

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:

K. FRIERSON AND
L. FRIERSON

) OTA Case No. 22029721
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OPINION

Representing the Parties:

For Appellants:

K. Frierson
L. Frierson

For Respondent:

Bradley J. Coutinho, Tax Counsel III

For Office of Tax Appeals:

Andrew Jacobson, Tax Counsel III

A. KLETTER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, K. Frierson and L. Frierson (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$10,329 and applicable interest for the 2016 tax year.

Appellants waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUE

Whether appellants have shown error in FTB’s proposed assessment of additional tax, which is based on a federal determination.

FACTUAL FINDINGS

1. Appellants timely filed their joint 2016 California Resident Income Tax Return (California return).
2. FTB received information from the IRS that it had audited and determined that appellants failed to include other income of \$111,056 reported on a federal Form 1099-MISC and

interest income of \$11.¹ Accordingly, the IRS increased appellants' federal adjusted gross income (AGI) by \$111,067. On July 29, 2019, the IRS's determination became a final federal determination for the 2016 tax year.²

3. On July 27, 2020, FTB issued appellants a Notice of Proposed Assessment (NPA) proposing to follow the IRS adjustments and increase appellants' California AGI by \$111,067, consisting of other income of \$111,056 and interest income of \$11.³
4. Appellants filed a timely protest. Their protest letter dated August 18, 2020, stated that they had responded to the IRS regarding their 2016 federal tax liability. Appellants disagreed with FTB's proposed assessment on the grounds that that half of the compensation from a lawsuit involving Ecolab, *Ross v. Ecolab Inc.*, was for punitive damages, which they claimed is not taxable. Appellants also asserted that they had made \$37,019 in tax payments to cover tax liabilities, which they contended should result in a California refund. Appellants included copies of their 2016 California return and 2016 federal return, federal audit documentation, and documentation concerning *Ross v. Ecolab Inc.*
5. FTB acknowledged the protest in a letter dated March 5, 2021, and requested documentation reflecting that the federal audit was being reconsidered. In a letter dated July 9, 2021, FTB stated that it would affirm its position unless appellants provided proof that the IRS cancelled or reduced its assessment. FTB received no response to its letters. On January 25, 2022, FTB issued a Notice of Action affirming the NPA.
6. Appellants' timely appeal followed. On appeal, appellants contend that they are still "fighting the IRS" as they disagree with its decision. Appellants attach various correspondences with the IRS concerning their 2016 federal tax liability, and a copy of a statement issued by CPT Group, Inc. (CPT statement), the settlement administrator for

¹ The 2016 IRS CP2000 Data Sheet dated March 11, 2022, indicates that the \$111,056 in other income was from "Ross v. Ecolab Fund" and the \$11 in interest was from "McKesson Employees." Wage income was also reported by "Ross v. Ecolab Fund" on federal Form W-2 which is not at issue in this appeal. Appellants do not provide any argument concerning the \$11 in interest. Accordingly, OTA does not address it further.

² The IRS assessed an accuracy-related penalty, but FTB did not follow this adjustment. It is not at issue.

³ For personal income tax purposes, California generally conforms to Internal Revenue Code (IRC) section 62, defining federal AGI, except as otherwise provided. (R&TC, § 17072(a).) A taxpayer must generally report the same federal AGI from the federal return on his or her California return, subject to California-specific addition and subtraction modifications.

Ross v. Ecolab Fund, to appellant K. Frierson. The CPT statement includes a 2016 federal Form 1099-MISC and a 2016 federal Form W-2.

DISCUSSION

When the IRS makes a final federal determination, a taxpayer must concede the accuracy of the federal changes to a taxpayer's income or state where the changes are erroneous. (R&TC, § 18622(a).) It is well settled that a deficiency assessment based on a federal adjustment to income is presumed to be correct and a taxpayer bears the burden of proving that FTB's determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Valenti*, 2021-OTA-093P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Gorin*, 2020-OTA-018P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Valenti, supra*; *Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.) However, OTA is not required to follow a federal determination and can conduct an independent investigation to determine whether it believes the federal determination is erroneous. (*Appeals of Lovinck Investments N.V. and Star Prospect International Limited*, 2021-OTA-294P; *Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104; *Appeal of Black*, 2023-OTA-023P.)

