v. Commissioner: The Ambiguous and Ever-Changing Definition of What Constitutes a Person Physical Injury under Internal Revenue Code Section 104(A)(2)

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NOTE

AMOS V. COMMISSIONER: THE AMBIGUOUS AND EVER-CHANGING DEFINITION OF WHAT CONSTITUTES A PERSONAL PHYSICAL INJURY UNDER INTERNAL REVENUE CODE SECTION 104(A)(2)

Benjamin T. Cory¹

I. INTRODUCTION

To ensure that a client benefits from a § 104(a)(2) exclusion, attorneys must assess possible tax treatment from the moment they begin documenting a case.² The two most important documents in determining whether a recovery is “on account of personal physical injuries,” and thus may be excluded under § 104(a)(2) are: 1) the settlement agreement; and 2) the complaint.³ To qualify for a § 104(a)(2) exclusion from gross income, it is critical that an attorney understand what constitutes a personal injury under this provision, and how to

1. J.D. anticipated May 2005, The University of Montana School of Law. I would like to acknowledge my grandmother Jeanne Tinnemann Cory, who was my inspiration in attending law school, and thank my wife Kris, who through her support has provided me with the time and energy to engage in endeavors such as this.

2. See ROBERT W. WOOD, *TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS* § 5.1 (2d ed. 1998).

3. See *id.* at §§ 5.21, 5.23.

draft the complaint and settlement agreement to ensure § 104(a)(2) will apply.

Since its enactment in 1919, neither the text nor the legislative history of § 104(a)(2) of the Internal Revenue Code has adequately defined the term "personal injuries."⁴ While it is clear that § 104(a)(2) excludes "the amount of any damages received on account of personal physical injuries or physical sickness" from gross income,⁵ deciphering what constitutes a "personal physical injury" has remained largely ambiguous. Due to the vague nature of § 104(a)(2), the courts have had difficulty limiting the scope of, as well as defining, "personal injuries" under § 104(a)(2).⁶

Section 61(a) of the Internal Revenue Code states: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived."⁷ Any exclusions from gross income are to be narrowly construed.⁸ While the § 104(a)(2) exclusion from gross income was originally limited to damages on account of physical injuries, courts quickly recognized that nonphysical injuries should also be excludable.⁹ From 1970 to 1996, § 104(a)(2) was applied to a wide variety of nonphysical injuries, as well as the economic and non-economic damages associated with the injury.¹⁰ However, in 1996 Congress substantially limited the scope of § 104(a)(2) when it amended § 104(a)(2) by requiring that "personal injuries" suffered be "physical."¹¹

The determination of what constitutes a "personal physical injury" under § 104(a)(2) is important to general practitioners and tax specialists. If a particular judgment or settlement is fully taxable to a plaintiff at ordinary income rates, the economic result of the litigation is far less beneficial than if the

4. United States v. Burke, 504 U.S. 229, 234 (1992).

5. 26 U.S.C. § 104(a)(2) (2000).

6. See Threlkeld v. Comm'r, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988); *Burke*, 504 U.S. 229 (1992); *Comm'r v. Schleier*, 515 U.S. 323 (1995). These cases, and the different tests each court used to determine whether a § 104(a)(2) exclusion is available will be discussed in detail later in this note.

7. 26 U.S.C. § 61(a) (2000).

8. *Burke*, 504 U.S. at 248 (citations omitted).

9. See *Hawkins v. Comm'r*, 6 B.T.A. 1023 (1927).

10. See J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 MONT. L. REV. 167 (1997).

11. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755, 1838-39 § 1605(a).

same award is excludable.¹² Unfortunately, both attorneys and their clients often focus on other aspects of a case and may overlook tax planning.

