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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 **JACQUES DELACROIX AND** ) Case No. 626423  
13 **KRISHNA DELACROIX<sup>1</sup>** )

		<u>Proposed</u> <u>Assessment</u>	
			Accuracy-Related
	<u>Year</u>	<u>Tax</u>	<u>Penalty</u>
	2008	\$9,456.00	\$1,891.20

18 Representing the Parties:

19 For Appellants: Samuel Kornhauser, Esq.  
20 For Franchise Tax Board: Christopher E. Haskins, Tax Counsel III

22 QUESTIONS: (1) Whether appellants have demonstrated error in the proposed assessment of  
23 additional tax, which was based upon federal adjustments.  
24 (2) Whether appellants have shown reasonable cause for the abatement of the  
25 accuracy-related penalty.

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28 <sup>1</sup> Appellants reside in Santa Cruz County, California.

1 HEARING SUMMARY

2 Introduction

3 Appellant-husband was a tenured professor at Santa Clara University (university),  
4 teaching business classes for more than 20 years. (FTB opening brief (FTB OB), p. 1.) In the fall of  
5 2004, two students accused appellant-husband of discrimination and harassment. (*Id.*, p. 2 & Ex. D,  
6 p. 2.) The university investigated the allegations and proposed training and supervision of  
7 appellant-husband's work to ensure compliance with the university's policy against discrimination and  
8 harassment. (*Id.*, Ex. D, p. 2.) Appellant-husband believed that he had been falsely accused and that  
9 the university had republished those accusations. (*Id.*) Consequently, he sued the university, its  
10 provost, its president, and its investigator for defamation, interference with prospective economic  
11 advantage, breach of contract, bad faith, and intentional and negligent infliction of emotional distress.  
12 (*Id.*) The individual defendants obtained an order granting them summary judgment prior to trial. (*Id.*)  
13 However, that order was never reduced to a judgment. (*Id.*) The university obtained summary  
14 adjudication of all causes of action, except the causes of action for breach of contract and bad faith.  
15 (*Id.*)

16 *Settlement*

17 On September 5, 2006, the first day of trial, the parties engaged in settlement  
18 discussions before the court and placed their settlement on the record. (*Id.*) The case settled for an  
19 amount that was to be paid in three equal installments of \$150,000, one each in 2006, 2007, and 2008  
20 (i.e., \$450,000 in total). (*Id.*, p. 2 & Ex. D, p. 2.)

21 When the parties placed the settlement on the record, the court stated: "We have an  
22 agreement. I'm going to announce it for the record. If anybody disagrees with anything I've said,  
23 interrupt me right away so we can get it right. At the end if I've left anything out, you'll have a chance  
24 to add things." (*Id.*, Ex. D, p. 2.) After stating the amount of the settlement and the payment dates, the  
25 court stated: "[T]he parties agree that this sum of money will be allocated to emotional distress  
26 damages; that there will be no withholding made by the university. But that if it turns out that the IRS  
27 challenges this and imposes withholding tax or penalties on the university for not withholding money,  
28 that the plaintiffs agree to indemnify and hold the university harmless. [¶] And that means that if there

1 are any penalties that the university incurs because of this, you have to pay them. You're going to owe  
2 them the money to pay those penalties, and that you can't sue them . . . if the IRS challenges this  
3 allocation." (*Id.*)

4 With regard to the question of the university issuing an Internal Revenue Service (IRS)  
5 Form 1099, after the court discussed the parties' costs and attorney fees and inquired whether there  
6 were any existing sanctions orders, counsel for the university stated: "Let me just go over this on the  
7 tax issue because this is where we normally recite the university, who's paying the money, not any of  
8 the individual named defendants, will issue a 1099. [¶] Professor will be responsible if the IRS comes  
9 back and successfully challenges the allocation. He'll be responsible for any taxes, interest and/or  
10 penalties that are resulting from that. I just want to make it clear so everybody understands how that  
11 works." (*Id.*, Ex. D, pp. 2-3.) The parties agreed that the court would retain jurisdiction to enforce the  
12 settlement. (*Id.*, Ex. D, p. 3.)

#### 13 *Preparation of Written Release*

14 On September 21, 2006, defendants sent a draft Settlement Agreement and Release  
15 (Release) to appellant-husband for review and signature. (*Id.*) The draft Release provided:  
16 "[University] shall issue Form 1099s to Plaintiff in connection with the payments." (*Id.*)

17 On October 2, 2006, appellant-husband sent defendants a "redlined" version of the  
18 Release "making several significant changes." (*Id.*) Both parties attached copies of the redlined  
19 Release to their papers in support of and in opposition to the motion to enforce the settlement  
20 agreement. (*Id.*) The redlined Release that defendants submitted to the court contained only typed  
21 changes and left the original language about the 1099 Forms intact. (*Id.*) The redline release that  
22 appellant-husband submitted to the court had the typed changes, as well as some hand-written changes  
23 that were not on the redlined Release that defendants filed. (*Id.*) As part of the hand-written changes,  
24 appellant-husband deleted the sentence that provided that the university would issue 1099 Forms. (*Id.*)

#### 25 *Legal Motion in Court*

26 As of November 27, 2006, there were still many unresolved issues regarding the terms  
27 of the written Release, which prompted appellant-husband to file a motion to enforce the settlement  
28 agreement. (*Id.*) Appellant-husband asked the court to order defendants to sign a version of the

