JIMMY B. & WANDA C. DUPREE ' STATE OF ALABAMA
103 Pineneedle Drive DEPARTMENT OF REVENUE
Ashford, AL 36312, ' ADMINISTRATIVE LAW DIVISION

Taxpayers, ' DOCKET NO. INC. 99-119

v. '

STATE OF ALABAMA '
DEPARTMENT OF REVENUE.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed 1993 income tax against Jimmy B. and Wanda C. Dupree (together ATaxpayers@). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. Mitch McNab represented the Taxpayers. Assistant Counsel David Avery represented the Department.

ISSUES

Jimmy Dupree (individually ATaxpayer@) received $6.5 million when he settled a lawsuit in 1993. The settlement agreement indicated that $1.75 million of that amount was received for Anon-economic losses.@ This case involves the following issues:

(1) Should a portion of the $1.75 million be excluded from income pursuant to Code of Ala. 1975, '40-18-14(3)(e)? That statute adopts by reference 26 U.S.C. '104(a)(2), which excludes from income Adamages received . . . on account of personal injuries or sickness@;

(2) Should the attorney fees paid by the Taxpayer be excluded from the Taxpayers= income, as argued by the Taxpayer, or allowed as an itemized deduction, as argued by the Department;

(3) Did the Department timely assess the tax in issue pursuant to Code of Ala. 1975, '40-2A-7(b)(2)?

FACTS

The Taxpayer=s father, Cecil B. Dupree, started Graceba Telephone Corporation in 1960. The company later changed its name to Graceba Total Communications, Inc., and is referred to herein as AGraceba@ or Acompany.@ The Taxpayer and his brother, Cecil E. Dupree, worked for and were officers of Graceba during the 1970's.

In the late 1970's, the Taxpayer=s father relinquished control of Graceba to Cecil E. Dupree, who was subsequently elected president and manager of the company. Over the next decade, Cecil Dupree allegedly schemed to remove or squeeze out the Taxpayer as an employee and shareholder of the company. As a result, the Taxpayer sued Cecil Dupree, Cecil=s wife Linda Dupree, and others in Houston County Circuit Court in 1991.

The complaint and a subsequent amended complaint contained ten counts. Count 1 alleged that Cecil Dupree had breached his fiduciary duty to Graceba. Count 2 alleged that Cecil Dupree had breached his fiduciary duty to the Taxpayer, as a minority stockholder in Graceba, by siphoning funds from the company for his personal use and to avoid paying the Taxpayer dividends, and engaging in oppressive conduct in an attempt to eliminate any benefits the Taxpayer might enjoy as a stockholder. Count 3 alleged that Cecil Dupree had breached his fiduciary duty as a trustee of the Cecil B. Dupree Trust, in which the Taxpayer was a beneficiary. Count 4 alleged that Cecil Dupree had breached a contract that required him to pay the Taxpayer $80,000, plus other miscellaneous benefits. Count 5 alleged that Cecil and Linda Dupree, as shareholders and directors of

Graceba, had negligently and wantonly engaged in oppressive behavior against the Taxpayer. Count 5, at paragraph 64, also alleged that the Taxpayer had suffered Amental anguish and aggravation.@ Count 6 alleged that Cecil and Linda Dupree had wasted Graceba=s assets and usurped Graceba=s opportunities for personal gain. Count 7 alleged that Cecil and Linda Dupree had illegally conspired to eliminate the Taxpayer=s ownership and economic interest in the company. Count 8 alleged that Cecil Dupree was guilty of fraud and misrepresentation relating to various transactions entered into as president of Graceba. Count 9 petitioned the Circuit Court to dissolve Graceba based on Cecil Dupree=s wrongful conduct. Count 10 alleged that Linda Dupree had breached her duties as a trustee in the Cecil B. Dupree Trust, in which the Taxpayer was a beneficiary.

