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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **KAMIL ISSA**) Case No. 869808

	<u>Years</u>	<u>Proposed Assessments</u>	<u>Late Filing Penalty</u>
	2006	\$98,001.00	-0-
	2007	\$154,589.00	\$38,647.25

16 Representing the Parties:

17 For Appellant: Mark A. Muntean, Attorney
18 For Franchise Tax Board: Judy F. Hirano, Tax Counsel III

20 QUESTIONS: (1) Whether appellant has shown that the Franchise Tax Board (FTB or respondent)
21 erred by not allowing damages awarded in a settlement agreement to be excluded
22 from his taxable income.
23 (2) Whether appellant has shown that he is entitled to deduct attorney fees and costs
24 related to his settlement.
25 (3) Whether appellant has shown error in the imposition of the late filing penalty for
26 2007.

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1 HEARING SUMMARY

2 Background

3 Appellant and a co-worker filed a Complaint for Damages (Complaint) against their
4 former employer¹ on May 1, 2001. The Complaint listed the following ten causes of action, with the
5 first six being based on the Fair Employment and Housing Act (FEHA): (1) discrimination and
6 (2) harassment based on race or national origin; (3) discrimination and (4) harassment based on sexual
7 orientation and/or perceived sexual orientation; (5) retaliation; (6) failure to take reasonable steps;
8 (7) breach of contract; (8) breach of implied covenant of good faith and fair dealing; (9) intentional
9 infliction of emotional distress; and (10) discrimination in violation of the Unruh Act.² The Complaint
10 sought general and special damages, as well as punitive damages and attorney fees and costs. (Resp.
11 Op. Br., exhibit A.)

12 After a jury trial, the jury returned a special verdict that was entered as the judgment on
13 July 11, 2006. (Resp. Op. Br., exhibit B.) The special verdict returned answers to specific questions,
14 and found that appellant was subjected to harassment due to his race or national origin (cause of action
15 number 4) from both his employer and a manager, which created a hostile or abusive work
16 environment. The jury did not find that he was subjected to retaliation by his employer based on his
17 complaints of harassment, but the jury did find that his employer failed to take reasonable steps to
18 prevent the harassment (cause of action number 6). (*Id.* at exhibit B, pp. 8-11.) The special verdict
19 ordered general damages for appellant of \$5,000,000, punitive damages against the employer for
20 \$25,000,000, and punitive damages against the manager of \$28. (*Id.* at exhibit B, p. 4.) The special
21 verdict also allowed for interest on the damages, costs as allowed by statute, and attorney fees to be
22 determined by a separate order. (*Id.* at exhibit B, p. 5.)

23 The defendants filed a motion for a new trial, which was granted in part and denied in
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25 ¹ The Complaint was filed against Roadway Package System, Inc. (RPS, Inc.), FedEx, Inc. (FedEx Ground, Inc.), two named
26 individuals that worked with appellants, and 75 unnamed individuals. (Resp. Op. Br., p. 1.) The judgment that was
27 ultimately entered into included FedEx Ground, Inc., and only one named manager as defendants. (*Id.* at exhibit B, p. 3; see
also *Id.* at exhibit C.)

28 ² These ten causes of action are found in the "First Amended Complaint for Damages" provided on appeal. (Resp. Op. Br.,
exhibit A.) This complaint is undated. Appellant states that the original complaint was filed on May 1, 2001, and he lists
nine causes of action, omitting the breach of contract cause of action. (App. Op. Br., p. 3.)

1 part. (Resp. Op. Br., exhibit C.) The court determined the compensatory and punitive damages
2 awarded by the jury were excessive, and directed that the judgment against the employer be reduced to
3 \$750,000 for compensatory damages and \$5,250,000 for punitive damages.³ (*Id.* at exhibit C, pp. 2-5.)
4 These amounts did not include attorney fees and costs, which appellant could still pursue. Appellant
5 had the option to accept the reduced award, or otherwise the employer would be entitled to a new trial
6 on the issue of compensatory and punitive damages only. (*Id.* at exhibit C, p. 7.) In October of 2006,
7 appellant accepted the court's reduced award and the jury award was therefore vacated. (*Id.* at
8 exhibit C, pp. 9-13.) The defendants appealed, however, and the court action continued.

9 On November 13, 2006, the parties entered into a settlement agreement. (Resp. Op. Br.,
10 exhibit D.) The settlement agreement states that it was entered into to resolve the lawsuit, the claims
11 made with the Department of Fair Employment and Housing (DFEH), and other potential claims. (*Id.*
12 at exhibit D, p. 1.) Under the settlement agreement, appellant was entitled to an initial payment of
13 \$1,041,270, followed by an additional \$1,612,500, plus interest, when the agreement became final. A
14 payment of \$5,442,460 was made to the law firm representing appellant and his co-plaintiff.⁴ (*Id.* at
15 exhibit D, p. 2.) Appellant received the initial payment in December of 2006, and received the second
16 payment in February of 2007.⁵ (*Id.* at exhibits E & F.)

