OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18053138
C. HEAD AND	)
Z. FELICIANO	)
	)
	)

OPINION

Representing the Parties:

For Appellants: Dashiell C. Shapiro, Wood LLP

For Respondent: Nathan H. Hall, Tax Counsel III

For Office of Tax Appeals: Andrea Long, Tax Counsel

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, C. Head and Z. Feliciano (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing to assess additional tax of $304,276, a late-filing penalty of $76,069, an accuracy-related penalty of $60,855.20, and applicable interest, for the 2013 tax year.

Appellants waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether proceeds received from the settlement of a lawsuit may be excluded from appellants' taxable income.
2. Whether the late-filing penalty may be abated.
3. Whether the accuracy-related penalty may be abated.

FACTUAL FINDINGS

1. Between 2002 and 2013, C. Head (appellant-husband) held dual appointments at the University of California, Los Angeles (UCLA) David Geffen School of Medicine as Associate Professor in Residence of Head and Neck Surgery and as the attending surgeon

at the West Los Angeles Campus of the Veteran Affairs (VA) Greater Los Angeles Healthcare System.

2. On April 17, 2012, appellant-husband filed a lawsuit against the Regents of the University of California (Regents) and individuals who were affiliated with UCLA (collectively, defendants). Appellant-husband raised numerous factual allegations of discrimination, harassment, retaliation and emotional distress. Appellant-husband alleged a campaign of harassment and intimidation by the defendants. One such example reportedly occurred at the year-end closing ceremony and party for the UCLA Head and Neck Department in or around June 2006 where appellant-husband was subjected to extreme public harassment that was retaliatory and racially offensive.

3. Appellant-husband's complaint dated April 17, 2012, alleged causes of action for: (1) discrimination; (2) harassment; (3) failure to prevent harassment, discrimination, and retaliation; (4) retaliation under the Fair Employment and Housing Act; (5) retaliation for whistleblowing under Labor Code section 1102.5; (6) intentional infliction of emotional distress; and (7) whistleblower protection from retaliation for UC employees under Government Code section 8547 and for attorneys' fees and costs for punitive damages.

4. The April 17, 2012 complaint stated that, as a "direct and proximate result of Defendant UC REGENTS conduct," appellant-husband suffered in numerous ways, including "physical and emotional pain, loss of self-esteem, stress, anxiety, sleeplessness, headaches, nervousness, stigma, loss of future earning capacity, humiliation, loss of enjoyment of life, and physical injury and manifestations including heart palpitations, nausea and other physical symptoms."

5. Appellant-husband subsequently amended his complaint. In his third amended complaint dated May 14, 2013, appellant-husband alleged causes of action for: (1) violation of Health and Safety Code section 1278.5; (2) violation of Labor Code sections 98.6 and 1102.5; (3) retaliation for whistleblowing; (4) discrimination; (5) harassment; (6) retaliation; (7) failure to prevent discrimination, harassment, and retaliation; (8) defamation; and (9) intentional infliction of emotional distress. The complaint sought judgment for compensatory damages including, but not limited to: (1) lost wages, benefits, and non-economic damages; (2) attorneys' fees; (3) cost of suit; (4) punitive damages and penalties; (5) prejudgment interest; and (6) injunctive relief from the

defendants engaging in discrimination, harassment and retaliation and to enjoin them from violating California Labor laws and California Health and Safety laws.

6. The third amended complaint did not include language alleging any "physical injury." With regard to the cause of action for intentional infliction of emotional distress, the third amended complaint alleged that appellant-husband "suffered severe emotional distress, depression, trauma, and nightmares as a result of Defendant's conduct."

7. In a June 24, 2016 letter from appellant-husband's primary care physician, Dr. Mattimore, the physician states that appellant-husband was diagnosed with "hypertension, coronary artery disease and prediabetes" in 2012.[1] The physician notes that "these conditions are consistent with physiological consequences of the nature, scope and duration of workplace stress and harassment that [appellant-husband] described." The physician asserts that "the medical conditions, including hypertension and chronic cardiovascular disease, were caused and exacerbated by the stress and harassment that [he] has described and continues to experience." The physician adds that "the psychological symptoms, including post-traumatic stress disorder, were an additional medical consequence of this stress …." The physician states that, based on his recommendation, appellant-husband was placed on medical disability for 11 months.

