

JOHN A. & CATHERINE KNICKREHM
8016 Lauderdale Road, SW
Huntsville, AL 35802-2916,

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers,

DOCKET NO. INC. 97-438

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department denied a refund of 1996 income tax claimed by John A. and Catherine Knickrehm (jointly "Taxpayers"). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, 40-2A-7(c)(5)a. A hearing was conducted on January 21, 1998. The Taxpayers represented themselves. Assistant Counsel Jeff Patterson represented the Department.

The issue in this case is whether payments received by John Knickrehm (individually "Taxpayer") from his ex-employer in 1996 pursuant to a "Mutual Separation Agreement & Release" should be excluded from gross income for Alabama income tax purposes pursuant to Code of Ala. 1975, 40-18-14(2)e.

The Taxpayer was employed by Loral Corporation. In November 1995, the Taxpayer and Loral entered into a Mutual Separation Agreement & Release. The Taxpayer had not sued Loral or made any employment discrimination claims against Loral before signing the Agreement.

The Agreement provided that the Taxpayer's job would be terminated by mutual agreement on December 1, 1995. Loral agreed to pay the Taxpayer

\$58,732.50 in bi-weekly installments. In return, the Taxpayer agreed to release Loral from all age, race,

sex or other discrimination claims, and from any other employment-related claims the Taxpayer may have against Loral.

The Taxpayer received \$56,124.86 in 1996 pursuant to the Agreement. The Taxpayers failed, however, to report the amount as income on their 1996 Alabama return. The Department audited the Taxpayers, included the amount in the Taxpayers' gross income, and assessed tax accordingly. The Taxpayers paid the additional tax to stop interest from accruing, and petitioned for a refund. The Department denied the refund, and the Taxpayers appealed to the Administrative Law Division.

The Taxpayers claim that the payments received pursuant to the Agreement are exempt from Alabama income tax under 40-18-14(2)e. That statute exempts from Alabama tax any amounts excludable from federal gross income pursuant to 26 U.S.C. 104. Section 104(a)(2) excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness."

Specifically, the Taxpayer claims that the amounts paid by his ex-employer are damages received on account of personal injuries because in return, he waived all rights to sue Loral for age discrimination or any other employment-related claim.

The term "damages" as used in 104(a)(2) "means an amount received (other than worker's compensation) through a prosecution of a legal suit or action based

upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." Treas. Reg. 1.104-1(c).

The Taxpayer did not sue Loral or otherwise make a claim against Loral before entering into the Agreement. Consequently, this case turns on whether the Agreement constitutes a "settlement agreement entered into in lieu of prosecution" within the scope of 104(a)(2). In my opinion, it does not because there was no bona fide dispute settled by the Agreement. "Where the issue is an asserted exclusion from taxable income, it is imperative that a 'settlement' involve a bona fide dispute." Taggi v. U.S., 35 F.3d 93, 96 (2nd Cir. 1994).

In Taggi, the taxpayer entered into a separation agreement and release with his employer. The taxpayer received a lump sum in return for releasing the employer from all claims arising from any age, sex, race or other forms of discrimination, or any other employment-related claims. The taxpayer claimed that the payments were excludable under Section 104. The Court disagreed because there was no specific, on-going dispute settled by the agreement.

"The Tax Court consistently has stressed the importance of a bona fide dispute over excludable damages. See, e.g., Glynn v. Commissioner, 76 T.C. 116, 121, 1981 WL 11320 (1981) ("Here, no claim for personal injury was ever made."), aff'd, 676 F.2d 682 (1st Cir. 1982); Whitehead v. Commissioner, 41 T.C.M. (CCH) 365, 368, 1980 WL 4334 (1980) ("Furthermore, there was no evidence presented that petitioner asserted any tort claims during the settlement negotiations with the university."); Anderson v. Commissioner, supra, 38 T.C.M. (CCH) at 1208 ("Dr. Anderson never made such a claim or represented to Leaseure that such a claim was contemplated by him [for defamation or loss reputation]")."

"The following excerpt from Kurowski v. Commissioner, 917 F.2d 1033, 1036 (7th Cir. 1990), illustrates the proper application of this rule:

"Except for after-the-fact self-serving testimony by the taxpayer, nothing in the record shows that the settlement was to compensate taxpayer for any 'personal injuries or sickness' within Section 104(a)(2) of the Code. Indeed, no such claim had been made in the settlement negotiations. It is axiomatic that while taxable income should be broadly construed, exclusions to income should be narrowly defined. Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir. 1990) (holding that punitive damages are not excludable income within the meaning of Section 104(a)(2)). As in Glynn v. Commissioner, 76 T.C. 116 (1981), affirmed without published opinion, 676 F.2d 682 (1st Cir. 1982), since no claim for personal injuries was ever made, the settlement amounted to severance pay."

Taggi, at page 96.

Taggi is directly on point in this case. The Taxpayer had not sued or otherwise made a claim against Loral before entering into the Agreement. In the Agreement itself, the Taxpayer acknowledges that Loral had not discriminated against him or otherwise acted unlawfully toward him. Consequently, because the Agreement was not a "settlement agreement" within the context of 104(a)(2), the payments received by the Taxpayer were not exempt from Alabama income tax under 40-18-14(2)e. The refund claimed by the Taxpayers was thus properly denied by the Department.

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

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Entered January 29, 1998.

BILL THOMPSON
Chief Administrative Law Judge

BT:ks

cc: Jeff Patterson, Esq.
John A. and Catherine A. Knickrehm
Kim Herman (503-28-5995)