1 Release that he attached to his motion. (*Id.*)

2 In opposition to the motion, defendants argued that appellant-husband “wants to add  
3 several paragraphs to the agreement, which were not only never agreed to at the settlement conference,  
4 but also completely mischaracterize the lawsuit and leave defendants susceptible to liability for tax  
5 fraud.” (*Id.*, Ex. D, pp. 3-4.) They asserted that while they had agreed that the settlement proceeds  
6 would be allocated to “purported emotional damages, they did not agree to anything more than that  
7 with respect to the characterization of damages.” (*Id.*, Ex. D, p. 4.) They argued that the university  
8 was legally required to issue 1099 Forms, that this term had been agreed to on the record, and that  
9 defendants had “no intention of evading their tax responsibilities to assist [appellant-husband] in setting  
10 new precedent on this issue.” (*Id.*)

11 At the November 27, 2006 hearing on the motion, the court observed, “The transcript  
12 does not help me a lot because it doesn’t tell me one way or another whether a 1099 was going to be  
13 filed. The language is a little loose.” (*Id.*) The judge quoted defense counsel’s comments at the  
14 hearing, where the defense counsel stated, “[T]his is where we normally recite the university, who’s  
15 paying the money, not any of the individual named defendants, will issue a 1099.” (*Id.*) The court  
16 commented, “And I don’t know if that means he’s saying it because he’s going to issue a 1099 or he’s  
17 saying it because we normally issue a 1099, and this time we’re not issuing a 1099. . . . I can’t tell from  
18 the language, and I don’t have a recollection. [¶] And I personally wasn’t thinking about 1099s. I was  
19 thinking about withholding tax.” (*Id.*)

20 The court observed that the parties’ agreement was to allocate the settlement proceeds to  
21 emotional distress damages and stated that the issue was whether or not the university had to issue a  
22 1099 Form. (*Id.*) The judge summarized some legal research she had done and concluded that it was  
23 unclear whether damages for emotional distress were taxable to appellant-husband. (*Id.*) The court  
24 stated, “The only thing I need to decide is whether or not this agreement precludes a 1099 from being  
25 filed.” (*Id.*) The court did not see anything in the agreement that precluded the 1099 and held that the  
26 university should be allowed to file 1099 Forms. (*Id.*) The court’s decision was affirmed in an  
27 unpublished decision by the California Court of Appeal, Sixth Appellate District, on March 7, 2008.  
28 (*Id.*, Ex. D pp. 1-9.)

1           Procedural Background

2           As noted above, appellant-husband received settlement proceeds in three equal  
3 installments of \$150,000, one each in 2006, 2007, and 2008 (i.e., \$450,000 in total). (FTB OB, p. 2.)  
4 The only tax year at issue in this appeal is 2008. (*Id.*, p. 1.) Appellants filed a joint 2008 California  
5 resident income tax return, reporting, among other things, a California taxable income of negative  
6 \$3,334.<sup>2</sup> (*Id.*, Ex. A, p. 1.) Appellants did not report the settlement proceeds of \$150,000, which  
7 appellants received in the 2008 tax year, on their 2008 California return. (*Id.*, p. 4 & Ex. A, p. 1.)

8           Later, the Franchise Tax Board (FTB or respondent) received information<sup>3</sup> showing that  
9 the IRS increased appellants' 2008 federal taxable income by \$150,000 (hereinafter adjustment "a") on  
10 account of appellant-husband's settlement award of \$150,000 for the 2008 tax year. (*Id.*)

11           On August 15, 2011, the FTB sent appellants an audit correspondence letter that  
12 conformed to adjustment "a" above by adding \$150,000 to appellants' 2008 California taxable income,  
13 which increased appellants' 2008 California taxable income from negative \$3,334 to \$146,666. (*Id.*,  
14 p. 4 & Ex. B, pp. 1-3.) The audit correspondence letter set forth an additional tax of \$8,734, but did not  
15 include an interest amount. (*Id.*, Ex. B., p.2.) In early October 2011, appellants submitted a payment  
16 of \$8,734. (*Id.*, Ex. F.) (A copy of the check is included with appellants' appeal letter.) The FTB  
17 credited the payment to appellants' FTB account on October 5, 2011. (*Id.*)

18           Subsequently, the FTB sent appellants a second audit correspondence letter dated  
19 November 9, 2011, stating, among other things, that the FTB received appellants' payment of \$8,734  
20 but indicated that interest had not been set forth in the prior audit correspondence letter. (*Id.*, p. 4 &  
21 Ex. B, p. 4.)

22           Later, the FTB received a final federal audit report showing that, in addition to  
23 adjustment "a" above, the IRS increased appellants' 2008 federal taxable income by \$7,766 (hereinafter  
24 adjustment "b"). (*Id.*, p. 5.) In addition, the final federal audit report indicated that the IRS imposed an  
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26 \_\_\_\_\_  
27 <sup>2</sup> A copy of appellants' joint 2008 California income tax return was not provided on appeal. The reported California taxable  
28 income amount of negative \$3,334 is taken from the Notice of Proposed Assessment (NPA), a copy of which is attached as  
Exhibit A to the FTB's opening brief.

<sup>3</sup> On appeal, the FTB does not specify what "information" it received.

1 accuracy-related penalty. (*Id.*)

2 On November 14, 2011, the FTB issued an NPA that conformed to adjustments “a-b”  
3 above by adding \$157,766 to appellants’ 2008 California taxable income, which increased appellants’  
4 2008 California taxable income from negative \$3,334 to \$154,432. (*Id.*, p. 5 & Ex. A.) The NPA  
5 imposed an additional tax of \$9,456.00, plus interest of \$1,277.79. In addition, the NPA set forth an  
6 accuracy-related penalty of \$1,891.20. (*Id.*, Ex. A.)

