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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 **MICHAEL REZNITSKY**¹) Case No. 552490
13)

<u>Year</u>	<u>Tax</u>	<u>Proposed Assessment</u> <u>Penalty</u> ²
2007	\$37,389.00	\$7,477.80

16 Representing the Parties:

17
18 For Appellant: Michael Reznitsky
19 For Franchise Tax Board: Anjali Balasingham, Tax Counsel
20

21 **QUESTION:** Whether appellant has shown that respondent erred by not allowing damages awarded
22 pursuant to a settlement agreement to be excluded from his taxable income.

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27 ¹ Appellant resides in San Francisco. In his protest and appeal letters, appellant referred to himself as Michael Reznitsky,
28 and other documents in the file also refer to Michael Reznitsky, but appellant filed his 2007 California resident income tax
return using the name Mikhail Reznitskiy. (Appeal Letter; Resp. Opening Br., p. 2, exhibits A- B, F.)

² This is an accuracy related penalty, which respondent agrees on appeal to cancel. (Resp. Opening Br., p. 1, fn. 1.)

1 HEARING SUMMARY

2 Background

3 Appellant filed a timely California resident income tax return for the 2007 tax year. He
4 used the single filing status and reported wages of \$50,000, federal adjusted gross income (AGI) of
5 \$55,582 and California adjustments (subtraction) of \$5,559. Appellant reported California AGI of
6 \$50,023 and claimed a standard deduction of \$3,516 and, California taxable income of \$46,507, and a
7 tax of \$1,942. He also claimed income tax withholdings of \$3,000 and an overpayment of \$1,058.
8 Respondent accepted appellant's 2007 return and remitted a refund of \$1,058. (Resp. Opening Br., p. 2,
9 exhibit B.)

10 Respondent subsequently audited appellant's 2007 return after receiving information that
11 in 2007 appellant received a lawsuit settlement award. During the audit, respondent determined that on
12 February 8, 2006, appellant filed a complaint against his former employer, 1980 Vallejo Street
13 Homeowners Association (the Association), which the parties ultimately settled in April 2007; appellant
14 provided respondent with a copy of the complaint. (Resp. Opening Br., pp. 1-2, exhibit A.) According
15 to the complaint, appellant began working as a resident building manager for the Association on July 1,
16 1992 and the Association fired him on September 29, 2005. The complaint includes the following
17 causes of action: 1) tortious termination in violation of public policy; 2) breach of contract (bad faith);
18 3) unjust enrichment; 4) unfair business practices; 5) violation of sections of the California Labor Code
19 relating to employer retaliation and failure to pay minimum wage and overtime wages; and 6) violation
20 of the San Francisco Minimum Living Wage Ordinance. (Resp. Opening Br., pp. 1-2, exhibit A.)
21 Respondent determined that in April 2007, the parties settled the lawsuit and executed a Release and
22 Settlement Agreement (settlement agreement). Appellant provided respondent with a copy of the
23 settlement agreement, which provides in section 1.7.1(a)(i)(1)-(3) that the Association agreed in
24 consideration for settling the lawsuit to pay appellant \$800,000 made payable as follows: 1) appellant's
25 law firm would receive \$350,000, which would be reflected on a Form 1099 issued to it; 2) appellant
26 would receive \$50,000 less applicable tax withholdings and subject to required reporting, which would
27 be reflected on a W-2 form issued to him; and 3) appellant would receive \$400,000 for "personal
28 injury/emotional distress." (Appeal Letter, Attachment.) Section 1.7.1(a)(iv) of the settlement

1 agreement provides:

2 **REZNITSKY** has advised **ASSOCIATION** that he is allocating the settlement proceeds
3 among: 1) personal injuries/emotional distress; 2) lost rental value; and 3) lost wages.
4 **ASSOCIATION** takes no position as to the proper allocation of the proceeds for tax
5 purposes or otherwise.