This note focuses on the physical injury requirement of § 104(a)(2), and the proposition that the definition of “physical injury” and whether damages were received “on account of” personal physical injuries may depend largely upon how a case is presented. Part II of this note provides an overview of the case law and legislative history of § 104(a)(2). Part III explains the facts, holding, and reasoning of *Amos v. Commissioner*.¹³ Part IV examines the implications of the personal injury standard used in *Amos*, and the importance of demonstrating that damages received are “on account of” personal physical injuries. Part V of the note analyzes the practical implications of *Amos*, as well as the importance of drafting a settlement agreement properly in order to justify a § 104(a)(2) exclusion. Part VI discusses the need for change and the arbitrary standard developed in response to the insertion of the word “physical” into the personal injury requirement

II. RELEVANT CASE LAW AND LEGISLATIVE HISTORY OF SECTION 104(A)(2)

A. Case Law

Because neither I.R.C. § 104(a)(2) nor the regulations define or interpret what constitutes a personal injury, the courts have been forced to determine what type of injuries qualify for a § 104(a)(2) exclusion. Many of the early cases interpreting the scope of injuries included in § 104(a)(2) provided a broad definition of injuries qualifying for § 104(a)(2) treatment.¹⁴ Then, beginning with *Threlkeld v. Commissioner*,¹⁵ which held a “personal injury” included “any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law,”¹⁶ § 104(a)(2) began to be applied more broadly.¹⁷

12. See WOOD, *supra* note 2, § 1.11.

13. T.C. Memo. 2003-329.

14. See *Hawkins*, 6 B.T.A. at 1025 (holding that both physical and nonphysical injuries were within the scope of § 104(a)(2)); and *Seay v. Comm’r*, 58 T.C. 32, 40 (1972) (defamation of personal reputation constituted a personal injury under § 104(a)(2)).

15. 87 T.C. 1294 (1986), *aff’d*, 848 F.2d 81 (6th Cir. 1988).

16. *Id.* at 1308.

17. See *Bent v. Comm’r*, 87 T.C. 236 (1986), *aff’d*, 835 F.2d 67 (3d Cir. 1987)

Following *Threlkeld*, the essential element necessary to qualify for a § 104(a)(2) exclusion was that the income involved must have been derived from the establishment of an invasion of any personal right.¹⁸ The United States Supreme Court modified this standard in *United States v. Burke*,¹⁹ requiring that for damages to be excludable under § 104(a)(2), they must be “based upon tort or tort-type rights.”²⁰

In 1995, however, the United States Supreme Court in *Commissioner v. Schleier*²¹ significantly narrowed the scope of excludable damages. In *Schleier*, the Court was asked to determine whether back pay and liquidated damages received under the Age Discrimination and Employment Act constituted damages received on account of a personal injury.²² The *Schleier* Court held that two independent requirements must be met by a taxpayer before a § 104(a)(2) exclusion applies.²³ Under *Schleier*, a taxpayer must first “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.’”²⁴

The “on account of” test as interpreted by *Schleier* requires a showing of a nexus between damages and the personal injury. The *Schleier* Court provided a helpful hypothetical demonstrating the application of this nexus or causal relationship requirement.²⁵ The *Schleier* Court’s hypothetical indicates that in addition to damages intended as compensation

(holding that the denial of an individual’s First Amendment rights qualified as a personal injury); *Metzger v. Comm’r*, 88 T.C. 834 (1987), *aff’d*, 845 F.2d 1013 (3d Cir. 1988) (holding that personal injuries included discrimination on the basis of sex, race or national origin); and *Byrne v. Comm’r*, 883 F.2d 211 (3d Cir. 1989) (holding that personal injuries may include termination from employment).

18. *Threlkeld*, 87 T.C. at 1305 (citations omitted).

19. 504 U.S. 229 (1992). In *Burke*, employees of the Tennessee Valley Authority brought an action under Title VII of the Civil Rights Act of 1964 alleging illegal sex discrimination. The Court concluded that the damages received by the employees were not tort-like personal injuries because of the limited nature of damages afforded under Title VII. The Court stressed that in determining if a tort-like personal injury exists, it is important that a broad array of damages are available to compensate the plaintiff.

20. *Id.* at 234. The language used by the Court can be found in 26 C.F.R. § 1.104-1(c) (2004), which specifically links “personal injury” to damages “based on tort or tort-type rights.”

21. 515 U.S. 323 (1995).

22. *Id.* at 324-25.

23. *Id.* at 337 (citations omitted).

24. *Id.*

25. *Id.* at 329.

for the personal injury itself (pain and suffering and medical expenses), damages for economic losses that are causally linked to the personal injury may also be excluded from gross income.²⁶ For example, if an individual suffers a physical injury in a car crash and subsequently is forced to miss work on account of the physical injuries suffered, damages recovered for lost wages may be excluded under § 104(a)(2).²⁷ Thus, the *Schleier* Court recognized that as long as a sufficient nexus is established, a broad range of damages may be excludable under § 104(a)(2).²⁸ As a result of the *Schleier* standard, attorneys who wish their clients to benefit from § 104(a)(2) exclusion should pay careful attention to demonstrate in both the complaint and the settlement agreement that any damages awarded are “on account” of the personal injuries.

