

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No. 19075028  
D. HAGER AND )  
C. HAGER )  
\_\_\_\_\_ )

**OPINION**

Representing the Parties:

For Appellants: Christopher Hamilton, Attorney

For Respondent: Sonia Woodruff, Tax Counsel IV  
David Hunter, Tax Counsel IV

For Office of Tax Appeals: Grant S. Thompson, Tax Counsel IV

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, D. Hager and C. Hager (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing \$84,695 of additional tax, and applicable interest, for the 2015 tax year.

Office of Tax Appeals Administrative Law Judges Josh Lambert, Huy “Mike” Le, and Andrea L.H. Long held a virtual oral hearing for this matter on May 19, 2021. At the conclusion of the hearing, the record was closed and this matter was submitted for a written opinion.

**ISSUE**

Whether a damage award received by D. Hager (appellant-husband) is excluded from gross income pursuant to Internal Revenue Code (IRC) section 104(a)(2).<sup>1</sup>

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<sup>1</sup> As relevant to the issues here, California conforms to IRC section 104 pursuant to R&TC section 17131.

FACTUAL FINDINGSAppellant-Husband's Lawsuit*Complaint*

1. On April 30, 2007, appellant-husband filed a 24-page complaint against defendants, the Los Angeles County Sheriff's Department (LACSD) and various unidentified individuals,<sup>2</sup> before the Superior Court of the State of California. The complaint alleges a concerted effort by LACSD to fabricate and conceal evidence of criminal conduct by one or more deputies and a conscious plan to violate appellant-husband's rights "in the method and manner in which he was terminated." The complaint includes the following allegations:
  - a. LACSD received information from an informant indicating that Deputy JA had come across a methamphetamine lab and was "taken care of." An initial homicide investigation led to an execution of a search warrant affidavit in which a detective filed an affidavit declaring that he believes "Deputy [X]" and other unidentified individuals murdered Deputy JA to prevent the exposure of their criminal activity. The affidavit was given to a supervisor who took no action on it. Information on the murder investigation was leaked to Deputy X by LACSD personnel.
  - b. Appellant-husband interviewed an informant who stated that he could provide information on a large methamphetamine dealer, that the "word on the street" was that Deputy JA had been killed, and that Deputy X was "dirty."
  - c. An Assistant Sheriff ordered appellant-husband to assist the Drug Enforcement Agency (DEA) in its investigation of the narcotics case.
  - d. During the investigation, appellant-husband and his DEA counterpart obtained additional reports that Deputy JA was killed and that Deputy X was a suspect. Informants stated that Deputy X would keep seized narcotics and warn a major drug dealer "when the 'heat' was on and to shut down operations."
  - e. Sergeant "H," who had been assigned to investigate the disappearance of Deputy JA, conducted a "reinvestigation in which he 're-interviewed'" some informants and witnesses, as well as some investigators. Sergeant H concluded that there was an

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<sup>2</sup> We will be referring to the defendants collectively as LACSD for simplicity.

- “overwhelming” likelihood that Deputy JA killed himself. The investigation by Sergeant H was flawed. Among other things, he did not interview all informants, and he made untrue statements.
- f. At a meeting, appellant-husband confronted Sergeant H about misstatements, and the meeting was abruptly ended. A lieutenant who supervised appellant-husband was ordered to prepare a report. The lieutenant later delivered a lengthy memorandum regarding the relevant facts.<sup>3</sup>
  - g. Appellant-husband was subsequently transferred to another division “and on April 24, 2002 was placed on medical disability due to injuries previously suffered on duty.” Appellant-husband feared for his safety and met with an FBI agent to disclose what he knew.
  - h. While criminal cases were pending from the DEA task force, LACSD defamed and disparaged appellant-husband. Among other things, LACSD represented to the U.S. Attorney’s Office that appellant-husband had lied in search warrants and affidavits, and Deputy X “told whoever would listen” in LACSD that appellant-husband had lied. A DEA agent and Assistant U.S. Attorney sought to interview six deputies concerning the seizure of methamphetamine labs, and they refused, stating “they did not want to talk because [appellant-husband] was caught lying in the investigation, [appellant-husband] had 14 internal investigations open, [appellant-husband] was a ‘[expletive]-bird.’” Appellant-husband believes that LACSD continues to defame him in order to justify its retaliatory termination.
  - i. As a result of appellant-husband’s work with the DEA task force, over 32 individuals were convicted, he was rated as “outstanding” in reviews, and he received awards.
  - j. Appellant-husband believes that various persons filed false complaints with LACSD against him.
  - k. On or about December 3, 2002, appellant-husband was informed of LACSD’s intent to terminate him based on allegations that he had conducted a “personnel investigation” of Deputy X, “recklessly accused” Deputy X of illegal activities, and made false statements. These allegations were false and known to be false or made with reckless disregard for the truth as appellant-husband’s information was

