HOWARD C. & ANN C. OLIVER '
10065 Emerald Coast Parkway W. C3
Destin, Florida 32541, '

Taxpayers, '

v. '

STATE OF ALABAMA '
DEPARTMENT OF REVENUE.

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. INC. 98-458

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Howard C. and Anne C. Oliver (together ATaxpayers@) for 1990 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on March 30, 1999. Robert Walthall represented the Taxpayers. Assistant Counsel Mark Griffin represented the Department.

Howard C. Oliver (individually ATaxpayer@) settled a lawsuit in 1990. The issue in this case is whether a portion of the settlement proceeds received by the Taxpayer should be excluded from income pursuant to Code of Ala. 1975, ' 40-18-14(3)(e). That Alabama statute 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.@

The Taxpayer was hired by James C. Wilson, Jr. (AWilson@) in 1979. Wilson was involved in numerous business ventures that primarily involved the ownership and operation of shopping malls and other commercial properties. The Taxpayer and Wilson agreed that the Taxpayer would own five percent of Wilson=s interest in a venture. While employed by Wilson, the Taxpayer obtained a five percent interest in eighteen partnerships. The Taxpayer resigned his job with Wilson effective December 31, 1986. However, he retained his interest in the eighteen partnerships.

Wilson sued the Taxpayer in November 1987. The complaint demanded that Wilson be allowed to

purchase the Taxpayer=s interest in four of the partnerships for ten dollars each. The complaint further alleged that the Taxpayer should be required to transfer his interest in the remaining fourteen partnerships to Wilson for no consideration.

Wilson subsequently offered to pay the Taxpayer $479,000 for his interest in the various partnerships. The Taxpayer rejected Wilson=s offer, and instead filed a counterclaim against Wilson in November 1988, and an amended counterclaim in April 1989. The counterclaims asserted seventeen claims against Wilson, including fraud, misrepresentation, bad faith, breach of fiduciary duty, oppression, conspiracy, and others. The total damages claimed in the counterclaims were $52,075,000 in compensatory damages and $72,500,000 in punitive damages.

The parties settled the lawsuit in March 1990. Pursuant to the settlement, Wilson and the other partners transferred their interest in one of the partnerships, Shelby Associates, to the Taxpayer. Wilson also issued two promissory notes to the Taxpayer, one for $987,813 and a second for $1.4 million. Payment of the notes was conditioned on certain events occurring.[1] In return, the Taxpayer conveyed his interest in the remaining seventeen partnerships to Wilson. The settlement agreement also included the usual settlement disclaimer that neither party was admitting liability.

The Taxpayers filed their 1990 Alabama income tax return in October 1991. The Taxpayers claim they reported $517,607 of the settlement proceeds on that return. The Department argues that none of the settlement proceeds were reported on the return. The return itself, on Schedule D, indicates that the amount received by the Taxpayer for his five percent interest in the seventeen partnerships was $517,607. How the

[1]The notes were later reduced and settled by the parties and are not relevant to this case.

Taxpayers determined the sales price for the various partnership interests is not in evidence.

The Taxpayer transferred a five percent interest in Shelby Associates to his wife so the partnership would not collapse as a single member entity. The Taxpayers subsequently sold Shelby Associates to Metropolitan Life Insurance Company in 1992 for $6.7 million.

The Taxpayers filed an amended 1990 return in December 1993. The amended return reported $6,365,000, or 95 percent of the $6.7 million sales price, as the amount received by the Taxpayer from the 1990 settlement. Of that amount, the return identified $755,393 as taxable income received pursuant to the settlement on account of certain non-personal injury and contractual claims. With the $517,607 reported on the original 1990 return, the Taxpayers thus reported $1,273,000 as taxable income in 1990, or 20 percent of the total the Taxpayer received from the settlement. The Taxpayers excluded from income the remaining 80 percent, or $5,092,000, pursuant to ' 104(a)(2).

The Department audited the Taxpayers and disallowed the $5,092,000 exclusion claimed on the amended return. The Department also included as income the $517,607 it claims was not reported on the Taxpayers= original 1990 return. Those adjustments resulted in the final assessment in issue. The Taxpayers appealed.

The Taxpayers reported $1,273,000, or 20 percent of the total settlement received by the Taxpayer, as taxable income in 1990. The issue is whether the Taxpayers properly excluded from income the remaining 80 percent, or $5,092,000, pursuant to ' 104(a)(2). 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 counterclaim clearly alleged certain tort-like injuries. A portion of the $5,092,000 should thus be excluded from income pursuant to ' 104(a)(2). As explained below, however, only that portion attributable to compensatory damages can be excluded, not that portion attributable to punitive damages.