B. Legislative History and Historical Perspective of the IRS

Damages received on account of personal injuries may be excluded from gross income under § 104(a)(2).²⁹ The rationale for this exclusion is that an individual should not be subject to taxation on money damages intended to make the taxpayer whole from personal injuries. While the purpose of § 104(a)(2) is fairly clear, its application has proved to be much more complicated.

The legislative history of § 104(a)(2) offers little explanation of the term “personal injuries.”³⁰ In 1960, however, the IRS promulgated regulations that “formally linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles.”³¹ Relying on a broad definition of “personal injury,” many rulings and court decisions during the 1970’s and 1980’s allowed exclusion for damages arising from both physical and non-physical personal injuries.³² In 1989, Congress went so far as to reject a bill which would have limited § 104(a)(2)

26. *Id.*

27. *Schleier*, 515 U.S. at 329-30 (citing *Threlkeld*, 87 T.C. at 1300).

28. *Id.* at 337.

29. 26 U.S.C. § 104(a)(2) (2000).

30. *United States v. Burke*, 504 U.S. 229, 234 (1992).

31. *See id.* and 26 C.F.R. § 1.104-1(c) (2004).

32. *See Rev. Rul. 85-98*, 1985-2 C.B. 51 (a § 104(a)(2) exclusion does not make a distinction between physical or emotional injuries); *Seay v. Comm’r*, 58 T.C. 32 (1972), *acq.*, 1972-2 C.B. 3 (allowing embarrassment, mental strain, and injury to personal reputation to be excluded under § 104(a)(2)).

exclusions to physical injuries or physical sickness.³³ In rejecting such a bill it would appear that Congress acknowledged that § 104(a)(2) was not limited solely to damages awarded on account of physical injuries or sickness.

However, in 1996 Congress reversed its position and amended § 104(a)(2) to require that the "personal injury" suffered be a "personal *physical* injury" in order to qualify for a § 104(a)(2) exclusion.³⁴ In addition, the 1996 amendments provided that punitive damages were no longer excludable, even when received in connection with a physical injury.³⁵ In addition to requiring the "personal injury" suffered be "physical," the statute specifically provided that "emotional distress shall not be treated as a physical injury or physical sickness."³⁶ The Conference Committee Report makes clear that emotional distress may also include physical symptoms such as insomnia, headaches, or stomach disorders.³⁷

While the 1996 amendments clearly state that § 104(a)(2) only applies to "physical injuries," the amendments did not adequately define what types of injuries qualified as "physical." Just as "personal injury" was never defined, "physical injury" has also yet to be defined in the regulations. The IRS would prefer an extremely narrow definition of "physical injury," requiring observable harm.³⁸ While some commentators have argued for a much broader reading of "physical injury," which would merely require pain resulting from a physical touching, without the requirement of any observable harm.³⁹ The key point is that the term "physical injury" in § 104(a)(2) remains largely undefined, and it is the responsibility of the attorney to review the case law and legislative history of § 104(a)(2) and demonstrate accordingly that a "physical injury" has occurred. Unfortunately, the guidance currently is sparse in this area.

33. See H.R. REP. NO. 101-247, at 1354-55 (1989).

34. See 26 U.S.C. § 104(a)(2) (1996) (emphasis added).

35. *Id.*

36. *Id.*

37. See H.R. CONF. REP. NO. 104-737, at 301 (1996).

38. See Priv. Ltr. Rul. 200041022 (July 17, 2000) (stating "direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a)(2)."). It should be noted that in this same ruling the IRS refused to decide if a physical contact which does not manifest in the form of a cut, bruise, or other similar bodily harm would constitute a "physical injury." *Id.*