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<sup>3</sup> This panel has reviewed the memorandum; however, it will not be summarized here.

corroborated by an independent investigation conducted by a homicide detective, was obtained with the assistance with a DEA agent, and was corroborated by tape recordings and reports.

- l. On July 28, 2003, LACSD terminated appellant-husband's employment, falsely asserting, among other things, that he had violated policy by recklessly accusing Deputy X of illegal activities and making these allegations to his superiors, and by making false statements to his supervisor concerning information from wire taps and informants.
  - m. Appellant-husband believes that his termination was retaliation for his reporting of information concerning Deputy X and the disappearance of Deputy JA, was intended to cover up potential or actual criminal activity by members of LACSD, and that the termination constituted "[a] renewed and continual assertion and publication of the defamatory statements and claims by defendants, all of which were communicated to third parties, and were intended to destroy [appellant-husband]'s career as a law enforcement officer."
  - n. Appellant-husband believes that on or about August 12, 2003, and subsequently, LACSD provided his home address and mailing address to third persons without his permission, creating a danger to his personal safety and violating his privacy.
2. The complaint lists two causes of action: for retaliatory discharge for reporting of information on criminal matters, and for wrongful termination in violation of public policy. It alleges that, as a result of LACSD's actions, appellant-husband "suffered general and special damages, including, but not limited to, past and future wage loss and other employment compensation and benefits . . . ." It further alleges that he "suffered severe mental and emotional pain and suffering, including but not limited to, grief, shame, humiliation, embarrassment, anger, disappointment, damage to reputation, and worry . . . ." The complaint also states that appellant-husband protested illegal activities, which subjected him to retaliation by LACSD. The complaint seeks general and special damages, according to proof.

*Motion to Exclude Evidence*

3. Appellant-husband's counsel moved to exclude evidence that appellant-husband was awarded a medical disability retirement. The counsel argued that evidence of such

medical disability payments was “completely irrelevant” and constituted a “collateral source” of funds that should not be allowed to reduce any damages that might have to be paid by LACSD. He further argued that appellant-husband paid for the insurance as consideration for his employment and that LACSD should not be able to obtain a credit for something that appellant-husband paid for.

4. LACSD’s trial counsel argued that the evidence should not be barred because it goes to the issue of damages. The counsel further argued that “the disability doesn’t have anything to do with the gravamen of this lawsuit, but it impacts the issue of damages because the plaintiff, in terms of loss of income, in fact, can’t work any longer.”
5. The court denied the motion to exclude the evidence.

#### *Opening Statements*

6. In his opening statement, appellant-husband’s trial counsel argued that appellant-husband “was forced to take a medical disability retirement from an injury he received” in March of 2002. He further argued that the disability benefit is “basically [that] you get whatever your accrued retirement is early[,]” so that “you get less over your retired life.” The trial counsel argued that, because of his termination, appellant-husband was “unemployable; his reputation has been destroyed; and, indeed, he lives in fear” because LACSD refused to grant him a permit to carry a concealed weapon and criminals know where he lives. He did not reference the fact appellant-husband was injured while chasing a suspect or argue that the injury was caused by LACSD.
7. In his opening statement, LACSD’s trial counsel primarily argued that appellant-husband was not wrongfully terminated. He further argued that “coincidentally,” appellant-husband has been on medical disability, which he went on “[w]ithin a few days after being terminated,” and that “he was declared by his physicians to be physically incapable of working as a deputy sheriff because of that unrelated injury.”

