

CECIL T. & ESTHER L. KIRKSEY	§	STATE OF ALABAMA
111 Waterleaf Road		DEPARTMENT OF REVENUE
Huntsville, AL 35811,	§	ADMINISTRATIVE LAW
DIVISION		
Taxpayers,	§	DOCKET NO. INC. 01-652
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

FINAL ORDER

The Revenue Department assessed Cecil T. and Esther L. Kirksey (“Taxpayers”) for additional 1993 income tax on August 3, 2000. The assessment was based on IRS information that the Taxpayers had failed to report lawsuit settlement proceeds of \$18,081 they received in 1993.

The Taxpayers had discussed the taxability of the proceeds with the Department before the final assessment was entered, and continued to communicate with the Department after the final assessment was entered. However, they failed to formally appeal the final assessment until October 2001.

The Department moved to dismiss the Taxpayers’ appeal because it was not timely filed within 30 days, as required by Code of Ala. 1975, §40-2A-7(b)(5)a. The Administrative Law Division dismissed the appeal on November 27, 2001.

The Taxpayers applied for a rehearing. The Administrative Law Division subsequently learned that the Taxpayers’ 2000 refund had been applied to pay the 1993 liability. The Administrative Law Division thus reinstated the appeal as an appeal of a denied refund of 1993 tax. A hearing was conducted on March 21, 2002. The Taxpayers attended the hearing. Assistant Counsel Jeff Patterson represented the Department.

As indicated, the Department assessed the Taxpayers based on IRS information showing that the Taxpayers had received lawsuit settlement proceeds of \$18,081 in 1993. The Department initially included the entire amount in gross income, but allowed the Taxpayers to deduct \$7,708 in legal fees and other lawsuit-related expenses. The resulting tax and interest due was \$777.54. The Department entered a preliminary assessment against the Taxpayers for that amount on February 4, 2000. The Taxpayers filed a petition for review.

The Department notified the Taxpayers on May 10, 2000 that it had held their case in abeyance pending the outcome of an issue-related case in the Administrative Law Division. The Administrative Law Division subsequently held in that case that when a settlement agreement between parties to a lawsuit does not allocate between punitive and compensatory damages, the Department should accept the allocation percentage reached by the IRS. *Kitchens v. State of Alabama, Inc.* 97-320 (Admin. Law Div. 11/22/99). Consequently, the Department adopted the IRS allocation concerning the Taxpayers, and accordingly taxed only \$5,794 of the settlement proceeds. The tax and interest was thus reduced to \$442.28, as of June 10, 2000. The Department entered the final assessment in issue for that amount, plus additional interest, on August 3, 2000.

At some point during the review process, the Taxpayers made the claim that they were entitled to a \$73,000 theft loss in 1993. The Taxpayers claim that as a result of the fraudulent actions on an insurance agent, a \$73,000 life insurance policy on the life of Mrs. Kirksey was canceled, which caused them to suffer a \$73,000 loss. The Department has never formally responded to the Taxpayers' theft loss claim.

The first issue is whether the Department properly taxed a portion of the settlement proceeds received by the Taxpayers in 1993.

Code of Ala. 1975, §40-18-14(e)(3) adopts by reference 26 U.S.C. §104(a)(2), which excludes from income “damages received . . . on account of personal injuries or sickness.” The burden is on a taxpayer to prove that an amount is excludable under §104(a)(2). *U.S. v. Wodtke*, 627 F.Supp. 1034 (1985).

“Damages received” includes any amount received on account of a tort or tort-type claim. However, during the year in issue, the exclusion did not apply to punitive damages received in a case not involving physical injury or physical sickness. *U.S. v. Burke*, 112 S.Ct. 1867 (1992). See also, *Griffin v. C.I.R.*, 2001 WL 20924 (U.S. Tax Ct.), 81 T.C.M. (CCH) 972, T.C.M. (RIA) 2001-005; *C.I.R. v. Schleir*, 515 U.S. 323 (1995). The Taxpayers’ settlement did not involve physical injuries. Thus, any punitive damages received are not excludable.

The Taxpayers failed to submit a copy of the complaint filed in their lawsuit or a copy of the settlement agreement. Thus, there is no evidence indicating that the proceeds should be excluded under §104(a)(2). The final assessment in issue is based on the IRS’s finding that a portion of the proceeds were excludable. The Department’s final assessment based on that IRS information is *prima facie* correct, and the burden was on the Taxpayers to prove that it was incorrect. They failed to do so. Consequently, as in *Kitchens, supra*, the Department properly allocated taxable punitive damages versus excludable compensatory damages based on the IRS information. See also, *Kerns v. State of Alabama, Inc.* 01-408 (Admin. Law Div. 9/12/01); *Fine v. State of Alabama, Inc.* 00-430 (Admin. Law Div. 12/12/00).

The next issue is whether the Taxpayers were entitled to a \$73,000 theft loss in 1993. Code of Ala. 1975, §40-18-15(a)(6) allows for a nonbusiness theft loss. The Taxpayers are not entitled to a theft loss deduction in this case,

however, because they did not suffer a \$73,000 loss in 1993 relating to the life insurance policy.

The Taxpayers' claim they incurred a \$73,000 loss because the \$73,000 insurance policy on Mrs. Kirksey's life was canceled. However, the policy did not have an actual value of \$73,000. Mr. Kirksey would have received the policy proceeds only upon the death of his wife. That did not occur. The policy may have had some small cash value, although there is no evidence of that fact in the record.

The final assessment is affirmed. Judgment is entered against the Taxpayers for 1993 tax and interest of \$458. Additional interest is also due from the date of entry of the final assessment, August 3, 2000.

This Final Order 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

cc: Keith Maddox, Esq.
Cecil T. Kirksey
Kim Herman