6 During the audit, appellant provided respondent with copies of letters from Leigh
7 Kimberg, M.D., an internist, Khenu Singh, M.D., a psychiatrist, and Henry Lee, M.D., a psychiatrist,
8 dated September 19, 2006, April 21, 2009, and August 21, 2006, respectively, describing appellant's
9 psychiatric treatment, symptoms and diagnoses, including post-traumatic stress disorder, anxiety, and
10 depression. (Appeal Letter, Attachments.) During the audit, respondent agreed with appellant that the
11 award was made due to his condition of major depressive disorder. Respondent determined, however,
12 that appellant incorrectly excluded the settlement income of \$400,000 from his reported gross income on
13 his 2007 return. (Resp. Opening Br., p. 2.)

14 On August 5, 2009, respondent issued a Notice of Proposed Assessment (NPA) for tax
15 year 2007, which revises appellant's taxable income from \$46,507 to \$446,507 by including \$750,000
16 of unreported settlement income less legal fees of \$350,000 (i.e., \$400,000). The NPA proposes
17 additional tax in the amount of \$37,389.00 plus interest and imposes an accuracy related penalty of
18 \$7,477.80. (Resp. Opening Br, pp. 2-3; Appeal Letter, Attachment.)

19 Appellant protested the NPA and requested a protest hearing, which was held by
20 telephone on June 29, 2010. (Resp. Opening Br., p. 3, exhibits F and G.) In a determination letter dated
21 July 13, 2010, the protest hearing officer concluded that the settlement payment was due to a wrongful
22 termination and a labor dispute and, as a result of the wrongful termination, appellant was diagnosed
23 with major depressive disorder. Based on the information appellant provided during the audit and the
24 protest, the protest hearing officer held that the settlement income should not have been excluded from
25 appellant's AGI under Internal Revenue Code (IRC) section 104(a)(2) because the settlement was not
26 the result of "physical injury or physical sickness." She further held, "Because your action dealt with
27 unlawful termination and the employment relationship referred to under IRC Section 62(e)(18)(ii), the
28 \$350,000 in legal fees will be allowed to offset the taxable portion of the settlement." She
recommended affirming the 2007 NPA. The protest hearing officer requested additional documents or

1 supporting legal authority by no later than August 17, 2010, if appellant believed her understanding of
2 the facts was incomplete or incorrect. (Resp. Opening Br., exhibit G.) The protest hearing officer
3 issued a final recommendation letter dated August 24, 2010, in which she acknowledged appellant's
4 response to the July 13, 2010 determination letter³ and stated that her final recommendation was to
5 affirm the 2007 NPA. (Resp. Opening Br., exhibit H.)

6 Respondent issued a Notice of Action (NOA) dated September 23, 2010, affirming the
7 NPA based on the August 24, 2010 final determination letter. (Appeal Letter, Attachment.) This timely
8 appeal followed.

9 Contentions

10 Appellant's Contentions

11 Appellant states that the settlement award resulted from a lawsuit he filed on February 8,
12 2006, against his former employer for wrongful termination and a labor dispute. (Appeal Letter, p. 1.)
13 Appellant contends that his medical diagnosis of major depressive disorder as a result of wrongful
14 termination was not yet determined at the time his lawyer prepared the lawsuit. Appellant states that he
15 continues to take medication for insomnia and he has lost earning capacity for the rest of his life.
16 Appellant states that he reported the \$50,000 settlement amount as gross income on his 2007 return, but
17 he did not report the \$400,000 settlement amount as gross income because his tax accountant determined
18 that this amount was not taxable under IRC section 104(a). Appellant attached to the appeal letter
19 copies of the settlement agreement, the three letters from Drs. Kimberg, Singh, and Lee, which he
20 submitted to respondent during the audit, the NPA, and the NOA, as well as an excerpt from a 1040
21 Quickfinder Handbook for tax year 2007, which discusses, among other things, insurance claims and
22 lawsuits. (Appeal Letter, p.2, Attachments.)