#### *Evidence Presented at Trial*

8. Extensive evidence was presented at the trial. The trial transcript is over 1,600 pages and numerous exhibits were presented. The trial cannot be fully summarized here but we will highlight some of the testimony as relevant to this appeal. Appellant-husband testified as follows:

- i. He was injured in March of 2002 while working with Special Agent B. He had just arrested a suspect and the suspect “slipped her handcuffs out of the backseat of his undercover car[,]” opened the door and jumped out of the vehicle. He pursued the suspect with Special Agent B behind him and then tripped landing flat on his stomach and face. He was able to knock the suspect’s feet out from under her, and Special Agent B detained the suspect. He was in pain “just about everywhere.” He continued to work, although he continued to suffer pain. He initially did not take time off. He went to the emergency room but “they really didn’t do anything until later down the road.”
- ii. At the beginning of April of 2002, he was informed he was the subject of an internal affairs investigation while he was participating in a surveillance operation. He was informed he had been accused of falsifying affidavits and making false statements.
- iii. When asked what happened after being informed of the internal affairs investigation, appellant-husband stated, “That’s when I was off injured on duty. I decided since I wasn’t working the case anymore that I would take care of my medical issues.” He suffered pain in his neck and spine and testified that “injured on duty” means that “it’s work-related” so that “your medical bills and your compensation should be picked up by your employer.” A doctor placed him off duty due to his injuries.
- iv. He was subsequently placed off duty again and “went through several treatments.”
- v. After he received a notice of intent to terminate his employment in December of 2002, it was recommended that he undergo cervical spinal surgery. However, he chose not to undertake the surgery because he feared the surgery could cause a loss of neck mobility, and, as he “was already being terminated,” he did not feel “it was worth the surgery, since [he] didn’t have a job to go back to.”
- vi. He received a medical disability retirement.

9. An orthopedic surgeon retained by appellant-husband’s counsel testified as follows:
- i. Appellant-husband had “a number of injuries” with the “main injury” occurring in March of 2002, when he was “chasing a prisoner and fell, injuring multiple areas.”
  - ii. The surgeon testified that he was aware that appellant-husband received a medical disability retirement and that appellant-husband’s job classification required “arduous” activities. As of 2003, appellant-husband was medically disabled within the “arduous” classification.
  - iii. There were some procedures that might have ameliorated or cured appellant-husband’s neck problem. The primary procedure was neck surgery to address appellant-husband’s disk problems through a fusion. Such a fusion would involve removing disk material, inserting bone between the vertebra, and applying a metal plate and screws. There are potential complications and, “by the very nature of the operation, we remove some motion from the neck.” However, “surprisingly,” some people have effectively normal range of motion, particularly in their thirties. “Theoretically, we’re taking away, at most, 20 percent of the motion.” However, “in reality, the other levels can kind of make up for that so that a person can certainly get good motion.” “It may not be a hundred percent, but it’s generally functionally satisfactory ..... ”<sup>4</sup>
10. One of the trial exhibits was a Physician’s Examination and Findings, dated July 30, 2003, which was prepared to evaluate appellant-husband for disability retirement. The report examines prior medical records, including medical records associated with appellant-husband’s March 2002 injury. It states that “the major thrust of his industrial problems from an orthopaedic standpoint stem from the March 2002 incident.” It finds “significant limitation of motion of the cervical spine” and that “extension of the cervical spine caused immediate pain . . . .” It states the doctor’s opinion that a successful cervical fusion would allow appellant-husband to return to full duty as a deputy sheriff. In summary, it finds that appellant-husband is unable to perform the arduous duties required by his employee classification and has met the guidelines for a service-connected disability retirement.

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<sup>4</sup> The excerpt of testimony that was provided cuts off here.

*Jury Instructions*

11. The judge advised the jury that they must consider all the evidence and decide what they think occurred based on the evidence admitted in the trial.
12. In addition, the trial judge advised the jury as follows:

*“The following are the specific items of noneconomic damages which are claimed by [appellant-husband]:*

*“Past and future mental suffering, loss of employment [sic.]<sup>5</sup> of life, anxiety, loss of reputation, and/or emotional distress.*

“No fixed standard exists for deciding the amount of these noneconomic damages. You must use your judgment to decide a reasonable amount based on the evidence and your common sense.