8. According to a letter from appellant-husband's employer dated April 24, 2013, appellant-husband was on a medical leave of absence from his employment beginning October 18, 2012. The letter indicates that on April 12, 2013, appellant-husband provided a note from his health care provider to his employer requesting an extension of the leave to May 12, 2013. The letter indicates that the health care provider requesting the extension is Dr. Shuman, whereas the health care provider who wrote the above-referenced June 24, 2016 letter is Dr. Mattimore. The letter does not indicate the specific reason for appellant's medical leave of absence.[2]

[1] We note that the letter states that appellant-husband suffered from a heart attack in August 2015. Because the heart attack occurred two years after the settlement of the lawsuit at issue, it will not be addressed further.

[2] The letter notes that the leave is designated as "paid time off" and that appellant-husband exhausted his leave entitlement under the Family Medical Leave Act and California Family Rights Act. The letter requests further information from appellant-husband to receive additional paid time off, such as a written statement from his physician stating he is "unable to work for reasons of extended personal illness, injury, or disability." The letter also provides information as to the process for appellant-husband to claim benefits under other programs, such as the Americans with Disabilities Act.

Settlement Agreement

9. On July 23, 2013, appellant-husband and the Regents executed a Settlement Agreement and Release of All Claims (Settlement Agreement) to resolve and settle all of the claims in the lawsuit against the defendants. In addition to listing the causes of action from the third amended complaint, the agreement states that appellant-husband "alleges he suffered damages including physical injuries and physical manifestation of emotional injuries in this case." The agreement also states that, although the Regents denies and disputes appellant-husband's claims and allegations, the parties enter into the agreement "to avoid the substantial expense and inconvenience of further litigation"

10. The Settlement Agreement provides a "General Release of All Claims" that releases and discharges the defendants from "any and all causes of action."[3] The agreement further provides that appellant-husband resign from his employment with the Regents effective the date of the Settlement Agreement.

11. The terms of the Settlement Agreement require the Regents to pay $125,000 directly to appellant-husband and to pay $4,375,000 jointly to appellant-husband and his attorneys, for a total payment amount of $4,500,000. The Settlement Agreement is silent as to how the $4,375,000 should be allocated. The Settlement Agreement states: "The Regents has made no representation about and takes no position on the tax consequences of this [Settlement Agreement]."

12. Appellants and FTB agree that the $125,000 payment was for back wages and this amount is not in dispute. The remaining $4,375,000 was paid to appellant-husband's attorneys who deducted attorneys' fees and transferred the remaining $2,310,097 to appellants as a net settlement payment.[4]

[3] The "General Release of All Claims" provides, in part, that appellant-husband "unconditionally, irrevocably and absolutely releases and discharges the [defendants] … from any and all causes of action, judgments, liens, indebtedness, damages, losses, claims (including attorneys' fees and costs), liabilities and demands of whatsoever kind and character that [appellant-husband] may now or hereafter have against the RELEASED PARTIES arising from incidents or events occurring on or before the EFFECTIVE DATE of this AGREEMENT."

[4] Appellant-husband commenced a second employment discrimination case on March 3, 2014, against the VA, and appeared before the House Veterans Affairs Committee to testify against the VA on July 8, 2014. Appellant-husband's declaration dated March 14, 2016, filed in his lawsuit against the VA, stated: "This hostile environment has led to undue stress on me, which has resulted in physical manifestations and serious health consequences." We note that this complaint was filed after the settlement was reached with the Regents.

2013 Return

13. Appellants untimely filed their 2013 California return on September 25, 2015, reporting taxable income of $532,944 and total tax of $46,529. Appellants did not report the $2,310,097 settlement payment on their return.

14. FTB issued a Notice of Proposed Assessment (NPA) on April 5, 2016. The NPA increased appellants' taxable income by $2,365,106, which included the settlement payment of $2,310,097 and disallowed itemized deductions of $55,009.[5] The NPA proposed an assessment of additional tax of $304,276, a late-filing penalty of $76,069, and an accuracy-related penalty of $60,855.20, plus interest.

15. On December 29, 2017, FTB issued a Notice of Action, affirming the NPA. This timely appeal followed.

DISCUSSION

Issue 1 - Whether proceeds received from the settlement of a lawsuit may be excluded from appellants' taxable income.

It is well established that a presumption of correctness attends FTB's determinations of fact and that taxpayers have the burden of proving such determinations erroneous. (*Appeal of Williams, et al.* (82-SBE-018) 1982 WL 11695.) To overcome the presumed correctness of FTB's finding as to issues of fact, taxpayers must introduce credible evidence to support their assertions, and if they do not support their assertions with such evidence, FTB's determinations must be upheld. (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.) FTB's determination that an exclusion should be disallowed is presumed correct and taxpayers must prove their entitlement to the claimed exclusion. (*Appeal of House* (93-SBE-016) 1993 WL 460749.)