23 Respondent's Contentions

24 Respondent argues that appellant fails the two-prong test for the exclusion of settlement
25 proceeds set forth in *Commissioner v. Schleier* (1995) 515 U.S. 323, as modified by the 1997
26 amendment to IRC section 104(a)(2) (the *Schleier* test). Respondent contends that appellant fails the
27

28 ³ A copy of appellant's response to the July 13, 2010 determination letter is not in the file.

1 second prong of the *Schleier* test, which requires that the damages were received on account of personal
2 physical injuries or physical sickness. Respondent does not dispute that in 2007 appellant received
3 \$400,000 of settlement proceeds on account of his medical condition of major depressive disorder.
4 Respondent asserts that appellant has not established that the \$400,000 of settlement income was due to
5 personal physical injuries or physical sickness. Respondent contends that the medical condition of
6 major depressive disorder is an emotional injury, which does not entitle appellant to exclude the
7 settlement income from his gross income. (Resp. Opening Br., p. 4.)

8 Citing *Wells v. Commissioner*, T.C. Memo 2010-5, respondent notes that IRC section
9 104(a) expressly provides, “For purposes of paragraph (2) [of IRC section 104(a)], emotional distress
10 shall not be treated as a physical injury or physical sickness.” Citing *Lindsey v Commissioner*, T.C.
11 Memo 2004-113, aff’d. (8th Cir. 2005) 422 F.3d 684, respondent asserts that under IRC section
12 104(a)(2), damages are not qualified for exclusion from gross income due to the emotional distress, even
13 if there are physical symptoms, such as back pain, weight loss, or insomnia. (Resp. Opening Br., pp. 4-
14 5.) Respondent contends the letter from Dr. Singh shows that he diagnosed appellant with major
15 depressive disorder, which he characterized as “a major psychiatric disorder,” rather than as a physical
16 injury or physical sickness. Respondent also contends the letter from Dr. Lee similarly shows that
17 appellant was diagnosed with major depressive disorder, and neither of these two doctors indicated that
18 this disorder resulted from a physical injury or physical sickness. Respondent further contends that the
19 letter from Dr. Kimberg states that appellant developed progressive anxiety and depression as a result of
20 the Association’s alleged mistreatment and wrongful termination, and, although Dr. Kimberg diagnosed
21 appellant with severe depression with psychotic features and some symptoms of post-traumatic stress
22 disorder, Dr. Kimberg did not mention any physical injuries. (Resp. Opening Br., p. 5.)

23 Respondent also argues that appellant fails the first prong of the *Schleier* test, which
24 requires the underlying cause of action giving rise to the settlement award be based upon tort or tort type
25 rights. Citing *Taggi v. United States* (2d Cir. 1994) 35 F.3d 93, 96-97 and *Hess v. Commissioner*, T.C.
26 Memo 1998-240, respondent argues, “When an award arises in the context of both tort and non-tort
27 claims, such as is the case here, the taxpayer must provide the evidence to show that the award is
28 properly allocated to the tort claims; otherwise, the entire award is considered to be taxable income.”

1 According to respondent, appellant has not established that the Association awarded him the \$400,000
2 of settlement proceeds due to the complaint's only tort-based claim, tortious termination in violation of
3 public policy, rather than the many non-tort based claims contained in the complaint. (Resp. Opening
4 Br., p. 5.) Respondent asserts that, even though his claims against the Association were not grounded
5 in personal injury or emotional distress (such as a negligence claim), it was appellant's election to
6 allocate the \$400,000 of settlement proceeds to "personal injury/emotional distress." (Resp. Opening
7 Br., p. 6.)