7 In response, appellant-husband sent the FTB a protest letter dated December 7, 2011,  
8 questioning why the NPA dated November 14, 2011, listed an additional tax of \$9,456.00, an  
9 accuracy-related penalty of \$1,891.20, and interest of \$1,277.79, when the FTB’s prior audit  
10 correspondence letters (dated August 15, 2011 and November 9, 2011) list only an additional tax of  
11 \$8,734.00. (*Id.*, p. 5 & Ex. B, p. 5.)

12 On January 4, 2012, the FTB sent appellants a letter, explaining that, after the FTB  
13 issued the second audit correspondence letter dated November 9, 2011, the FTB received a final federal  
14 audit report showing that the IRS (i) increased appellants’ 2008 federal taxable income by \$150,000  
15 (i.e., adjustment “a” above), (ii) increased appellants’ 2008 federal taxable income by \$7,766 (i.e.,  
16 adjustment “b” above), and (iii) imposed an accuracy-related penalty. In addition, the FTB explained  
17 that appellants’ prior payment of \$8,734 would be applied to the proposed assessment after it became a  
18 final assessment.<sup>4</sup> (*Id.*, p. 5 & Ex. B, p. 6.)

19 Later, the FTB sent appellants a letter dated June 15, 2012, requesting that, if appellants  
20 had any further evidence that they wished to present (e.g., if appellants had evidence that the IRS  
21 reduced or cancelled the federal assessment), appellants should submit such evidence to the FTB by  
22 July 15, 2012. (*Id.*, p. 5 & Ex. B, pp. 7-9.) Enclosed with the FTB’s letter was a copy of appellants’  
23 federal transcript (CP2000) for the 2008 tax year. (*Id.*, Ex B., p. 9.) The federal transcript showed,  
24 among other things, adjustments of \$150,000 and \$7,766. (*Id.*)

25 In response, appellants sent the FTB a letter dated July 6, 2012, asserting that the federal  
26 transcript (CP2000) might relate to other taxpayers, as appellants claimed a mortgage interest deduction  
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<sup>4</sup> Because appellants submitted a timely appeal to the State Board of Equalization, the proposed assessment is not final.

1 totaling \$14,302, which was not represented in the federal transcript.<sup>5</sup> (*Id.*, pp. 5-6 & Ex. B, p. 10.)

2 After reviewing the matter, the FTB affirmed the NPA in a Notice of Action (NOA)  
3 dated July 30, 2012. (Appeal Letter (AL), Ex. 1.) The NOA proposed an additional tax of \$9,456.00,  
4 an accuracy-related penalty of \$1,891.20, and interest of \$1,613.07. (*Id.*) This appeal followed. (FTB  
5 OB, p. 6.)

## 6 Contentions

### 7 Appellants' Appeal Letter

8 Appellants make two arguments. First, appellants argue that the \$150,000 was  
9 compensation for emotional distress to make appellant-husband “whole”—i.e., it represents a  
10 restoration of capital in an attempt to bring him back to the state he was in prior to the infliction of the  
11 emotional harm. (AL, pp. 1-5.) In short, appellants assert that there was no “gain” because the  
12 \$150,000 was paid in an attempt to bring appellant-husband back to his prior state, citing *O’Gilvie v.*  
13 *United States* (1996) 519 U.S. 79, 84-86. (*Id.*) In relation to this argument, appellants assert that the  
14 damages awarded to appellant-husband are not taxable under the 16th Amendment to the U.S.  
15 Constitution or under any cognizable definition of income or gain in the tax code:

16 The personal injury-related damages awarded Dr. Delacroix are not taxable as ‘income’  
17 under the 16th Amendment to the U.S. Constitution, *O’Gilvie v. United States*, 519 U.S.  
18 79, 84-86 (1996), or under any cognizable definition of income or gain in the tax code.  
19 *Burk-Waggoner Oil v. Hopkins*, 269 U.S. 110, 114 (1925). In an unbroken line of cases,  
20 the Supreme Court and the U.S. Court of Appeals have drawn a sharp distinction between  
21 monetary awards which constitute a taxable “accession to wealth” and monetary awards  
22 that make a person “whole” by compensating that person’s various losses. See, e.g.,  
23 *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432, n. 8 (1955) (personal injury  
24 recoveries are “by definition compensatory only” and are thus nontaxable); *Doyle v.*  
25 *Mitchell Bros.*, 235 F. 686, 688 (6th Cir. 1916) (monies paid to compensate for losses in a  
26 fire are not income”) . . . . (AL, p. 2.)

27 Appellants assert that the Supreme Court and the United States Courts of Appeals have  
28 drawn a sharp distinction between monetary awards that constitute an “accession to wealth,” and thus  
29 are taxable income, and monetary awards that merely make a person “whole” as a result of  
30 compensating a person’s various losses, citing to *Commissioner v. Glenshaw Glass Co.* (1955) 348  
31 U.S. 426, 432, n. 8; *Raytheon Production Corp. v. Commissioner* (1st Cir. 1944) 144 F.2d 110, 113;

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<sup>5</sup> Staff notes that the federal transcript (CP2000) provided as Exhibit B to the FTB’s opening brief shows adjustment amounts, not necessarily the deduction amounts claimed by appellants on their federal return.