39. See ROBERT W. WOOD, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS § 2.23 (Supp. 2001).

III. AMOS V. COMMISSIONER

A. *The Facts*

On January 15, 1997, Eugene Amos Jr. (Mr. Amos) was working as a television cameraman at a basketball game between the Chicago Bulls and the Minnesota Timberwolves.⁴⁰ During the game, Dennis Rodman (Mr. Rodman), a player for the Chicago Bulls, fell onto a group of photographers, which included Mr. Amos.⁴¹ At some point during this incident Mr. Rodman kicked Mr. Amos.⁴² Mr. Amos was then taken by ambulance to a local hospital.⁴³

Mr. Amos told hospital personnel that he had experienced shooting pain to his neck immediately after being kicked in the groin.⁴⁴ Mr. Amos also reported that this pain was subsiding.⁴⁵ Mr. Amos was able to walk, though he was limping and complained of pain.⁴⁶ However, medical personnel at the hospital did not observe any obvious signs of trauma.⁴⁷ Mr. Amos was offered, but refused additional pain medication.⁴⁸ While Mr. Amos was being treated at the hospital, he contacted an attorney, Gale Pearson, to represent him concerning the evening's incident.⁴⁹ After leaving the hospital, Mr. Amos filed a police report, in which he claimed Mr. Rodman had assaulted him.⁵⁰

40. *Amos*, T.C. Memo. 2003-329 [¶ 5]. [*Editor's Note*: The Montana Law Review has adopted legal citation as specified by THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION (Columbia Law Review Ass'n et al. eds., 17th ed. 2000). However, this note contains multiple citations to the *Amos* Tax Court Memorandum, which contains no page or paragraph numbering to aid the reader in locating the author's sources. To aid the reader, the editor, in collaboration with the author, has adopted a convention for pinpoint citation of *Amos* as suggested by ASS'N LEGAL WRITING DIRS. & DARBY DICKENSON, ALWD CITATION MANUAL § 6.3 (2000). Under this convention, unnumbered paragraphs in *Amos* will be indicated by a paragraph symbol and paragraph number in brackets to illustrate the information has been added by the author and does not appear in the original source.]

41. *Id.*

42. *Id.*

43. *Id.* [¶ 6].

44. *Id.*

45. *Id.*

46. *Amos*, T.C. Memo. 2003-329 [¶ 6].

47. *Id.*

48. *Id.*

49. *Id.* [¶ 7].

50. *Id.* [¶ 8].

On January 16, 1997, Mr. Amos obtained further treatment at another hospital.⁵¹ Mr. Amos complained to medical personnel about pain in his groin area, but did not advise them of any specific symptoms related to his groin pain.⁵² The medical personnel determined that there was no swelling of Mr. Amos' groin, but were unable to ascertain if Mr. Amos had any bruising.⁵³ Mr. Amos was given some pain medication and told to continue taking his other prescribed medications.⁵⁴

Shortly after the incident, an attorney representing Mr. Rodman contacted Mr. Amos' attorney.⁵⁵ They met several times, including one meeting in which Mr. Rodman's attorney noticed that Mr. Amos was limping.⁵⁶ On January 21, 1997, Mr. Rodman and Mr. Amos executed a "Confidential Settlement Agreement and Release" (agreement).⁵⁷ The agreement stated that Mr. Amos would release Mr. Rodman from any claims sustained by Mr. Amos arising out of or in connection with the incident that occurred between Mr. Rodman and Mr. Amos at the January 15, 1997 basketball game.⁵⁸ The agreement provided that as consideration for this release, Mr. Rodman would pay Mr. Amos \$200,000.⁵⁹

The agreement noted in the first paragraph that the release included claims, demands or actions "concerning any physical, mental or emotional injuries that may arise in the future allegedly resulting from the Incident."⁶⁰ The agreement also specifically noted that part of the consideration was given to prevent Mr. Amos from defaming Mr. Rodman, to keep the terms of the agreement confidential, and for Mr. Amos promising not to pursue criminal action against Mr. Rodman.⁶¹ The agreement also provided that Mr. Amos was not to publicize facts relating to the incident, though the agreement did not specifically mention that consideration was given in exchange

51. *Id.* [¶ 9].

52. *Amos*, T.C. Memo. 2003-329 [¶ 9].

53. *Id.*

54. *Id.* At the time of the incident, Mr. Amos was already taking pain medication for an unrelated, pre-existing back condition.

55. *Id.* [¶ 10].

56. *Id.*

57. *Id.* [¶ 11].

58. *Amos*, T.C. Memo. 2003-329 [¶ 11].

