

JOSEPH L. & GAYLE N. FINE	§	STATE OF ALABAMA
P.O. Box 138		DEPARTMENT OF REVENUE
Montgomery, AL 36101,	§	ADMINISTRATIVE LAW
DIVISION		
ROBERT B. & SUSAN D. GEDDIE	§	DOCKET NOS. INC. 00-430
6315 Kathmoor Drive		INC. 00-629
Montgomery, AL 36117,	§	
Taxpayers,	§	
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

FINAL ORDER (INC. 00-629)
FINAL ORDER ON APPLICATION FOR REHEARING (INC. 00-430)

These consolidated cases involve final assessments of 1995 income tax (Docket Inc. 00-430 also involves a 1996 final assessment). They also involve the same issue - should a part or all of the proceeds received by the Taxpayers from the settlement of a lawsuit be excluded from income pursuant to Code of Ala. 1975, §40-18-15(e)(3). That Alabama statute adopts by reference 26 U.S.C. §104. During the years in issue, §104(a)(2) excluded from income “damages received . . . on account of personal injuries or sickness.” That section further provided, however, that the exclusion “shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.”¹

A hearing was conducted in Inc. 00-430 on December 11, 2000, before the cases were consolidated. The Taxpayers’ representative failed to appear at the hearing. The Administrative Law Division entered a Final Order on December 12, 2000 affirming the final assessments in issue, which were based

¹Congress removed punitive damages received in non-physical injury cases from the scope of the exclusion provision in 1989.

on IRS information that 65 percent of the settlement was taxable, and that 35 percent was excludable pursuant to §104(a)(2).

The Taxpayers' representative applied for a rehearing, arguing that the parties had agreed to hold the case in abeyance pending a Montgomery County Circuit Court case involving the taxability of proceeds received by another plaintiff in the same lawsuit. *Clark D. and Tammy Fine v. State of Alabama*, CV-00-2406-PR. The Department agreed to stay the case until the Circuit Court case was decided, and a Preliminary Order was entered to that effect on January 10, 2002. Inc. 00-629 was also held in abeyance pending a decision in the above referenced Montgomery County Circuit Court case.

The Circuit Court subsequently ruled for the taxpayers in the above case, holding that the entire settlement proceeds were "paid on account of mental anguish for physical injuries," and thus excludable under §104(a)(2). The Court ordered the Department to refund the \$1,746.50 in issue in the case, plus interest. The Department elected not to appeal due to the small amount involved.

The Department notified the Administrative Law Division that the Taxpayers had prevailed in the Circuit Court action, but that the Department did not acquiesce in the decision. These two cases pending before the Administrative Law Division were thus consolidated and set for hearing on March 12, 2002. Frank Wilson represented the Taxpayers at the hearing. Assistant Counsels Mark Griffin and David Avery represented the Department.

The Taxpayers argue that the Department is bound by the rationale of the Circuit Court's decision because the Department's chief counsel had orally

agreed that the Department would apply the holding in the Circuit Court action to the two cases pending before the Administrative Law Division.²

The Alabama Supreme Court has held that the Department cannot be estopped from properly assessing and collecting tax based on statements by a Department employee. *Boswell v. Abex Corp.*, 317 So.2d 317 (Ala. 1975); *State v. Maddox Tractor and Equipment Co.*, 69 So.2d 426 (1953). Consequently, even if there was evidence that the Department's chief counsel had orally agreed to abide by the Circuit Court decision, it is problematic whether the Department would be bound by her actions.

In any case, there is no admissible evidence of such an agreement in the record. The Department attorney who represented the Department in the Circuit Court action also was not aware of any such agreement when he elected not to appeal the Circuit Court Order. Under the circumstances, the Department is not bound in these cases by the rationale of the prior Circuit Court decision involving different taxpayers.

The second issue is whether the Department correctly followed the IRS's allocation and excluded only 35 percent of the settlement proceeds under §40-18-15(e)(3).

"Damages received" as the phrase is used in §104(a)(2) includes any amount received due to a personal injury arising from a tort or tort-type claim. During the period in issue, the term "personal injury" included both physical and non-physical injuries. However, since 1989, the exclusion has not applied to punitive damages received in a case not involving physical injury or physical sickness. *U.S. v. Burke*, 112 S.Ct. 1867 (1992). Consequently, during the period

²The chief counsel that the Taxpayers claim they had an agreement with is no longer employed by the Department.

in issue, the exclusion applied in non-physical injury cases only to amounts received as compensatory damages for pain and suffering, mental anguish, damage to reputation, etc. *Burke, supra*.

Some of the proceeds in this case were received on account of personal injury, but none were received due to physical injury. Consequently, that amount attributable to punitive damages is not excludable. The settlement agreement does not allocate the proceeds between excludable compensatory damages and taxable punitive damages. In such cases, the nature of the underlying claim must be ascertained, which is best determined by the complaint. *Delaney v. C.I.R.*, 99 F.3d 20 (1996).

The Taxpayers' complaint in Count 1 alleges that the defendants breached their contract with the plaintiffs. Damages received in a contract dispute are not received on account of personal injuries, and thus are not excludable under §104(a)(2).

Count 2 broadly alleges fraud, which is a tort-based claim. However, the complaint demanded an unspecified amount of both compensatory and punitive damages. Under the circumstances, the Department's adoption of the IRS allocation of 35 percent as excludable is reasonable.³

The Final Order in Inc. 00-430 is affirmed. The final assessment in Inc. 00-629 is also affirmed. Judgment is entered against the Taxpayers in Inc. 00-629 for 1995 tax and interest of \$18,161.25. Additional interest is also due from the date of entry of the final assessment, September 6, 2000.

³For other cases in which the IRS allocation was adopted, see *Kerns v. State of Alabama*, Inc. 01-408 (Admin. Law Div. 9/12/01); *Kitchens v. State of Alabama*, Inc. 97-320 (Admin. Law Div. 11/22/99).

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

Entered April 5, 2002.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

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