

LIZZIE DUBOSE	§	STATE	OF
ALABAMA			
Route 2, Box 364		DEPARTMENT	OF
REVENUE			
Midway, AL 36053,	§	ADMINISTRATIVE	LAW
DIVISION			
818	§	DOCKET NO. INC. 01-	
v.	§		
STATE OF ALABAMA	§		
DEPARTMENT OF REVENUE.			

**OPINION AND PRELIMINARY ORDER**

The Revenue Department assessed Lizzie Dubose (“Taxpayer”) for 1995 income tax. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on January 29, 2002. CPA James Carmichael represented the Taxpayer. Assistant Counsel Keith Maddox represented the Department

**ISSUE**

The issue in this case is whether all or a part of a lawsuit settlement received by the Taxpayer in 1995 should be excluded from income pursuant to Code of Ala. 1975, §40-18-14(e)(3). That section adopts by reference 26 U.S.C. §104. During the period 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.”<sup>1</sup>

**FACTS**

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

The Taxpayer purchased furniture and other items on credit from a furniture store in Tuskegee, Alabama in 1993. The Taxpayer sued the store, an employee of the store, and others in Bullock County Circuit Court in 1994. The Taxpayer's complaint alleged that the defendants falsely increased her account balance and otherwise deceived her concerning the amount she owed, and also published false credit information about her, which harmed her reputation in the community. The complaint claimed that because of the defendants' actions, the Taxpayer suffered emotional distress and mental pain and anguish. The complaint accused the defendants of defamation (Count 1), the tort of outrage (Count 2), negligence and/or wantonness (Count 3), and negligent or wanton supervision (Count 4). The Taxpayer demanded an unspecified amount of both compensatory and punitive damages.

The Taxpayer settled the lawsuit in 1995 for \$88,888.89. She received \$44,092.59 after attorney fees. In return, she executed a general release of all claims against the defendants. The settlement agreement did not specify whether the amount received was for compensatory or punitive damages.

The Taxpayer failed to report the lawsuit proceeds on her 1995 federal and Alabama returns. The IRS included the entire \$88,888.89 in the Taxpayer's gross income, and allowed her a Schedule A deduction for the attorney fees.<sup>2</sup>

The Department received the above IRS information, and assessed the Taxpayer on only her net settlement proceeds of \$44,092.59.<sup>3</sup> The Taxpayer appealed.

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<sup>2</sup>The Taxpayer's CPA claims that the IRS eventually settled with the Taxpayer based on her ability (or inability) to pay.

<sup>3</sup>The Department correctly excluded the attorney fees from the Taxpayer's gross income, instead of allowing them as a Schedule A deduction, based on the Administrative Law Division's holding in *Kitchens v. State of Alabama, Inc.* 97-

## ANALYSIS

As indicated, §40-18-14(e)(3) adopts by reference IRC §104(a)(2), which excludes from income damages received (through judgment or settlement) on account of personal injuries or sickness. The burden is on a taxpayer to prove that an amount is excludable under §104(a)(2). *C.I.R. v. Schleier*, 115 S.Ct. 2159, 2163 (1995).

“Damages received” includes any amounts received on account of a tort or tort-type claim. However, since 1989, the exclusion has not applied to punitive damages received in a case not involving physical injury or physical sickness. During the period in issue, the term “personal injury” included both physical and non-physical injuries. *U.S. v. Burke*, 112 S.Ct. 1867, 1872 (1992).<sup>4</sup> Consequently, during the period 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*.

The damages received by the Taxpayer did not arise from a physical injury. Thus, that portion attributable to punitive damages is not excludable.<sup>5</sup>

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320 (Admin. Law Div. 11/22/99). That decision was based on *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir. 2000) and *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959). 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.

<sup>4</sup>Effective September 1995, §104(a)(2) was amended to apply only to amounts received due to physical injury or physical sickness. The Taxpayer received the settlement proceeds in this case in August 1995, before the effective date of that change.

<sup>5</sup>In one of the cases cited by the Taxpayer, *Roemer, Jr. v. Comm.*, 83-2 USTC (1983), the Tax Court pointed out that all punitive damages received from a personal injury were excludable. However, that case was decided in 1983, before the law was changed in 1989.

The settlement agreement does not allocate the payment between excludable compensatory damages and taxable punitive damages. In such cases, the nature of the underlying claim or claims must be ascertained, which is best determined by the complaint. *Delaney v. C.I.R.*, 99 F.3d 20, 25 (1996); *Kitchens, supra*.

The Taxpayer's complaint asserted defamation, outrage, negligence, and wantonness, all of which are tort-based claims. Damages received to compensate the Taxpayer for her mental distress and anguish resulting from those actions would thus be excludable under §104(a)(2). However, the complaint demanded an unspecified amount of both compensatory and punitive damages. Consequently, under the circumstances, 50 percent of the net proceeds should be attributed to taxable punitive damages. The remaining 50 percent is excluded under §104(a)(2).<sup>6</sup>

The Department also argues that in addition to taxing the 50 percent attributable to punitive damages, 46 percent of the remainder should be taxed as compensation for economic, non-tort claims. I disagree. The complaint alleges that the defendants' actions caused the Taxpayer to pay more than she owed, but the complaint did not make a claim for reimbursement of that amount. All four counts in the complaint involved tort-related claims.

The Department is directed to recompute the Taxpayer's liability as indicated above. A Final Order will then be entered for the adjusted amount due.

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<sup>6</sup>In prior cases involving this issue, the Administrative Law Division adopted the percentage split arrived at by the IRS, primarily because Alabama follows the federal statute on the subject. *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); *Kitchens, supra*. That same rationale will be applied in future cases, absent extraordinary circumstances.

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 April 5, 2002.

BILL THOMPSON  
Chief Administrative Law Judge

bt:dr

cc: Keith Maddox, Esq.  
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Kim Herman