“To recover for future mental suffering loss of enjoyment, life, anxiety, loss of reputation and/or emotional distress, a plaintiff [must] prove that he or she is reasonably certain to suffer that harm.

“For future mental suffering, loss of enjoyment of life, anxiety, loss of reputation, and/or emotional distress, determine the amount in current dollars paid at the time of judgment that will compensate the plaintiff for such noneconomic loss.

“This amount of noneconomic damages should not be further reduced to present cash value because that reduction should only be performed – be performed with respect to economic damages.” (Trial Transcript, pp. 3920 – 3922, italics added.)

*Initial Closing Arguments of Appellant-Husband’s Trial Counsel*

13. In his initial closing arguments, appellant-husband’s trial counsel argued that appellant-husband was terminated for allegedly conducting a personnel investigation, “recklessly accusing another deputy of criminal conduct,” and “allegedly lying to his supervisor.” He contended that these types of circumstances not only preclude employment but “shatter[] your reputation.” With regard to damages, appellant-husband’s trial counsel argued that appellant-husband’s reputation had been “destroyed” and that he could not get a job or “hold his head up” because he was wrongly fired for something he did not do

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<sup>5</sup> From the context, it appears the judge meant to refer to “loss of enjoyment.” This “[sic.]” notation is in the trial transcript.



and that “no self-respecting policeman would ever do.” He concluded that “[t]he emotional distress, loss of earnings, . . . I submit to you, is in a range of [\$]2 million to \$5 million, depending upon how you view the devastating effects on his reputation, on his psyche, on his ability to live with himself.”

*Closing Arguments of Defense Trial Counsel*

14. LACSD’s trial counsel argued that it did not make sense for appellant-husband to claim past loss of earnings and future loss of earnings. LACSD’s trial counsel argued that, due to appellant-husband’s medical disability retirement, he could no longer work as a deputy sheriff even if he had not been terminated. On this ground, he argued that appellant-husband could not claim loss of earnings due to the termination of his employment.

*Rebuttal Closing Argument of Appellant-Husband’s Trial Counsel*

15. In his rebuttal arguments, appellant-husband’s trial counsel noted that a doctor testified that appellant-husband had a “good chance” of going back to work if he had surgery and that the damage analysis “was predicated upon a \$72,000 a year salary.” He argued that this was the base salary of a deputy salary and that alternative security employment would have paid somewhere between \$50,000 and \$100,000 a year, or about \$75,000, “midrange.” He further stated: “So that if we take this one step further – setting aside this whole issue of the physical – he was prevented from getting gainful employment because the department was out to destroy him.” He further argued that, “[w]hen you’re a cop, your whole being is wrapped up in that[,]” that the jury had seen on the stand what it means for a cop to have their gun and badge taken, that it’s their “entire reputation,” and that LACSD “destroyed him – in order to bury this [Deputy X] and [Deputy JA] issue once and for all.”

*Jury Verdict*

16. The jury found that appellant-husband disclosed information to a government or law enforcement agency, that he had “reasonable cause to believe that the information disclosed constituted a violation of California or Federal statute(s)[,]” that LACSD retaliated against him for disclosing the information, and that the retaliation caused him damages.

17. The jury awarded total damages of \$4,506,015, consisting of \$806,041 for past economic damages, \$1,199,974 for future economic damages, and \$2,500,000 for past noneconomic damages.

*Court of Appeal Opinion*

18. Following an initial ruling and petitions for rehearing from both parties, the California Court of Appeal ruled on rehearing that there was no substantial evidence to support the award of economic damages.<sup>6</sup> It therefore reversed the award of economic damages and otherwise sustained the trial court’s judgment.
19. The Court of Appeal found that substantial evidence supported the verdict that terminating appellant-husband for falsely reporting wiretapped conversations was a pretext. However, the court determined that the award of economic damages must be reversed because appellant-husband “was disabled and could not perform the job of deputy sheriff with or without accommodations.”
20. The Court of Appeal found that LACSD showed that appellant-husband “took medical disability leave (*unrelated to the charged policy violations that led to his termination*)” prior to the termination of his employment. (Italics added.) It further found that, as there was no evidence appellant-husband was able to continue to work as a deputy sheriff, he was not entitled to recover backpay.
21. Appellant-husband’s trial counsel argued to the court that LACSD’s wrongful conduct “forever destroyed” his ability to obtain employment in his field and sought to distinguish a case that did not involve an industrial disability. However, the court rejected this argument, stating that appellant-husband’s “medical disability, that is, injury to his neck and back, is *unrelated* to any wrongful conduct associated with [appellant-husband’s] termination or damage to his reputation.” (Italics added.)