59. *Id.*

60. *Id.*

61. *Id.*

for this promise.⁶²

When Mr. Amos filed his tax return for the taxable year 1997, he excluded from his gross income all of the \$200,000 he received from Mr. Rodman under the agreement.⁶³ The Commissioner of the IRS then notified Mr. Amos that he was not entitled to exclude the settlement from his gross income.⁶⁴

B. Holding

The Tax Court found that despite the fact that Mr. Amos had only suffered minimal injury, Mr. Rodman's dominant reason for paying the settlement was to compensate Mr. Amos for physical injuries relating to the incident.⁶⁵ However, the Tax Court also found that Mr. Rodman paid Mr. Amos a portion of the settlement in return for Mr. Amos agreeing not to: "(1) Defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident."⁶⁶ The Tax Court also held that the settlement agreement did not specify the portion of damages paid on account of Mr. Amos' physical injuries and the portion paid on account of nonphysical injuries.⁶⁷ The Tax Court determined that \$120,000 of the settlement amount was attributable to Mr. Amos' physical injuries and \$80,000 of the settlement was attributable to nonphysical injuries.⁶⁸ As such, the Tax Court held that \$120,000 of Mr. Amos' injuries could be excluded under § 104(a)(2), but the remaining \$80,000 had to be included as gross income under § 61(a).⁶⁹

C. Reasoning

The Tax Court began its analysis of Mr. Amos' position by relying on the premise announced in *Welch v. Helvering*,⁷⁰ that the taxpayer "bears the burden of proving that the determination in the notice to include the settlement amount at

62. *Id.*

63. *Id.* [¶ 12].

64. *Amos*, T.C. Memo. 2003-329 [¶ 13].

65. *Id.* [¶ 25].

66. *Id.* [¶ 27].

67. *Id.* [¶ 28].

68. *Id.*

69. *Id.*

70. 290 U.S. 111 (1933).

issue in petitioner's gross income is erroneous."⁷¹ The Tax Court then acknowledged the rule established in *Schleier*, establishing that before a recovery may be excluded under § 104(a)(2) a taxpayer must demonstrate that the recovery was based on tort or tort type rights, and that the damages were received on account of physical injuries or sickness.⁷² The Tax Court also reasoned that subsequent to the 1996 Congressional amendments, § 104(a)(2) requires that "in order to be excluded from gross income, any amounts received must be on account of personal injuries that are physical or sickness that is physical."⁷³

Following its analysis of the general requirements of § 104(a)(2), the Tax Court then analyzed the affect of the settlement agreement upon a taxpayer's ability to qualify for a § 104(a)(2) exclusion. The Tax Court began its analysis with the general rule that, where damages are received pursuant to a settlement agreement, the nature of the claim controls whether damages may be excluded.⁷⁴ The Tax Court noted that, where a settlement agreement lacks express language allocating the settlement, the intent of the payor is critical to determining the allocation of damages.⁷⁵ The Tax Court reasoned that "the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment."⁷⁶

The Tax Court then concluded Mr. Rodman's dominant reason for paying the settlement was to compensate Mr. Amos for his physical injuries.⁷⁷ The Tax Court based its reasoning upon a combination of factors, including the settlement agreement, a statement from Mr. Rodman, and a statement from Mr. Amos' attorney. The settlement agreement expressly provided that Mr. Rodman's payment was in exchange for a release from any claims that Mr. Amos might have by reason of any damages or injuries sustained as a result of the incident.⁷⁸ Mr. Rodman's statement specifically stated that he entered into the agreement "to resolve any potential claims."⁷⁹

71. *Amos*, T.C. Memo. 2003-329 [¶ 14] (citing *Welch*, 290 U.S. at 115).

72. *Id.* [¶ 18] (citing *Schleier*, 515 U.S. at 336-37).

73. *Id.* [¶ 19] (citing Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1839-39 (1996)).

74. *Id.* [¶ 20] (citing *Burke*, 540 U.S. at 237).

75. *Id.* (citing *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965)).

76. *Amos*, T.C. Memo. 2003-329 [¶ 20] (citing *Agar v. Comm'r*, 290 F.2d 283 (2d Cir. 1961)).

77. *Id.* [¶ 25].

78. *Id.* [¶ 26].

