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10 **BOARD OF EQUALIZATION**  
11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
13 ) **PERSONAL INCOME TAX APPEAL**  
14 **TAKASHI WATANABE AND** ) Case No. 461159  
15 **MARCIA WATANABE<sup>1</sup>** )

<u>Year</u>	<u>Proposed Assessment</u>
2003	\$ 14,574.39 <sup>2</sup>

16 Representing the Parties:

17  
18 For Appellants: Ryan Erlich, Attorney  
19 For Franchise Tax Board: Mark McEvilly, Tax Counsel III  
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22 **QUESTIONS:** (1) Whether attorney's fees awarded to appellant-wife as part of an arbitration award  
23 are excluded from California gross income?  
24 (2) Whether appellants may have attorney's fees included in their California adjusted  
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26 <sup>1</sup> Appellants' address is in Rancho Palos Verdes, Los Angeles County, California.

27 <sup>2</sup> This amount consists of \$11,904 in tax and \$2,670.39 in interest through June 30, 2008. Respondent should be prepared at  
28 the hearing to provide a current interest amount. The Notice of Action (NOA) states that interest was suspended between  
October 16, 2005 and September 29, 2006, pursuant to Revenue & Taxation Code (R&TC) section 19116.

1 gross income that have already been reported by their attorney as part of his  
2 California adjusted gross income?

3 HEARING SUMMARY

4 Background

5 Appellants Takashi and Marcia Watanabe, husband and wife, timely filed their 2003  
6 California joint filing status 540 return. The return reported California Adjusted Gross Income (AGI) of  
7 \$272,344 reduced by \$25,547 in itemized deductions, resulting in California taxable income amount of  
8 \$246,797.<sup>3</sup> This amount included federal form 1040 line 21 “other income” amount of \$200,900<sup>4</sup>,  
9 which consisted of \$249,000 received by appellant-wife Marcia from Toyota Motor Sales (TMS) in a  
10 legal settlement reported by TMS to her in the amount of \$249,000 on a 1099-MISC, offset by a  
11 \$48,100 “arbitration award” amount.<sup>5</sup> The return reported tax of \$18,716 that appellants timely paid  
12 through withholding, an estimated tax payment, and a payment made with the return.

13 Respondent audited appellants’ 2003 return and, after correspondence with appellants  
14 and their representative, determined that appellants received payments from TMS totaling \$399,000: the  
15 \$249,000 arbitration award reported on the 1099-MISC, plus the attorney’s fees payment of \$150,000  
16 that was paid by TMS in a separate check to appellant-wife’s arbitration attorney. Respondent  
17 determined that appellants were entitled to deduct \$134,152 in attorney’s fees as a miscellaneous  
18 itemized deduction<sup>6</sup>, but that the California Alternative Minimum Tax (AMT) required miscellaneous  
19 itemized deductions to be added back as a preference item. Hence, respondent issued a Notice of  
20 Proposed Assessment that added \$198,100 to appellants’ taxable income and subjected appellants to the

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24 <sup>3</sup> See Respondent’s Opening Brief, Exhibit A, page 1.

25 <sup>4</sup> See Respondent’s Opening Brief, Exhibit A, page 8.

26 <sup>5</sup> See Respondent’s Opening Brief, Exhibit A, page 14. This refers to the \$48,100 emotional distress damages portion of the  
27 award, which appellants now admit is taxable, even though they have not paid any tax on it.

28 <sup>6</sup> See Respondent’s NPA; Respondent’s Opening Brief, page 2, fourth full paragraph.

1 AMT, resulting in total additional tax of \$11,904<sup>7</sup>, plus interest from April 15, 2004.<sup>8</sup> After a protest  
2 hearing, respondent affirmed the NPA and issued a Notice of Action (NOA). This timely appeal  
3 followed.

4 The arbitration award resulted from an employment dispute between appellant-wife and  
5 TMS. The arbitration award expressly awarded appellant-wife \$249,000 for the following amounts:  
6 \$27,500 in initial lost wages; \$180,000 for past and future wage loss; and \$41,500 for emotional  
7 distress.<sup>9</sup> The arbitrator subsequently awarded appellant \$150,000 in attorney's fees and costs, which  
8 TMS paid to appellant's attorney in a separate check for \$155,000.<sup>10</sup> The separate TMS check also  
9 included an additional \$5,000 in fees that appellant-wife agreed to pay to her arbitration attorney<sup>11</sup>,  
10 which she admits is taxable because she had control over them and "voluntarily paid them to the  
11 attorney."<sup>12</sup> In contrast, appellants argue that the \$150,000 was paid directly to the attorney pursuant to  
12 a fee-shifting arrangement that under California Government Code section 12965, subdivision (b)<sup>13</sup>,  
13 making the fees the property of the attorney.