R&TC section 17071 incorporates Internal Revenue Code (IRC) section 61, which defines "gross income" to include "all income from whatever source derived," except as otherwise provided by statute. R&TC section 17131 incorporates IRC section 104. As relevant here, IRC section 104(a)(2) excludes from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as

[5] The disallowed itemized deductions of $55,009 is not at issue in this appeal. The disallowance of these itemized deductions appears to be due to a limitation on itemized deductions for California taxpayers filing jointly whose federal adjusted gross income exceeds $200,000. (See R&TC, § 17077(a); IRC, § 68(a).)

periodic payments) on account of personal physical injuries or physical sickness." IRC section 104(a) provides in part that "[f]or purposes of [IRC section 104(a)(2)], emotional distress shall not be treated as a physical injury or physical sickness," except for damages not in excess of the cost of medical care attributable to emotional distress. When damages are received under a settlement agreement, the nature of the claim that was the actual basis for the settlement determines whether the damages are excludable under IRC section 104(a)(2). (*Stepp v. Commissioner*, T.C. Memo. 2017-191.) The nature of the claim is generally determined by reference to the terms of the agreement. (*Ibid.*)

Appellants argue that appellant-husband suffered physical injuries as a result of the harassment and that, therefore, they are entitled to exclude the settlement payment from their income, pursuant to IRC section 104(a)(2). FTB contends that the origin of the claim that formed the basis of the settlement award was not related to physical injury or physical sickness and, therefore, appellants cannot exclude the settlement payment from their gross income. As noted above, we may determine whether a settlement payment is excludable under IRC section 104(a)(2) by examining the terms of the settlement agreement. In this case, the agreement states that the parties desire to settle all claims, including "all claims asserted in the ACTION, all issues that were raised or could have been raised in the ACTION and any claims or potential claims arising from any transactions or occurrences to date …." Such a general release so broad and inclusive does not determine the nature of the claim. (*Green v. Commissioner*, T.C. Memo. 2014-23.) Furthermore, although the agreement mentions "personal injuries" among a list of other claims, the agreement does not allocate any portion of the payment to physical injuries and is, in fact, silent as to the allocation of the payment. This indicates that the compensation was not for physical injuries. (See *Ahmed v. Commissioner*, T.C. Memo. 2011-295, affd. (11th Cir. 2012) 498 Fed.Appx. 919; *Evans v. Commissioner*, T.C. Memo. 1980-14 ["In the absence of an allocation of the settlement among the various claims, all of the payment must be included in petitioner's gross income"].)

When a settlement agreement lacks express language stating what the settlement amount was paid to settle, then the most important factor in determining any exclusion under IRC section 104(a)(2) is the intent of the payor regarding the purpose in making the payment. (*Simpson v. Commissioner* (2013) 141 T.C. 331, 340.) The intent of the payor in making the payment may be determined by examining all the facts and circumstances of the case, including

the complaint that was filed and the details surrounding the litigation. (*Allum v. Commissioner*, T.C. Memo. 2005-177.) In *Ahmed v. Commissioner*, *supra*, the court concluded that a settlement payment was not for physical injuries, given that the complaint placed little emphasis on physical injuries, that the settlement agreement's only mention of "personal injuries" was in boilerplate language, and that no other evidence showed that any part of the settlement was for personal injuries.

While appellant-husband's original complaint alleged "physical injuries," the original complaint provides little emphasis on his alleged physical injuries. The third amended complaint alleges multiple causes of action that were also alleged in the original complaint, including discrimination, harassment, retaliation, and intentional infliction of emotional distress. However, the third amended complaint removed the original complaint's references to any alleged physical injuries. The lack of emphasis on "physical injuries" in both the Settlement Agreement and the third amended complaint strongly suggests that the purpose of the payment was not to compensate appellant-husband for physical injuries and physical sickness, but was attributable to appellant-husband's numerous other claims.

FTB further contends that, to the extent any compensation was paid on account of such physical manifestations of emotional distress, those amounts are still includable in appellants' gross income. FTB notes that the legislative history of IRC section 104(a) states that it "is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress. (H.R. Conf. Rep. No. 104-737, at p. 301 n. 56 (1996).) However, before determining whether any of the payments appellant-husband received under the settlement agreement qualify for the exclusion, the evidence must indicate that the payments were made on account of "personal physical injuries or physical sickness" within the meaning of IRC section 104(a)(2). (See *Lindsey v. Commissioner* (8th Cir. 2005) 422 F.3d 684, 689.)

