STATE OF ALABAMA, DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE
	§	ADMINISTRATIVE LAW DIVISION
vs.	§	
LANCE R. AND ELAINE C. LEFLEUR		DOCKET NO. INC. 93-328
c/o William B. Sellers P. O. Drawer 4540	§	
Montgomery, AL 36106,	§	
Taxpayers.	§	

FINAL ORDER

The Revenue Department assessed 1991 Alabama income tax against Lance R. and Elaine C. LeFleur (together "Taxpayers"). The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on March 17, 1994. William B. Sellers and Alan Rothfeder represented the Taxpayers. Assistant counsel Beth Acker represented the Department.

Lance R. LeFleur ("Taxpayer") received $1,000,000 in 1991 to settle a lawsuit he had filed against Blount Energy Resource Corporation ("BERC"), Blount, Inc. ("Blount") and former Blount President Bill VanSant ("VanSant"). The issue in this case is what portion, if any, of the $1,000,000 should be excluded from Alabama income tax pursuant to Code of Ala. 1975, §40-18-14(2)(e). That section exempts all amounts received pursuant to a lawsuit as compensation for tort or tort-like injuries.

The Taxpayer was employed as senior vice-president of BERC, which was a wholly-owned subsidiary of Blount. BERC was engaged

in resource recovery, with operations in both the United States and Switzerland.

Blount decided to sell BERC in late 1988. Anticipating the sale, Blount either discharged or reassigned a number of BERC employees. Blount also offered certain incentive bonuses and severance benefits to the remaining employees, including the Taxpayer, in the event BERC was sold. Those benefits are explained in an April 6, 1989 letter from VanSant to the Taxpayer.

Because of the Taxpayer's intimate knowledge concerning BERC, Blount and the Taxpayer entered into an agreement dated April 27, 1989 whereby the Taxpayer agreed to help Blount sell BERC. In return, Blount agreed to pay the Taxpayer an incremental commission based on the sales price of the BERC assets.[1]

In accordance with the April 27, 1989 agreement, the Taxpayer developed a presentation program, presented the program to prospective BERC bidders, and otherwise actively engaged in efforts to sell BERC for the best price.

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[1] The April 27, 1989 agreement provided that Taxpayer would receive no commission if BERC sold for less than 20 million, 2% of the 5 million above 20 million, 3% of the next 3 million, 4% of the next 3 million, and 5% of anything above 31 million.

Several bids were received in September and October 1989, either for all or only specific parts of the company. The bids were opened in mid-October 1989. The Taxpayer testified that the highest bids were $28,000,000 for BERC's North American components, and $30,000,000 for its Swiss component. However, those bids were later withdrawn. BERC was subsequently sold in at least three separate transactions. The sales price for part of the North American assets was approximately $18,000,000. The sales price of the remaining components was not submitted into evidence.

The Taxpayer met with VanSant on October 23, 1989 and was informed that Blount intended to alter the April 27, 1989 agreement. Specifically, VanSant claimed that the Taxpayer's commission would be based only on the sales price of BERC's North American assets. The Taxpayer refused to agree or otherwise alter the April 27, 1989 agreement at that time.

The Taxpayer and VanSant met again on November 2, 1989. The Taxpayer again refused to alter the April 27, 1989 agreement. As a result, the Taxpayer was abruptly fired, instructed to clean out his desk, and then escorted by two Blount employees to the parking lot. Numerous Blount employees witnessed the firing.

The Taxpayer sued Blount, BERC and VanSant in Montgomery County Circuit Court in January 1991. The five count complaint claimed damages for breach of the April 6 and April 27, 1989

agreements, as well as fraud, mental anguish and emotional distress.

Oscar Reak ("Reak") subsequently replaced VanSant as president of Blount. The Taxpayer and Reak met in November 1991 and agreed that Blount would pay the Taxpayer $1,000,000 to settle the case. The settlement agreement is set out in a letter from Reak to the Taxpayer dated December 2, 1991. That letter provides that "[T]his letter will document the agreement which we have reached, through our attorneys, on November 28, 1991."