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. California conforms to the general inclusion of settlement payments in gross income. (*Ibid.*; *Appeal of Head and Feliciano*, 2020-OTA-127P.) Exclusions from gross income are construed narrowly. (*Polone v. Commissioner* (9th Cir. 2007) 505 F.3d 966, 969, citing *Commissioner v. Schleier* (1995) 515 U.S. 323, 328.) "[T]he taxpayer bears the burden of showing that he [or she] falls squarely within the requirements for the exclusion." (*Forste v. Commissioner*, T.C. Memo. 2003-103.)

R&TC section 17131 incorporates IRC section 104. 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 periodic payments) on account of personal physical injuries or physical sickness."⁴ (*Ibid.*; *Appeal of Head and Feliciano, supra.*) IRC

⁴ IRC section 104(c) states that the phrase (other than punitive damages) shall not apply to punitive damages awarded in a civil action which is a wrongful death action. Appellants do not argue, and the evidence does not show that IRC section 104(c) is applicable.

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.

At protest, appellants claimed that \$111,056 of the settlement reported by the *Ross v. Ecolabs Fund* on Form 1099-MISC should be excluded from their 2016 gross income as punitive damages. However, the exclusion from gross income under IRC section 104(a) is limited to personal physical injuries and physical sickness. (*Ibid.*; *Appeal of Head and Feliciano, supra.*)

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). (*U.S. v. Burke* (1992) 504 U.S. 229, 237; *Appeal of Head and Feliciano, supra.*) The nature of the claim is generally determined by reference to the terms of the settlement agreement. (*Bagley v. Commissioner* (1995) 105 T.C. 396, 406; *Appeal of Head and Feliciano, supra.*) “The critical question is, in lieu of what was the settlement amount paid.” (*Bagley v. Commissioner, supra.*) Where the settlement agreement does not expressly allocate the payment to specific claims, 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*, citing *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.)

The record on appeal does not contain a copy of the settlement agreement for *Ross v. Ecolab Inc.*, or any other documents that show that the settlement encompassed any personal physical injuries or physical sickness suffered by appellant K. Frierson. At protest, appellants attached a summary judgment order dated September 28, 2015, which indicates that *Ross v. Ecolab Inc.* concerned overtime, meal breaks, wages, and other labor code violations. Furthermore, the CPT statement indicates that one-half of the settlement proceeds represents “alleged unpaid wages” that are to be reported on the 2016 Form W-2, while the other half of the settlement proceeds are “allocated as penalties and interest” that are to be reported on the 2016 Form 1099-MISC. These documents strongly suggest that the purpose of the settlement payment was not to compensate appellant K. Frierson for physical injuries and physical sickness but was attributable to the claims arising in the lawsuit. Appellants have failed to establish their right to

an exclusion from gross income. (*Forste v. Commissioner, supra*, T.C. Memo 2003-103.)

On appeal, appellants provided copies of letters that they wrote to the IRS dated April 1, 2019, August 15, 2019, and February 27, 2020, in which they stated that they disagreed with the IRS’s imposition of additional tax. These do not establish that the IRS reduced the assessment. (*Appeal of Valenti, supra*.) On appeal, FTB provided appellants’ 2016 account transcript dated March 11, 2022, which shows that the final federal determination has not been cancelled or reduced. Therefore, appellants have failed to show that the IRS has modified or revised the federal determination upon which FTB’s proposed assessment is based.⁵

HOLDING

Appellants have not shown error in FTB’s proposed assessment of additional tax, which is based upon a federal determination.

DISPOSITION

FTB’s action is sustained.

DocuSigned by:

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Asaf Kletter
Administrative Law Judge

We concur:

DocuSigned by:

CB1E7DA37831416
Josh Lambert
Administrative Law Judge

DocuSigned by:

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Veronica I. Long
Administrative Law Judge

Date Issued: 5/26/2023

⁵ Appellants also asserted they had made sufficient tax payments to cover their federal and state tax liabilities. Their 2016 Form 1099-MISC does not show that CPT withheld any federal or state taxes. Rather, it appears that on their federal return, appellants reported only \$37,019 from the *Ross v. Ecolab Inc.* settlement.