

KENNON R. & CAROLYN PATTERSON§
705 EAST MAIN STREET
NOTASULGA, AL 36866,

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 06-1080

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

**OPINION AND PRELIMINARY ORDER ON TAXPAYERS'
APPLICATION FOR REHEARING**

The Revenue Department assessed Kennon R. and Carolyn Patterson (jointly "Taxpayers") for 1998, 1999, and 2000 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A Final Order was entered on January 29, 2007 affirming the final assessments. The Taxpayers timely applied for a rehearing. The rehearing was conducted on September 15, 2009. Sam McCord represented the Taxpayers. Assistant Counsel Keith Maddox represented the Department.

ISSUES

Kennon Patterson (individually "Taxpayer") was president and chairman of the board of Community Bank in Blountsville, Alabama before and during the years in issue. He was convicted of bank fraud and other crimes in federal court in 2003. Specifically, the Taxpayer had various contractors perform work on his farm during the subject years, and he surreptitiously arranged for the Bank to pay for part of the work. The parties agree that the value of those services provided by the contractors that were paid by the Bank constituted taxable income to the Taxpayers. The first issue involves how the dollar value of those services should be computed.

The Taxpayers contend that only the dollar value of the actual work performed by the contractors on the Taxpayers' property, or \$834,602, should be treated as income. The Department counters that the total amount billed to and paid by the Bank, or \$1,192,423.29, constituted income attributable to the Taxpayers. That amount includes insurance, workers compensation, overhead, and profit, in addition to the dollar value of the actual work performed.¹

A second issue is whether Carolyn Patterson (individually "spouse") should be relieved of liability as an innocent spouse. See, Code of Ala. 1975, §40-18-27(e).

FACTS

The Taxpayers purchased a large farm in Blount County, Alabama in approximately 1990. They lived in an existing house on the farm until the late 1990's, at which time they began construction on a large house on the farm.

The Taxpayers were involved in building the house during the years in issue. Several other construction projects, repairs, etc. were also in progress on the farm during those years. Various contractors performed the work. All of the contractors billed the Taxpayers directly for at least some of the work performed. But several of the contractors also fraudulently billed the Bank for some of the work.

The evidence shows that the Taxpayers paid from \$50,000 to \$150,000 a month for the work on the house and farm. The Taxpayer earned approximately \$1.5 million annually in salary and dividends during the subject years. He used that money, and various loans,

¹ The Department assessed the Taxpayers based on additional income of approximately \$1.4 million. The Department now concedes that \$1,192,423.29 is the correct amount, and that the final assessments should be reduced accordingly.

to pay the above amounts. The Taxpayer's spouse also contributed some of her money to pay the construction bills.

The Taxpayers' house construction and farm related projects were managed by another Bank employee. The Taxpayer wrote the employee one or more checks to pay the monthly construction/repair related bills. The employee in turn paid the various contractors.

As indicated, several of the contractors billed the Bank for some of the work they performed on the Taxpayers' farm. A Bank employee in cahoots with the Taxpayer and those contractors approved the bills for payment. The Bank eventually paid the contractors almost \$1.2 million for work performed on the Taxpayers' farm. The bills submitted by the contractors to the Bank included a charge for the actual work performed, and also amounts for insurance, workers compensation, overhead, and profit.

The conspiracy was uncovered in 2002 or 2003, and the Taxpayer was subsequently convicted of bank fraud and various other crimes in federal court. He is currently in federal prison at Maxwell Air Force Base in Montgomery, Alabama.

The Taxpayer was removed from his position at the Bank after his crimes were discovered. The Bank also foreclosed on and sold the Taxpayers' farm. The Taxpayer's spouse is currently residing in a mobile home in Notasulga, Alabama.

The spouse testified at the September 15 hearing that her husband had handled all of the bills relating to the construction of the house and additions/improvements on the farm, and that she believed that the \$50,000 to \$150,000 they were paying each month was for all of the work being performed. She believed that her husband's \$1.5 million annual income, plus various loans, was more than enough to pay all of the bills. She explained that she was unaware that the Bank was paying some of the farm bills. She

testified that she and her husband's lifestyle did not change during the years in issue, and that everything about their finances seemed to be above board and normal.