1 *Farmers' & Merchants' Bank v. Commissioner* (6th Cir. 1932) 59 F.2d 912; *Gilbertz v. United States*  
2 (10th Cir. 1987) 808 F.2d 1374, 1378. (*Id.*, pp. 2-3.) Appellants contend that appellant-husband's  
3 compensatory damage award was not derived from salaries, wages, or compensation for personal  
4 services, but was paid to make appellant-husband "whole" for his emotional distress. (*Id.*, p. 5.)

5 Second, appellants argue that "there was no interest due or accuracy penalty applicable  
6 because there was a legitimate dispute as to whether any tax was owed and because [appellants] were  
7 relying on the legal advice of their tax attorney, Samuel Kornhauser, who advised them that he believed  
8 they did not owe any tax for 2008 because the \$150,000 was not taxable compensation, but rather  
9 'return of capital' to restore [appellant-husband] to his former position . . . ." (*Id.*, p. 2.)

#### 10 The FTB's Opening Brief

11 The FTB makes four arguments. First, the FTB asserts that a deficiency assessment  
12 based on a federal adjustment is presumed correct and appellants have the burden of showing that the  
13 deficiency assessment is erroneous, citing to the *Appeal of Sheldon I. and Helen R. Brockett*, 86-SBE-  
14 109, decided on June 18, 1986.<sup>6</sup> (FTB OB, p. 6.) The FTB argues that "[a]ppellants have provided no  
15 evidence or information calling into doubt the correctness of the federal audit; instead in their Opening  
16 Brief, appellants argue that the monies received from the settlement of their lawsuit against the  
17 University is not taxable by California." (*Id.*, p. 8.)

18 Second, the FTB notes that, in appellants' appeal letter, appellants argue that *O'Gilvie v.*  
19 *United States, supra*, mandates that California not tax settlement proceeds that are meant to make a  
20 taxpayer whole. (*Id.*) The FTB argues, however, that such an argument fails because *O'Gilvie*  
21 addressed a situation arising prior to the 1996 amendment to Internal Revenue Code (IRC) section 104  
22 which excluded damages from emotional distress. (*Id.*) Thus, the FTB asserts that the *O'Gilvie*  
23 decision, like all cases which predate the 1996 amendment to IRC section 104, is not relevant to the  
24 facts of this appeal. (*Id.*) The FTB asserts that, in *Murphy v. Internal Revenue Service* (2007) 493 F.3d  
25 170, 172, the taxpayers raised many of the same arguments that appellants are raising (i.e., return of  
26 capital to make taxpayer whole; settlement proceeds are not taxable under the 16th Amendment to the  
27

28 <sup>6</sup> Board of Equalization cases are generally available for viewing on the Board's website ([www.boe.ca.gov](http://www.boe.ca.gov)).

1 U.S. Constitution) but the Court rejected all of those theories in favor of the clear language of IRC  
2 section 104. (*Id.*, p. 9.) The FTB also cites *Blackwood v. Commissioner*, T.C. Memo 2012-190,  
3 wherein the court determined that a settlement award of \$100,000 was taxable, stating that “[t]he flush  
4 language of section 104(a) provides that emotional distress shall not be treated as a physical injury or  
5 sickness.” The FTB contends that the amendment to IRC section 104 was effective after August 20,  
6 1996, and thus, appellants’ settlement receipts (which were received in 2006, 2007, and 2008) are  
7 taxable. (*Id.*)

8 Third, the FTB argues that appellant-husband’s causes of action do not allege a physical  
9 injury—i.e., the causes of action allege only defamation, interference with prospective economic  
10 advantage, breach of contract, bad faith, and intentional and negligent infliction of emotional distress  
11 (and the FTB notes that only the causes of action for breach of contract and bad faith remained at the  
12 start of trial when the settlement was reached). (*Id.*, p. 10.) Based on the foregoing, the FTB argues  
13 that appellants cannot exclude the settlement award from their 2008 California taxable income, citing to  
14 *Murphy v. Internal Revenue Service*, *supra*, and *Hennessey v. Commissioner*, T.C. Memo 2009-132.  
15 (*Id.*)

16 Fourth, the FTB argues that appellants substantially understated their taxable income  
17 and have not shown reasonable cause for an abatement of the accuracy-related penalty. (*Id.*, pp. 11-16.)  
18 Specifically, the FTB asserts that appellants have not shown that they reasonably relied in good faith on  
19 the advice of their tax advisor because (i) when appellants excluded the settlement income on their  
20 2008 California return, there was not an honest misunderstanding of fact or law concerning the  
21 exclusion of settlement awards for emotional distress, as IRC section 104(a)(2) was very clear on the  
22 subject of emotional distress awards, or settlement payments based on emotional distress claims, were  
23 taxable income, (ii) considering all facts and circumstances, the advice given to appellants by  
24 Mr. Kornhauser was not based on the law as it related to appellants’ facts and circumstances, (iii) while  
25 Mr. Kornhauser is an attorney, he does not focus his practice on tax matters, as evidenced by the fact  
26 (A) that Martindale.com, lists his areas of practice as follows: securities (75%), business law (10%),  
27 labor law (5%), insurance fraud (5%), and copyright law (5%), and (B) the State Bar of California does  
28 not list Mr. Kornhauser as a taxation law specialist, and (C) no information has been provided showing