14 The arbitration award states that TMS wrongfully terminated appellant-wife's  
15 employment through age discrimination in violation of the California Fair Employment and Housing  
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18 <sup>7</sup> The total tax liability in the NPA was \$30,620, consisting of \$25,066 in income tax and \$5,554 in AMT. The NPA  
19 recognized that appellants had already paid \$18,716 and assessed them for \$11,904 in additional tax, plus interest.

20 <sup>8</sup> The subsequently issued Notice of Action (NOA) lists the interest due as two amounts totaling \$2,670.39 through June 30,  
21 2008, with interest suspended pursuant to Revenue & Taxation Code section 19116 for the period between October 16, 2005  
and September 29, 2006.

22 <sup>9</sup> Respondent's Opening Brief, Exhibit F, page 12: 27-28.

23 <sup>10</sup> Respondent's Opening Brief, Exhibit G; Exhibit F, page 13.

24 <sup>11</sup> See Respondent's Opening Brief, Exhibit O, page 5, quoting Stipulation Regarding Payment Of Arbitration Award and  
Attorney's Fees.

25 <sup>12</sup> Appellants' Reply Brief, page 2, paragraph 1.

26 <sup>13</sup> This is a provision of the California Fair Employment and Housing Act (FEHA), and authorizes private lawsuits and  
27 subsequent recovery of attorney's fees upon receipt of a right to sue letter from the California Department of Fair  
Employment and Housing. In *Flannery v. Prentice* (2001) 26 Cal. 4<sup>th</sup> 572, 575, the California Supreme Court held that in a  
28 dispute between the attorney and the client, fees awarded pursuant to this section "absent proof on remand of an enforceable  
agreement to the contrary, the attorney fees awarded in this case belong to the attorneys who labored to earn them."

1 Act (FEHA) that caused appellant to suffer emotional distress and lost wages.<sup>14</sup> The arbitration award  
2 does not mention any physical injury suffered by appellant-wife, nor has appellant-wife submitted any  
3 evidence of physical injury or medical treatment for physical injury. The arbitration award is dated  
4 June 18, 2003.<sup>15</sup> As for the attorney's fees, according to appellant (and not factually disputed by  
5 respondent):

6 "there was an enforceable agreement between appellants and their attorney...the  
7 agreement specifically allowed the attorney, in the alternative, to accept either the court  
8 awarded fees or a 40% contingency fee. The attorney chose to rely on the court awarded  
9 fees, and then added \$5,000 (with the client's consent)."<sup>16</sup>

9 Appellant-wife's arbitration attorney was Mr. Michael J. Faber of Santa Monica, California; see  
10 Respondent's Opening Brief, Exhibit G. He is not representing her in this tax proceeding.

11 During the Franchise Tax Board protest hearing, appellants' present tax attorney is  
12 quoted by the Franchise Tax Board protest hearing officer as stating: "It is unfair to make the taxpayer  
13 pay when the attorney has included the money in his income."<sup>17</sup> The FTB hearing officer in the protest  
14 unit responded as follows:

15 "IRC § requires each taxpayer to include all income in their gross income. The fact that  
16 both taxpayer and the attorney included income shows under IRC section 61, both earned  
17 income that was required to be included in their own gross income. The attorney's  
18 reporting does not alter the taxpayer's reporting. This is the normal process. A person  
19 earns gross income, that, they pay taxes on that income. Then they go and buy the  
20 services of someone else who now has gross income and that someone else then reports  
21 income and pays taxes. There are no provisions in the law for unfairness. Thus, no  
22 adjustment can be made for unfairness."<sup>18</sup>

20 In their Appeal Letter, appellants state: "Attorney Faber included \$150,000 in his income. Thus, a total  
21 of \$549,000 becomes subject to income tax."<sup>19</sup> Appellants have not substantiated that attorney Faber  
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23 <sup>14</sup> Respondent's Opening Brief, Exhibit F, pages 10-12.

24 <sup>15</sup> Respondent's Opening Brief, Exhibit F, page 13: 12.