Appellants’ 2015 Return

22. During 2015, following a jury trial, appellant-husband received an award of \$3,098,662, including interest and litigation costs. After subtracting attorney’s fees and expenses,

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<sup>6</sup> Appellants provided a full copy of the court’s decision, which was filed on August 5, 2014. On August 19, 2014, the court modified the opinion and certified it for partial publication. The modifications are not relevant to the issues on appeal. (See *Hager v. County of Los Angeles, et al.* (2014) 228 Cal.App.4th 1538.)

- amounts paid to a litigation finance company and amounts advanced to appellant-husband in a prior tax year, appellant-husband received \$892,069.
23. Appellants did not report any income from the award on their 2015 California income tax return.
  24. On January 26, 2017, following an audit, FTB issued a Notice of Proposed Assessment proposing additional taxable income of \$892,069 from the 2015 judgment, and additional taxable income of \$350,000 from a 2012 advance provided by a litigation finance company.
  25. During protest, FTB determined that the 2012 advance of \$350,000 was not taxable in 2015 but that the proposed assessment was otherwise correct. Accordingly, on June 11, 2019, FTB issued a Notice of Action proposing additional income of \$892,069 and additional tax of \$84,695, plus interest. Appellants then filed this timely appeal.

## DISCUSSION

### Introduction

A presumption of correctness attends FTB’s determinations of fact and taxpayers have the burden of proving such determinations erroneous. (*Appeal of Head & Feliciano*, 2020-OTA-127P.) FTB’s determination that an exclusion from income should be disallowed is presumed correct and taxpayers must prove their entitlement to the claimed exclusion. (*Ibid.*)

IRC section 61 defines “gross income” to include “all income from whatever source derived,” except as otherwise provided by statute.<sup>7</sup> IRC section 104(a)(2) excludes from gross income “the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness.” IRC section 104(a) provides in relevant 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. However, Treasury Regulation section 1.104-1(c)(1) provides that “damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2).”

Appellants argue that appellant-husband’s noneconomic damage award should be excluded from taxable gross income on the ground that the jury awarded the damages “on

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<sup>7</sup> As relevant here, R&TC section 17071 incorporates IRC section 61.

account of” appellant-husband’s physical injury. More specifically, appellants argue that the noneconomic damages were paid as a result of the injury appellant-husband suffered while chasing a suspect in March of 2002 and that LACSD’s retaliatory conduct exacerbated appellant-husband’s injury. In addition, appellants assert that “since [appellant-husband] has established the link between his physical injury and damages he received, all damages related to such physical injury, even emotional damages, are not taxable under IRC § 104(a)(2).”

In order to demonstrate that the damages were awarded “on account of” appellant-husband’s physical injury, appellants must show a “direct causal link” between the damages and the physical injury. (See, e.g., *Rivera v. Baker West, Inc.* (9th Cir. 2005) 430 F.3d 1253 (*Rivera*), 1257; *Domeny v. Commissioner*, T.C. Memo. 2010-9 (*Domeny*)).) Where damages are received pursuant to a settlement agreement, the language of the settlement agreement may show whether the damages were paid on account of physical injury. (See, e.g., *Rivera, supra*; *Domeny, supra*.) However, where there is no settlement agreement, or the settlement agreement does not resolve the issue, courts may rely on the jury’s verdict, or other facts and circumstances of the litigation, to determine why the payor paid the damages. (See, e.g., *Vincent v. Commissioner*, T.C. Memo. 2005-95 (*Vincent*); *Domeny, supra*.)

Here, LACSD paid the noneconomic damages pursuant to a jury’s verdict, rather than pursuant to a settlement agreement. Therefore, in order to determine whether the damages were paid “on account of” appellant-husband’s physical injuries, we consider all the facts and circumstances of the litigation, including the complaint, evidence and argument presented at trial, the judge’s instructions to the jury, and the jury’s findings.