17 Appellant reported \$511,352 in non-employee compensation from the employer on his
18 2006 federal tax return. (Resp. Op. Br., p. 6 & exhibit G.) Appellant also reported a payment of
19 \$1,041,000 as a personal injury payment and applied a \$1,041,000 Internal Revenue Code (IRC)
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22 ³ The judge noted that a compensatory award of \$750,000 may still seem high, but was only 15 percent of the amount
23 awarded by the jury. (Resp. Op. Br., exhibit C, p. 3.) The judge stated that punitive damages are usually limited to no more
24 than ten times the amount of compensatory damages, and in this scenario found that a multiplier of seven was appropriate.
(*Id.* at exhibit C, pp. 4-5.)

25 ⁴ The settlement agreement stipulates that it settles the lawsuit filed jointly by appellant and his co-plaintiff. The settlement
26 provides separate amounts for each individual plaintiff and one sum for the law firm representing both plaintiffs. Therefore,
27 of the \$5,442,460 payment for attorney fees, one-half, or \$2,721,230, is attributable to appellant. Adding the \$2,653,770 in
28 payments made directly to appellant pursuant to the settlement agreement (i.e., \$1,041,270 + \$1,612,500) to appellant's
share of the attorney fees paid on his behalf produces a total settlement payment for appellant of \$5,375,000 (i.e.,
\$2,653,770 + \$2,687,500).

⁵ The second payment, after the addition of \$10,494 in interest, totaled \$1,622,994 (i.e., \$1,612,500 + \$10,494). (Resp. Op.
Br., exhibit F.)

1 section 108 exclusion from tax.⁶ (*Id.* at exhibit H, p. 17; see *Id.* at exhibit G, p. 4.) Appellant filed his
2 California resident tax return on October 15, 2007, and reported a federal adjusted gross income (AGI)
3 of \$50,450, and, after adjustments, a California AGI of \$69,490. Appellant did not report the 2006
4 settlement payment amount as taxable income. Appellant reported and paid a \$4,021 liability that
5 included tax, interest, and an underpayment of estimated tax penalty. (*Id.* at exhibits H & I.)

6 Appellant filed a late 2007 California resident tax return on May 15, 2009, and reported
7 a federal AGI of \$8,680. (Resp. Op. Br., exhibit J.) Appellant's return calculated a California AGI of
8 negative \$225 and zero tax due. Appellant did not report the 2007 settlement payment amount as
9 taxable income. Appellant's 2007 federal tax return included a Federal Supplemental Information sheet
10 which stated that he received \$2,653,777 in compensatory damages over several years, including
11 \$1,041,000 paid in 2006, and that these amounts were excluded from his taxable income under IRC
12 section 104(a)(2) on account of a personal physical injury. (*Id.* at exhibit J, p. 20.)

13 Respondent examined appellant's 2006 and 2007 returns and issued Notices of Proposed
14 Assessment (NPAs) on September 7, 2011, proposing to add to taxable income the net settlement
15 payments for each year. (Resp. Op. Br., exhibit K.) The NPA for 2006 added \$1,041,270 to taxable
16 income and proposed an additional tax of \$98,001. (*Id.* at exhibit K, p. 1.) The NPA for 2007 added
17 \$1,622,994 to taxable income and proposed an additional tax of \$154,589. The 2007 NPA also
18 imposed a late filing penalty of \$38,647.25. (*Id.* at exhibit K, p. 3.) After a protest period, respondent
19 affirmed the NPAs with Notices of Action dated February 13, 2015. (*Id.* at exhibit L.) This timely
20 appeal followed.

21 Contentions

22 Appellant's Contentions

23 *Settlement Award*

24 Appellant states that he is a Christian Lebanese American who immigrated to the
25 United States from Lebanon to flee religious persecution from the Muslim terrorist organization called
26 Hezbollah. Appellant contends that, while working for his employer in Oakland during the time
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⁶ Respondent notes that IRC section 108(a) applies to income of certain amounts otherwise includible in income due to the discharge of indebtedness, and does not apply to appellant's settlement payment. (Resp. Op. Br., p. 6.)

1 leading up to his lawsuit he was subjected to repeated physical attacks, verbal threats, abuse, and
2 harassment by drivers and terminal managers.⁷ (App. Op. Br., p. 2.) Appellant provides a list of
3 alleged instances of injury and harassment that appellant contends was testified to in court, including
4 unwanted physical touching by other drivers. (*Id.* at exhibits C & D.) Appellant asserts that he also
5 suffered emotional distress from harassment and discrimination. (*Id.* at p. 3.)

6 Appellant contends that the origin of the claim controls the tax treatment of a recovery
7 in a lawsuit, and that the origin of the claim is determined with reference to claims raised in the
8 complaint, litigated, and resolved in a verdict or settlement. (App. Op. Br., p. 6; *State Fish Corp. v.*
9 *Commissioner* (1967) 48 T.C. 465, 474, acq. 1968-2 C.B. 3, mod., (1967) 49 T.C. 13.) Appellant
10 asserts that the IRS generally views the complaint as the most persuasive evidence of the origin of the
11 claim. (Rev. Rul. 85-98, 1985-2 C.B. 51 (1985).)

