THOMAS R. MCALPINE P.O. Box 161486 Mobile, AL 36616,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. INC. 98-432
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed income tax against Thomas R. McAlpine (ATaxpayer@) for 1986 through 1994. 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 September 10, 1999, in Mobile, Alabama. Attorney George Whitfield and CPA Mark Pawlowski represented the Taxpayer. Assistant Counsel Duncan Crow represented the Department.

ISSUES

This case involves the following issues:

(1) Did the Department timely assess the Taxpayer as required by Code of Ala. 1975, '40-2A-7(b)(2)? That issue turns, in part, on whether the Taxpayer filed fraudulent returns for the subject years with the intent to evade tax. Code of Ala. 1975, '40-2A-7(b)(2)a.

(2) Did the Department correctly disallow alimony deductions claimed by the Taxpayer in 1993 and 1994?

(3) Did the Department correctly disallow one-half of the home mortgage interest deducted by the Taxpayer in 1987 through 1992?

(4) Did the Department correctly include as income two checks received by the Taxpayer from Bay City Construction Company in 1991?

FACTS

The Taxpayer is an attorney in Mobile, Alabama. He and his wife were having marital problems in the late 1980's and early 1990's. The couple divorced in 1993.

The Department discovered in 1993 that the Taxpayer had failed to file Alabama income tax returns for 1986 through 1992. A Department examiner and a special agent from the Department=s Special Investigations Unit visited the Taxpayer at his law office on September 23, 1993, and read him his Miranda[1] rights. The Department subsequently criminally prosecuted the Taxpayer for failure to file returns or pay the tax due.[2] The Taxpayer pled guilty in November 1996 to one count of failure to timely file his 1992 Alabama return and pay the tax due.

On May 23, 1994, during the course of the Department=s criminal investigation, the Taxpayer filed individual Alabama returns for 1987 through 1991. The returns were prepared by the Taxpayer=s CPA. The

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[1]Miranda v. Arizona, 384 U.S. 436 (1966).

[2]The Taxpayer was charged pursuant to Code of Ala. 1975, '40-29-112, which provides that any person that willfully fails to file a return or pay tax is guilty of a misdemeanor. It is unclear for which years the Taxpayer was criminally prosecuted. The Civil Action Summary, Department Exhibit 3, states three counts, but the November 18, 1996 entry on the Summary shows that Counts I, II, and III were *nol prossed*, and that the Taxpayer pled guilty to Count IV relating to 1992.

Taxpayer filed his 1992 return on March 18, 1997, his 1993 return on January 18, 1996, and his 1994 return on April 18, 1995. He never filed a 1986 return.

The Department audited the Taxpayer for 1986 through 1994. The Department prepared a 1986 return for the Taxpayer, which is not contested. The Department adjusted the Taxpayer=s 1987 through 1994 returns as follows:

(1) The Department disallowed alimony deducted by the Taxpayer in 1993 and 1994. The Department claims the payments were a property settlement, and thus not deductible.

(2) The Department disallowed one-half of the home mortgage interest deducted by the Taxpayer on his 1987 through 1992 returns. The Department disallowed the interest because (1) the Taxpayer=s ex-wife also claimed one-half of the interest on her individual returns for the subject years, (2) the Taxpayer failed to prove that the income used to pay the mortgage was his income, and not his ex-wife=s, and (3) the Taxpayer failed to provide checks verifying the amounts claimed.

The Taxpayer contends he paid the mortgage with income from his law practice. He provided the Department with some canceled checks for 1990, 1992, and 1993 during the audit. Those checks were disallowed solely because the Taxpayer=s ex-wife had claimed one-half of the interest on her returns. See, Taxpayer Ex. 2. The Taxpayer also provided 25 checks at the September 10 hearing. Those checks were written on the Taxpayer=s individual checking account.

(3) The Department included in the Taxpayer=s 1991 income two checks from Bay City Construction payable to the Taxpayer. The checks totaled $3,109.86. One of the checks was for Alegal fees@.

