

**OFFICE OF TAX APPEALS  
STATE OF CALIFORNIA**

In the Matter of the Appeal of:  
**M. PHAN**

) OTA Case No. 22019551  
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**OPINION**

Representing the Parties:

For Appellant: M. Phan

For Respondent: Brian Werking, Tax Counsel III

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. Phan (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$915.00, a late-filing penalty of \$228.75, and applicable interest for the 2019 tax year.

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

**ISSUES**

1. Whether appellant has established error in FTB’s determination that appellant has a filing requirement for the 2019 tax year and owes tax.
2. Whether appellant has established reasonable cause to abate the late-filing penalty.

**FACTUAL FINDINGS**

**Appellant’s Complaints Against the Marukai Corporation and the Settlement Agreement**

1. On August 15, 2018, appellant filed a complaint with the Department of Fair Employment and Housing (DFEH) against the Marukai Corporation (Marukai) for employment discrimination. In the complaint, appellant stated that she worked for Marukai as a sushi chef from January 2015 to October 2017. Appellant alleged that she was subject to sexual harassment at Marukai beginning around July 2015. Appellant also

- alleged that she suffered a rash after being relocated to a workstation near the frying area of the kitchen around September 2017. DFEH issued a right to sue letter, which closed its investigation and permitted appellant to bring civil action against Marukai.
2. On December 6, 2018, appellant filed a complaint with the Superior Court of California against Marukai for a severe hostile work environment, sexual harassment in the workplace, retaliation, and wrongful termination. Appellant sought damages for past and future loss of earnings and benefits, damages for severe and disabling mental and emotional distress, punitive damages, and attorneys' fees. The complaint includes the following allegations:
    - a. Appellant experienced sexual harassment in the workplace and filed several complaints with her supervisors. Marukai retaliated against appellant for filing these complaints by relocating appellant next to a hot food fryer and an industrial heat blower where appellant developed a rash.
    - b. Appellant experienced shoulder, back, and disk injuries from lifting heavy boxes during her employment at Marukai. Appellant filed several complaints with her supervisors about her pain and discomfort, to no avail.
    - c. Appellant wrote a letter to Marukai's president explaining the abuse and sexual harassment she experienced in the workplace. Appellant received no response and was terminated shortly thereafter with no reason given.
    - d. Appellant suffered from severe anxiety, depression, insomnia, nightmares, headaches, memory loss, and incontinence because of being wrongfully terminated and the harassment she experienced at Marukai.
  3. On July 2, 2019, appellant signed a settlement agreement with Marukai. The terms of the settlement agreement provided that appellant would receive a total gross amount of \$70,000, "which includes settlement related to [appellant's] alleged personal bodily injuries." The settlement agreement stated that appellant "acknowledges and agrees that this settlement payment is in full settlement of any and all claims asserted by [appellant] or that could have been asserted by [appellant] against [Marukai]."

4. The settlement agreement states Marukai will report the settlement payment to the IRS on Form 1099-Miscellaneous and the settlement payment will be issued to the William M. Crosby Client Trust Account.<sup>1</sup>

#### Procedural History

5. FTB received information showing that appellant received \$41,237 of income reported on a Form 1099-Miscellaneous issued by William M. Crosby Trust Account.<sup>2</sup> FTB determined that appellant had a 2019 filing requirement.<sup>3</sup> On June 15, 2021, FTB issued a Request for Tax Return to appellant asking appellant to file her 2019 California tax return because FTB did not have a record of her 2019 California tax return. Appellant did not respond.
6. Subsequently, FTB issued a Notice of Proposed Assessment (NPA) proposing to assess tax of \$915.00 and a late-filing penalty \$228.75, plus interest, based on the \$41,237.00 of income reported on the Form 1099-Miscellaneous.
7. Appellant protested the NPA. Appellant claimed that the \$41,237 of income was for “pain and suffering compensation . . . .”<sup>4</sup> In a supplementary letter, appellant explained to FTB that she is not able to pay the proposed assessment because she has been unemployed since 2017 and has several health conditions preventing her from working/earning income.
8. FTB issued a Notice of Action affirming the NPA.
9. This timely appeal followed.
10. On appeal, appellant provides letters from her chiropractor, counselor, and psychiatrist stating that appellant suffers from lupus, spine injury, moderate to severe anxiety, depression, neck and shoulder pain, and rashes.

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<sup>1</sup> W. Crosby was appellant’s attorney during the lawsuit against and settlement with Marukai.

<sup>2</sup> It appears that appellant received \$41,237 of the \$70,000 settlement payment after deducting attorney’s fees.

<sup>3</sup> For the 2019 tax year, the filing threshold for a single individual under 65 years of age with no dependents was California gross income of \$18,241 or adjusted gross income of \$14,593.

<sup>4</sup> With her protest, appellant provided several letters from healthcare professionals explaining her physical impairments.

## DISCUSSION

### Issue 1: Whether appellant has established error in FTB’s proposed assessment.

A presumption of correctness attends FTB’s determinations of fact, and taxpayers have the burden of proving such determinations erroneous. (*Appeal of Head and 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.*)

Internal Revenue Code (IRC) section 61(a) defines “gross income” to include “all income from whatever source derived” except as otherwise provided by statute.<sup>5</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.”<sup>6</sup> For purposes of IRC section 104(a), emotional distress is not treated as physical injury or physical sickness, except for damages not in excess of the cost of medical care attributable to emotional distress.