12 Appellant states that IRC section 104(a)(2) provides that gross income does not include
13 the amount of any damages, other than punitive damages, received on account of personal physical
14 injuries or physical sickness. Appellant contends that there are no regulations or other guidance from
15 the IRS or respondent directly defining what the physical injury or illness requirement entails.
16 Appellant cites to the decision in *Amos v. Commissioner*, T.C. Memo. 2003-329 (*Amos*) wherein a
17 cameraman was kicked in the groin by a professional basketball player, they privately settled for
18 \$200,000, and the court determined that 60 percent of the settlement could be excluded. Appellant
19 asserts that the injury is the same whether a petitioner is kicked in the groin or grabbed in the groin, and
20 the compensation is excluded from income. Appellant also provides references to articles arguing that
21 gender and sexual discrimination can be more harmful than physical injuries. (App. Op. Br., pp. 6-8.)

22 Appellant contends that he sued his employer because his employer (and other workers)
23 harassed, discriminated, and injured him, “which arose on account of that personal physical injury
24 inflicted by [other employees].” (App. Op. Br., p. 9.) Appellant specifically claims three types of
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26 ⁷ As stated above, the original Complaint appears to have been filed against appellant’s employer and approximately
27 77 individuals. The special verdict decided by the jury only included appellant’s employer and one manager. Appellant
28 should be prepared to discuss at the hearing whether the named manager engaged in any alleged physical attacks, or if this
manager was instead involved in harassment or failing to prevent harassment, and whether this shows what transgressions
were the real focus of the trial and verdict.

1 physical injuries were discussed during trial: (1) being physically punched by his manager; (2) being
2 pushed around and knocked into filing cabinets by a manager in the office; and, (3) on multiple
3 occasions, being grabbed in a sexually inappropriate manner accompanied by equally inappropriate
4 statements. Appellant states that he did allege discrimination and name calling but contends that it was
5 the personal physical injury that shocked the jury, and claims that the jury awarded the damages based
6 on the gross and shocking personal physical injury. (App. Reply Br., pp. 1-2.)

7 Appellant concedes that emotional distress, by itself, is not excludable from gross
8 income under IRC section 104(a)(2), but claims that appellant in this appeal suffered personal physical
9 injury and personal physical sickness and the settlement award was based on that conduct. Appellant
10 likens his facts to those in the nonprecedential Private Letter Ruling 200121031, in which a worker's
11 heirs received an award after the worker contracted lung cancer while on the job. Appellant references
12 the alleged testimony presented at trial in which numerous instances of physical abuse and injury were
13 read or testified to in court, and upon which appellant asserts the jury based its decision. (*Id.* at pp. 10-
14 12 & exhibits C-F.) Appellant contends that this was never a case of emotional distress standing on its
15 own. Appellant also references an IRS Chief Counsel Advice Memoranda discussing the sexual abuse
16 of a child and in which the IRS concluded it was reasonable to assume that all damages were the result
17 of the physical injuries of the abuse, and asserts that appellant's harm, including emotional distress, is
18 similarly attributable to physical injuries suffered by appellant. (*Id.* at pp. 11-12.)

19 Appellant contends that his interpretation of IRC section 104(a)(2) need only be
20 reasonable. To support this proposition, appellant cites to a Tax Court decision analyzing alternate
21 accounting theories presented by the IRS and the taxpayer as to how to allocate certain expenses among
22 various mining operations. The court determined that the taxpayers did not have the burden of showing
23 its method was more fair than the IRS's proposed method, but rather to show that its method was
24 defensible under cost accounting principles.⁸ Appellant also notes that the law no longer requires that
25 damages be received from actions based upon tort or tort type rights, and contends that this shows that
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27 ⁸ Appellant should be prepared to explain at the hearing how a choice of general accounting options relates to the
28 interpretation of an Internal Revenue Code section providing for a limited exclusion to gross income with specified
requirements.

1 the IRS has abandoned its decision in *United States v. Burke* (1992) 504 U.S. 229. (App. Op. Br.,
2 pp. 12-20; App. Reply Br., p. 3.)

3 Appellant asserts that the settlement agreement controls, and that the agreement
4 allocates the recovery to emotional distress and physical injury from emotional distress. (App. Op. Br.,
5 pp. 21-21; App. Reply Br., pp. 5-6.) Appellant states that, when parties expressly allocate a settlement
6 between tort type personal physical injury damages and other damages, it will be respected for tax
7 purposes to the extent the parties entered into the agreement in an adversarial context at arm's length
8 and in good faith, quoting *Moulton v. Commissioner*, T.C. Memo. 2009-38. Appellant contends that
9 the parties allocated the settlement payments to emotional distress including emotional distress
10 attendant to physical injury. (App. Reply Br., 5-6.)

11 *Attorney Fees and Costs*

12 Appellant asserts he is entitled to an above-the-line deduction for attorney fees and court
13 costs paid in connection to his lawsuit.⁹ (App. Op. Br., pp. 21-23.) Appellant contends that respondent
14 is attempting to “dodge conformity” to federal law by creating stricter rules and not allowing the
15 deduction of attorney fees. (App. Reply Br., pp. 2-3, 6.)