The Taxpayers' CPA, who is also their son-in-law, testified that he did the Taxpayers' tax returns before and during the years in issue, and that he was very aware of the Taxpayers' finances during those years. He explained that the Taxpayers' records relating to the house construction and farm improvements seemed normal, and that it appeared that the Taxpayers were themselves paying for all of the work. He further testified that he discussed the Taxpayers' returns with the Taxpayer, with little input from his mother-in-law. Consequently, the mother-in-law was not intimately familiar with the particulars of the couple's returns, and had no reason to suspect that the returns were incorrect.

ANALYSIS

The Taxpayers concede that when the Bank paid the contractors for work performed on the Taxpayers' house and farm, they recognized some amount of taxable income. As indicated, they claim that they only received the value of the actual labor performed by the contractors, or \$834,602. The Department claims that the Taxpayers realized income equal to what the Bank paid for the work, or \$1,192,423.29, which includes the insurance, workers compensation, overhead, and profit billed by the contractors to the Bank.

The Administrative Law Division has never addressed this issue, and neither party has offered any case law or other authority in support of their positions. The parties speculated at the September 15 hearing that if the contractors had billed the Taxpayers directly instead of the Bank, they would have billed a different amount. But there is no way of knowing if the contractors would have billed the Taxpayers more, less, or the same.

Under the circumstances, I can only assume that the contractors would have billed the Taxpayers the same as they billed the Bank. Consequently, the value received by the Taxpayers was the amount paid by the Bank for the work. The Department is thus directed to compute the liabilities using the income figure of \$1,192,423.29.

Concerning the spouse's innocent spouse claim, an Alabama taxpayer may be allowed innocent spouse status to the same extent allowed under federal law. Section 40-18-27(e). Under federal law, a person qualifies as an innocent spouse if (1) they filed a joint return which had an understatement of income due to erroneous items of the spouse, (2) when they signed the joint return they did not know or have reason to know that there was an understatement of tax, and (3) taking into account all facts and circumstances, it would be unfair to hold the innocent spouse liable for tax on the unreported income. 26 U.S.C. §6015.²

The initial inquiry in this case is whether the spouse knew or had reason to know that her husband had defrauded the Bank of money during the years in issue. The "reason to know" standard was discussed in *Kistner v. Commissioner*, 18 F.3d 1521 (11th Cir. 1994), as follows:

A spouse has "reason to know" if a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be

² Before 1998, the federal innocent spouse provision was at 26 U.S.C. §6013(e). That section was repealed and the current innocent spouse provision at §6015(b) was enacted in 1998 as part of the IRS Restructuring and Reform Act of 1998 (P.L. 105-206). That legislation generally made it easier for individuals to qualify for innocent spouse relief. It also allows a spouse to elect for separation of liability treatment, §6015(c), and also equitable relief, §6015(f). However, Alabama law only allows for innocent spouse relief at §40-18-27(e). For a good explanation of the current federal statute, see, Harper, *Federal Tax Relief for Innocent Spouses: New Opportunities Under the IRS Restructuring and Reform Act of 1998*, 61 Ala. Law. 204 (May 2000).

expected to know that the tax liability stated was erroneous or that further investigation was warranted. *Stevens v. Commissioner of Internal Revenue* [89-1 USTC §9330], 872 F.2d 1499, 1505 (11th Cir. 1989). The test establishes a 'duty of inquiry' on the part of the alleged innocent spouse. *Stevens* [89-1 USTC §9330], 872 F.2d at 1505. The courts have recognized several factors that are relevant in determining the 'reason to know,' including (1) the alleged innocent spouse's level of education; (2) the spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of income, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances. *Stevens* [89-1 USTC §9330], 872 F.2d at 1505.

Kistner, 18 F.3d at 1525.

The spouse in this case had no reason to know that her husband had masterminded a scheme whereby the Bank was paying for some of their personal farm expenses. Considering the Taxpayer's large annual income and his ability to obtain large loans, it is believable and reasonable that the spouse believed in good faith that the Taxpayer could and did pay for all of the work done on the house and farm. There is no evidence that the Taxpayers' lifestyle changed during the subject years, or that they made extravagant, extraordinary expenditures in those years. The spouse also did not benefit from the Taxpayer's illegal scheme because she lost her new house and farm and now lives in a mobile home. The spouse is thus entitled to innocent spouse relief from the final assessments in issue.

The Department should recompute the liabilities for the subject years as indicated above. A Final Order will then be entered against the Taxpayer, individually, for the amounts due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order,

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

Entered November 19, 2009.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Ron Bowden, Esq.
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Tony Griggs