

1 John O. Johnson
Tax Counsel
2 Board of Equalization, Appeals Division
450 N Street, MIC:85
3 PO Box 942879
Sacramento CA 95814
4 Tel: (916) 319-9118
5 Fax: (916) 324-2618

6 Attorney for the Appeals Division

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

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **KLAUS W. WANG**¹) Case No. 441035

<u>Year</u>	<u>Proposed Assessment</u> ²
2003	\$132,753

17 Representing the Parties:

18 For Appellant: John O. Kent, Brager Tax Law Group
19 For Franchise Tax Board: Mark McEvilly, Tax Counsel III

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

23 ///

24 ///

25 ///

27 ¹ Appellant resides in Alhambra, Los Angeles County.

28 ² Respondent should be prepared to provide the amount of interest that has accrued as of the hearing date.

1 HEARING SUMMARY

2 Background

3 *Settlement Background*

4 The proposed assessment at issue in this appeal arises from income gained in a settlement
5 agreement that was excluded from appellant's taxable income on his original return for 2003. Appellant
6 was employed by Sony³ for over 14 years before being terminated after taking leave under the
7 California Family Rights Act.⁴ Appellant filed a lawsuit against Sony on December 1, 1999 alleging
8 various causes of actions regarding breach of contract, discrimination, harassment, and wrongful
9 demotion.⁵ Appellant amended his complaint four times before asserting a final cause of action of
10 retaliation in violation of Government Code Section 12945.2 on January 8, 2003. (App. Op. Br., exhibit
11 13.)

12 The jury in the lawsuit returned a special verdict form on July 31, 2003, in which it
13 answered seven questions all in favor of appellant, and awarded appellant damages of \$1,450,000.
14 (App. Op. Br., exhibit 14.) On the same day, appellant's representative sent a settlement agreement to
15 Sony in an attempt to settle the matter prior to "punitive damages proceedings" for \$2.5 million, which
16 appellant indicates Sony accepted.⁶ (App. Op. Br., exhibit 18.) The letter was largely silent as to the
17 intent of the payor (Sony) in making the settlement. The letter also stated that the settlement did not
18 affect appellant's Workers' Compensation Appeals Board (WCAB) settlement previously entered into
19 by appellant and Sony.⁷ (*Id.*)

20
21 ³ References to "Sony Corporation" and "Sony Electronics" in the briefing do not seem to differentiate between the two, and
22 for purposes of this hearing summary, we will refer to the entity as simply "Sony."

23 ⁴ Appellant's employment appears to have been from July 8, 1985, to November 8, 1999. (See Resp. Reply Br., p. 2.)

24 ⁵ For the complete list of original and subsequent causes of action, see respondent's opening brief, page 2.

25 ⁶ For a complete breakdown of payments, attorney's fees, and costs, see respondent's opening brief, exhibit E. Appellant was
26 initially allocated \$1.5 million of the \$2.5 million settlement (App. Op. Br., exhibit 16, p. 5) and his attorney was allocated \$1
27 million (App. Op. Br., exhibit 17.) Appellant's opening brief, exhibit 15, is a copy of a check made out to appellant from the
28 client trust account of appellant's representative in the lawsuit for \$1,441,529.06.

⁷ It appears as though appellant entered into a settlement for workers' compensation with Sony prior to settling the lawsuit
which produced the income at issue. The evidence in the record does not provide the workers' compensation settlement
amount or terms. Evidence provided by appellant suggests that it was at least partially based on the physical injuries
sustained while working for Sony. (See App. Op. Br., exhibit 1.)

1 ///

2 *Procedural Background*

3 Appellant filed a timely 2003 California income tax return. Appellant reported California
4 adjusted gross income (AGI) of \$501,864, itemized deductions of \$25,587, and a taxable income of
5 \$476,277. (Resp. Op. Br., exhibit A.) The AGI included \$500,000 in reported income from a legal
6 settlement. Appellant reported a total tax of \$42,377, estimated tax payments of \$40,000, and submitted
7 the difference of \$2,377 with the return.