1 that Mr. Kornhauser is a certified public accountant, (iv) given the facts of this appeal, appellants  
2 should have known that Mr. Kornhauser was not knowledgeable in the relevant aspects of the Internal  
3 Revenue Code or the Revenue and Taxation Code, (v) the advice Mr. Kornhauser gave to appellants  
4 was based on an unreasonable legal assumption, as the law was clear and even an uneducated person  
5 would have known this, let alone appellant-husband, who was a business professor with over 20 years  
6 of experience, (vi) appellants and Mr. Kornhauser were very aware of the resistance by the university to  
7 their request to not furnish the IRS with Form 1099s, stemming from the university's fear that it would  
8 be aiding tax fraud, and (vii) when a taxpayer has information that would tend to raise doubts, the  
9 taxpayer must reasonably verify or investigate matters themselves, even though the taxpayer previously  
10 consulted a professional advisor, citing to the *Appeal of James A. Alyn and Lisa E. Alyn* (2009-SBE-  
11 001), decided May 27, 2009. (*Id.*)

12 Appellants' Reply Brief

13 Appellants make three arguments. First, appellants assert that the FTB's failure to credit  
14 appellants' with their payment of \$8,734 (which appellants submitted in early October 2011) is a  
15 primary reason for this appeal. (App. Reply Br., p. 1.) In short, appellants argue that, even if  
16 appellant-husband's reimbursement for emotional distress is taxable, then, at most, appellants owe  
17 \$722 in additional tax for 2008, not \$9,456. (*Id.*)

18 Second, appellants argue that a reimbursement for emotional distress is not taxable  
19 income. (*Id.*, p. 2.) Specifically, appellants assert that (i) *Murphy v. Internal Revenue Service, supra*, is  
20 not binding on the Ninth Circuit (California), (ii) *Blackwood v. Commissioner, supra*, is a Tax Court  
21 case and therefore is not binding precedent in California, (iii) the Ninth Circuit has not ruled on the  
22 constitutionality of IRC section 104, (iv) "the constitutional reasoning" in *O'Gilvie v. United States,*  
23 *supra*, and *Commissioner v. Glenshaw Glass Co., supra*, is correct, and (v) a reimbursement for  
24 physical injuries from emotional distress is excludable from income, citing to *Domeny v.*  
25 *Commissioner*, T.C. Memo 2010-9. (*Id.*)

26 Third, appellants argue that the accuracy-related penalty should not be imposed because  
27 (i) they relied upon the advice of their attorney, Mr. Kornhauser, (ii) Mr. Kornhauser handled the  
28 underlying litigation and settlement and therefore was aware of the facts, (iii) even in 2008, there was

1 uncertainty as to whether compensation for symptoms of emotional distress were taxable, citing to  
2 *Domeny v. Commissioner, supra*, and *Longoria v. Commissioner*, T.C. Memo 2009-162, (iv) there is no  
3 Ninth Circuit precedent on the issue, (v) contrary to the FTB's insinuation, Mr. Kornhauser is  
4 competent to give tax advice, having an LLM in Taxation and having practiced law for over 35 years,  
5 the first five of which were devoted almost exclusively to tax matters, and (vi) even the judge in the  
6 underlying civil proceedings concluded that it was unclear (to her) whether the settlement proceeds  
7 were taxable income to appellant-husband. (*Id.*, pp. 2-5.)

### 8 Applicable Law

#### 9 Burden of Proof - Generally

10 A taxpayer who claims a deduction and/or an exclusion has the burden of proving by  
11 competent evidence that he or she is entitled to such. (See *New Colonial Ice Co. v. Helvering* (1934)  
12 292 U.S. 435; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.) Unsupported assertions  
13 cannot satisfy a taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov.  
14 17, 1982.)

#### 15 Proposed Assessment

16 A taxpayer must report federal changes to income or deductions to the FTB within six  
17 months of the date the federal changes become final. (Rev. & Tax. Code, § 18622, subd. (a).) The  
18 taxpayer must concede the accuracy of the federal changes or prove that those changes, and any  
19 California deficiency assessment based thereon, are erroneous. (Rev. & Tax. Code, § 18622, subd. (a);  
20 *Appeal of Sheldon I. and Helen R. Brockett, supra*; *Appeal of Aaron and Eloise Magidow, supra*.)

#### 21 Settlement Proceeds

22 R&TC section 17071 incorporates IRC section 61, which defines "gross income" to  
23 include "All income from whatever source derived" except as expressly provided by statute. IRC  
24 section 61(a) broadly defines as income any accession to wealth, and statutory exclusions from income  
25 are narrowly construed. (*United States v. Burke* (1992) 504 U.S. 229, 233.)

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1 R&TC section 17131 incorporates IRC section 104. IRC section 104(a)(2) excludes  
2 from gross income:

3 [T]he amount of any damages (other than punitive damages) received  
4 (whether by suit or agreement and whether as lump sums or as periodic  
payments) on account of personal physical injuries or physical sickness.

5 IRC section 104(a) further provides (in the flush language of the subdivision) that: “For purposes of  
6 paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.” IRC  
7 section 104(a) then provides that: “the preceding sentence shall not apply to an amount of damages not  
8 in excess of the amount paid for medical care . . . attributable to emotional distress.” Medical care is  
9 defined for purposes of this statute in IRC section 213(d)(1), subparagraph (A) or (B).