The complaints requested the following relief: (1) damages sustained by Graceba as a result of Cecil Dupree=s wrongful conduct, (2) all dividends wrongfully withheld from the Taxpayer by Cecil Dupree, or at his direction, (3) the removal of Cecil Dupree as trustee of the Cecil B. Dupree Trust, and that all income wrongfully withheld from the Trust be paid to the Taxpayer, (4) $80,000 in damages as a result of Cecil Dupree=s breach of contract with the Taxpayer, (5) damages sufficient to compensate the Taxpayer for the loss of his rightful share of the company=s distributions denied him, plus punitive damages, (6) that Cecil and Linda Dupree be required to repay Graceba the amount of loss caused the company due to their negligent and willful acts, plus punitive damages, (7) that Cecil and Linda Dupree be required to compensate the Taxpayer for the losses he suffered due to their conspiracy to deprive him of his rightful ownership and economic interest in Graceba, plus punitive damages, (8) that the Taxpayer be compensated as a result of fraud committed by Cecil Dupree in his operation of Graceba, (9) that the Court dissolve Graceba and award the Taxpayer his rightful proportionate share of the proceeds, and (10) that Linda Dupree be replaced as trustee of the Cecil B. Dupree Trust, and be required to repay the Taxpayer for his losses due to her wrongful acts as trustee.

The parties settled the lawsuit in October 1992. The settlement agreement required the defendants to pay the Taxpayer as follows:

(1) $4.5 million for the transfer of all of the Taxpayer's interest in Graceba;

(2) $250,000 for executing the settlement agreement;

(3) $4 million for alleged economic losses; and

(4) $1.75 million for alleged non-economic losses.

The Taxpayer received the above amounts in 1993. Linda Dupree paid $857,500 of the alleged non-economic loss. Cecil Dupree paid the balance.

The Taxpayers filed their original 1993 Alabama return in April 1994. They filed an amended return in May 1997, and a second amended return in September 1997. In total, the Taxpayers reported all of the settlement proceeds, except the $1.75 million designated as non-economic loss. The Taxpayers also failed to report that amount on their 1993 federal return.

The IRS adjusted the Taxpayers' 1993 return by including the entire $1.75 million as income. The Department received notice of the initial IRS audit change on December 17, 1997. The IRS subsequently excluded 35 percent of the $1.75 million from income pursuant to '104(a)(2).

The Department included the entire $1.75 million as income based on the initial IRS adjustment. The Department refused to exclude 35 percent of the amount, as did the IRS pursuant to '104(a)(2), because it determined that the IRS settlement was Abased on the IRS=s statutory ability to compromise debts owed the U.S., a power which is not granted to the Department of Revenue.@ Dept. brief, at p. 3. The Department entered a preliminary assessment against the Taxpayers on October 9, 1998. A final assessment was entered on December 14, 1998. The Taxpayers appealed.

<u>ANALYSIS</u>

<u>Issue 1 - Should any part of the $1.75 million be excluded from income pursuant to '104(a)(2)</u>?

Section 104(a)(2) excludes from income damages received on account of tort or tort-like personal injuries. Section 104(a)(2) was amended in 1996 by P.L. 104-188. Under the current version of '104(a)(2), only damages received on account of personal physical injuries or physical sickness can be excluded. However, the pre-1996 statute applies in this case because the year involved is 1993. Under the pre-1996 statute, damages for non-physical personal injuries can also be excluded under certain circumstances.

The criteria for excluding income pursuant to the pre-1996 version of '104(a)(2) was explained by the U.S. Tax Court in <u>Gregg v. C.I.R.</u>, 77 T.C.M. 1215 (1999):

> In *United States v. Burke*, *supra* at 237, the Supreme Court held that to qualify for the section 104(a)(2) income exclusion, a taxpayer must show that the legal basis for recovery redresses a Atort-like personal injury.@
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> In *Commissioner v. Schleier, supra* at 336, the Supreme Court concluded

