

GLADIE KITCHENS
801 Courtney Street
Mobile, AL 36616,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 97-320

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Gladie Kitchens (ATaxpayer@) for 1993 Alabama 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 June 24, 1999 in Mobile, Alabama. Bob Galloway represented the Taxpayer. Assistant Counsel Duncan Crow represented the Department.

ISSUES

The Taxpayer received \$217,846 in 1993 to settle a lawsuit against Liberty National Life Insurance Company. The issues in this case are:

(1) Should all or a portion of the settlement proceeds be excluded from income pursuant to Code of Ala. 1975, ' 40-18-14(3)(e). That section adopts by reference 26 U.S.C. ' 104. During the period in issue, ' 104(a)(2) excluded from income Adamages received . . . on account of personal injuries or sickness.@ That section further provided, however, that the exclusion Ashall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness@, and

(2) Should the legal fees retained by the Taxpayer=s attorneys be excluded from the Taxpayer=s income, as argued by the Taxpayer, or allowed as an itemized deduction,

as argued by the Department.

FACTS

The Taxpayer sued Liberty National and others in Mobile County Circuit Court in 1992. The complaint alleged that the Defendants' actions caused the Taxpayer economic loss, mental anguish, and emotional distress. The complaint demanded an unspecified amount of actual and punitive damages.

The Taxpayer settled the lawsuit in March 1993 for \$217,846. Her attorneys retained 40 percent of that amount, or \$87,138, plus advanced costs of \$1,291. The Taxpayer thus received a net settlement of \$129,417.

The Taxpayer failed to report the settlement proceeds on her 1993 federal or Alabama returns. The IRS included the entire amount as income, and taxed the Taxpayer accordingly. The Taxpayer appealed. The IRS settled the dispute by allowing the Taxpayer to exclude 45 percent of the settlement proceeds as compensatory damages pursuant to ' 104(a)(2). The remaining 55 percent was treated as taxable punitive damages.

The Revenue Department included the settlement proceeds as taxable income for Alabama purposes in 1993. The Department also required the Taxpayer to deduct the attorney fees relating to the lawsuit as an itemized deduction, subject to the two percent floor. The Taxpayer appealed.

Issue (1) - The ' 104(a)(2) Exclusion

Section 104(a)(2) excludes from income damages received on account of tort or tort-like injuries. Dotson v. U.S., 87 F.3d 682 (1996). The Taxpayer's complaint alleged

various tort-like injuries. As indicated, however, '104(a)(2), as it read during the period in issue, also specified that the exclusion did not apply to punitive damages received in a case not involving physical injuries or sickness. See, Ogilvie v. U.S., 117 S.Ct. 452 (1996); Rice v. U.S., 834 F.Supp. 1241 (1993). The issue thus is what portion of the settlement proceeds constituted taxable punitive damages versus excludible compensatory damages.

The settlement agreement failed to allocate the proceeds between punitive and compensatory damages. In such cases, other factors, including the complaint filed by the Taxpayer, should be considered. Delaney v. C.I.R., 99 F.3d 20 (1996); Metzger v. Comm'r, 88 T.C. 834 (1987), aff'd without published opinion 845 F.2d 1013 (CA-3, 1988); Threlkeld v. C.I.R., 87 T.C. 1294 (1986), aff'd 848 F.2d 81 (6/2/88). In Rev. Rul. 85-98, the IRS, relying on Rev. Rul. 58-418, stated that the best evidence available to determine a proper allocation is the taxpayer's complaint since the amount of punitive damages relative to compensatory damages requested have a reasonable relationship to what a jury might be expected to reward.

The Taxpayer's complaint requested an unspecified amount of punitive and actual (compensatory) damages. That would suggest that the settlement should be equally allocated between punitive and compensatory damages. The IRS and the Taxpayer settled on a 55 percent punitive damages versus 45 percent compensatory damages basis.

Given that Alabama has adopted the federal statute on point, that 55/45 percent split is reasonable and should also be applied for Alabama purposes.

Issue (2) - The Legal Fees

The law in the federal Eleventh Circuit, which includes Alabama, is clear that legal fees paid in such cases should not be included in the taxpayer's income. Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1955). In Davis v. C.I.R., 76 T.C. Memo 1998-248, the U.S. Tax Court, relying on Cotnam, stated as follows:

ANext, we address whether the amounts retained by petitioner's attorneys should be excluded from petitioner's income. Respondent determined that petitioner must include the full amount of the punitive damages award in income but that she may deduct the attorney's fees as a miscellaneous itemized deduction. Petitioner contends that she is required to report as income only that portion of the award paid to her by her attorneys.

APetitioner relies on Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1955), affg. in part and revg. in part 28 T.C. 947 (1957). In Cotnam, the taxpayer was awarded a judgment of \$120,000 and paid attorney's fees of \$50,365.83 pursuant to a contingent fee arrangement. The Commissioner treated the \$120,000 as taxable income and allowed a deduction for the attorney's fees. The Court of Appeals for the Fifth Circuit held that the \$50,365.83 in attorney's fees should not have been included in the taxpayer's income. *Id.* at 125.

ARespondent makes several arguments to the effect that contingent attorney's fees should not reduce the amount of a judgment but constitute a miscellaneous itemized deduction. See, e.g., Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); Bagley v. Commissioner, 105 T.C. 396, 418-419 (1995), affd. 121 F.3d 393 (8th Cir. 1997). Under the Golsen rule, however, we follow the law of the circuit in which this case is appealable, here the Eleventh Circuit. Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1974). Under Bonner v. City of Prichard, Alabama, 661 F.2d 1206 (11th Cir. 1981), decisions of the former Court of Appeals for the Fifth Circuit are binding precedent for courts in the Eleventh Circuit. Respondent has not brought to our attention any legal authority that overrules the Court of Appeals for the Fifth Circuit's opinion in Cotnam v. Commissioner, *supra*, a case that is squarely on point. On brief, respondent candidly admits that this Court may feel constrained to follow the rule in

Cotnam. In fact, we do feel so constrained. Accordingly, we find that the portion of the award retained by petitioner's attorneys should be excluded from her income, and she is entitled to summary judgment on this issue.®

Based on the above authority, the legal fees retained by the Taxpayer's attorneys should not be included in the Taxpayer's 1993 income. Forty-five percent of the net amount received by the Taxpayer, or \$58,238, should be excluded from the Taxpayer's 1993 income pursuant to ' 40-18-14(3)(e). The balance of the net settlement proceeds, or \$71,179, should be included in the Taxpayer's 1993 income.

The Department is directed to recompute the Taxpayer's liability as indicated above. A Final Order will then be entered. 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 November 22, 1999.