8 On August 16, 2005, respondent issued a letter to appellant indicating that his return was
9 under review. (Resp. Op. Br., exhibit B.) This letter also informed appellant that respondent had
10 information that he received an award settlement of \$1,500,000 from Sony. In a separate letter issued on
11 the same day, respondent requested documentation regarding the settlement award. (Resp. Op. Br.,
12 exhibit C.) Appellant responded on October 17, 2005, by providing the attorney-client contingent fee
13 agreement, a breakdown of fees for appellant's legal representation in the lawsuit and settlement, a
14 complete copy of the final settlement agreement, and a copy of the settlement check appellant received
15 from his legal representatives (Resp. Op. Br., exhibits D-G).

16 On February 1, 2006, respondent issued a letter to appellant reasserting its position that
17 the entire settlement amount is includable as gross income. (Resp. Op. Br., exhibit I.) Respondent
18 issued a Notice of Proposed Assessment (NPA) on April 24, 2006. (Resp. Op. Br., exhibit J.) The NPA
19 reflected a \$2,000,000 increase to appellant's taxable income (originally reported as \$476,277) to reflect
20 the settlement income, but allowed adjusted itemized deductions of \$839,999 for attorney fees paid from
21 the settlement.⁸ The NPA proposed an additional tax of \$132,753.

22 Appellant timely protested the NPA on June 22, 2006, arguing that the origin of his claim
23 against Sony was his physical injuries. (Resp. Op. Br., exhibit K.) Appellant's protest also stated that
24 he suffered mental impairment as a result of his physical injuries. Appellant concluded by saying that
25 the damages awarded in the settlement with Sony should be excluded from his income, and that the
26 attorney's fees paid out from the award were not includable in appellant's income regardless.

27 _____
28 ⁸ The attorney fees in the amount of \$1,048,470 respondent allowed as an itemized deduction triggered the alternative minimum tax.

1 Respondent reviewed the complaints filed by appellant against Sony and concluded that
2 appellant alleged emotional distress, but that there were no allegations of personal physical injury.
3 (Resp. Op. Br., p. 4.) Respondent reviewed the medical documentation provided and determined that it
4 was in connection with a workers' compensation claim against Sony and not in connection with the
5 lawsuit for wrongful termination from which the settlement resulted. Finding that its audit examination
6 correctly included the entire settlement amount as gross income, respondent issued a Notice of Action
7 affirming the NPA on February 1, 2008. (Resp. Op. Br., exhibit L.) This timely appeal followed.

8 Contentions

9 Appellant contends that the settlement award resulted from a lawsuit with Sony over
10 emotional distress that arose due to physical injury experienced on the job. Therefore, appellant asserts,
11 the settlement came from an action which had its origin in a physical injury or sickness and the damages
12 are excludable from his income tax. Appellant contends that since the award amount is excludable from
13 taxes, the attorney fees are as well. In the alternative, appellant argues that the attorney fees were
14 shifted according to California Government Code section 12965(b), and therefore were received by the
15 attorneys and are not taxable income for appellant. (App. Op. Br., p. 24.)

16 Respondent asserts that the basis for the lawsuit was the mental or emotional harassment
17 and not any personal physical injuries. In addition, respondent contends that appellant has not shown
18 that the lawsuit was based on a tort or tort type right. Respondent acknowledges that appellant may
19 have received workers' compensation for physical injuries sustained on the job, but contends that no part
20 of the settlement award at issue was paid on account of physical injuries. Respondent contends that
21 appellant incorrectly applied California Government Code section 12965(b), and that the attorney fees
22 are non-excludable income.