> that a tort or tort-like claim is a necessary but insufficient condition for excludability under section 104(a)(2). The Supreme Court held that excludability under section 104(a)(2) also requires that the amounts received be Aon account of personal injuries or sickness,@ focusing on whether there is a proximate cause between any personal injury and the damages recovered. *Commissioner v. Schleier, supra* at 336.
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> It is well settled that Apersonal injuries@ include intangible as well as tangible harms, and nonphysical as well as physical injuries. *Commissioner v. Schleier, supra* at 329 n.4; *United States v. Burke, supra* at 234 n.6; *Threlkeld v. Commissioner* [Dec. 43,209], 87 T.C. 1294, 1305 (1986), affd. [88-1 USTC **&**9370] 848 F.2d 81 (6th Cir. 1988). In *United States v. Burke, supra* at 239, the Supreme Court distinguished personal tort-like injuries from Alegal injuries of an economic character.@ Similarly, in *Commissioner v. Schleier, supra* at 331, the Supreme Court distinguished Ainjuries that were personal rather than economic.@ See also *Robinson v. Commissioner* [Dec. 49-648], 102 T.C. 116, 126 (1994), affd. in part, revd. in part on another issue [95-2 USTC **&**50,644] 70 F.3d 34 (5th Cir. 1995) and cases cited therein (damages are not excludable under section 104(a)(2) if they are Areceived pursuant to the settlement of economic rights arising out of a contract (e.g., lost profits)); *Kightlinger v. Commissioner* [Dec. 52,903(M)], T.C. Memo. 1998-357, and cases cited therein (recovery for damages to Abusiness or property@ is separate and distinct from recovery for personal injuries.)
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> To determine whether damages are received on account of personal injuries under section 104(a)(2), we look to the nature of the claim underlying the damages award. *United States v. Burke, supra* at 237; *Threlkeld v. Commissioner, supra* at 1305. Our focus is on the nature of the taxpayer=s injury and whether the award was received on account of personal or nonpersonal injuries. *Threlkeld v. Commissioner, supra* at 1308; *Bennett v. Commissioner* [Dec. 49,819(M)], T.C. Memo. 1994-190.

The Taxpayers argue that the settlement agreement specifying that the $1.75 million was received for Anon-economic loss@ is controlling. However, a settlement agreement is not dispositive. <u>Rozpad v. C.I.R.</u>, 154 F.3d 1 (1998); <u>Bagley v. C.I.R.</u>, 121 F.3d 393 (1997). Such agreements are suspect because the payor party has nothing to lose by agreeing that a portion of the payment is for excludable personal injuries, or in this case, Anon-economic loss.@ Rather, as indicated, the nature of the underlying claim is controlling. Delaney v. Commissioner, 99 F.3d 20 (1996).

The best evidence of the nature of the Taxpayer=s underlying claim is his complaint. The Taxpayer=s complaint in substance claims that the defendants harmed his economic interests by mismanaging the company and the Trust, and attempting to remove him as an officer and shareholder of the company without due compensation. The only personal injury asserted by the Taxpayer is one claim in Count 5 that he suffered Amental anguish and aggravation.@ Viewing the complaint as a whole, the Taxpayer=s lawsuit was clearly an attempt to recover his rightful economic share of the company and the Trust. The Anon-economic loss@ also could have been for punitive damages, which are requested in several Counts in the complaint. Punitive damages cannot be excluded under '104(a)(2). O=Gilvie v. U.S., 117 S.Ct. 452 (1996); Rice v. U.S., 834 F.Supp. 1241 (1993).

The '104(a)(2) exclusion must be narrowly construed. Rozpad v. C.I.R., supra. The burden was on the Taxpayer to prove that a portion of the settlement was excludable under '104(a)(2). The Taxpayer failed to carry that burden.

The above holding is consistent with the holding in Linda H. Dupree v. State of Alabama, Inc. 97-293 (Admin. Law Div. 3/31/98). The issue in that case was whether the $857,500 paid by Linda Dupree to the Taxpayer as her share of the $1.75 million Anon-economic loss@ constituted a business-related loss. The Administrative Law Division applied the Aorigin of the claim@ test set out in U.S. v. Gilmore, 83 S.Ct. 623 (1963) in holding that the payment related to Linda Dupree=s business as an officer and director of Graceba. The payment was thus a business-related economic recovery, and not excludable by the Taxpayer under '104(a)(2). See also, State of Alabama v. Despinakis, Inc. 87-233 (Admin. Law Div. 4/28/89).