The Taxpayer claims the checks were reimbursement for expenses relating to an airplane he owned jointly with the two owners of Bay City Construction. That claim is supported by the testimony of Neil Green, one of the two owners of Bay City Construction. Green testified that the Bay City employee that prepared the checks probably put Alegal fees@ on one of the checks because the Taxpayer=s law firm occasionally represented Bay City Construction.

(4) The Department included interest income the Taxpayer failed to report on his 1987, 1988, and 1989 returns in the amounts of $713, $830, and $467, respectively. The Department also included unreported partnership income of $1,397 in 1989. The Taxpayer concedes he failed to report the above income, but argues that the amounts were only inadvertently omitted.

(5) Finally, at the request of the Special Investigations Unit, the Department assessed the 50 percent fraud penalty against the Taxpayer for 1986 through 1992, pursuant to Code of Ala. 1975, '40-2A-11(d).

ANALYSIS

ISSUE (1) - DID THE DEPARTMENT TIMELY ASSESS THE TAXPAYER?

The Department timely entered the 1992, 1993, and 1994 preliminary assessments within three years from when the returns for those years were filed. '40-2A-7(b)(2). The Taxpayer never filed a 1986 return. Consequently, the Department was authorized to assess the Taxpayer for that year at any time. '40-2A-7(b)(2)a. The issue thus is whether the Department timely assessed the Taxpayer for 1987 through 1991.

The Department entered the 1987 through 1991 preliminary assessments on February 3, 1998, more than three years after the Taxpayer filed his returns for those years on May 23, 1994. Those years are thus time-barred unless the Taxpayer filed fraudulent returns with the intent to evade tax, in which case the Department is authorized to assess the tax at any time. See again, '40-2A-7(b)(2)a.

The Alabama statute that allows the Department to assess tax at any time if a fraudulent return is filed, '40-2A-7(b)(2)a., is modeled generally after the relevant federal statute, 26 U.S.C. '6501(c). Consequently, federal case law should be followed in interpreting the Alabama statute. Best v. State, Department of Revenue, 417 So.2d 197 (Ala.Civ.App. 1981).

The Department is required to prove fraud by clear and convincing evidence. Bradford v. C.I.R., 796 F.2d 303 (1986). AThe burden is upon the Commissioner to prove affirmatively by clear and convincing evidence actual and intentional wrong-doing on the part of the (taxpayer) with a specific intent to evade the tax.@ Lee v. U.S., 466 F.2d 11, 14 (1972), citing Eagle v. Commissioner of Internal Revenue, 242 F.2d 635, 637 (5th Cir. 1957). The existence of fraud must be determined on a case-by-case basis from a review of the entire record. Parks v. Commissioner, 94 T.C. 654, 660 (1990).

The Department claims the Taxpayer filed fraudulent returns because he (1) deducted his home mortgage interest paid from 1987 through 1992, (2) failed to report the two checks from Bay City Construction as income in 1991, and (3) failed to report interest income in 1987 and 1988, and interest and partnership income in 1989. I disagree.

Concerning the interest deduction, the Department now concedes that if the Taxpayer paid the interest, and can verify the amounts paid, he should be allowed the entire deduction. This issue thus turns on whether the Taxpayer can verify the amounts claimed. See Issue (3), below. But even if he cannot verify the

amounts claimed, failure to provide records to support an otherwise allowable deduction does not, by itself, constitute fraud.

The Taxpayer omitted interest income of $713 in 1987 and $830 in 1988; interest and partnership income of $1,864 in 1989; and, assuming the two checks from Bay City Construction were income, $3,110 in 1991. The omission of that relatively small amount of income is insufficient to establish a willful intent to evade tax. AFailure to report or mere understatement of income is not, standing alone, sufficient to prove fraud,...@ Rohde v. United States, 273 F.Supp. 190, 192 (1967). The Amere under reporting of gross receipts or income is itself insufficient to establish a finding of fraud (unless there are) >repeated understatements in successive years when coupled with other circumstances showing an intent to conceal or misstate taxable income...=@ Barrigan v. C.I.R., 69 F.3d 543, 546 (1995), citing Furnish v. C.I.R., 262 F.2d 727, 728 (1958).