25 <sup>16</sup> See Appellants' Responding Brief, page 2, paragraph 1; Respondent's Opening Brief, Exhibit M, page 2.

26 <sup>17</sup> Respondent's Opening Brief, Exhibit P, page 22.

27 <sup>18</sup> Respondent's Opening Brief, Exhibit P, page 23.

28 <sup>19</sup> Appellants' Responding Brief, Exhibit A thereto, page 3.

1 included the \$150,000 in the income reported on his personal or entity tax return for 2003. Respondent  
2 should have this information, but has not attempted to determine whether or not this is true. If attorney  
3 Faber reported this as his income, it is likely because TMS sent a separate \$150,000 check for this  
4 amount to him and did not include the \$150,000 in the 1099-MISC for \$249,000 it issued to appellant-  
5 wife.<sup>20</sup>

### 6 Contentions

7 Appellants do not deny receiving an arbitration award on June 18, 2003 totaling  
8 \$249,000, and admit they did not report \$48,100 of this amount, and that such \$48,100 is taxable. In  
9 their Appeal Letter, appellants “do[es] not dispute the full inclusion in income of this amount” of  
10 \$249,000 awarded by the arbitrator,<sup>21</sup> and in their reply brief state that the unreported \$48,100 “should  
11 not have been excluded since appellants cannot substantiate medical treatment received for such an  
12 amount.”<sup>22</sup> However, appellants argue that the \$150,000 in attorney’s fees treated as their 2003 income  
13 by respondent in fact belongs to the arbitration attorney (Mr. Faber), was reported by the arbitration  
14 attorney as his income on his 2003 return, and is not taxable income to appellants.<sup>23</sup>

15 Respondent treats the unreported \$198,100<sup>24</sup> as California adjusted gross income, with a pre-  
16 AMT miscellaneous itemized deduction for \$134,152 in legal fees that is added back under the AMT.

17 Appellants in their Appeal Letter argue that their arbitration attorney, Mr. Michael Faber,

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19 “indicates that this amount (\$150,000) was included as gross income on his 2003 income  
20 tax return. Taxpayer did not include this amount on her return as it was paid directly to  
21 her attorney and was not included on her Form, 1099 from Toyota. Taxpayer’s contention  
22 is that attorney’s fees recovered under FEHA prosecuted cases are not includible in the  
23 litigant’s income under California Government Code Section 12965(b).”<sup>25</sup>

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22 <sup>20</sup> See Respondent’s Opening Brief, Exhibit G (letter from arbitration attorney Faber to appellant-wife).

23 <sup>21</sup> Appellants’ Appeal Letter, page 1, paragraph 2.

24 <sup>22</sup> Appellants’ Responding Brief, page 1, paragraph 3. Thus, in the event appellants prevail in this appeal, the matter needs to  
25 be remanded to the Franchise Tax Board to issue an assessment for the regular income tax and/or AMT on \$48,100, plus  
26 interest.

26 <sup>23</sup> Appellants’ Appeal Letter, page 1, paragraph 3.

27 <sup>24</sup> The \$48,100 in emotional distress damages and the \$150,000 in attorney’s fees.

28 <sup>25</sup> Appellants’ Appeal Letter, page 1, paragraph 3.

1 Appellants also argue that the combined effect of taxing appellants on the full \$349,000, the AMT denial  
2 of the miscellaneous expenses deduction, and the fact that “[a]ttorney Faber included \$150,000 in his  
3 income” means:

4 “a total of \$549,000 becomes subject to income tax. This result seems totally  
5 unreasonable, especially since the law applied beginning in 2004 under the American  
6 Disabilities Act would allow taxpayer to exclude those fees ‘above the line’ and avoid the  
7 impact of the alternative minimum tax.”<sup>26</sup>

8 Thus, appellants dispute only the inclusion in their income of the \$150,000 in attorney’s fees, and admit  
9 they owe tax on the unreported \$48,100 in emotional distress damages. Appellants argue that under  
10 *Flannery v. Prentice* (2001) 26 Cal.App.4th 572 and its interpretation of FEHA (Government Code  
11 Section 12965, subdivision (b)), fees awarded under agreements such as appellants’ agreement with  
12 their arbitration attorney belong to the attorney rather than the client, absent an express written  
13 agreement to the contrary (which does not exist here).