16 *Late Filing Penalty*

17 Appellant contends that respondent seeks to impose a late filing penalty for 2007 based
18 on the argument that appellant's 2007 tax return was not filed timely. Appellant asserts that the penalty
19 is based on the additional tax proposed on appeal and that, without the additional tax, there is no
20 penalty.¹⁰ (App. Op. Br., p. 23; App. Reply Br., p. 3.)

21 Respondent's Contentions

22 *Settlement Award*

23 Respondent contends that its determination disallowing the exclusion of income is
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25 ⁹ Appellant argues the law surrounding why this type of deduction is allowed in some circumstances, but does not provide
26 any proposed calculation of what attorney fees he should be entitled to or how it would affect the proposed assessment on
27 appeal here. As discussed in the Staff Comments section below, appellant should be prepared to discuss what amount, if
any, appellant alleges he is entitled to claim as an above-the-line deduction for attorney fees and court costs.

28 ¹⁰ Appellant should be prepared to clarify at the hearing whether he argues that the penalty should be abated for any other
reason.

1 presumed correct, citing the *Appeal of George R. II and Edna House*, 93-SBE-016, decided on
2 October 28, 1993. Respondent contends that gross income, under IRC section 61 and Revenue and
3 Taxation Code (R&TC) section 17071, includes income from all sources, and the exception provided
4 for in IRC section 104(a) is limited to damages received on account of personal physical injuries or
5 physical sickness. Respondent asserts that appellant bears the burden of establishing that the settlement
6 payments were received on account of physical injuries or physical sickness for the income to be
7 excludable under IRC section 104(a)(2). (*Espinoza v. Commissioner* (5th Cir. 2011) 636 F.3d 747,
8 749-750; *Green v. Commissioner* (2014) T.C. Memo. 2014-23, p. 9.) Respondent contends that there
9 must be a direct causal link between the damages and any physical injury or physical sickness
10 sustained, and that the pertinent question in determining the tax treatment of a settlement payment is,
11 “in lieu of what was the settlement amount paid?” (Resp. Op. Br., pp. 7-10; *United States v. Burke*
12 (1992) 504 U.S. 229, 237;¹¹ *Bagley v. Commissioner* (1995) 105 T.C. 396, 406, affd. (8th Cir. 1997)
13 121 F.3d 393; accord, *Delaney v. Commissioner* (1st Cir. 1996) 99 F.3d 20, 23-24.) Respondent asserts
14 that an express statement in a settlement agreement will generally be followed in determining the nature
15 of the payment, but does not necessarily control if contradictory facts indicate otherwise. (Resp. Op.
16 Br., p. 11.)

17 Respondent contends that the claims settled were in the nature of harassment and a
18 failure to take steps to prevent harassment, not physical injury or physical sickness, and therefore the
19 settlement income is not excludable under IRC section 104(a)(2). Respondent asserts that appellant’s
20 Complaint asserted no claims for physical injuries or physical sickness. Respondent states that in
21 appellant’s second cause of action, harassment based on race or national origin, appellant asserted he
22 was subjected to verbal abuse and physical harassment, but contends that nowhere in the Complaint is
23 there any allegation of specific physical injuries or physical sickness for which he sought damages.

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26 ¹¹ Appellant contends that the *Burke* decision was abandoned by the Internal Revenue Service when it issued new
27 regulations that no longer require that a settlement be on account of a tort-like claim to qualify under IRC section 104(a)(2).
28 *Burke* was superseded by statute, as noted in *Perez v. Commissioner* (2015) 144 T.C. 51, at pages 61-62, to remove the tort-
like claim requirement and to allow for the IRC section 104(a)(2) exclusion to apply to taxpayers who are physically injured
and recover under no-fault statutes. However, subsequent court decisions still cite to *Burke* after the change in law for its
discussion on what constitutes “on account of” personal physical injury or physical illness. (See, e.g., *Connolly v.*
Commissioner, T.C. Memo. 2007-98 [“In lieu of what where the damages awarded?”]; *Bond v. Commissioner*, T.C. Memo.
2005-251 [discussing how to decide the purpose of a payment].)

1 Respondent contends that the jury award was based on finding the defendants liable for two claims:
2 (1) harassment based on race or national origin, and (2) the failure to take reasonable steps to prevent
3 harassment. Therefore, respondent asserts, the claims set forth in the Complaint that were settled and
4 released in the settlement agreement were not for physical injuries or physical sickness, and there is no
5 evidence in the jury award that any damages were awarded for physical injuries or physical sickness.
6 (Resp. Op. Br., pp. 11-13.)

7 Respondent addresses appellant's opening brief exhibits C, D, and E, and asserts that
8 these are statements purportedly presented at trial or in post-trial motions, but constitute unsupported
9 assertions and should be given little weight. (Resp. Op. Br., p. 14; *Appeal of Aaron and Eloise*
10 *Magidow*, 82-SBE-274, Nov. 17, 1982.) Furthermore, respondent asserts, in all three of these exhibits,
11 there is no evidence of any physical injury or physical sickness that appellant suffered for which he
12 sought damages in the Complaint. Respondent asserts that *Amos v. Commissioner*, T.C. Memo. 2003-
13 329 is distinguishable from this appeal because, in that case, the court found that 60 percent of the
14 \$200,000 award was for compensation for the resulting physical injuries from being kicked in the
15 groin, whereas in this appeal there is no evidence that appellant was "grabbed in the groin" as claimed
16 by appellant and the only claims submitted to the jury for which damages were awarded were for
17 harassment based on race or national origin and the failure to take reasonable steps to prevent the
18 harassment. Respondent points out that the court's remittitur in appellant's case defined the harassment
19 as "mostly just offensive name-calling," including "harassment and ethnic name-calling almost every
20 workday." (Resp. Op. Br., pp. 14-15.)

