Simpson v. Commissioner, 141 T. C. No. 10 (2013)

In Simpson v. Commissioner, the U. S. Tax Court ruled that a settlement payment received by Kathleen Simpson was not excludable from gross income under I. R. C. § 104(a)(1) as a workers' compensation benefit due to lack of required state approval. However, 10% of the settlement was excludable under § 104(a)(2) for personal physical injuries. The court also allowed a deduction for attorney's fees and costs under § 62(a)(20). This decision highlights the complexities of tax treatment of settlement proceeds and the importance of statutory compliance.

Parties

Kathleen S. Simpson and George T. Simpson, Petitioners, v. Commissioner of Internal Revenue, Respondent. The Simpsons were the taxpayers challenging the IRS's determination of tax deficiency. The Commissioner of Internal Revenue represented the government's position on the tax treatment of the settlement proceeds received by Kathleen Simpson.

Facts

Kathleen Simpson, an employee of Sears, Roebuck & Co. , suffered physical and mental health issues due to her work conditions. After her employment was terminated, she sued Sears for employment discrimination under California's Fair Employment and Housing Act (FEHA). After the court dismissed most of her claims, Simpson's attorney pursued a settlement based on her potential workers' compensation claims, as Sears had failed to inform her of her eligibility for such benefits. The settlement agreement, which included payments for lost wages, emotional distress, physical and mental disabilities, and attorney's fees, did not mention workers' compensation explicitly nor was it submitted for approval by the California Workers' Compensation Appeals Board (WCAB). The Simpsons excluded the settlement proceeds from their income on their tax return, leading to a tax deficiency notice from the IRS.

Procedural History

The IRS issued a notice of deficiency to the Simpsons, determining a tax deficiency and an accuracy-related penalty. The Simpsons petitioned the U. S. Tax Court to challenge this determination. The IRS later conceded the penalty. The Tax Court considered whether the settlement proceeds were excludable under I. R. C. §§ 104(a)(1) and 104(a)(2), and whether attorney's fees and costs were deductible under § 62(a)(20).

Issue(s)

1. Whether any portion of the $250,000 settlement payment received by Kathleen Simpson is excludable from gross income under I. R. C. § 104(a)(1) as amounts received under workers' compensation acts?

2. Whether any portion of the $250,000 settlement payment is excludable from gross income under I. R. C. § 104(a)(2) as damages received on account of personal physical injuries or physical sickness?
3. Whether the portion of the settlement allocated to attorney's fees and court costs is deductible under I. R. C. § 62(a)(20)?

Rule(s) of Law

1. I. R. C. § 104(a)(1) excludes from gross income "amounts received under workmen's compensation acts as compensation for personal injuries or sickness. "
2. I. R. C. § 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. "
3. I. R. C. § 62(a)(20) allows a deduction for attorney's fees and court costs paid by, or on behalf of, a taxpayer in connection with any action involving a claim of unlawful discrimination, not exceeding the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement resulting from such claim.

Holding

1. No portion of the settlement payment is excludable under I. R. C. § 104(a)(1) because the settlement agreement was not approved by the California Workers' Compensation Appeals Board as required by state law.
2. Ten percent of the $98,000 portion of the settlement payment allocated to "emotional distress, physical and mental disability" is excludable under I. R. C. § 104(a)(2) as damages received on account of personal physical injuries and physical sickness.
3. The $152,000 allocated to attorney's fees and court costs is deductible under I. R. C. § 62(a)(20).

Reasoning

The court's reasoning focused on statutory interpretation and the factual context of the settlement:
– Under § 104(a)(1), the settlement was not excludable because it did not meet California's requirement for WCAB approval, rendering it invalid as a workers' compensation settlement.
– The court applied the new regulations under § 104(a)(2), which no longer required the underlying claim to be based on tort or tort type rights, to find that 10% of the $98,000 was excludable as it was intended to compensate for personal physical injuries and sickness.
– The court allowed the deduction of attorney's fees and court costs under § 62(a)(20) based on the settlement's connection to an unlawful discrimination claim, despite the factual inconsistency with the claim that the entire settlement was for

workers’ compensation.
The court relied on extrinsic evidence, including the testimony of Simpson’s attorney, to interpret the intent behind the settlement and its allocation. It also used the Cohan rule to estimate the deductible amount of attorney’s fees and court costs when precise substantiation was lacking.

Disposition

The court held that the settlement payment was not excludable under § 104(a)(1), but 10% of the $98,000 portion was excludable under § 104(a)(2), and the $152,000 allocated to attorney’s fees and court costs was deductible under § 62(a)(20). A decision was to be entered under Rule 155.

Significance/Impact

The Simpson case underscores the necessity of complying with state workers’ compensation laws to secure tax exclusions under § 104(a)(1). It also demonstrates the impact of regulatory changes on the interpretation of § 104(a)(2), expanding its scope to include settlements not based on tort rights. This ruling provides clarity on the tax treatment of settlement proceeds and the deductibility of related legal expenses, influencing legal strategies in employment and discrimination cases. Subsequent courts have referenced Simpson in addressing similar tax issues, and it has practical implications for taxpayers and attorneys in structuring settlements to achieve favorable tax outcomes.