14 Respondent argues that the \$150,000 in awarded attorney’s fees is part of the damages  
15 award recovered by appellants, and that the United States Tax Court has held that *Flannery v. Prentice*,  
16 *supra*, and other state law non-tax analysis of the ownership of legal fees is irrelevant to the issue of  
17 whether or not the attorney’s fees award portion of an arbitration award is included within the broad and  
18 sweeping definition of gross income in Internal Revenue Code (IRC) section 61 or are specifically  
19 excluded by IRC section 104(a)(2). See *Nancy J. Vincent v. Commissioner*, TC Memo Op. 2005-95,  
20 where the Tax Court stated at page 17, footnote 11 as follows:

21 “Petitioner’s reliance on *Flannery v. Prentice*, 26 Cal. 4th 572, 110 Cal.Rptr.2d 809, 28  
22 P.3d 860 (2001) is misplaced. We are not bound by State law classifications as to the  
23 ownership of income. . . . Any contingent attorney’s fees paid by petitioner on account of  
24 her (taxable) civil settlement would properly be income under *Commissioner v. Banks*,  
25 *supra*, and she may not escape this argument by arguing that, because her attorney’s fees  
26 and costs were awarded by a civil court pursuant to a statutory fee shifting provision, the  
27 income is properly attributable to her attorney. See *Sinyard v. Comm’r.*, 268 F.3d 756  
28 760 (9th Cir. 2001), affirming T.C. Memo 1998-364.”

29 Because California Revenue & Taxation Code (R&TC)<sup>27</sup> section 17131 specifically incorporates IRC

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31 <sup>26</sup> Appellants’ Appeal Letter, page 3, paragraph 1.

32 <sup>27</sup> All statutory references are to the Revenue and Taxation Code unless otherwise noted.

1 section 104, and because section 17071 specifically incorporates IRC section 61, United States Tax  
2 Court and other interpretations of these IRS provisions govern the California Personal Income Tax  
3 liability of appellants, not the California Supreme Court's interpretation of Government Code section  
4 12965.

5 Respondent in its Opening Brief does not address appellants' second argument that the  
6 \$150,000 has already been taxed as part of attorney Faber's income.

#### 7 Applicable Law

8 Appellants do not argue that the arbitration award falls within any of the exclusions  
9 contained in IRC section 104.<sup>28</sup> The California and federal AMT statutes treat itemized miscellaneous  
10 deductions as an add-back preference item, meaning that the AMT covered taxpayer must remove them  
11 from the Schedule A deduction category. See IRC section 56(b)(A)(i); section 17062.

12 In *Flannery v. Prentice* (2001) 26 Cal.4th 572, 575, the California Supreme Court held in  
13 the context of a fee dispute between a lawyer and a client regarding fees awarded pursuant to FEHA,  
14 fees awarded pursuant FEHA "absent proof on remand of an enforceable agreement to the contrary, the  
15 attorney fees awarded in this case belong to the attorneys who labored to earn them."

16 In *Commissioner of Internal Revenue v. Banks and Banaitis* (2005) 543 U.S. 426 at 430,  
17 the U.S. Supreme Court held that "as a general rule, when a litigant's recovery constitutes income, the  
18 litigant's income includes the portion of the recovery paid to the attorney as a contingent fee" because "a  
19 contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of  
20 the client's income from any litigation recovery"; *id.*, 543 U.S. at 434.

21 In *Sinyard v. Commissioner* (9th Cir. 2001) 268 F.3d 756, 758, the U.S. Court of Appeals  
22 for the Ninth Circuit affirmed the U.S. Tax Court's holding that legal fees awarded in the taxable portion  
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24 <sup>28</sup> Nor could they, because appellant-wife's arbitration award recovery is for a contractual right rather than "tort-type"  
25 recoveries excluded under certain circumstances by IRC section 104. See *United States v. Burke* (1992) 504 U.S. 229, 241-  
26 242; see also, *Commissioner v. Schleier* (1995) 515 U.S. 323, 328-329 (discussing requirement that injuries excluded from  
27 income be "on account of personal injuries or sickness."); *O'Gilvie v. United States* (1996) 519 U.S. 79, 82 (to be excluded  
28 from income, damage award must be "by reason of" or "because of" personal injuries). In addition, there is no proof that any  
part of the award was for physical injury, which is now the scope of the 1996-2004 coverage of IRC section 104. While this  
award entered on June 18, 2003 may constitute the type of anti-discrimination award eligible for an above-the-line deduction  
of attorney's fees under IRC section 62(a)(19), the effective date of the latter statute added by the American Jobs Creation  
Act of 2004 (118 Stat. 1418) is October 22, 2004, and the effective date of the California conformity statute (section 17072)  
is January 1, 2005. Both of these dates are subsequent to the 2003 date of the arbitration award.