10 Prior to its amendment by the Small Business Job Protection Act of 1996 (SBJPA),  
11 Pub. L. 104-188, sec. 1605, 110 Stat. 1838, IRC section 104(a)(2) excluded from gross income amounts  
12 received on account of personal injuries or sickness.<sup>7</sup> The reference to personal injuries in the former  
13 version of IRC section 104(a)(2) included “nonphysical injuries to the individual, such as those  
14 affecting emotions, reputation, or character”. (*United States v. Burke, supra*, 504 U.S. at p. 235 fn. 6,  
15 p. 239.) (See also *Robinson v. Commissioner* (T.C. 1994) 102 T.C. 116, 126); *Fono v. Commissioner*,  
16 79 T.C. 680, 692 (1982), affd. without published opinion 749 F.2d 37 (9th Cir. 1984).) On August 20,  
17 1996, the SBJPA amended IRC section 104(a)(2) to exclude from gross income “the amount of any  
18 damages (other than punitive damages) received (whether by suit or agreement and whether as lump  
19 sums or as periodic payments) on account of personal physical injuries or physical sickness”. (SBJPA,  
20 § 1605(a), 110 Stat. 1838.)

21 The SBJPA amendment thus narrowed the exclusion set forth in IRC section 104(a)(2)  
22 by replacing “personal injuries” with “personal physical injuries” and by replacing “sickness” with  
23 “physical sickness.” The legislative history of this amendment clarifies that “the term emotional  
24 distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such  
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26 <sup>7</sup> The SBJPA also amended IRC section 104(a) to explicitly except punitive damages from the exclusion provided by IRC  
27 section 104(a)(2).

28 In both *Commissioner v. Schleier (Schleier)* (1995) 515 U.S. 323, and *O’Gilvie v. United States* (1996) 519 U.S. 79, the  
Supreme Court addressed the 1988 version of IRC section 104. See the history/evolution of IRC section 104(a)(2) below.

1 emotional distress.” (H. Conf. Rept. 104-737, at p. 301 fn. 56 (1996), 1996-3 C.B. 741, 1041 fn. 56.)  
2 (See also *Hawkins v. Commissioner* (2005) T.C. Memo 2005-149.) Section 1605(d) of the SBJPA, 110  
3 Stat. 1839, provides (with an inapplicable exception) that “the amendments made by this section shall  
4 apply to amounts received after the date of the enactment of this Act, in taxable years ending after such  
5 date.”

6 In 1995, one year prior to the enactment of the SBJPA, the United States Supreme Court,  
7 in *Commissioner v. Schleier, supra*, 515 U.S. at p. 336-337, set forth a two-prong test for determining  
8 whether amounts are excludable from gross income under IRC section 104(a)(2): (1) the underlying  
9 claims must be based on tort or tort-type rights; and (2) the damages received must be on account of  
10 personal injuries or sickness. Regarding the first prong of this test, effective January 23, 2012, the IRS  
11 issued a final regulation which amended Treasury Regulation section 1.104-1(c) to reflect the SBJPA  
12 amendments to IRC section 104(a)(2), and to delete the “tort or tort-type rights” requirement from the  
13 regulation.<sup>8</sup> Additionally, regarding the second prong of the test, as detailed above, the SBJPA  
14 narrowed the exclusion to damages received on account of personal physical injuries or physical  
15 sickness only. (See *Shaltz v. Commissioner*, T.C. Memo. 2003-173; *Henderson v. Commissioner*, T.C.  
16 Memo. 2003-168.) As a result, the continued relevancy of the two-prong test established in *Schleier* is  
17 questionable.

18 When a settlement agreement exists, determining the exclusion from gross income  
19 depends on the nature of the claim that was the actual basis for settlement. (*Stocks v. Commissioner*  
20 (1992) 98 T.C. 1, 10.) If the settlement agreement lacks express language stating what the settlement  
21 amount was paid to settle, then the most important factor in determining any exclusion under IRC  
22 section 104(a)(2) is the intent of the payor regarding the purpose in making the payment. (*Id.*) What  
23 the settlement agreement actually settled is a question of fact. (*Id.*)

24 In determining whether a settlement was paid “on account” of alleged personal injuries,  
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26 <sup>8</sup> Amended Treasury Regulation section 1.104-1(c)(3) provides:

27 “This paragraph (c) applies to damages paid pursuant to a written binding agreement, court decree, or  
28 meditation award entered into or issued after September 13, 1995, and received after January 23, 2012.

28 Taxpayers also may apply these final regulations to damages paid pursuant to a written binding  
agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received  
after August 20, 1996. . . .”

1 a court begins:

2 [B]y looking at the language in the settlement agreement. The language contained in an  
3 agreement will be respected to the extent the settlement agreement is entered into an  
4 adversarial context, at arm's length, and in good faith. (*Massot v. Commissioner*, T.C.  
Memo 2000-24.)

5 Courts have also looked at the special verdict form returned by a jury to see if they found an underlying  
6 physical injury or sickness as a cause for an award. (*Nancy J. Vincent v. Commissioner*, T.C. Memo  
7 2005-95.)

8 History/Evolution of IRC section 104(a)(2)

9 Prior to 1989, IRC section 104(a) provided in relevant part that:

- 10 (a) In general.--Except in the case of amounts attributable to (and not in excess of)  
11 deductions allowed under section 213 (relating to medical, etc., expenses) for any  
12 prior taxable year, gross income does not include  
13 (1) . . .  
14 (2) the amount of any damages received (whether by suit or agreement and whether  
as lump sums or as periodic payments) on account of personal injuries or  
sickness;  
15 . . .