79. *Id.*

The Tax Court concluded that Mr. Amos' only potential claims were for physical injuries he claimed he suffered as a result of the incident at the basketball game.⁸⁰ In his statement, Mr. Amos' attorney contended the entire settlement was on account of Mr. Amos' physical injuries.⁸¹ The Tax Court found that Mr. Rodman's dominant reason for entering into the settlement agreement was to compensate Mr. Amos for physical injuries.⁸² However, it should be noted that the Tax Court never discussed why Mr. Amos' injuries qualified as physical injuries under § 104(a)(2).

The Tax Court went on to state that because the settlement agreement specifically mentioned consideration was also given for nonphysical injuries, a portion of the settlement must be allocated to those damages as well.⁸³ Because the settlement agreement did not specify the apportionment of the settlement, the Tax Court reasoned that it should apportion the settlement between physical and nonphysical injuries based upon a review of the entire record.⁸⁴ The Tax Court determined that \$80,000 of the settlement agreement was attributable to nonphysical injuries, and thus that portion of the settlement could not be excluded from gross income under § 104(a)(2).⁸⁵

IV. CHANGES TO THE DEFINITION OF "PHYSICAL INJURY" UNDER SECTION 104(A)(2) AND THE IMPORTANCE OF THE "ON ACCOUNT OF" STANDARD

Based upon Tax Court's reasoning in *Amos*, it would appear that the scope of what constitutes a "physical injury" under § 104(a)(2) may be broader than the limited definition advocated by the IRS. In accordance with *Amos*, it can be argued that the minimum requirements of § 104(a)(2) are that an individual must experience (1) a physical touching, and (2) that as a result of the touching the individual experiences pain. The Tax Court in *Amos* did not require that Mr. Amos satisfy the strict

80. *Id.*

81. *Id.*

82. *Amos*, T.C. Memo 2003-329 [¶ 26].

83. *Id.* [¶ 27]. The Tax Court noted that the settlement agreement also provided that a portion of the consideration given was to: (1) prevent defamation, (2) prevent disclosure of the existence or terms of the settlement, (3) prevent publicizing facts relating to the incident, and (4) to prevent Mr. Amos from assisting in any criminal prosecution of Mr. Rodman. *Id.*

84. *Id.* [¶ 28].

85. *Id.*

standard of the IRS requiring an observable injury, such as a cut or bruise, in order for an injury to be classified as physical. In contrast, the record in *Amos* is clear that upon Mr. Amos' arrival at the hospital medical personnel did not observe any obvious signs of trauma, bruising or swelling.⁸⁶

The only objective data observed regarding Mr. Amos' condition was that he walked with a limp.⁸⁷ Upon arriving at the hospital, Mr. Amos complained of pain, yet refused the pain medications offered to him.⁸⁸ The following day Mr. Amos sought further treatment at a different hospital.⁸⁹ The medical personnel at the second hospital determined that there was no swelling of Mr. Amos' groin, and they were unable to ascertain if Mr. Amos had any bruising.⁹⁰

Despite the fact that Mr. Amos had no observable injury, as defined by the IRS in its ruling, the Tax Court concluded that Mr. Amos had suffered a physical injury.⁹¹ Mr. Amos did not have any cuts, bruises, swelling or bleeding, as the IRS has argued are necessary to constitute a "physical injury."⁹² The only facts available in the record indicating a "physical harm" are that Mr. Amos was subjected to physical contact with Mr. Rodman and that he complained of pain caused by that contact. While Mr. Amos did go to the hospital following the incident, there is no evidence in the record that he suffered any cuts, bruises, swelling or bleeding. Based on the holding in *Amos*, it is clear that at least the tax court will not require observable harm for an injury to qualify as "physical" under § 104(a)(2).

In determining whether § 104(a)(2) was applicable, the Tax Court focused extensively on whether the damages Mr. Amos received were "on account of" physical injury. The Tax Court concluded that despite the fact that Mr. Amos' damages based upon his physical injuries may have been nominal, in this case \$1, "it is the nature and character of the claim settled, and not its validity, that determines whether the settlement payment can be excluded from gross income under § 104(a)(2)."⁹³ This holding suggests the importance of emphasizing during the

86. *Id.* [¶ 6].

87. *Id.*

88. *Amos*, T.C. Memo 2003-329 [¶ 6].

89. *Id.* [¶ 9].