23 Applicable Law

24 Revenue and Taxation Code (R&TC) section 17071 incorporates Internal Revenue Code
25 (IRC) section 61, which defines "gross income" to include "All income from whatever source derived"
26 except as expressly provided by statute. R&TC section 17131 incorporates IRC section 104. IRC
27 section 104(a)(1) excludes amounts received under workmen's compensation acts as compensation for
28 personal injuries or sickness. IRC section 104(a)(2) excludes from gross income:

1 ///

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

5 (Int.Rev. Code, § 104(a)(2).) IRC section 104(a) provides that “For purposes of paragraph (2),
6 emotional distress shall not be treated as a physical injury or physical sickness.” However, it also states
7 that “the preceding sentence shall not apply to an amount of damages not in excess of the amount paid
8 for medical care... attributable to emotional distress.” (*Id.*) Medical care is defined for purposes of this
9 section in IRC section 213(d)(1), subparagraph (A) or (B).

10 The United States Supreme Court interpreted IRC section 104(a)(2) as containing two
11 distinct and independent requirements for excluding an amount from gross income: (1) the underlying
12 cause of action must be based in “tort or tort type rights;” and (2) the amount received by suit or
13 agreement must be received “on account of personal injuries.” (*O’Gilvie v. United States* (1996) 519
14 U.S. 79; *Commissioner v. Schleier* (1995) 515 U.S. 323.)

15 The Small Business Job Protection Act of 1996 amended IRC section 104(a)(2) to change
16 “personal injuries” to “personal physical injuries” and to change “sickness” to “physical sickness.”
17 (P.L. 104-188, section 1605(a) (Aug. 20, 1996) 110 Stat. 1838 (generally effective for amounts received
18 after August 20, 1996, in tax years ending after that date).

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

25 In determining whether a settlement was paid “on account” of alleged personal injuries, a court
26 begins:

27 [B]y looking at the language in the settlement agreement. The language contained in an
28 agreement will be respected to the extent the settlement agreement is entered into an
adversarial context, at arm’s length, and in good faith.

(*Massot v. Commissioner*, T.C. Memo 2000-24.) Courts have also looked at the special verdict form

1 returned by a jury to see if they found an underlying physical injury or sickness as a cause for an award.
2 (*Nancy J. Vincent v. Commissioner*, T.C. Memo 2005-95.)

3 It is well established that a presumption of correctness attends respondent's
4 determinations as to issues of fact and that the taxpayer has the burden of proving such determinations
5 erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) To overcome the
6 presumed correctness of respondent's finding as to issues of fact, a taxpayer must introduce credible
7 evidence to support his assertions, and if he does not support his assertions with such evidence,
8 respondent's determinations must be upheld. (*Id.*)

9 Attorney fees awarded to a prevailing party are considered earned by the party and not
10 the party's attorneys, even if the fees are separated in the award agreement, and are generally non-
11 excludable when the award is considered income. (*Green v. Commissioner*, T.C. Memo 2007-39;
12 *Vincent v. Commissioner, supra.*) This is true under a contingency arrangement. (See Resp. Op. Br.,
13 exhibit D.) "The attorney is an agent who is duty bound to act only in the interests of the principal, and
14 so it is appropriate to treat the full amount of the recovery as income to the principal." (*Commissioner v.*
15 *Banks* (2005) 543 U.S. 426, 436.) The portion paid for attorney's fees may be deductible, but is not
16 excludable absent some other provision of law. (*Id.*) According to the statutes comprising the
17 alternative minimum tax (AMT) for California, which incorporates the IRC for purposes of calculations,
18 miscellaneous itemized deductions, such as attorney's fees, are not allowed when calculating the AMT.
19 (Rev. & Tax. Code, § 17062; Int.Rev. Code, §§ 55 & 56(b)(1)(A)(i).)

