

THOMAS B., JR. & RUTH C. PAULK
1509 Southampton Court
Decatur, AL 35601,

Taxpayers,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NOS. INC. 01-343
INC. 01-373

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed 1994 and 1995 income tax against Thomas B., Jr. and Ruth C. Paulk (ATaxpayers@). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on August 10, 2001 in Birmingham, Alabama. Thomas Paulk (ATaxpayer@) and his attorney, Larry Weaver, attended the hearing. Assistant Counsel Keith Maddox represented the Department.

The issue concerning 1994 is whether interest that has accrued on the tax due for the year should be abated. The issue concerning 1995 is whether the failure to timely file and pay penalties assessed by the Department for that year should be waived for reasonable cause.

The 1994 final assessment is based on income received by the Taxpayer from the settlement of a lawsuit. The IRS audited the Taxpayers concerning the settlement proceeds, and eventually agreed to tax only 40 percent of the net amount received. The IRS treated the remaining 60 percent as exempt pursuant to 26 U.S.C. ' 104(a)(2). The IRS also excluded from income the legal fees paid by the Taxpayers.

Alabama has adopted by reference IRC ' 104. See, Code of Ala. 1975, ' 40-18-14(3)(e). Consequently, the Department adopted the IRS position, and taxed only 40 percent of the settlement proceeds. The Department also excluded the Taxpayers' legal fees from income.¹

The Taxpayers agree with the amount of 1994 tax assessed by the Department. However, because the IRS investigation took so long, the Taxpayers have petitioned the IRS for an abatement of interest, which is pending. If the IRS abates the interest due on the federal

¹For other cases involving this issue, see, *Peggy M. Parker v. State, Inc.* 98-366 (Admin. Law Div. 4/2/00); *Jimmy & Wanda Dupree v. State, Inc.* 99-119 (Admin. Law Div. OPO 3/17/00); *Gladie Kitchens v. State, Inc.* 97-320 (Admin. Law Div. OPO 11/22/99).

liability, the Taxpayers contend that the Department should also abate the interest due on the Alabama liability.²

The Administrative Law Division will hold the case in abeyance pending a final decision by the IRS concerning the 1994 interest. The Taxpayers concede that if the IRS does not abate the interest, the Department also should not abate the interest. However, if the federal interest is abated, the Department agrees that the matter should be submitted to the Department's Taxpayer Advocate for review. Under recently enacted law, the Taxpayer Advocate (and only the Taxpayer Advocate) has the authority to waive interest that has accrued due to undue delay. Code of Ala. 1975, ' 40-2A-4(b)(1)c.

²The Alabama tax due on the settlement proceeds was \$12,312. The Taxpayers paid that amount to the Department in February 2001. The Department agreed at the time that the payment would be applied to pay the tax in full. However, the Department instead applied the payment first to interest, and then to the tax due. Consequently, the final assessment entered on April 24, 2001 shows tax due of \$9,806.06. The \$151.26 in interest shown on the final assessment is the additional interest that accrued from when the Taxpayers paid the \$12,312 in February, until the final assessment was entered on April 24.

The only issue concerning 1995 is whether penalties assessed by the Department should be waived for reasonable cause.

The Taxpayer practiced law until the Spring of 1994. He took a salaried job with the Alabama Farmers Cooperative at that time. Consequently, his employer began withholding Alabama income tax from his wages.

In June or July 1995, the Taxpayer received \$41,000 from his old law firm. The income was from the settlement of a lawsuit the Taxpayer had worked on while in private practice.

Because the \$41,000 was not subject to withholding, the Taxpayers were required to file a quarterly return, and pay the estimated tax due. Code of Ala. 1975, ' ' 40-18-82 and 40-18-83. They failed to do so. Rather, they reported the income and paid the tax due with their annual return. Consequently, the Department assessed the Taxpayers for failing to file a quarterly return or pay the tax due.

A penalty may be waived for reasonable cause. Code of Ala. 1975, ' 40-2A-11(h). Reasonable cause includes, but is not limited to, instances in which a taxpayer fails to file a return and/or pay a tax because of a non-recurring, honest mistake. Rev. Proc. 97-003.

Under the circumstances, the Taxpayers' failure to file a declaration of estimated tax and pay the tax due constituted a non-recurring, honest mistake. But for the one-time, lump-sum payment received in 1995, the Taxpayers would not have otherwise been required to file quarterly returns for the year. The Department also concedes that the Taxpayers have a history of timely filing their returns and paying the tax due. The penalties are waived for reasonable cause.

As indicated, these consolidated appeals will be held in abeyance pending a decision

by the IRS, and if applicable, by the Department's Taxpayer Advocate, concerning the abatement of interest on the 1994 liability. The Taxpayer's representative should keep the Administrative Law Division informed concerning the IRS proceeding. An appropriate Order will be entered when the interest issue is finally decided.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days. Code of Ala. 1975, ' 40-2A-9(g).

Entered August 16, 2001.