ROBERT W. TURNBOW 6040 Cedar Knot Court Mobile, Alabama 36608,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
R. WOOD TURNBOW Post Office Box 16965 Mobile, Alabama 36616,	§	DOCKET NOS. INC. 94-440 INC. 94-441
Taxpayers,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed income tax against Robert W. Turnbow and R. Wood Turnbow (together "Taxpayers") for the year 1990. The Taxpayers both appealed to the Administrative Law Division. The appeals were consolidated and a hearing was conducted on January 19, 1996 in Mobile, Alabama. Bob Galloway represented the Taxpayers. Assistant Counsel Duncan Crow represented the Department.

The Taxpayers are CPAs and were sued for malpractice in 1990. The primary issue in this case is whether the Taxpayers, as accrual basis taxpayers, should be allowed to deduct the damages claimed in the lawsuit as a loss on their individual 1990 Alabama returns. A second issue is whether the Department should have first assessed the partnership before assessing the partners individually.

The Taxpayers are CPAs and operated as a partnership in Mobile, Alabama. The Taxpayers used the accrual basis of accounting. The partnership, and presumably the Taxpayers individually, were sued for malpractice in 1990. The suit claimed

$2,705,000.00 in damages.

The Taxpayers each claimed a portion of the alleged damages as a loss on their individual 1990 Alabama returns. Robert Turnbow claimed $2,164,000.00, and R. Wood Turnbow claimed $541,000.00.

The malpractice suit was never tried or settled, and thus a judgment was never entered in the case. The claim itself was disallowed when the Taxpayers filed for bankruptcy in 1992.

The Department reviewed the Taxpayers' 1990 returns and disallowed the claimed losses. The Department argues that the losses were not "evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained," as required by Department Reg. 810-3-15-.07(2)(a). Rather, the Department contends that the losses were anticipated losses, and thus cannot be allowed. See, Department Reg. 810-3-15-.07(4).

The Taxpayers argue that as accrual basis taxpayers, the losses should be allowed in the year they were incurred, 1990. The Taxpayers contend that because they did not contest either their liability, or the amount of the claimed damages, all events had occurred in 1990 fixing their liability and the amount of the loss with reasonable certainty.

The accrual method of accounting is explained in U.S. Master Tax Guide (CCH 1995) at ¶1515, as follows:

> Under the accrual method, income is accounted for when the right to receive it comes into being - i.e., when all the events that determine the right have occurred. It is not the actual receipt but the *right to receive* that governs. Expenses are deductible on the accrual basis in the year incurred - i.e., when all the events have occurred that fix the amount of the item and determine the liability of the taxpayer to pay it. See ¶1539 for a discussion of this "all-events test" as it relates to

economic performance.

As cited above, ¶1539 of the U.S. Master Tax Guide explains the "all-events" test as follows:

> Under the "all-events" test, an accrual-basis taxpayer is generally entitled to deduct the face amount of an accrued expense in the tax year in which (1) all of the events have occurred that determine the fact of liability and (2) the amount of the liability can be determined with reasonable accuracy. All of the events that establish liability for an amount, for the purpose of determining whether such amount has been incurred regarding any item, are treated as not occurring any earlier than the time that economic performance occurs (Code Sec. 461(h)).
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> Under an exception to the above rules for economic performance, payment is considered to be economic performance for the following: (1) liabilities to another person arising out of any workers' compensation, tort, or breach of contract claims against the taxpayer or any violation of law by the taxpayer; (2) rebates and refunds; (3) awards, prizes, and jackpots; (4) insurance, warranty and service contracts; and (5) taxes other than creditable foreign taxes. The IRS may specify additional "payment liabilities" in the future (Reg. §1.461-4(g)).

26 U.S.C.A. §461, cited above, is entitled "General rule for taxable year of deduction." Section 461(f) provides that if an accrual basis taxpayer contests an asserted liability, the deduction shall be allowed only in the taxable year that the liability is subsequently paid. Section 461(h) concerns "economic performance", and reads in pertinent part as follows:

> (h) Certain liabilities not incurred before economic performance. -
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> (1) In general. - For purposes of this title, in determining whether an amount has been incurred with

> respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.
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> (2) Time when economic performance occurs. - Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:
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> * * *
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> (C) Workers compensation and tort liabilities of the taxpayer. - If the liability of the taxpayer requires a payment to another person and -
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> (i) arises under any workers compensation act, or
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> (ii) arises out of any tort,
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> economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentences.

In summary, a loss is allowed under the accrual method only if (1) during the year all events have occurred establishing the fact of liability, (2) the amount of the liability can be determined with reasonable certainty, and (3) economic performance has occurred.

In this case, the Taxpayers' liability was never fixed. A judgment was never entered, and the Taxpayers obviously contested the lawsuit up until they filed for bankruptcy in 1992. Consequently, neither the fact of liability nor the amount of the alleged liability was ever fixed. The fact that the Taxpayers now conveniently after the fact concede that they were liable for the

entire $2,705,000.00 is insufficient.

In addition, economic performance did not occur as required by §461(h)(2)(C). That section provides that if the liability of a taxpayer arises out of a tort action, such as malpractice or negligence, economic performance occurs only when payments are actually made. The Taxpayers made no payments in this case, and thus there was no economic performance. Without a fixed and certain liability, and without economic performance, a loss cannot be claimed by the Taxpayers under the accrual method in 1990.

Concerning the Taxpayers' argument that the tax should have been assessed first at the partnership level, the Internal Revenue Code, at 26 U.S.C.A. §6221 et seq., does provide certain procedures for first determining tax at the partnership level. However, there is no such requirement under Alabama law. Code of Ala. 1975, §40-18-24 requires that individuals conducting business through a partnership are liable for income tax only in their individual capacity. The Taxpayers claimed the subject losses on their individual returns. The Department thus correctly assessed the Taxpayers individually.

The above considered, the final assessments are affirmed. Judgment is entered against Robert W. Turnbow for income tax of $339.61, and R. Wood Turnbow for income tax of $355.43, plus applicable interest.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 23, 1996.

BILL THOMPSON
Chief Administrative Law Judge