#### Complaint

Appellant-husband’s complaint argues that LACSD unlawfully retaliated against him, defamed him, and destroyed his career. It contends that, as a result of LACSD’s actions, appellant-husband “suffered general and special damages, including, but not limited to, past and future wage loss and other employment compensation and benefits, all in a sum according to proof.” The complaint highlights that appellant-husband “suffered severe mental and emotional pain and suffering, including but not limited to, grief, shame, humiliation, embarrassment, anger, disappointment, damage to reputation, and worry, all to his detriment and according to proof.”

The complaint does not expressly seek damages for physical injury or physical sickness. It only briefly mentions appellant-husband’s physical injuries. Specifically, it notes that

appellant-husband was transferred and shortly thereafter “was placed on medical disability due to injuries previously suffered on duty.” The 24-page complaint does not otherwise reference the physical injuries appellant-husband suffered while chasing a suspect.

Appellants point to other sections of the complaint that allege LACSD directed spite and hatred toward appellant-husband, defamed him, retaliated against him, and endangered his safety. However, the complaint does not expressly tie these allegations to the physical injuries suffered by appellant-husband, and these allegations appear consistent with an award of damages for defamation and pain and suffering.

Appellants note that Treasury Regulation section 1.104-1(c)(1) provides that damages for pain and suffering can be excluded from income if the pain and suffering arose from a physical injury. However, the complaint does not allege that the claimed pain and suffering resulted from appellant-husband’s physical injuries.

It is difficult to read the complaint and conclude that appellant-husband was seeking damages for the physical injuries he suffered while chasing a suspect. However, as appellants point out, the complaint’s claimed damages are stated broadly and could include damages for physical injury or physical sickness. Moreover, it is possible that, while the complaint did not emphasize appellant-husband’s physical injuries, later testimony and evidence could establish that damages should be paid on account of appellant-husband’s physical injury. Therefore, while we do not find that the complaint shows that damages were paid on account of physical injury, it does not foreclose that possibility.

#### Motion to Exclude Evidence

FTB argues that appellant-husband’s trial counsel moved to exclude evidence of appellant-husband’s injuries and medical disability from the trial. FTB notes that LACSD’s counsel responded by saying that “the disability doesn’t have anything to do with the gravamen of this lawsuit, but it impacts the issue of damages because the plaintiff, in terms of loss of income, in fact, can’t work any longer.” FTB contends that the motion shows that appellant-husband’s medical issues were “unrelated to his employment lawsuit.”

However, it appears that the trial counsel sought to exclude evidence that appellant-husband received a medical disability retirement, rather than excluding any evidence of appellant-husband’s injuries. The trial counsel’s goal was to prevent LACSD from using

appellant-husband's disability retirement income to reduce the amount of economic damages that appellant-husband might otherwise have received.

The court denied the motion. As noted below, the trial court subsequently allowed the introduction of evidence regarding the injuries appellant-husband suffered while chasing a suspect.

The motion to exclude evidence relates to the calculation of appellant-husbands's economic damages. Furthermore, we do not place any weight on the statement of LACSD's trial counsel that appellant-husband's medical issues were "unrelated to his employment lawsuit[.]" because this is simply an assertion of opposing counsel. While the motion to exclude evidence does not demonstrate that appellant-husband's medical issues were unrelated to his noneconomic damages, it also does not support appellants' position that noneconomic damages were awarded on account of appellant-husband's physical injuries.

#### Opening Statements

The opening statements do not support appellants' argument that LACSD paid the damages on account of physical injury. Appellant-husband's trial counsel argued that, because of the circumstances of the termination of his employment, appellant-husband was "unemployable," his reputation was "destroyed," and he "lives in fear." He did not reference the fact appellant-husband was injured while chasing a suspect or argue that LACSD caused the injury.