The agreement allocated the $1,000,000 as follows: (1) $0 relating to breach of the April 6, 1989 letter; (2) $200,000 resulting from breach of the April 27, 1989 agreement; (3) $800,000 for the tort claims of personal injuries for pain and suffering; and (4) $0 for punitive damages. Blount also agreed to purge the Taxpayer's personnel records, and the Taxpayer agreed to keep the terms and conditions of the settlement confidential.

The Taxpayers reported $200,000 as taxable income on their 1991 Alabama return. The remaining $800,000 was excluded as being for personal injuries and compensatory damages and thus exempt under §40-18-14(2)(e).

The Department audited the Taxpayers, included the entire $800,000 as taxable income, and based thereon entered the final assessment in issue. The Taxpayers timely appealed to the Administrative Law Division.

Code of Ala. 1975, §40-18-14(2)(e) exempts from Alabama income tax any amounts exempt under 26 U.S.C. §104. 26 U.S.C. §104 exempts all amounts received by judgment or settlement resulting from a lawsuit based on a tort or tort-type claim. Section 104 excludes damages received for both physical and non-physical injuries. U. S. v. Burke, 112 S.Ct. 1867.

In Bill McKay v. C.I.R., 102 T.C. 16 (1994), the U. S. Tax Court explained whether a payment under a settlement agreement is exempt under §104, as follows:

> We have stated that express language in a settlement agreement is the most important factor in deciding whether a payment was made on account of a tortious personal injury for purposes of exclusion under section 104(a)(2). *Byrne v. Commissioner*, supra at 1007 (quoting *Metzger v. Commissioner*, supra at 837); see *Bent v. Commissioner*, supra at 244; *Glynn v. Commissioner*, supra at 120. We are not bound, however, by any factor or factors that are inconsistent with the true substance of the taxpayer's claim, nor are we bound by express allocations in a written settlement agreement if the parties did not engage in bona fide, arms-length, adversarial negotiations. *Robinson v. Commissioner*, supra.

The threshold question in this case is whether the 20% contract/80% personal injury allocation included in the settlement agreement was adversarially negotiated at arm's-length. If so, the allocation must be accepted.

Clearly, the $1,000,000 settlement itself was negotiated at arms-length in that both parties had an adversarial interest in how much the Taxpayer would be paid to settle the case.

Unfortunately, the record is not fully developed as to whether the allocation in the settlement agreement was also negotiated at arm's-length. Neither Reak nor any of the attorneys involved in negotiating the settlement testified at the administrative hearing. The only relevant testimony was offered by the Taxpayer, at pages 31 and 32 of the transcript, as follows:

> Q. At the time of the settlement or the time you and Mr. Reak met, did you or didn't -- let me restate that. At the time you and Mr. Reak met, did Mr. Reak indicate to you that he was aware of the mental and emotional anguish you had suffered as a result of your termination?
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> A. Yes.
>
> Q. Did you discuss with Mr. Reak your damages due to the emotional distress you suffered?
>
> A. Yes.
>
> Q. At the time you and Mr. Reak met to discuss this issue, did you discuss a pecuniary settlement and an allocation of those damages?
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> A. We met one time and discussed all those matters.
>
> Q. In that allocation, did you attempt to give consideration to what you believed a jury might find in deciding your case?
>
> A. Yes.
>
> Q. Now, did you sign the settlement agreement?
>
> A. Yes.
>
> Q. Did a representative of Blount sign this agreement?
>
> A. Yes.

Q. Was it negotiated between Blount and you on an arm's length basis?

A. Yes.

Q. Did you give consideration in the settlement to each of the elements upon which you sued?

A. Yes.

The Department argues that the allocation was non-adversarial and made for tax avoidance only. However, that argument is not supported by the evidence. Rather, as stated, the only relevant evidence on point is the Taxpayer's testimony that the settlement and allocation were both negotiated at arm's length. In light of that undisputed testimony, I cannot speculate that the allocation was not at arm's-length. Accordingly, the assessment in issue must be dismissed.

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

Entered on November 7, 1994.

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BILL THOMPSON
Chief Administrative Law Judge