90. *Id.*

91. *Id.* [¶ 25].

92. *See* Priv. Ltr. Rul. 200041022 (July 17, 2000), *supra* note 38.

93. *Amos*, T.C. Memo. 2003-329 [¶¶ 22-23].

litigation process that a client's injuries were received "on account of" personal physical injuries, even when the injury may be minor. Based upon *Amos*, it is clear that in demonstrating that injuries suffered are "on account of" personal injuries, one need only prove nominal damages to receive the benefits of § 104(a)(2).

V. PRACTICAL IMPLICATIONS OF *AMOS* UPON DOCUMENTING A CASE IN A MANNER THAT WILL QUALIFY FOR SECTION 104(A)(2) EXCLUSION

A. Importance of the Underlying Claim and Establishing a Physical Injury

The tax result regarding § 104(a)(2) treatment of a particular settlement award or judgment will be determined by reference to the underlying claim of the lawsuit.⁹⁴ The determination of whether a settlement payment may be excluded from gross income depends on the nature of the claim asserted, not the validity of the claim.⁹⁵ Of particular importance in making this determination is the language of the settlement agreement and the complaint.⁹⁶ Many courts will reference the settlement agreement itself in determining the purpose for which a payment was made.⁹⁷

94. See *WOOD*, *supra* note 2, § 1.3.

95. *Bent*, 87 T.C. 236, 244 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987).

96. See *McKay v. Comm'r*, 102 T.C. 465 (1994), *vacated*, 84 F.3d 433 (5th Cir. 1996) (unpublished table decision). In *McKay*, an individual brought suit against his former employer alleging wrongful discharge, breach of contract and a RICO claim. *Id.* at 470. Following a jury award in favor of the employee, the parties entered into a settlement agreement. *Id.* at 471. The settlement agreement provided a lump sum of \$25 million, with approximately \$9 million of that amount going to the employee's attorney. *Id.* Pursuant to the settlement agreement, \$12,250,215 was paid in extinguishment of the wrongful discharge tort claim, and \$2,044,085 was paid in extinguishment of the breach of contract claim. *Id.* at 472. This allocation was based upon the probable success of each claim on appeal. *Id.* Because the \$12,250,215 award for the wrongful discharge was based upon tort-type rights (a physical injury was not required when the case was decided), the parties agreed that this amount should be excluded from the employee's gross income under § 104(a)(2). *Id.* In determining whether the portion of the settlement allocated to the wrongful discharge could be excluded, the Tax Court looked first to the express language of the settlement agreement. *Id.* at 482. The Tax Court also noted that in the absence of express allocation within the settlement agreement, courts should consider pleadings, jury awards or judgments in determining the basis of a claim for § 104(a)(2) purposes. *Id.* at 483.

97. See *Knuckles*, 349 F.2d 610. In *Knuckles*, the Court noted that the most important factor in determining if a settlement payment was made on account of a

In determining the purpose of the payment, the Tax Court in *Amos* was forced to look at the settlement agreement as a whole, as well as Mr. Rodman's intent. Fortunately for Mr. Amos, as well as the attorney who drafted the agreement, the Tax Court found that Mr. Rodman's dominant purpose in entering into the settlement agreement was to compensate Mr. Amos for the physical injuries he suffered at the basketball game. At the same time, the Tax Court held that a large portion of the settlement agreement was not awarded on account of physical injuries, and as a result Mr. Amos did not receive the benefit of § 104(a)(2) for that portion of the settlement. The *Amos* case provides an excellent example of the importance of considering the requirements of § 104(a)(2) when drafting a settlement agreement.

B. Allocating the Settlement

Because of the ambiguity of what constitutes a physical injury under § 104(a)(2), it is critical that attorneys who wish to obtain the benefit of § 104(a)(2) exclusion for their clients outline in both the initial complaint and the settlement agreement that the damages sought or recovered are on account of physical injuries. However, because courts look skeptically upon settlement agreements that are not reached as the result of arms-length, adversarial settlement negotiations, attorneys must assure that the allocation is more than mere window dressing.⁹⁸ When drafting the settlement agreement, the attorney should be careful to specifically allocate the portions of the settlement that are attributable to physical injuries and those which are attributable to nonphysical injuries. If the settlement agreement fails to specifically allocate the damages awarded, courts are likely to do as the *Amos* court and make the

personal injury, is the express language of the settlement agreement. *Id.* at 613. In the absence of express language allocating the settlement, courts will look to the intent of the payor as to the purpose of making the payment. *Id.* Leaving this determination to the courts can be a dangerous proposition for taxpayers, as it was for the taxpayer in *Knuckles*, where the court ultimately determined that the settlement award was not on account of personal injuries. *Id.*