20 STAFF COMMENTS

21 The damages awarded to appellant through the settlement agreement in 2003 will be
22 excludable from his taxable income if they were received on account of physical injury or sickness
23 sustained by appellant. (Int.Rev. Code, § 104(a)(2).) Appellant submitted a multitude of documents
24 including declarations, depositions, and expert reports as evidence that he suffered injury while working
25 for Sony. (App. Op. Br., exhibits.) However, it appears as though the majority of statements in these
26 documents relate to mental and emotional maladies, and some documents were created for appellant's
27 workers' compensation claim, and not for his lawsuit against Sony that resulted in the settlement
28 agreement. (See, e.g., App. Op. Br., exhibit 1.) From the record, it appears as though appellant suffered

1 physical maladies from repetitive occupational activities. Appellant indicates that, as a result of
2 suffering these physical ailments and taking medical leave, his employer harassed him and caused
3 mental and emotional distress. This distress, along with the loss of his job, appears to be the basis of the
4 lawsuit from whence the settlement resulted, and under IRC section 104(a) are only excludable up to the
5 amount paid for medical expenses attributable to the emotional distress. Appellant should be prepared
6 to provide any evidence of medical expenses that qualify income under IRC section 104(a) as
7 excludable.

8 Appellant should also be prepared to provide evidence showing that the damages
9 awarded from the settlement were paid on account of physical injuries or illness. Both parties should
10 also discuss the relevance of *Nancy J. Vincent v. Commissioner*, T.C. Memo 2005-95, which has similar
11 facts to this appeal. In *Vincent*, the court looked to the special verdict returned by the jury, which gave
12 no indication that physical injury or illness was considered. In this appeal, the jury verdict also appears
13 to lack any specific mention of a physical injury or illness.⁹ (App. Op. Br., exhibit 14.) The court in
14 *Vincent* found that even though the medical condition of the taxpayer was considered at length, it was
15 the discriminatory action of the employer which caused lost wages and emotional distress that was the
16 basis for the jury award, and the award was therefore not excludable from income taxes.¹⁰ (*Vincent v.*
17 *Commissioner, supra.*)

18 Appellant's fourth and final amended complaint states that Sony retaliated against
19 plaintiff by terminating him when he exercised his right to take leave under CFRA and FMLA.¹¹ (App.
20 Op. Br., exhibit 13.) The complaint states that, as a proximate result of Sony's retaliation against
21 plaintiff, he suffered substantial losses in earnings and other employment and retirement benefits as well
22 as emotional distress, mental anguish, embarrassment, humiliation, and anxiety. Appellant did not list
23

24 ⁹ Question number 5 on the special verdict, which the jury answered in the affirmative, asks if a decision (presumably
25 appellant's termination) by Sony was a substantial factor in causing harm to appellant, but does not stipulate the type of
26 harm.

27 ¹⁰ In *Vincent*, the court found that the former employer discriminated against the taxpayer because of her physical condition
28 or disability, but still found that the discrimination was the basis for awarding damages, not the underlying physical injury or
disability.

¹¹ CFRA is the acronym for the California Family Rights Act, and FMLA refers to the Family Medical Leave Act.

1 physical injuries as a reason for why he was requesting damages. (*Id.* at p. 4.) The settlement
2 agreement does not contain express language as to what the damages are for, but does state that in
3 accepting the payment, appellant waives appeal rights and dismisses the action. (App. Op. Br., exhibit
4 18.)

5 If the Board finds that the damages were paid on account of physical injury or physical
6 sickness, and thereby finds the income to be excludable, then the attorneys' fees should also be
7 excludable. If the Board finds that less than 100 percent of the income is excludable, then the parties
8 should be prepared to discuss whether the attorneys' fees are excludable. Appellant should be prepared
9 to distinguish *Commissioner v. Green, supra*, and *Vincent v. Commissioner, supra*, which strongly
10 suggest that attorneys' fees are not excludable. Both parties should be prepared to discuss the
11 ramifications of the AMT on the attorneys' fees, if any, and whether it prevents appellant from
12 deducting the fees.

13 ///

14 ///

15 ///

16 Wang_jj

17

18

19

20

21

22

23

24

25

26

27

28