#### Evidence Presented at Trial

The evidence presented at trial regarding appellant-husband's physical injuries and disability retirement related to the issue of economic damages. LACSD's trial counsel argued that appellant-husband did not lose earnings because, due to his injuries, he could not have continued his employment with LACSD even if LACSD had not terminated his employment. The evidence presented does not link appellant-husband's physical injury with retaliatory acts or other conduct by LACSD. For example, appellant-husband's trial counsel did not ask appellant-husband why he did not call for backup, and appellant-husband's testimony does not indicate that he had to chase the suspect because he could not call for backup. Instead, appellant-husband's trial counsel argued that the injuries were not so severe that appellant-husband could not do any type of work and that LACSD's conduct limited his ability to obtain other work.

Appellants argue that appellant-husband “introduced evidence at trial that LACSD’s retaliatory conduct exacerbated [appellant-husband]’s injury.” In support, appellants point to trial testimony that appellant-husband could have undergone a surgery that might have cured his neck injury but he chose not to do so because he had no job to return to and there were risks associated with the surgery.

However, the testimony does not suggest that appellant-husband’s physical injuries worsened due to his decision not to undergo surgery. Rather, the testimony suggests that appellant-husband’s physical injuries might have improved if he had elected to undergo surgery. Even if the testimony could support an inference that the termination of appellant-husband’s employment exacerbated his physical injuries, there is no evidence that the jury made this same conclusion and awarded noneconomic damages on this ground.

In sum, although the jury was presented with evidence of appellant-husband’s physical injuries, the trial record does not suggest that the jury awarded, or that LACSD paid, noneconomic damages on account of those injuries.

#### Jury Instructions

The jury instructions do not expressly reference the physical injuries appellant-husband suffered while chasing a suspect or any claim for damages for physical injuries. The trial judge initially advised the jury that “the specific items of noneconomic damages” claimed by appellant-husband are “Past and future mental suffering, loss of employment [sic.] of life, anxiety, loss of reputation, and/or emotional distress.” The trial judge then twice instructed the jury with regard to potential damages for “future mental suffering, loss of enjoyment of life, anxiety, loss of reputation, and/or emotional distress.”

Appellants point out that the trial judge also advised that the jury should consider all the evidence presented at trial and this evidence included evidence of appellant-husband’s physical injuries. Appellants argue that we should infer that the jury awarded noneconomic damages for the physical injury based on all the facts and circumstances. Appellants, citing to *Morton v. Manhattan Lunch Co.* (1940) 41 Cal.App.2d 70, 72, state that “a jury’s role is not only to find the ultimate facts established by the evidence, but to make any *reasonable inferences that arise from the facts . . .*” In this connection, appellants note that the jury found that appellant-husband suffered acts of retaliation and heard evidence that he feared for his safety. However,

we see nothing in the trial record to show that the jury strayed from the judge’s instructions by also considering to compensate appellant-husband for his physical injuries.

Appellants argue that the noneconomic damages should be excluded from gross income on the theory that they were paid on account of emotional distress that arose from appellant-husband’s physical injuries. (See Treas. Reg. § 1.104-1(c)(1).)

In general, these types of damages do not constitute damages paid for physical injuries or physical illness. (See *Murphy v. IRS* (D.C. Cir. 2007) 493 F.3d 170, 175-176, finding that damages paid for mental pain, anguish, and damage to reputation did not constitute damages paid for physical injuries.) However, Treasury Regulation section 1.104-1(c)(1) states an exception under which damages for emotional distress may be excluded from gross income if the damages are attributable to physical injury or physical illness.

Appellants have not shown that this exception applies here. The jury was not asked to award damages on the basis that appellant-husband’s physical injuries caused him emotional distress, and appellants have not shown that the jury did so.

#### Closing Arguments

In his closing arguments, appellant-husband’s trial counsel never argued that appellant-husband was physically injured because he had to chase a suspect due to difficulty obtaining backup; never argued that appellant-husband incurred medical expenses for which he should receive damages; and never argued that appellant-husband’s physical injuries caused him emotional distress. Rather, with respect to damages, appellant-husband’s trial counsel asked the jury to award damages based on damages to appellant-husband’s reputation, his employability, and his psyche, as a result of LACSD wrongly terminating his employment. Therefore, the closing arguments suggest that the jury awarded noneconomic damage on these grounds, rather than on account of appellant-husband’s physical injuries.