21 Respondent disagrees with appellant's position that the settlement payments were for
22 physical injuries based on the payment allocation statement in the settlement agreement, which reads
23 that the settlement payments are to be treated as damages for appellant's "allegations of emotional
24 distress, including emotional distress attendant to alleged physical injury." Respondent contends that
25 the payment allocation statement in the settlement agreement is undermined by the Complaint, the
26 jury's special verdict, and the court's remittitur. Respondent also contends that the flush language of
27 IRC section 104(a) states that emotional distress is not a physical injury or physical sickness, and
28 quotes from the legislative history of IRC section 104(a)(2) which states, in part, "The House bill also

1 specifically provides that emotional distress is not considered a physical injury or physical sickness,”
2 but also states, “the exclusion from gross income applies to any damages received based on a claim of
3 emotional distress that is attributable to a physical injury or physical sickness” However,
4 respondent asserts, there must in the first instance be a bona fide physical injury or physical sickness
5 and appellant does not specify any physical injuries or physical sickness for which the settlement
6 payments purportedly were made, and there is no evidence of such physical injuries or physical
7 sickness. (Resp. Op. Br., pp. 16-17.)

8 Respondent contends that, in appellant’s claims for harassment based on race or national
9 origin and the failure to take reasonable steps to prevent harassment (i.e., the claims in the Complaint
10 for which the jury awarded damages), he claimed harm from the “loss of wages, salary, benefits and . . .
11 employment related opportunities,” and “humiliation, mental anguish, and emotional and physical
12 distress.” (Resp. Op. Br., p. 17 & exhibit A, pp. 12-13, 23, 31-32.) Respondent asserts that appellant
13 failed to identify any physical injuries or physical sickness that were settled and released as part of the
14 settlement. Respondent contends that the judge’s remittitur awarded mostly punitive damages (seven
15 times the amount of compensatory), and IRC section 104(a)(2) expressly provides that punitive
16 damages are not excludable from gross income. Respondent asserts that the judge’s remittitur
17 discussed how much to award for emotional distress, and the compensatory damages he awarded were
18 clearly for emotional distress. (*Id.* at pp. 17-18.) Respondent contends that, while the judge discussed
19 the harm as being physical rather than economic, he was emphasizing that appellant did not suffer mere
20 monetary harm but rather emotional harm that may have had physical effects. Respondent asserts that
21 settlement amounts paid for the physical symptoms of emotional distress are includable in income. (*Id.*
22 at p. 19.)

23 Respondent asserts that the settlement agreement should not dictate the nature of the
24 settlement payments since the payment allocation statement was not drafted at arm’s length in an
25 adversarial context but rather with a tax motivation. Respondent notes that the statement provides that
26 the employer agreed and consented to appellant’s allocation of the settlement consideration, and thus it
27 was appellant who determined the allocation and the employer had no interest in ensuring that the
28 payments accurately represented the true nature of the payments. (Resp. Op. Br., p. 19.)

1 *Attorney Fees and Costs*

2 Respondent asserts that the proposed assessments for 2006 and 2007 added to taxable
3 income the net settlement proceeds excluding attorney fees and costs, and therefore appellant has not
4 shown that he is entitled to another deduction for attorney fees and costs. Respondent contends that a
5 litigant's income includes the part of the settlement proceeds paid to his attorney, but IRC section
6 62(a)(20) allows for an above-the-line deduction for attorney fees and court costs paid by the litigant in
7 connection with an action involving an unlawful discrimination claim. Accordingly, respondent asserts
8 that appellant's settlement income for 2006 included the \$1,041,270 settlement payment, plus
9 \$2,721,230 representing his half of the \$5,442,460 attorney fees; however, respondent states that
10 appellant was allowed an above-the-line deduction for the attorney fees because his action included
11 claims of unlawful discrimination. Therefore, respondent asserts that appellant has already been
12 allowed to deduct the attorney fees and court costs and he is not entitled to an additional deduction for
13 attorney fees and costs. (Resp. Op. Br., pp. 20-21.)

14 *Late Filing Penalty*

15 Respondent asserts that appellant filed his 2007 tax return in May of 2009, over a year
16 beyond the due date. Respondent contends that the late filing penalty, imposed under R&TC section
17 19131, subdivision (a), is properly imposed.