98. Compare *Robinson v. Comm'r*, 102 T.C. 116 (1994), *aff'd in part, rev'd in part, and remanded on another issue*, 70 F.3d 34 (5th Cir. 1995) (holding that because the settlement agreement was not made at arms-length, and through an adversarial negotiation process, the Court was not required to follow the allocation outlined by the settlement agreement need not be followed), with *McKay*, 102 T.C. at 465 (upholding the allocation of damages as outlined by the settlement agreement because the negotiations were arms-length and adversarial in nature).

determination on their own. While courts are not bound to accept the allocation of damages established in a settlement agreement, it is in a party's best interest to specifically allocate damages between physical and nonphysical injuries, so as not to risk the chance that a court will determine that the damages awarded are not on account of physical injuries.

VI. THE NEED FOR CHANGE

By inserting the word "physical" into § 104(a)(2) Congress created an arbitrary and ambiguous standard. As early as 1926 courts began applying § 104(a)(2) to both physical and nonphysical injuries.⁹⁹ For many years the focus of whether a damage award received § 104(a)(2) treatment was based upon a determination of whether the claim sounded in tort.¹⁰⁰ By allowing a broad interpretation of "personal injury," courts were not forced to play the role of scientists and draw arbitrary lines for determining whether a victim of a personal injury should be afforded the benefits of § 104(a)(2). Prior to the insertion of the word "physical," courts were simply asked to determine (1) whether the individuals claim was based upon tort or tort-type rights and (2) whether the damages received were on account of personal injuries.

Under the pre-1996 system, an individual who suffered severe emotional distress and underwent years of expensive therapy or even lost her job as a result of a tort-type injury was afforded the benefit of § 104(a)(2) exclusion for damages recovered. Under current § 104(a)(2), that same severely injured individual would be taxed upon that damage award simply because there was no evidence of a physical injury, such as a bruise or cut. To continue to apply § 104(a)(2) solely to "physical injuries" completely ignores the well established fact that psychological injuries can be at least as detrimental to an individual as physical injuries and that psychological injuries have a significant physical dimension. Not only does the current "personal physical injury" standard arbitrarily prejudice a huge number of individuals who have suffered real and quantifiable psychological injuries, but it has forced courts to apply an ambiguous standard. If, as apparently was the case, Congress was concerned that the exclusion of damages for non-physical injuries resulted in an inappropriate exclusion of economic

99. See generally *Threlkeld*, 87 T.C. 1294.

100. *Id.* at 1305.

damages, Congress in 1996 could have simply provided in § 104(a)(2) that economic damages like punitive damages are not excludable. If this had been the case, there would have been no need to add the word “physical” to the statute and the current ambiguity and arbitrary distinctions would have been avoided. To avoid the ambiguous and arbitrary distinction of § 104(a)(2) Congress should rectify this problem accordingly.

VII. CONCLUSION

The holding in *Amos*, indicates that courts will not always limit § 104(a)(2) exclusion to the narrow definition of “physical injuries” that the IRS advocates. When determining whether § 104(a)(2) exclusion is appropriate, the tax court appears to be willing to apply a more lenient standard than the “cutting, bruising, or swelling” standard of the IRS. Based upon the holding in *Amos*, a showing of even minor physical injuries is sufficient to trigger the application of the § 104(a)(2) exclusion. It appears that a physical touching accompanied by pain, suffered as a result of that touching satisfies the “on account of” standard and will qualify as a “physical injury” under § 104(a)(2).

While what constitutes “damages received on account of *physical injuries*” remains ambiguous, it is clear that, for a client to benefit from § 104(a)(2) exclusion, attorneys must draft their clients’ pleadings and settlement agreements in a manner that emphasizes the nature and existence of the physical injury. Ultimately, attorneys should be aware of the importance of demonstrating that damages were awarded “on account of” personal physical injuries. In doing so, it is the nature and character of the claim that is important, not its validity.