16 In 1989, IRC section 104 was amended, adding the following to the flush language of  
subdivision (a):

17 Paragraph (2) shall not apply to any punitive damages in connection with a case not  
18 involving physical injury or physical sickness.

19 And, then, in 1996, as described above, the statute was amended again (by the SBJPA),  
20 revising subdivision (a)(2), and replacing the flush language of subdivision (a) (added by the 1989  
21 amendment to the statute above) with the following, such that the relevant portion of IRC section 104(a)  
22 currently reads as follows:

- 23 (a) In general.--Except in the case of amounts attributable to (and not in excess of)  
24 deductions allowed under section 213 (relating to medical, etc., expenses) for any  
25 prior taxable year, gross income does not include  
26 (1) . . .  
27 (2) the amount of any damages received (other than punitive damages) received  
(whether by suit or agreement and whether as lump sums or as periodic payments)  
on account of personal physical injuries or physical sickness;  
28 . . .

. . . For purposes of paragraph (2), emotional distress shall not be treated as a physical  
injury or physical sickness. The preceding sentence shall not apply to an amount of  
damages not in excess of the amount paid for medical care (described in subparagraph  
(A) or (B) of section 213(d)(1) attributable to emotional distress.

1                    Accuracy-Related Penalty

2                    R&TC section 19164, which generally incorporates the provisions of IRC section 6662,  
3 provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty  
4 applies to the portion of the underpayment attributable to (1) negligence or disregard of rules and  
5 regulations, or (2) any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) For an  
6 individual, there is a “substantial understatement of income tax” when the amount of the  
7 understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on  
8 the return, or \$5,000. (Int.Rev. Code, § 6662(d)(1).) In determining whether there is a substantial  
9 understatement, the taxpayer excludes any portion of the understatement for which (1) there is  
10 *substantial authority* for the treatment of the position, or (2) the position was *adequately disclosed* in  
11 the tax return (or a statement attached to the return) and there is a reasonable basis for the treatment of  
12 the item. (Int.Rev. Code, § 6662(d)(2)(B).) To qualify as an adequate disclosure, Treasury Regulations  
13 generally require that the taxpayer disclose the details of his or her position on either a federal Form  
14 8275, a Form 8275-R, or a qualified amended return. (Treas. Reg. § 1.6662-4(f).) Even if an  
15 understatement is found to be substantial, the penalty shall not be imposed to the extent the taxpayer  
16 can show reasonable cause and good faith. (Rev. & Tax. Code, § 19164, subd. (d); Int.Rev. Code,  
17 § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164, subd. (a).)

18                    A determination of whether a taxpayer acted with reasonable cause and in good faith is  
19 made on a case-by-case basis and depends on the pertinent facts and circumstances, including the  
20 taxpayer’s efforts to assess the proper tax liability, the taxpayer’s knowledge and experience, and the  
21 extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).)

22                    With respect to an underpayment attributable to reliance by the taxpayer on professional  
23 advice, Treasury Regulation section 1.6664-4(c)(1)(ii) provides the advice must not be based on  
24 unreasonable factual or legal assumptions (including assumptions regarding future events) and must not  
25 unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any  
26 other person. That provision further states, as an example, the advice must not be based on a  
27 representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true,  
28 such as an inaccurate representation or assumption regarding the taxpayer’s purposes for entering into a

1 transaction or for structuring a transaction in a particular manner.

2 Interest Abatement

3 Interest is not a penalty but is merely compensation for the taxpayers' use of the money.  
4 (Rev. & Tax. Code, § 19101, subd. (a); *Appeal of Amy M. Yamachi*, 77-SBE-095, June 28, 1977;  
5 *Appeal of Audrey C. Jaegle*, 76-SBE-070, June 22, 1976.) To obtain interest abatement, an appellant  
6 must qualify under one of the following three statutes: R&TC sections 19104, 19112, or 21012. R&TC  
7 section 21012 does not appear applicable here because there has been no reliance on any written advice  
8 requested of respondent. Under R&TC section 19112, interest may be waived for any period for which  
9 respondent determines that an individual or fiduciary demonstrates an inability to pay that interest solely  
10 because of extreme financial hardship caused by a significant disability or other catastrophic  
11 circumstance. This statute does not provide any authority for the Board to review the FTB's  
12 determination whether to abate interest for extreme financial hardship.

13 Under R&TC section 19104, respondent may abate all or a part of any interest on a  
14 deficiency to the extent that interest is attributable in whole or in part to any unreasonable error or delay  
15 committed by respondent in the performance of a ministerial or managerial act.<sup>9</sup> (Rev. & Tax. Code,  
16 § 19104, subd. (a)(1).) An error or delay can only be considered when no significant aspect of the error  
17 or delay is attributable to the appellant and after respondent has contacted the appellant in writing with  
18 respect to the deficiency or payment. (Rev. & Tax. Code, § 19104, subd. (b)(1).) There is no

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20 <sup>9</sup> In the *Appeal of Michael and Sonia Kishner*, 99-SBE-007, decided on September 29, 1999, the Board adopted the language  
21 from Treasury Regulation section 301.6404-2(b)(2), defining a "ministerial act" as:

22 [A] procedural or mechanical act that does not involve the exercise of judgment or discretion, and that  
23 occurs during the processing of a taxpayer's case after all prerequisites to the act, such as conferences and  
24 review by supervisors, have taken place. A decision concerning the proper application of federal tax law  
(or other federal or state law) is not a ministerial act.