8 Assuming section 1.7.1(a)(i)(3) of the settlement agreement was construed as an express
9 allocation for tax purposes, respondent argues that it must be disregarded because it does not reflect a
10 proper allocation under the surrounding circumstances. Citing *Threlkeld v. Commissioner* (1986) 87
11 T.C. 1294, 1306-1307, affd. (6th Cir. 1988) 848 F.2d 81, respondent argues, "When the settlement
12 agreement expressly allocates the damage award to the underlying claims, that allocation is generally
13 binding for tax purposes, provided that the parties entered into the agreement in an adversarial context,
14 at arm's length, and in good faith." Respondent points out that the settlement agreement lacks any
15 express language allocating the \$400,000 settlement proceeds to the underlying claims of appellant's
16 complaint. Citing *Robinson v. Commissioner* (1994) 102 T.C. 116, 129, affd. in part and revd. in part on
17 other grounds, 70 F.3d 34 (5th Cir. 1995), respondent asserts, "It is well-established that the terms of a
18 settlement agreement cannot be blindly accepted, 'especially when the circumstances behind the
19 agreement indicate that the allocation of the amounts contained therein was uncontested, non-
20 adversarial, and entirely tax motivated.'" (Resp. Opening Br., p. 6.)

21 Respondent argues there are several indications that the allocation at issue was
22 uncontested, non-adversarial, and entirely tax motivated. First, respondent contends the settlement
23 agreement expressly provides that it was appellant's unilateral election to allocate the \$400,000 of
24 settlement proceeds to personal injury/emotional distress and if the Association tried in good faith to
25 allocate the settlement proceeds to appellant's underlying claims, the results would likely be different
26 because there is no cause of action grounded in personal injury or emotional distress and in the
27 complaint's prayer for relief there is no specific request for damages for personal injury or emotional
28 distress. Respondent also asserts, "It is therefore incongruent that personal injury/emotional distress

1 compensation constituted the single largest percentage of [appellant’s] settlement award (50%).”
2 Second, respondent contends that the adversarial element required for an express allocation is weakened
3 because there were “mutually advantageous financial implications” for both appellant and the
4 Association to allocate the \$800,000 of settlement proceeds “for personal injuries/emotional distress,”
5 because it allowed appellant to claim an income exclusion and thus enjoy a tax benefit and it allowed the
6 Association to avoid admission of the viability or validity of the complaint’s claims, which may have
7 exposed the Association to penalties for violations of various codes, such as the San Francisco
8 Administrative Code, California Labor Code, and California Business and Professions Code. (Resp.
9 Opening Br., pp. 6-7.) Third, respondent contends that the allocation provision of the settlement
10 agreement “was not forged in an adversarial context” and must therefore be disregarded in the absence
11 of corroborating evidence. (Resp. Opening Br., p. 7.)

12 Respondent argues there is no evidence showing that the Association intended the
13 \$400,000 of settlement proceeds be allocated to any tort-based claim. Respondent cites *Green v.*
14 *Commissioner* (5th Cir. 2007) 507 F.3d 857, 868, affg. T.C. Memo 2005-250, for the proposition that
15 “[w]hen the settlement agreement lacks express language allocating the proceeds to underlying claims,
16 an allocation may be made by considering other facts that reveal the payor’s intent.” (underscore in the
17 original.) Respondent asserts that appellant’s complaint includes causes of action grounded
18 predominantly in economic injury, rather than tort injury, and it is thus not logical to conclude that the
19 Association intended the \$400,000 settlement proceeds be allocated exclusively to appellant’s one tort-
20 based cause of action. Respondent also asserts that appellant’s unilateral election to allocate the
21 \$400,000 of settlement proceeds “for personal injuries/emotional distress,” is insufficient evidence to
22 establish the Association’s reason for the settlement. (Resp. Opening Br., p. 7.)

23 Lastly, respondent states that appellant appears to contest respondent’s imposition of
24 interest. Respondent asserts that the imposition of interest is mandatory and appellant has not
25 demonstrated any of the circumstances for abatement of interest. (Resp. Opening Br., pp. 6-7.)