Where damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for the settlement controls whether such damages are excludable. (*U.S. v. Burke* (1992) 504 U.S. 229, 237.) The taxpayer must show that the settlement proceeds were in lieu of damages for personal physical injuries or physical sickness. (*Bagley v. Commissioner* (1995) 105 T.C. 396, 406.) If the 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. (*Appeal of Head and Feliciano, supra.*) The payor’s intent is based on all the facts and circumstances of the case, including the complaint that was filed and the details surrounding the litigation. (*Rivera v. Baker West, Inc.* (9th Cir. 2005) 430 F.3d 1253, 1257.) The nature of the claim cannot be determined from a general release that is broad and inclusive. (*Appeal of Head and Feliciano, supra.*)

Appellant argues that Marukai intended the settlement payment to compensate her for personal physical injuries or physical sickness. To support her position, appellant provides letters from her chiropractor, counselor, and psychiatrist confirming that she experienced a rash, and shoulder, back, and disk injuries. Appellant provided the complaint she filed with the DFEH

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<sup>5</sup> R&TC section 17071 incorporates IRC section 61.

<sup>6</sup> R&TC section 17131 incorporates IRC section 104.

showing she experienced a rash while working at Marukai. However, appellant's complaint did not assert any claims based on personal physical injury or physical illness, nor did appellant's complaint mention the allegations filed with the DFEH. While the settlement agreement stated that the settlement payment includes a settlement related to appellant's alleged personal bodily injuries, appellant made claims against Marukai only for a severe hostile work environment, sexual harassment in the workplace, retaliation, and wrongful termination. In the action, appellant also sought damages for past and future loss of earnings and benefits, damages for severe and disabling mental and emotional distress, punitive damages, and attorneys' fees only. Although the Office of Tax Appeals (OTA) does not question that appellant undoubtedly suffered emotional distress and its consequential effects, Congress explicitly provided that "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. (IRC, § 104(a).) Appellant has not alleged or shown that the settlement payment should be reduced by the cost of medical care.

In addition, the settlement agreement states Marukai will report the settlement payment to the IRS on Form 1099-Miscellaneous. The issuance of a Form 1099-Miscellaneous is an indication that Marukai intended that the entire settlement payment be taxable because Marukai did not allocate the \$70,000 settlement payment between taxable and non-taxable amounts. (*Domeny v. Commissioner*, T.C. Memo. 2010-9.) Based on the evidence in the record, Marukai's intent for making the settlement payment was not to compensate appellant for personal physical injury or physical illness. Therefore, appellant has not established that the settlement payment was for personal physical injuries or physical sickness.

#### Appellant's Asserted Inability to Pay

Appellant argues that she is not able to pay the proposed assessment. However, the question of determining the correct amount of the tax liability versus the question of a taxpayer's ability to pay a tax liability are two separate and distinct concepts. (*Appeal of Robinson*, 2018-OTA-059P.) While OTA is sympathetic to appellant's situation, OTA lacks the authority to

make discretionary adjustments to a proposed assessment of tax based on a taxpayer's ability to pay.<sup>7</sup> (*Ibid.*) Therefore, appellant has not established error in FTB's proposed assessment.

Issue 2: Whether appellant has established reasonable cause to abate the late-filing penalty.

California imposes a penalty for failing to file a return on or before the due date, unless the taxpayer shows that the failure is due to reasonable cause and not due to willful neglect. (R&TC, § 19131(a); *Appeal of Xie*, 2018-OTA-076P.) When FTB imposes a penalty, it is presumed to have been imposed correctly. (*Ibid.*) A taxpayer may rebut this presumption by providing credible and competent evidence supporting abatement of the penalty for reasonable cause. (*Ibid.*) Reasonable cause for late filing is shown when the evidence establishes that an ordinarily intelligent and prudent businessperson would have acted similarly under the same circumstances. (*Appeal of Head and Feliciano*, *supra.*)

Here, appellant has not provided an explanation that would demonstrate reasonable cause for failing to timely file a 2019 tax return. As discussed above, appellant failed to substantiate her assertions that she did not have a filing requirement because her income was not taxable. Accordingly, appellant has not established reasonable cause to abate the late-filing penalty.

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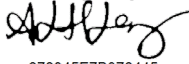
<sup>7</sup> FTB may consider appellant's inability to pay under its payment arrangement or offer-in-compromise programs. If appellant is experiencing difficulties in paying her liabilities once the decision in this appeal is final, she may contact FTB to discuss payment options. (See <https://www.ftb.ca.gov/pay/if-you-cant-pay/index.html>.)

HOLDINGS

1. Appellant has not established error in FTB’s determination that appellant has a filing requirement for the 2019 tax year and owes tax.
2. Appellant has not established reasonable cause to abate the late-filing penalty.

DISPOSITION

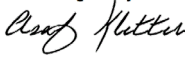
FTB’s action is sustained in full.

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Andrea L.H. Long  
 Administrative Law Judge

We concur:

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Asaf Kletter  
 Administrative Law Judge

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Richard Tay  
 Administrative Law Judge

Date Issued: 8/17/2023