18 Applicable Law

19 Burden of Proof

20 It is well established that a presumption of correctness attends respondent's
21 determinations as to issues of fact and that the taxpayer has the burden of proving such determinations
22 erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980; *Appeal of*
23 *George R. II and Edna House*, 93-SBE-016, Oct. 28, 1993.) To overcome the presumed correctness of
24 respondent's finding as to issues of fact, a taxpayer must introduce credible evidence to support his
25 assertions, and if he does not support his assertions with such evidence, respondent's determinations
26 must be upheld. (*Ibid.*)

27 Settlement Award

28 R&TC section 17071 incorporates IRC section 61, which defines "gross income" to

1 include “all income from whatever source derived” except as expressly provided by statute. R&TC
2 section 17131 incorporates IRC section 104. IRC section 104(a)(1) excludes amounts received under
3 workers’ compensation acts as compensation for personal injuries or sickness. IRC section 104(a)(2)
4 excludes from gross income “the amount of any damages (other than punitive damages) received
5 (whether by suit or agreement and whether as lump sums or as periodic payments) on account of
6 personal physical injuries or physical sickness[.]” (Int.Rev. Code, § 104(a)(2).) IRC section 104(a)
7 provides in part that “[f]or purposes of paragraph (2), emotional distress shall not be treated as a
8 physical injury or physical sickness.”¹²

9 When a settlement agreement exists, determining the exclusion from gross income
10 depends on the nature of the claim that was the actual basis for settlement. (*Stocks v. Commissioner*
11 (1992) 98 T.C. 1, 10.) In determining whether a settlement was paid “on account” of alleged personal
12 physical injuries, a court begins “by looking at the language in the settlement agreement. The language
13 contained in an agreement will be respected to the extent the settlement agreement is entered into in an
14 adversarial context, at arm’s length, and in good faith.” (*Massot v. Commissioner*, T.C. Memo. 2000-
15 24.) Courts have also looked at the special verdict form returned by a jury to see if they found an
16 underlying physical injury or sickness as a cause for an award. (*Nancy J. Vincent v. Commissioner*,
17 T.C. Memo. 2005-95.) The U.S. Tax Court has explained as follows: “Under California law, . . . we
18 must consider all credible evidence to determine whether the language of the agreement is fairly
19 susceptible of more than one interpretation, and if it is, we must consider extrinsic evidence relevant to
20 prove which one of these meanings reflects the intent of the contracting parties.” (*Simpson v.*
21 *Commissioner* (2013) 141 T.C. 331, 340.) If the settlement agreement lacks express language stating
22 what the settlement amount was paid to settle, then the most important factor in determining any
23 exclusion under IRC section 104(a)(2) is the intent of the payor regarding the purpose in making the
24 payment. (*Ibid.*) What the settlement agreement actually settled is a question of fact. (*Ibid.*)

25 The U.S. Supreme Court focused on the phrase “on account of” from IRC section
26

27 ¹² IRC section 104(a) also provides that the exclusion of emotional distress from the definition of physical injury and
28 physical sickness “shall not apply to an amount of damages not in excess of the amount paid for medical care . . .
attributable to emotional distress.” Medical care is defined for purposes of this statute in IRC section 213(d)(1),
subparagraph (A) or (B).

1 104(a)(2) in *O’Gilvie v. United States* (1996) 519 U.S. 79, finding that those words impose a stronger
2 causal connection, making the provision applicable only to those personal injury lawsuit damages that
3 were awarded by reason of, or because of, the personal injuries.¹³ This analysis was followed in
4 *Murphy v. Internal Revenue Service*, in which it was similarly found that a taxpayer must demonstrate
5 that he or she was awarded damages “because of” his or her physical injuries to be entitled to tax
6 exclusion under IRC section 104(a)(2). (*Murphy v. Internal Revenue Service* (2007) 493 F.3d 170.)

7 The California Labor Code, at sections 3600 and 3602, provide generally that the right
8 to compensation through the workers’ compensation system is the exclusive remedy against an
9 employer for any injury arising out of and sustained during the course of employment. Specific
10 exceptions are provided that allow employees to bring a civil action for damages as if Labor Code
11 section 3602 did not exist, but are limited to situations in which the injury or death is caused by a
12 willful physical assault by the employer, the injury is aggravated by the employer’s fraudulent
13 concealment of the existence of the injury and its connection to employment, or the injury is caused by
14 a defective product manufactured and sold or leased by the employer to a third party and subsequently
15 used by the employee.¹⁴

16 Attorney Fees and Costs

17 Attorney fees awarded to a prevailing party are considered earned by the party and not
18 the party’s attorneys, even if the fees are separated in the award agreement, and are generally non-
19 excludable when the award is considered income. (*Green v. Commissioner*, T.C. Memo. 2007-39;
20 *Vincent v. Commissioner*, T.C. Memo. 2005-95.) “The attorney is an agent who is duty bound to act
21 only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as
22 income to the principal.” (*Commissioner v. Banks* (2005) 543 U.S. 426, 436.) The portion paid for
23 attorneys’ fees may be deductible, but is not excludable absent some other provision of law. (*Ibid.*)
24 IRC section 62(a)(20) generally excludes from gross income attorney fees and court costs paid by a
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27 ¹³ IRC section 104(a)(2) was revised in 1996, the year of this decision, to change “personal injuries or sickness” to “personal
28 physical injuries or physical sickness,” hence the court’s omission of the “physical” requirement in this decision.

¹⁴ As discussed in Staff Comments below, there is no record that appellant filed a worker’s compensation claim for the time
period at issue in the law suit.