26 Applicable Law

27 Presumption of Correctness

28 It is well-established that deductions and exclusions are a matter of legislative grace and

1 are allowable only where the conditions established by the Legislature have been satisfied. (*New*
2 *Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of George R. II and Edna House*,
3 93-SBE-016, Oct. 28, 1993.) Respondent’s determination that a deduction or exclusion should be
4 disallowed is presumed correct and appellants must prove their entitlement to the claimed deductions or
5 exclusions (*Welch v. Helvering* (1933) 290 U.S. 111; *Appeal of George R. II and Edna House, supra.*)
6 Unsupported assertions cannot satisfy that burden of proof. (*Appeal of James C. and Monablance A.*
7 *Walshe*, 75-SBE-073, Oct. 20, 1975.) In the absence of uncontradicted, credible, competent, and
8 relevant evidence showing that respondent’s determinations are incorrect, they must be upheld. (*Appeal*
9 *of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) Appellant’s failure to produce
10 evidence that is within his control gives rise to a presumption that such evidence is unfavorable to his
11 case. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

12 IRC section 104(a)(2)

13 R&TC section 17071 incorporates IRC section 61. IRC section 61(a) provides that gross
14 income includes all income from whatever source derived, except as otherwise expressly provided by
15 statute. Although IRC section 61(a) broadly defines as income any accession to wealth, statutory
16 exclusions from income are narrowly construed. (*Commissioner v. Schleier, supra*, 515 U.S. at 328;
17 *United States v. Burke* (1992) 504 U.S. 229, 233.) R&TC section 17131 incorporates IRC section 104.
18 IRC section 104(a)(2) excludes from gross income, among other items, damages received pursuant to a
19 settlement “on account of personal physical injuries or physical sickness.” IRC section 104(a) further
20 provides, “For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or
21 physical sickness.” It also provides that “the preceding sentence shall not apply to an amount of
22 damages not in excess of the amount paid for medical care . . . attributable to emotional distress.”
23 Medical care is defined for purposes of this section in IRC section 213(d)(1), subparagraph (A) or (B).

24 Prior to its amendment by the Small Business Job Protection Act of 1996 (SBJPA),
25 Pub. L. 104-188, sec. 1605, 110 Stat. 1838, IRC section 104(a)(2) excluded from gross income amounts
26 received on account of personal injuries or sickness. The reference to personal injuries in the former
27 version of IRC section 104(a)(2) included “nonphysical injuries to the individual, such as those affecting
28 emotions, reputation, or character”. (*United States v. Burke , supra*, 504 U.S. at 235 n.6, 239. See also

1 *Robinson v. Commissioner, supra*, 102 T.C. at 126; *Fono v. Commissioner*, 79 T.C. 680, 692 (1982),
2 affd. without published opinion 749 F.2d 37 (9th Cir. 1984). On August 20, 1996, the SBJPA amended
3 IRC section 104(a)(2) to exclude from gross income “the amount of any damages (other than punitive
4 damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on
5 account of personal physical injuries or physical sickness”. (SBJPA, § 1605(a), 110 Stat. 1838.) The
6 SBJPA amendment thus narrowed the exclusion set forth in IRC section 104(a)(2) by replacing
7 “personal injuries” to “personal physical injuries” and replacing “sickness” to “physical sickness.” The
8 legislative history of this amendment clarifies that “the term emotional distress includes symptoms (e.g.,
9 insomnia, headaches, stomach disorders) which may result from such emotional distress.” (H. Conf.
10 Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041 n.56. See also *Hawkins v. Commissioner*
11 (2005) T.C. Memo 2005-149.) Section 1605(d) of the SBJPA, 110 Stat. 1839, provides that (with an
12 inapplicable exception) “the amendments made by this section shall apply to amounts received after the
13 date of the enactment of this Act, in taxable years ending after such date.”