Here, appellants have not established the required direct causal link between the amount paid and the asserted physical injuries. (See *Banaitis v. Commissioner* (9th Cir. 2003) 340 F.3d 1074, 1080.) Appellants provide no credible, contemporaneous evidence to establish that appellant-husband suffered from physical ailments as a result of the defendants' conduct, much less that his purported physical ailments were the reason for the settlement payment. In this regard, we note that the physician's letter provided by appellants is dated June 24, 2016, three

years after the Settlement Agreement in 2013. Appellants have not shown that they provided any evidence of appellant-husband's alleged physical ailments to the Regents in connection with his lawsuit. As appellants have not demonstrated that any part of the settlement was to compensate appellant-husband for physical injuries and physical sickness, we do not reach any determination as to whether appellant-husband's alleged physical injuries would qualify for the exclusion.

Appellants cite to *Parkinson v. Commissioner*, T.C. Memo. 2010-142 (*Parkinson*), in which the court allowed an exclusion under IRC section 104(a)(2) where the petitioner alleged that he suffered a heart attack as a direct result of misconduct by coworkers, which he claimed amounted to intentional infliction of emotional distress. The court held that it is "self-evident that a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress." (*Ibid*.) The settlement agreement did not expressly allocate or characterize the settlement payment, other than to state it was made as "noneconomic damages and not as wages or other income." (*Ibid*.) The court held that at least one-half of the settlement payment was attributable to claims of physical injury because the petitioner's physical injuries were the overriding focus of the complaint. (*Ibid*.) However, unlike in *Parkinson*, appellant-husband's complaint placed little emphasis on his physical ailments, and appellants have not shown that any part of the payment was attributable to his purported physical ailments as opposed to the other claims which were the primary focus of his complaint.

Appellants also cite to *Domeny v. Commissioner*, T.C. Memo. 2010-9, where the court held that a portion of a settlement payment was made on account of physical injuries, even though the settlement agreement was silent as to the payor's intent. In that case, the settlement payments were segregated into three separate payments: wage compensation, attorneys' fees, and nonemployee compensation. (*Ibid*.) Unlike the wage compensation and attorneys' fees, a Form 1099-MISC was issued for the nonemployee compensation and there was no reduction for withholding. Due to the differing tax and reporting treatments for the payments, the court determined that the payor was aware that at least part of the settlement -- the nonemployee compensation -- may not be subject to tax, i.e., was due to physical illness and excludable under IRC section 104(a)(2). (*Ibid*.) Additionally, the petitioner provided evidence proving that she was physically ill and that she advised the payor of her illness (multiple sclerosis) before her employment was terminated. (*Ibid*.)

In the present appeal, the Settlement Agreement states, "The Regents has made no representation about and takes no position on the tax consequences of this [Settlement Agreement]." Therefore, the Regents specifically communicates that we should not draw any conclusion as to whether the payments were meant to be included in appellants' gross income based on the terms of the agreement or the tax treatment of the payments. Additionally, appellants have not offered credible, contemporaneous evidence proving appellant-husband's physical ailments, or that those ailments were the basis for the Regents' settlement payment. As stated above, the Settlement Agreement does not allocate payments to physical injury or sickness, and the complaints placed little emphasis on appellant-husband's physical ailments, indicating that the payments were not compensation for appellant-husband's alleged physical injuries or physical sickness. (See *Molina v. Commissioner*, T.C. Memo. 2013-226.)

Accordingly, appellants have failed to prove that any portion of the payments received under the Settlement Agreement was to compensate appellant-husband for physical injuries or physical sickness, within the meaning of IRC section 104(a)(2). Thus, we determine that the Settlement Agreement proceeds may not be excluded from appellants' taxable income.

Issue 2 - Whether the late-filing penalty may be abated.

California imposes a penalty for failing to file a valid return on or before the due date, unless the taxpayers show that the failure is due to reasonable cause and not due to willful neglect. (R&TC, § 19131.) The late-filing penalty is calculated at 5 percent of the tax for each month or a fraction thereof that the return is late, with a maximum penalty of 25 percent of the tax. (R&TC, § 19131(a).) To establish reasonable cause, the taxpayers must show that the failure to file timely returns occurred despite the exercise of ordinary business care and prudence, or that such cause existed as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of Tons* (79-SBE-027) 1979 WL 4068.)

