Simpson v. Commissioner, 141 T. C. 331 (2013) (United States Tax Court, 2013)

In Simpson v. Commissioner, the U. S. Tax Court ruled that settlement proceeds from a workers' compensation claim not approved by the California Workers' Compensation Appeals Board are not excludable under IRC Section 104(a)(1). However, 10% of the settlement was deemed excludable under Section 104(a)(2) as damages for physical injuries. This case highlights the necessity of state approval for workers' compensation settlements and the broader scope of tax exclusions for physical injury damages.

Parties

Kathleen S. Simpson and George T. Simpson were the petitioners, filing as individuals. The respondent was the Commissioner of Internal Revenue. The case was heard in the United States Tax Court.

Facts

Kathleen Simpson worked for Sears, Roebuck & Co. and alleged that her job led to physical injuries and mental health issues. After her termination, she filed a lawsuit against Sears under California's Fair Employment and Housing Act (FEHA), alleging discrimination and retaliation. Following a partial dismissal of her claims, Simpson's attorney discovered her eligibility for workers' compensation benefits, which formed the basis for settlement negotiations. The settlement agreement, which did not mention workers' compensation explicitly, was not submitted for approval to the California Workers' Compensation Appeals Board (WCAB). The settlement allocated $98,000 to Simpson's emotional distress and physical disabilities, with 10% to 20% attributed to physical injuries.

Procedural History

The Simpsons filed a timely petition in the United States Tax Court to redetermine the Commissioner's determination of a federal income tax deficiency of $73,407 for 2009. The Commissioner had also imposed an accuracy-related penalty of $14,681, which was later conceded. The Tax Court's decision addressed the taxability of the $250,000 settlement received from Sears, excluding the $12,500 for lost wages that was already reported as income.

Issue(s)

Whether any portion of the $250,000 settlement received by the Simpsons in 2009 from Sears is excludable from their gross income under IRC Sections 104(a)(1) or 104(a)(2)?

Whether the portion of the settlement allocated to attorney's fees and court costs is deductible under IRC Section 62(a)(20)?

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Rule(s) of Law

IRC Section 104(a)(1) excludes from gross income "amounts received under workmen's compensation acts as compensation for personal injuries or sickness. " IRC Section 104(a)(2) excludes "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. " IRC Section 62(a)(20) allows a deduction for attorney's fees and court costs paid in connection with any action involving a claim of unlawful discrimination.

Holding

The Tax Court held that none of the settlement proceeds were excludable under IRC Section 104(a)(1) because the settlement was not approved by the WCAB as required by California law. However, 10% of the $98,000 allocated to physical injuries and sickness was excludable under IRC Section 104(a)(2). The court also held that the $152,000 allocated to attorney's fees and court costs was deductible under IRC Section 62(a)(20).

Reasoning

The court's reasoning included the following points:

– The settlement was not valid under California's workers' compensation laws because it was not approved by the WCAB, thus not qualifying for exclusion under IRC Section 104(a)(1).

– The new regulations under IRC Section 104(a)(2) removed the requirement that damages be based on tort or tort-type rights, allowing for the exclusion of damages for personal physical injuries or sickness regardless of the statutory basis for the claim.

– The court relied on credible testimony to determine that 10% of the $98,000 was attributable to Simpson's physical injuries and sickness, qualifying for exclusion under IRC Section 104(a)(2).

– The court applied the *Cohan* rule to estimate the deductible amount of attorney's fees and court costs under IRC Section 62(a)(20), based on credible evidence provided by Simpson's attorney.

– The court considered the legislative intent behind the IRC sections and the relevant case law, including *Commissioner v. Schleier* and *United States v. Burke*, to interpret the scope of exclusions and deductions.

Disposition

The Tax Court entered a decision under Rule 155, allowing the exclusion of 10% of

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the $98,000 under IRC Section 104(a)(2) and the deduction of $152,000 for attorney's fees and court costs under IRC Section 62(a)(20).

Significance/Impact

This case clarifies the importance of state approval for workers' compensation settlements to qualify for tax exclusion under IRC Section 104(a)(1). It also reflects the broader application of IRC Section 104(a)(2) following regulatory changes, allowing for the exclusion of damages for physical injuries even if not based on tort or tort-type rights. The decision impacts how settlements involving physical injuries are structured and reported for tax purposes, emphasizing the need for clear allocation and documentation of damages attributable to physical injuries.

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