1 taxpayer in connection with any action involving a claim of unlawful discrimination.

2 Late Filing Penalty

3 California imposes a penalty for the failure to file a return by its due date, unless the
4 failure to file was due to reasonable cause and not due to willful neglect. (Rev. & Tax. Code, § 19131.)
5 To establish reasonable cause, a taxpayer “must show that the failure to file timely returns occurred
6 despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an
7 ordinary intelligent and prudent businessman to have so acted under similar circumstances.” (*Appeal of*
8 *Howard G. and Mary Tons*, 79-SBE-027, Jan. 9, 1979.) Ignorance of a filing requirement or a
9 misunderstanding of the law generally does not excuse a late filing. (*Appeal of Diebold, Inc.*,
10 83-SBE-002, Jan. 3, 1983.)

11 The late filing penalty is calculated as 5 percent of the tax due for each month that a
12 valid tax return is not filed after it is due (determined without regard to any extension of time for filing
13 the return), not to exceed 25 percent of the tax. (Rev. & Tax. Code, § 19131, subd. (a).) For purposes
14 of calculating the penalty, the amount of tax required to be shown on the return shall be reduced by the
15 amount of any part of the tax which is paid on or before the date prescribed for payment of the tax.
16 (Rev. & Tax. Code, § 19131, subd. (c).)

17 STAFF COMMENTS

18 Appellant has the burden of proving what portion, if any, of his settlement award was
19 paid on account of personal physical injuries or physical sickness. The language of the settlement
20 agreement provides that the parties wish to “resolve and forever settle the [lawsuit] and the DFEH
21 complaints (collectively, the “Actions”), as well as any other potential claims . . . without the further
22 expenditure of time or expense of litigation.” (Resp. Op. Br., exhibit D, p. 1.) The agreement later
23 states that the payments were being made as damages for appellant’s “allegations of emotional distress,
24 including emotional distress attendant to alleged physical injury.” (*Id.* at exhibit D, p. 2.) This
25 language appears to state that appellant made some allegations of emotional distress with some link to
26 alleged physical injury. The U.S. Supreme Court stated that the “on account of” language imposes a
27 strong causal connection and that the provision is only applicable to damages awarded by reason of, or
28 because of, the personal physical injuries. (See *O’Gilvie v. United States* (1996) 519 U.S. 79; *Murphy*

1 *v. Internal Revenue Service* (2007) 493 F.3d 170.) The parties should discuss whether the settlement
2 agreement here provides express language stating that damages were paid on account of personal
3 physical injuries, and what portion of the settlement award represents those damages.

4 The parties should also discuss the Complaint, the jury verdict, and the court's remittitur
5 to understand the basis of appellant's claim and for what the employer was paying him in the
6 settlement. The original causes of action in the Complaint included discrimination, harassment,
7 retaliation, breaches of contract, and the infliction of emotional distress, but did not include references
8 to physical injury or sickness.¹⁵ The jury verdict found in favor of appellant for two actions,
9 harassment based on race or national origin and the employer's failure to prevent the harassment. The
10 jury and the judge both based their awards on general or compensatory damages, punitive damages, and
11 potential attorney fees and court costs. The judge's remittitur, in which he included the reduced
12 amounts accepted by appellant, even defined the harassment as "mostly just offensive name-calling,"
13 and stated that appellant suffered "harassment and ethnic name-calling almost every workday." (Resp.
14 Op. Br., exhibit C, pp. 2, 3.) The parties should discuss whether the settlement, which was expressly
15 entered into to settle the lawsuit and discrimination claims, could have included a payment for a
16 personal physical injury if the original claim did not present a personal physical injury as a claim upon
17 which relief could be granted.

18 Generally, if an employee is physically injured while at work, the employee's sole
19 remedy is to file a claim in the worker's compensation system. There is no record that appellant filed
20 any worker's compensation claim for any of the physical actions alleged by appellant on appeal. The
21 parties should discuss why no worker's compensation claim was filed if appellant was truly seeking
22 compensation for physical injuries, as it appears a worker's compensation claim might have been
23 required by the law if appellant was seeking damages for injuries sustained on the job.

24 If the Board were to find that some of the settlement payments were made on account of
25 a physical injury or physical sickness, the Board may wish to consider what portion of the payments
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27 ¹⁵ Appellant provides copies of typed testimony and statements that include some statements regarding the physical touching
28 of appellant, that he maintains were read to the jury, but the causes of action themselves make no reference to physical
injury or sickness.

1 this includes. (See, e.g., *Amos v. Commissioner*, T.C. Memo. 2003-329.) For example, the special
2 verdict returned by the jury found for appellant on the issues of harassment due to his race or national
3 origin and that the employer failed to take reasonable steps to prevent the harassment. The parties
4 should discuss whether any payments made on account of the employer’s failure to take reasonable
5 steps to prevent harassment would be considered made on account of physical injury. Likewise, the
6 parties should discuss whether any emotional distress caused by “offensive name-calling” or other
7 harassment that did not result in a personal physical injury, and was not attributable to a personal
8 physical injury, can be excluded from income. Punitive damages, the vast majority of the award
9 calculations done by both the jury and the judge, are explicitly not excludable from income under IRC
10 section 104(a)(2).¹⁶ If the Board finds that the payment allocation language of the settlement
11 agreement supports a finding that at least some portion of the payments were made on account of
12 physical injury, and that this finding is not contradicted by the terms of the Complaint, jury verdict, and
13 court’s remittitur, it appears as though the amount of the award attributable to any physical injury is
14 still limited where the payment allocation language alludes that it is for appellant’s emotional distress,
15 including [but not wholly comprised of] emotional distress attendant to an alleged physical injury.