Appellants contend that appellant-husband’s trial counsel had to “avoid lengthy discussion of [appellant-husband]’s injuries, because those injuries resulted from [his] failure to follow standard protocols.” Appellants state that standard protocol would have required appellant-husband to call for backup so that the suspect could be secured in a police car with a cage to ensure the suspect could not escape. They contend that the fact he did not do so could have been used by LACSD’s attorney to defend the wrongful termination claim. On this ground,



appellants contend that appellant-husband's trial counsel "had to walk a fine line by focusing on the retaliatory conduct and not the physical injuries resulting from that conduct."

We are not persuaded by this explanation. In short, we find it unlikely that the jury awarded damages based on an argument that was not raised at trial.<sup>8</sup>

### Jury Verdict

The jury awarded total damages of \$4,506,015, consisting of \$806,041 for past economic damages, \$1,199,974 for future economic damages, and \$2,500,000 for past noneconomic damages. The jury's verdict does not indicate whether the noneconomic damages were based on physical injuries or physical sickness, or other damages such as emotional distress and injury to reputation.

### Court of Appeal Opinion

Appellants argue that the Court of Appeal opinion is irrelevant because it does not address the noneconomic damages at issue in this appeal. However, the court's opinion discusses the injury suffered while appellant-husband was chasing a subject, which forms the basis of appellants' claim that the noneconomic damage award was paid on account of physical injury. The Court of Appeal makes it clear that appellant-husband's injuries were "*unrelated* to any wrongful conduct associated with [appellant-husband's] termination or damage to his reputation." (Italics added.)

### Summary

Based on our review of the litigation, we find that appellants have not shown a "direct causal link" between the award of noneconomic damages and appellant-husband's physical injuries. (See *Rivera, supra.*) While the jury heard evidence of appellant-husband's physical injuries, there is no evidence that the jury awarded noneconomic damages on account of those injuries. (See *Vincent, supra.*) On the contrary, as discussed above, our review of the litigation indicates that the jury awarded noneconomic damages for mental suffering, loss of enjoyment of life, anxiety, loss of reputation, and/or emotional distress.

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<sup>8</sup> On appeal, appellants provide declarations indicating that appellant-husband was injured in March of 2002 because he felt he could not call for backup because of animus and threats directed to him from other LACSD deputies. However, these declarations were made after the trial. Therefore, they do not show that the jury found that LACSD's conduct caused appellant-husband's physical injuries, that the jury awarded noneconomic damages on account of those injuries, or that LACSD paid noneconomic damages on account of the injuries.

Appellants argue that *Domeny, supra*, should control the result and supports a determination that an award of noneconomic damages is not taxable. In *Domeny*, the court determined that the taxpayer's settlement compensation was not taxable because the terms of the settlement agreement provided that a portion of the award would be reported as wage income and a portion would be reported as nonemployee compensation. From the terms of the settlement agreement and the differing tax and reporting treatments used for the payments, the court inferred that the taxpayer's former employer was aware that a part of the taxpayer's recovery may not have been subject to tax.

Unlike the tax court in *Domeny*, we have the ability to review the complaint, trial testimony, appellant-husband's closing arguments, and the judge's jury instructions, in order to determine whether noneconomic damages were paid on account of appellant-husband's physical injuries. While the tax court found that *Domeny* made "no other claim," the trial record here indicates that appellant-husband claimed noneconomic damages for mental suffering, loss of enjoyment of life, anxiety, loss of reputation, and/or emotional distress. There is no indication in the trial record that appellant-husband claimed damages on the ground that the termination of his employment worsened his physical injuries, or that the jury award damages on this ground. We thus find that appellant-husband's damage award was not made on account of physical injuries or physical sickness; therefore, the damage award is not excluded from gross income.

#### HOLDING

The damage award received by appellant-husband is not excluded from gross income pursuant to IRC section 104(a)(2).

DISPOSITION

FTB’s action is sustained.

DocuSigned by:

*Andrea L.H. Long*

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Andrea L.H. Long  
Administrative Law Judge

We concur:

DocuSigned by:

*Josh Lambert*

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Josh Lambert  
Administrative Law Judge

DocuSigned by:

*Huy "Mike" Le*

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Huy "Mike" Le  
Administrative Law Judge

Date Issued: 8/23/2021