FTB did not receive appellants' 2013 return until September 25, 2015, which is more than 1.5 years after the filing due date of April 15, 2014. Therefore, the late-filing penalty applies unless appellants can show reasonable cause for the late filing of the return.

Illness or other personal difficulties may be considered reasonable cause if the taxpayers present credible and competent proof that they were continuously prevented from filing a tax return. (*Appeal of Halaburka* (85-SBE-025) 1985 WL 15809.) When taxpayers allege

reasonable cause based on an incapacity due to illness or the illness of an immediate family member, the duration of the incapacity must approximate that of the tax obligation deadline. (See *Wright v. Commissioner*, T.C. Memo. 1998-224, citing *Hayes v. Commissioner*, T.C. Memo. 1967-80.) However, if the difficulties simply caused the taxpayers to sacrifice the timeliness of one aspect of their affairs to pursue other aspects, the taxpayers must bear the consequences of that choice. (*Appeal of Orr* (68-SBE-010) 1968 WL 1640.) The taxpayers' selective inability to perform tax obligations, while participating in regular business activities, does not establish reasonable cause. (*Watts v. Commissioner* (1999) T.C. Memo. 1999-416.)

Appellants argue that the delay in filing was due to appellant-husband's stress, medical depression, and anxiety from the harassment he experienced. However, despite appellant-husband's claims of disability, appellant-husband was able to appear before the House Veterans Affairs Committee to testify against the VA on July 8, 2014, which is only about three months after the filing due date of the 2013 tax return. Therefore, appellant-husband was not incapacitated and unable to timely file his return because he was able to conduct other business affairs. Additionally, the medical records provided do not indicate that appellant-husband suffered from any health conditions that caused him to be unable to timely file his return. Furthermore, appellants provide no evidence to show that appellant-wife was unable to file the return in the absence of appellant-husband's alleged inability to timely file. Appellants provide no evidence of steps taken to timely file their return or that they were prevented from filing their return despite the exercise of ordinary business care and prudence. Therefore, appellants have not established reasonable cause for the late filing of the return and the late-filing penalty may not be abated.

Issue 3 - Whether the accuracy-related penalty may be abated.

IRC section 6662, incorporated by R&TC section 19164, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. IRC section 6662(b) provides, in relevant part, that the penalty applies to the portion of the underpayment attributable to any substantial understatement of income tax. A substantial understatement of tax exists if the understated amount exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. (IRC, § 6662(d)(1).) An "understatement" is defined as the excess of the amount of tax required to be shown on the return for the tax year over the amount of the tax imposed which is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2).) The

accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to the underpayment. (IRC, § 6664(c)(1).)

The proposed assessment is for a revised total tax of $350,805, while appellants reported tax of $46,529. The understatement of $304,276 (i.e., $350,805 - $46,529) exceeds $35,080.50, which is the greater of 10 percent of the tax required to be shown on the return (i.e., 10 percent of $350,805) or $5,000. Accordingly, the penalty is properly imposed based on the substantial understatement of tax.

Appellants argue that the penalty should not be imposed because they correctly excluded the amounts received on account of physical injuries. However, as discussed above, appellants have not established that the compensation may be excluded from their taxable income. Appellants provide no other evidence or argument to show reasonable cause for the substantial underpayment. Additionally, while there are exceptions that allow for the accuracy-related penalty to be reduced or eliminated,[6] appellants do not provide any argument or evidence establishing that any of the exceptions apply. Accordingly, appellants have not shown that the accuracy-related penalty should be abated.

[6] Taxpayers may reduce or eliminate the understatement if they successfully demonstrate the following exceptions: (1) the taxpayers had substantial authority for their treatment of any item giving rise to the understatement; (2) the relevant facts affecting the item's tax treatment were adequately disclosed and there is a reasonable basis for the tax treatment of such item; or (3) the underpayment of any portion of the underpayment was due to reasonable cause and the taxpayers acted in good faith with respect to such portion of the underpayment. (IRC, §§ 6662(d)(2)(B), 6664(c)(1).)

HOLDINGS

1. The proceeds awarded in the settlement of the lawsuit may not be excluded from appellants' taxable income.
2. The late-filing penalty may not be abated.
3. The accuracy-related penalty may not be abated.

DISPOSITION

FTB's action is sustained.

DocuSigned by:
Josh Lambert
B90E40A720E3440...
Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
John O Johnson
873D9797B9E64E1...
John O. Johnson
Administrative Law Judge

DocuSigned by:
Jeffrey I. Margolis
5E9822FBB1BA41B...
Jeffrey I. Margolis
Administrative Law Judge

Date Issued: 3/11/2020