There are no Aother circumstances@ in this case showing that the Taxpayer willfully omitted the income from his return with the intent to evade tax. To the contrary, the Taxpayer filed the returns during the Department=s ongoing criminal investigation. He certainly knew the returns would be closely reviewed by the Department. The total income omitted by the Taxpayer, again assuming the two checks from Bay City Construction were income, totaled $6,517. At five percent, the tax on that income is $326. Under the circumstances, it is highly improbable that the Taxpayer, knowing his returns would be audited, intentionally failed to report income to save $326.

The fact that the Taxpayer failed to timely file his 1987 through 1991 returns also does not establish fraud for purposes of the Alabama statute of limitations at '40-2A-7(b)(2)a. That statute allows the Department to assess tax at any time in fraud cases only Aif a false or fraudulent return is filed with the intent to evade tax@. The statute thus requires that the return itself must be fraudulent.

Federal law can be distinguished because under the federal statute of limitations, tax can be assessed

at any time if a taxpayer files a fraudulent return, 26 U.S.C. ' 6501(c)(1), or if a taxpayer willfully attempts in any manner to defeat or avoid tax, 26 U.S.C. ' 6501(c)(2). Consequently, for federal purposes, if a taxpayer fails to file a return knowing that tax is owed, that is evidence of an attempt to evade tax that would allow the IRS to assess tax at any time. As indicated, however, for Alabama purposes the fraud statute of limitations applies only if the taxpayer willfully omits income from a return, or claims erroneous or excessive deductions on a return with the intent to evade tax.[3]

Objectively viewing the facts, the evidence does not establish that the Taxpayer willfully filed fraudulent returns with the intent to evade tax. Because there is no fraud, the Department=s assessments for 1987 through 1991 were not timely entered, and must be dismissed.

Even if the Taxpayer had filed fraudulent returns, the Department still may not have timely assessed the Taxpayer in accordance with the Alabama Court of Civil Appeals= opinion in New Joy Young Restaurant, Inc. v. State, Department of Revenue, 667 So.2d 1384 (Ala.Civ.App.1995). The Court held in New Joy Young that the statute that allowed the Department to assess tax at any time in fraud cases, Code of Ala. 1975, ' 40-

[3]The distinction between Alabama and federal law applies only to the different statute of limitations for assessing tax in fraud cases. It does not apply to the fraud penalty statutes because the Alabama statute at Code of Ala. 1975, ' 40-2A-11(d) was modeled after and is virtually identical to the federal fraud penalty statute at 26 U.S.C. ' 6653(b)(1).

23-18(b)(now ' 40-2A-7(b)(2)a.), must be read in conjunction with Code of Ala. 1975, ' 6-2-3. Section 6-2-3 provides that a civil fraud action must be filed within two years from when the fraud is discovered. The Court in substance held that if a taxpayer files a fraudulent return, the Department must assess the taxpayer within either the normal three year statute, or two years from when the Department discovered or is deemed to have discovered the fraud, whichever is later.

While I respectfully but strongly disagree with the Court=s rationale in New Joy Young, that case is currently the law in Alabama.[4] Consequently, the Department had only two years from when it discovered fraud to assess the Taxpayer. The Taxpayer filed his 1987 through 1991 returns in May 1994. Presumably, the Department was aware of the facts on which it based its fraud claim more than two years before the preliminary assessments were entered on February 3, 1998. Consequently, the Department was probably also barred by the rationale of New Joy Young from assessing the Taxpayer when it did.

The dismissal of the 1987 through 1991 final assessments as time-barred does not indicate approval of the Taxpayer=s willful failure to timely file returns and pay the tax due. He is an attorney, and certainly knew his legal and ethical obligation to file and pay. But reviewing the facts fairly and objectively, I cannot find that the Taxpayer filed his returns with the willful intent to evade tax.

The remaining issues concerning the open years 1992, 1993, and 1994 are discussed below.