14 It is clear from the express language of IRC section 104(a) that emotional distress,
15 including mental anguish, humiliation, embarrassment, and anxiety, shall not be treated as a physical
16 injury or physical sickness. “Physical manifestations of emotional distress such as fatigue, insomnia,
17 and indigestion do not transform emotional distress into physical injury or physical sickness.”
18 (*Connolly v. Commissioner* (2007) T.C. Memo 2007-98.) In *Wells v. Commissioner, supra*, the tax court
19 specifically held that emotional distress due to depression does not constitute a personal physical injury
20 or physical sickness under IRC section 104(a)(2). In that case, the taxpayer filed a lawsuit against her
21 employer asserting claims for employment discrimination and retaliation. The parties settled the lawsuit
22 and the taxpayer received a settlement payment pursuant to a settlement agreement, which provides that
23 the payment was made “as damages for her emotional distress due to depression and other claims, not as
24 wages or back pay.” The taxpayer did not argue “that the characterization of the payment does not
25 accurately reflect the nature of the claim or the settlement payment[.]” Applying IRC section 104(a)(2),
26 the tax court held the taxpayer failed to establish that she fell within the clear scope of the statutory
27 exclusion.

28 In *Commissioner v. Schleier, supra*, 515 U.S. at p. 336-337, the United States Supreme

1 Court set forth a two-prong test (the *Schleier* test) for determining whether amounts are excludable from
2 gross income under IRC section 104(a)(2): (1) the underlying claims must be based on tort or tort type
3 rights; and (2) the damages received must be on account of personal injuries or sickness. (See also
4 Treas. Reg. sec. 1.104-1(c).) The *Schleier* test was reformulated to incorporate the amendment to IRC
5 section 104(a)(2) pursuant to the SBJPA.⁴ (See *Shaltz v. Commissioner*, T.C. Memo. 2003-173;
6 *Henderson v. Commissioner*, T.C. Memo. 2003-168.) The second prong of the *Schleier* test thus
7 requires proof that the damages were received on account of personal physical injuries or physical
8 sickness. Other than imposing this additional requirement into the second prong of the *Schleier* test, the
9 SBJPA amendment did not alter the *Schleier* test. (*Goode v. Commissioner* (2006) T.C. Memo 2006-
10 48.)

11 Second Prong of *Schleier* Test

12 In determining whether a settlement was paid on account of personal physical injuries or
13 physical sickness, the courts will first examine the language in the settlement agreement. (*Massot v.*
14 *Commissioner* (2000) T. C. Memo 2000-24.) “Express allocations in a settlement, identifying payment
15 amounts deemed eligible for the section 104(a)(2) exclusion, are generally accorded conclusive effect
16 for tax purposes.” (*Goode v. Commissioner, supra*, citing *Fono v. Commissssioner, supra*.) The courts
17 will not defer to the express allocations in a settlement, however, “where circumstantial factors reveal
18 that the designation of the settlement proceeds was not the result of adversarial, arm’s length, and good
19 faith negotiations, and is incongruous with the ‘economic realities’ of the taxpayer’s underlying claims.”
20 (*Goode v. Commissioner, supra*, citing *Bagley v. Commissioner* (1995) 105 T.C. 396, 406-410. See also
21 *Massot v. Commissioner, supra*.)

22 First Prong of *Schleier* Test

23 When damages are received pursuant to a settlement agreement, the nature of the claim
24 that was the actual basis for settlement determines whether the settlement amounts are excludable from
25 gross income under IRC section 104(a)(2). (*Id.* See also *United States v. Burke, supra*; *Prasil v.*
26 *Commissioner*, T.C. Memo 2003-100.) The determination of the nature of the claim is a factual inquiry
27

28 ⁴ Staff notes that Treasury Regulation section 1.104-1(c) has not yet been amended to reflect the SBJPA amendment.

1 and is generally made by reference to the settlement agreement in light of the surrounding
2 circumstances, including the details surrounding the litigation, the allegations contained in the
3 complaint, and the course of the parties' settlement negotiations. (*Goode v. Commissioner, supra*;
4 *Robinson v. Commissioner, supra*.) "A key question to ask is: 'In lieu of what were the damages
5 awarded?'" (*Robinson v. Commissioner, supra*)