Before 1989, ' 104(a)(2) in pertinent part excluded from income Adamages received . . . on account of personal injuries or sickness.@ Section 104(a)(2) was amended in 1989 by Pub. L. 101-239, ' 7641(a). That amendment specified that the ' 104(a)(2) exclusion did not apply to punitive damages received in cases not involving physical injuries or sickness. However, that amendment applied only to causes of action filed after July 10, 1989. The Taxpayer filed his counterclaim in November 1988, and his amended counterclaim in April 1989. The pre-1989 version of ' 104(a)(2) thus applies in this case. Punitive damages were not excluded from income under the pre-1989 version of ' 104(a)(2). O=Gilvie v. U.S., 117 S.Ct. 452 (1996); see also, Rice v. U.S., 834 F.Supp. 1241 (1993), C.I.R. v. Miller, 914 F.2d 586 (1990), Roemer v. C.I.R., 716 F.2d 693 (1983). In Rice, supra, the Court explained as follows:

> AThe remaining question is whether the $236,195.00 punitive damage settlement is excludable under ' 104(a)(2). The history of the treatment of punitive damages under the Tax Code is somewhat tortured. Initially, punitive damages were taxed as ordinary income. But in 1975, the IRS issued a Revenue Ruling which interpreted ' 104(a)(2) to exclude punitive damages received on account of a personal injury. Rev. Rule. 75-45, 1975-1 C.B. 47; see Roemer v. C.I.R., 716 F.2d 693, 700 (9th Cir. 1983). In 1983, the Ninth Circuit held that in light of the Commissioner=s >liberal= interpretation of the statute in the Revenue Ruling, punitive damages awarded on a defamation claim were excluded from gross income. Roemer, 716 F.2d at 700.
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> AThen, in 1984, the IRS reversed field and revoked Rev. Rul. 75-45, because punitive damages do not compensate a taxpayer for loss and >are awarded not >on account of personal injury= but are determined with reference to the defendant=s degree of fault.= Rev. Rul. 84-108, 1984-2 C.B. 32. In C.I.R. v. Miller, 914 F.2d 586, 591 (4th Cir. 1990), the Fourth Circuit recognized the effect of the Commissioner=s shift:
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>> >[In Roemer], the Ninth Circuit was merely presenting proof that when in Rome one should do as the Romans do. However, in the first place, the Commissioner=s subsequent shift in position calls for Roemer, as a Roman, to shift also. Id. 914 F.2d at 591.=
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> AIn light of the 1984 Revenue Ruling and the general principle that exclusions from income are narrowly construed, the Miller court held that punitive damages should be included in gross income. Id.
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> AFinally, in 1989, Congress amended ' 104(a)(2) to provide that the exclusion for

> personal injury damages >shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.= The parties agree that the 1989 amendment has no bearing on this case, although plaintiffs argue that the IRS sought the 1989 amendment because =for previous and transition years, those punitive damages were in fact excludable.=
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> **A**Plaintiffs urge the court to follow Roemer. But Roemer relied solely (and perhaps reluctantly) on the 1975 Revenue Ruling that was subsequently revoked. Before that Ruling, it was well-settled that punitive damages were taxable income because they represented an accession to wealth rather than restoration of capital. See, e.g., Starrels v. C.I.R., 304 F.2d 574, 576-77 (9th Cir. 1962). Because the Ruling has been revoked, punitive damages are again taxable income.**@**

Rice v. U.S., 834 F.Supp. at 1245, 1246.

The issue thus becomes what portion of the settlement constituted non-excludable punitive damages.

The settlement agreement does not apportion the settlement between punitive and compensatory damages. In such cases, other relevant factors must be considered, including the types and amounts of damages claimed in a party=s complaint. Delaney v. C.I.R., 99 F.3d 20, 25 (1996); see also, Metzger v. Commissioner, 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 **A**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.**@**

In this case, the Taxpayer=s counterclaim and amended counterclaim sought punitive damages of $72,500,000 and compensatory damages of $52,075,000. The ratio of punitive to compensatory damages was

approximately 58 percent to 42 percent. Applying those percentages to the $5,092,000 in question, 38 percent of that amount, or $2,138,640, should be excluded from income pursuant to ' 104(a)(2). The punitive damages of $2,953,360 must be included in the Taxpayers= 1990 income.

The Department is directed to recompute the Taxpayers= 1990 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 19, 1999.