16 IRC section 104(a) provides that, for the purposes of IRC section 104(a)(2), “emotional
17 distress shall not be treated as a physical injury or physical sickness,” with an exception up to the
18 amount of expenses for medical care. Appellant provides literature arguing that this legal standard is
19 unfair to those who suffer non-physical injuries. Appellant also provides a nonprecedential discussion
20 of a fact pattern wherein serious physical harm was done to a minor but such time had passed that it
21 was difficult to establish the extent of the physical injuries, and therefore it was recommended that the
22 IRS treat the entirety of the award as compensation for physical injuries and attribute all damages for
23 emotional distress as being for physical injuries. Appellant also provides *Amos* as an example.
24 However, in *Amos*, the entirety of the case was based on one incident, the hard kick to a sensitive area
25 of a man who was then taken by ambulance to a hospital and reported shooting pain in his neck and a
26 limp. Despite the corpus of the suit being the single incident of physical injury to the plaintiff, the
27 court still only allocated 60 percent of the award to personal physical injury based on the fact that the
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¹⁶ There was also \$10,494 in interest included in the second payment to appellant, which would likewise not be excludable.

1 settlement agreement also specified that the payment was to prevent defamation and other concerns not
2 directly related to the physical injury. In other words, just because a suit involves an act of physical
3 injury (or even if it is wholly based on a single act of physical injury), does not mean the entire court or
4 settlement award becomes nontaxable under IRC section 104(a)(2).

5 For reference, in this matter, the jury award provided a total award of \$30 million, with
6 \$5 million for general damages and \$25 million for punitive damages (using a 5 times ratio). The judge
7 reduced this amount to a recommended \$6 million, with \$750,000 for compensatory damages and
8 \$5,250,000 being for punitive damages (using a 7 times ratio).¹⁷ These compensatory damage amounts
9 were awarded based on the jury's finding for appellant on his claims at trial of racial harassment and
10 failure to take steps to prevent such harassment. The settlement agreement awarded appellant a total of
11 \$5,375,000, when including his half of the attorney fees, with \$2,653,770 provided to appellant after
12 attorney fees and no specified indication for the amount attributable to punitive damages. The parties
13 should discuss whether, after the result of the jury's verdict and the judge's remittitur, the payor's intent
14 in settling the lawsuit with appellant was to compensate him for a personal physical injury, or whether
15 it appears as though the payor's intent was to compensate appellant for emotional distress caused by
16 racial harassment and violations of the FEHA while also releasing the employer from any further
17 liability and punitive damages.

18 A finding that the settlement award at issue here constitutes taxable income, not exempt
19 under IRC 104(a)(2), is not a finding that appellant did not suffer any physical harassment or even
20 injury at the hands of his employer, but merely states that the settlement amount was paid to settle the
21 court claim and DFEH discrimination action, and that those actions were only predicated on
22 nonphysical emotional distress and punitive damages or other claims not based on a personal physical
23 injury or physical illness.

24 Attorney Fees and Costs

25 Appellant contends that respondent is denying him his legal right to deduct attorney
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27 ¹⁷ The judge noted in his remittitur that, except in unusual cases, punitive damages may not be awarded in a ratio higher than
28 10 to 1, and proceeded to provide his rationale for why the plaintiffs in that case deserved a punitive-damage multiplier on
the high side rather than on the low side. (Resp. Op. Br., exhibit C, p. 4.)

1 fees. Respondent agrees that attorney fees are allowed as an above-the-line deduction for cases
2 involving unlawful discrimination; however, respondent notes that appellant's attorney fees have
3 already been excluded from his income. As part of the settlement, \$5,442,460 was issued to the law
4 firm representing appellant and his co-plaintiff. Normally, one-half of this amount (i.e., \$2,721,230)
5 would be attributable to appellant as gross income, but this amount was excluded from appellant's
6 gross income and only the \$1,041,270 paid directly to appellant was included in respondent's proposed
7 assessment calculations. Accordingly, appellant should be prepared to explain at the hearing why he
8 believes he is entitled to an additional deduction for attorney fees when he has been allowed a
9 deduction of \$2,721,230 already.

10 Late Filing Penalty

11 Appellant's 2007 tax return was due on April 15, 2008. Appellant filed his 2007 return
12 in May of 2009, more than a year beyond the return's due date. Because the penalty is based on the
13 outstanding tax liability, if appellant shows that there is no additional tax due for 2007, there will be no
14 outstanding tax liability on which to assess a penalty for the 2007 tax year, resulting in an elimination
15 of the penalty. Appellant has not asserted any other basis for why the penalty should be abated.

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