1 of an Age Discrimination in Employment Act (ADEA) were taxable income to both the client and the  
2 attorney:

3 “If A owes B a debt, and C pays the debt on A’s behalf, it is elementary that C’s payment  
4 *is income to A as well as to B*. Here, James Sinyard had contracted to pay Witthrop &  
5 Weinstine one-third of what he might receive in settlement. His obligation to the law  
6 firm was satisfied by IDS. The payment is therefore income to him. “The discharge by a  
7 third person of an obligation to him is equivalent to receipt by the person taxed. Old  
8 Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929).” (Emphasis added)

9 Thus, in the emphasized portion of this opinion, the court held that the legal fees are income to both the  
10 client and the attorney. In *Nancy J. Vincent v. Commissioner*, TC Memo. Op. 2005-95, page 17,  
11 footnote 11, the United States Tax Court stated:

12 “Petitioner’s reliance on *Flannery v. Prentice*, 26 Cal. 4<sup>th</sup> 572 (2001) is misplaced. We  
13 are not bound by State law classifications as to the ownership of income. . . . Any  
14 contingent attorney’s fees paid by petitioner on account of her (taxable) civil settlement  
15 would properly be income under *Commissioner v. Banks*, *supra*, and she may not escape  
16 this argument by arguing that, because her attorney’s fees and costs were awarded by a  
17 civil court pursuant to a statutory fee shifting provision, the income is properly  
18 attributable to her attorney. See *Sinyard v. Comm’r.*, 268 F.3d 756 760 (9<sup>th</sup> Cir. 2001),  
19 affirming T.C. Memo 1998-364.”

20 California R&TC section 17131 specifically incorporates IRC section 104, and section 17071  
21 specifically incorporates IRC section 61. The Tax Court decision in *Nancy J. Vincent*, *supra*, and the  
22 federal court decisions in *Sinyard* and *Banks and Banaitis* are interpretations of IRC 61 and 104.

### 23 Staff Comments

24 Appellants’ argument that the \$150,000 in awarded attorney’s fees and transmitted by  
25 TMS directly to appellant’s arbitration attorney is taxable income to the attorney is an argument  
26 properly directed to the California Legislature or the United States Congress<sup>29</sup>, not this Board.<sup>30</sup> The  
27 IRC has long treated such anticipatory assignment of income as income to both the client and the  
28 attorney; see *Sinyard v. Commissioner*, *supra*, and *Old Colony Trust Co. v. Commissioner* (1929) 279

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29 The AMT denial of the legal fees deduction is the largest source of the problem. See Laura Sager & Stephen Cohen, How  
the Income Tax Undermines Civil Rights Law, 73 *So. Cal. L. Rev.* 1075, 1078 (2000), cited in, *Sinyard v. Commissioner*,  
*supra*, 268 F.3d at 762-763 (dissenting opinion of McKeown, J.). For anti-discrimination awards on or after October 22,  
2004, Congress created an above-the-line deduction for legal fees in the American Jobs Creation Act of 2004, and California  
conforms to this effective January 1, 2005, through R&TC section 17072.

30 The matter could also be the subject of the initiative process set forth in Article II of the California Constitution.

1 U.S. 716, 729. In *Commissioner of Internal Revenue v. Banks and Banaitis* (2005) 543 U.S. 426, at 432,  
2 the U.S. Supreme Court expressly reversed a U.S. Court of Appeals for the Ninth Circuit decision  
3 finding that

4 “contingent-fee agreements under Oregon law operate not as an anticipatory assignment  
5 of the client's income but as a partial transfer to the attorney of some of the client's  
6 property in the lawsuit.”

7 Thus, appellants’ state law arguments that the attorney’s fees belong to the attorney are irrelevant for  
8 IRC section 61 income definition purposes, and it is IRC section 61 (and federal cases interpreting IRC  
9 section 61 such as the U.S. Supreme Court cases cited herein) that are incorporated into California  
10 R&TC section 17131, not *Flannery v. Prentice*.

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