6 "When the settlement agreement allocates clearly the settlement proceeds between
7 tortlike personal injury damages and other damages, the allocation is generally binding for tax purposes
8 (and the tortlike personal injury damages are excludable under section 104(a)(2)) to the extent that the
9 agreement is entered into by the parties in an adversarial context at arm's length and in good faith."
10 (*Robinson v. Commissioner, supra*.) An important factor in determining the validity of the agreement is
11 the payor's intent in making the settlement payment. (*Id.* See also *Stocks v. Commissioner* (1992)
12 98 T.C. 1, 10.) When the payor's intent is not clear from the settlement agreement, the payor's intent
13 must be determined by examining all of the facts and circumstances. (*Robinson v. Commissioner,*
14 *supra*) "Factors to consider include the details surrounding the litigation in the underlying proceeding,
15 the allegations contained in the payee's complaint and amended complaint in the underlying proceeding,
16 and the arguments made in the underlying proceeding by each party there." (*Id.*) "None of these factors
17 is always outcome-determinative; in a given case, any of these factors may ultimately be persuasive or
18 ignored." (*Id.*)

19 Abatement of Interest

20 The assessment of interest is mandatory on unpaid tax. (*Appeal of Amy M. Yamachi, 77-*
21 *SBE-095, June 28, 1977; Appeal of Audrey C. Jaegle, 76-SBE-070, June 22, 1976.*) Interest is also
22 mandatory with respect to the imposition of an accuracy-related penalty pursuant to R&TC section
23 19164. (Rev. & Tax. Code, § 19101, subd. (c)(2)(B).) This Board has held interest is not a penalty, but
24 is simply compensation for a taxpayer's use of money after the due date of the tax. (*Appeal of Audrey*
25 *C. Jaegle, supra*.) There is no reasonable cause exception to the imposition of interest. (*Id.*)

26 Respondent may abate interest accrued on a deficiency when the taxpayer identifies an
27 unreasonable error or delay that meets the following conditions: (1) it occurred after respondent
28 contacted the taxpayer in writing about the particular deficiency or overpayment underlying the disputed

1 interest; (2) it is not significantly attributable to the taxpayer; and (3) it is attributable to a ministerial or
2 managerial⁵ act performed by respondent. (*Appeal of Michael and Sonia Kishner*, 99-SBE-007,
3 Sept. 29, 1999; see also Rev. & Tax. Code, § 19104, subs. (a)(1) & (b)(1).) An error or delay will only
4 be taken into account if it occurred after respondent contacted the taxpayer in writing with respect to the
5 deficiency from which the interest accrued. (Rev. & Tax. Code, § 19104, subd. (b)(1).) Respondent's
6 determination not to abate interest is presumed correct, and the burden is on appellant to prove error.
7 (*Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.) R&TC section 19104, subdivision
8 (b)(2)(B), states that the Board shall have jurisdiction to determine whether respondent's failure to abate
9 interest was an abuse of discretion and to order an abatement of interest if it determines that such an
10 abuse occurred. (See also *Appeal of Ernest J. Teichert*, 99-SBE-006, Sept. 29, 1999.) In order to show
11 an abuse of discretion, appellant must establish that respondent exercised its discretion arbitrarily,
12 capriciously, or without sound basis in fact or law by refusing to abate interest. (*Beall v. United States*
13 (E.D. Tex. 2004) 335 F. Supp. 2d 743, 748; *Dadian v. Commissioner* (2004) T.C. Memo 2004-121;
14 *Woodral v. Commissioner* (1999) 112 T.C. 19, 23.)

15 STAFF COMMENTS

16 IRC section 104(a)(2)

17 Second Prong of *Schleier* Test

18 Respondent does not dispute that appellant was diagnosed with major depressive disorder
19

20 ⁵ In the *Appeal of Michael and Sonia Kishner* (99-SBE-007), decided on September 29, 1999, this Board adopted the
21 language from Treasury Regulation section 301.6404-2(b)(2), which defines a "ministerial act" as:

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

26 For acts performed in tax years beginning on or after January 1, 1998, respondent may also abate interest for "managerial
27 acts" as well. (Rev. & Tax. Code, § 19104(a)(1).) In *Appeal of Michael and Sonia Kishner*, the Board noted that Treasury
28 Regulation 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. Further, a general administrative decision, such as the IRS's decision on how to organize
the processing of tax returns or its delay in implementing an improved computer system, is not a
managerial act for which interest can be abated

1 subsequent to the termination of his employment with the Association, as indicated by the letters from
2 appellant's treating doctors. Appellant contends that he received \$400,000 of settlement proceeds as a
3 result of his diagnosis of major depressive disorder. Appellant argues that the settlement agreement
4 properly appropriated \$400,000 to physical injury and emotional distress. Appellant should be prepared
5 to explain why section 1.7.1(a)(iv) of the settlement agreement provides that appellant advised the
6 Association that he allocated the settlement proceeds among personal injuries/emotional distress, lost
7 rental value, and lost wages, whereas section 1.7.1(a)(i)(1)-(3), which sets forth the allocation of the
8 settlement payment among attorneys' fees (\$350,000), appellant (\$50,000)), makes no reference to lost
9 rental value or lost wages.

10 Assuming the Board determines that the Association paid appellant \$400,000 as damages
11 for emotional distress due to depression, it appears that, as a matter of law, such damages, not being
12 attributable to physical injury or physical sickness, are not excludable from appellant's gross income,
13 except to the extent that appellant expended any amounts for medical care to treat his emotional distress.
14 (Int. Rev. Code, § 104(a)(2); *Wells v. Commissioner, supra*, T.C. Memo 2010-5.) Appellant should be
15 prepared at oral hearing to present evidence to prove that the settlement payment of \$400,000 was
16 received on account of a physical injury or physical sickness other than the physical symptoms included
17 in the term emotional distress.

18 Staff notes the record does not disclose that any settlement proceeds were designated as
19 reimbursement for medical care attributable to the treatment of emotional distress. Appellant should be
20 prepared to show, if applicable, that any portion of the \$400,000 amount was designated as
21 reimbursement for medical care attributable to the treatment of emotional distress.

22 First Prong of *Schleier* Test

23 Assuming the Board determines that appellant satisfies the second prong of the *Schleier*
24 test by showing the \$400,000 amount was received on account of personal physical injuries or physical
25 sickness, the parties should be prepared to discuss whether appellant satisfies the first prong of the
26 *Schleier* test, i.e., whether the settlement award was properly allocated to an underlying cause of action
27 based upon tort or tort type rights. Appellant argues that the complaint does not include any claims
28 related to personal injury or emotional distress because his medical diagnosis of major depressive

1 disorder as a result of wrongful termination was only diagnosed after his lawyer drafted and filed the
2 complaint. Staff notes that the complaint has a court filing stamp of February 8, 2006, and the letters
3 from his treating doctors describing his mental health and diagnoses are dated after the filing of the
4 complaint, specifically, August 21, 2006, September 19, 2006, and April 21, 2009.

5 Abatement of Interest

6 Although respondent asserts that appellant appears to contest the imposition of interest,
7 staff finds no such contention on the part of appellant in either the protest letter or the appeal letter.
8 Nonetheless, interest may only be abated after the initial contact by respondent and if it makes a
9 ministerial or managerial act that causes undue delay or error that leads to the accrual of further interest.
10 In this instance, appellant has not provided any evidence of such a ministerial or managerial act or
11 alleged that respondent caused an unreasonable error or delay that led to the accrual of interest. If
12 appellant requests abatement of interest, he should be prepared to present evidence supporting abatement
13 for the reasons described above.

14 Additional Evidence

15 Pursuant to California Code of Regulations, title 18, section 5523.6, if appellant is able to
16 locate any additional evidence supporting his appeal, it should be submitted if possible to the Board and
17 respondent at least 14 days prior to the hearing date.⁶

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21 Reznitsky_lf

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28 ⁶ Exhibits should be submitted to: Claudia Madrigal, Board Proceedings Division, Board of Equalization. P. O. Box
942879 MIC: 80, Sacramento, CA 94279-0080