ISSUE (2) - THE ALIMONY DEDUCTION

The Taxpayer was required by his 1993 divorce decree to pay his ex-wife Aas alimony in gross@ $1,200 per month for 48 months. The Taxpayer deducted the above amounts as alimony on his 1993 and

[4]The Alabama Supreme Court denied certiorari in New Joy Young, but stated in its opinion that in denying certiorari, the Court did not wish to be understood as approving the language, reasons, or statements of law in the Court of Civil Appeals= opinion. That indicates to me that while the Supreme Court did not agree with the Court of Civil Appeals= rationale, it concurred in the result, probably because of the Department=s unexplained five year delay in assessing the taxpayer.

1994 returns pursuant to Code of Ala. 1975, '40-18-15(17). The Taxpayer contends the payments were deductible alimony because the parties understood that the amounts would constitute alimony. However, this issue turns on the language in the divorce decree, not what the parties may have understood.

Alimony may be deducted for Alabama purposes to the same extent allowed for federal purposes at 26 U.S.C. '215. Section 215 provides that alimony may be deducted if the payee spouse must include the amounts as income pursuant to 26 U.S.C. '71. Payments constitute alimony under '71 if certain conditions are met. One of those conditions is that the payor spouse is not required to make the payments after the death of the payee spouse.

In this case, the Taxpayer was obligated to pay $1,200 a month for 48 months, even if his ex-wife had died during the 48 month period. Because the payments did not terminate on the death of the ex-wife, the payments did not constitute alimony. The Department correctly disallowed the alimony deducted in 1993 and 1994. See, Margaret A. Kelley v. State of Alabama, INC. 97-269 (Admin. Law Div. 10/01/97).

ISSUE (3) - THE HOME MORTGAGE INTEREST DEDUCTION

The only open year involving the home mortgage interest deduction is 1992. As indicated, if the Taxpayer can prove he paid the mortgage interest in 1992, he should be allowed the entire deduction.

The Taxpayer provided the Department with some checks concerning 1992 during the audit. Nine of the 25 checks provided by the Taxpayer at the September 10 hearing also involved mortgage payments in 1992. Those checks were written on the Taxpayer=s individual account at Central Bank.

The Taxpayer claims he cannot obtain more canceled checks because they were destroyed by his bank. He argues that the Department subpoenaed his checks in conjunction with its criminal investigation, and that the Department should be required to provide those checks so he can verify the interest deductions. The

Department refuses to give the Taxpayer his checks, claiming it is prohibited from doing so by The Grand Jury Secrecy Act, Code of Ala. 1975, '12-16-216.

Section 12-16-216 broadly prohibits any person from divulging grand jury testimony or physical evidence. It does, however, permit the State to use such evidence Ain any manner permitted by law.@ I have not researched the issue, but it would seem that providing a taxpayer with his own bank records to verify a deduction would be permitted by law.

In any case, even if the Department is prohibited from providing the checks, the Taxpayer has otherwise sufficiently verified that he is entitled to the home mortgage interest deducted in 1992. That deduction should be allowed.

ISSUE (4) - THE BAY CITY CONSTRUCTION CHECKS

The Taxpayer received the two Bay City Construction checks in 1991. This issue is moot because the 1991 final assessment is time-barred by the statute of limitations.

SUMMARY

The tax and interest included in the 1986 final assessment is affirmed. The fraud penalty should be deleted from that assessment, and the Department should instead include the failure to timely file and pay penalties levied at Code of Ala. 1975, ''40-2A-11(a) and (b), and the negligence penalty levied at Code of Ala. 1975, '40-2A-11(c).

The 1987 through 1991 final assessments are dismissed.

The Department should adjust the 1992 final assessment by allowing the mortgage interest claimed in that year. The Department should also remove the fraud penalty, and instead include the failure to timely file and pay penalties, and the negligence penalty.

The 1993 and 1994 final assessments are affirmed.

Additional interest is also owed from the date of entry of the final assessments. The Department should recompute the Taxpayer=s liabilities as indicated above. The Department should also explain how the $14,871.68 paid by the Taxpayer on November 23, 1998 was applied to the adjusted liabilities. 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 October 26, 1999.