25 The Board has not yet adopted a definition for the term "managerial act." However, when a California statute is substantially  
26 identical to a federal statute (such as with the interest abatement statute in this case), the Board may consider federal law  
27 interpreting the federal statute as highly persuasive. (*Appeal of Michael and Sonia Kishner, supra*, (citing *Douglas v. State of*  
28 *California* (1942) 48 Cal.App.2d 835.)) In this regard, Treasury Regulations section 301.6404-2(b)(1) defines a "managerial  
act" as:

[A]n administrative act that occurs during the processing of a taxpayer's case involving the temporary or  
permanent loss of records or the exercise of judgment or discretion relating to management of personnel. A  
decision concerning the proper application of federal tax law (or other federal or state law) is not a  
managerial act.

1 reasonable cause exception to the imposition of interest. (*Appeal of Audrey C. Jaegle, supra.*)

2 The Board's jurisdiction in an interest abatement case is limited by statute to a review of  
3 respondent's determination for an abuse of discretion. (Rev. & Tax. Code, § 19104, subd. (b)(2)(B).)

4 To show an abuse of discretion, an appellant must establish that, in refusing to abate interest,  
5 respondent exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law.

6 (*Woodral v. Commissioner* (1999) 112 T.C. 19, 23.) Interest abatement provisions are not intended to  
7 be routinely used to avoid the payment of interest, thus abatement should be ordered only "where  
8 failure to abate interest would be widely perceived as grossly unfair." (*Lee v. Commissioner* (1999)  
9 113 T.C. 145, 149.) The mere passage of time does not establish error or delay that can be the basis of  
10 an abatement of interest. (*Id.* at p. 150.)

#### 11 STAFF COMMENTS

##### 12 Proposed Assessment

13 Staff notes that a deficiency assessment based on a federal adjustment is presumed  
14 correct and appellants have the burden of showing that the deficiency assessment is erroneous. (*Appeal*  
15 *of Sheldon I. and Helen R. Brockett, supra.*)

##### 16 Settlement Proceeds and Emotional Distress

17 Staff notes that the judge in the underlying court proceedings noted that appellants and  
18 the university agreed that the settlement proceeds of \$450,000 (i.e., \$150,000 in 2006, \$150,000 in  
19 2007, and \$150,000 in 2008) would be allocated to emotional distress damages.

20 At the oral hearing, appellants should be prepared to present evidence showing that the  
21 settlement amount of \$150,000 for 2008 was paid as damages for emotional distress that originated  
22 from a personal physical injury or physical sickness. Staff notes that the record does not appear to  
23 disclose that any settlement proceeds were paid for medical care attributable to the treatment of  
24 emotional distress that arose from a personal physical injury or physical sickness. As such, appellants  
25 should be prepared to present evidence to establish that any portion of the \$150,000 amount was paid  
26 for medical care attributable to the treatment of emotional distress that arose from a personal physical  
27 injury or physical sickness.

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1                   Accuracy-Related Penalty

2                   As noted above, the judge in the underlying court proceedings concluded that it was  
3 unclear (to her) whether the settlement proceeds were taxable income to appellant-husband. As  
4 indicated above, appellants assert that the accuracy-related penalty should be abated for reasonable  
5 cause because they relied upon the advice of their attorney as to whether the settlement proceeds of  
6 \$150,000 for 2008 were taxable. Appellants argue that, given the facts at hand, even the judge was not  
7 sure whether the settlement proceeds were taxable income. In response, the FTB argues that appellants  
8 have not shown that they reasonably relied in good faith on the legal opinion of Mr. Kornhauser, as  
9 appellants and Mr. Kornhauser were very aware of the resistance by the university to appellants'  
10 request that the university not furnish the IRS with Form 1099s, stemming from the university's fear  
11 that it would be aiding tax fraud. At the oral hearing, the parties should be prepared to further discuss  
12 whether appellants have shown reasonable cause for abatement of the accuracy-related penalty.

13                   Appellants' Payment of \$8,734

14                   As noted above, appellants assert that the FTB's failure to credit appellants for their  
15 payment of \$8,734—which appellants submitted in early October 2011—is a primary reason for this  
16 appeal. Staff notes that, in a letter dated January 4, 2012, the FTB states that appellants' payment of  
17 \$8,734 will be applied to the FTB's proposed assessment after it becomes a final assessment. Because  
18 appellants submitted this timely appeal to the Board, the FTB's proposed assessment has not become a  
19 final assessment. At the oral hearing, the FTB may want to clarify that the payment of \$8,734 will be  
20 reflected as being received by the FTB as of the date of payment, not the date of any final assessment.

21                   Interest Abatement

22                   Appellant requests abatement of interest in the appeal letter without stating the grounds  
23 for such relief and neither party mentions the issue thereafter. At the hearing, appellants should be  
24 prepared to specify the period of time for which they are requesting abatement of interest and state the  
25 specific grounds for such relief as outlined in the applicable law section above. The FTB should be  
26 prepared to describe the computation of the interest amount and state whether all or any portion of the  
27 interest accrual was suspended for any period, such as upon receipt of appellants' payment of \$8,734.

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Additional Evidence

If appellants have any further evidence that they wish to submit, pursuant to California Code of Regulations, title 18, section 5523.6, appellants should provide their evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.<sup>10</sup>

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<sup>10</sup> Evidence exhibits should be sent to: Mr. Khaaliq Abd’Allah, Associate Governmental Program Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879, MIC:80, Sacramento, California, 94279-0080.