This case can be distinguished from Gladie Kitchens v. State of Alabama, Inc. 97-320 (Admin. Law Div. 11/22/99). That case involved a lawsuit against an insurance company in which the plaintiff claimed economic loss, mental anguish, and emotional distress. The settlement did not identify what portion was for compensatory damages versus personal injury. The Administrative Law Division relied on the complaint, which demanded unspecified actual and punitive damages, in holding that a 55 percent/45 percent split accepted by the IRS was reasonable. Kitchens can be distinguished because clearly a substantial portion of the settlement in Kitchens was for excludable tort-like personal injuries. In this case, the amount received by the Taxpayer was in settlement of his economic interest in the company.

The issue was raised as to whether the Department should accept the IRS=s position concerning what percentage of a lawsuit settlement should be excluded under '104(a)(2). The Department=s attorney, in a well-written letter, argued that the Department is not required to blindly accept the IRS=s position. I agree, with the following proviso.

Code of Ala. 1975, '40-18-1.1(b) reads in part:

> AThe Legislature hereby finds and declares that the adoption by this state for its personal and corporate income tax purposes of certain provisions of the laws of the United States relating to the determination of income for federal income tax purposes will (1) simplify preparation of state income tax returns by taxpayers, (2) improve enforcement of the state income tax laws through better use of information obtained from federal income tax audits, and (3) aid the interpretation of the state tax laws through increased use of federal judicial and administrative determinations and precedents.@

The above statute at the least implies that the Department should follow federal administrative determinations when interpreting a federal statute that has been adopted by Alabama. Following IRS decisions would Aaid the interpretation of the state tax laws through increased use of federal . . . administrative determinations and precedents.@ Accepting IRS determinations would also result in the consistent interpretation of a statute applicable to both the federal government and Alabama. Taxpayers would not have to fight two battles on the same issue. However, '40-18-1.1 does not mandate that the Department accept all IRS determinations.

The Department also argues that the IRS decision to exclude 35 percent in this case cannot be accepted because the Department is prohibited from compromising a debt by Section 100 of the Alabama Constitution. I disagree.

Section 100 of the Alabama Constitution does prohibit the forgiveness of a fixed debt. However, a federal offer in compromise is not the forgiveness of a fixed debt. Rather, it is a settlement of a disputed liability claimed by the IRS. See generally, 34 Am Jur 2d, Federal Taxation, &70350 et seq.

Although Alabama does not have a statutory offer in compromise statute similar to 26 U.S.C. '7122(a), the Department does have the general authority to settle a case for less than the originally assessed amount. As a matter of practice, the Department settles or adjusts contingent liabilities regularly. It is only prohibited from forgiving a fixed liability. The liability in issue is being contested, and thus is not a fixed liability. Consequently, the Department is not prohibited from accepting the IRS=s allowance of the exclusion. But again, the Department is not, under current law, required to accept the IRS determination.

Issue 2 - The Legal Fees.

The Department allowed the legal fees paid by the Taxpayer as an itemized deduction, subject to the two percent floor. The Taxpayers argue that the entire amount should be excluded from income. I agree.

The law in the federal Eleventh Circuit, which includes Alabama, is clear that legal fees paid by a taxpayer in such cases should not be included in the taxpayer=s income. Cotnam v. Comm=r, 263 F.2d 199 (5th Cir. 1955); Davis v. C.I.R., 76 T.C. Memo 1998-248; see also, Kitchens v. State of Alabama, supra.

Issue 3 - The Statute of Limitations.

The Taxpayers filed their original 1993 return in April 1994. They filed amended returns in May and September 1997. The Department received the initial IRS audit changes that included the entire $1.75 million as income on December 17, 1997. The Department entered a preliminary assessment against the Taxpayers on October 9, 1998.

The Department is authorized to assess additional tax based on IRS audit changes within one year from when the IRS audit changes become final. Code of Ala. 1975, '40-2A-7(b)(2)g.1. The Taxpayers argue that any tax assessed under the special one-year statute must be limited to those changes made in the final IRS audit. I agree. As explained below, however, the Department otherwise properly assessed the tax in issue pursuant to '40-2A-7(b)(2).

The special one-year statute allows the Department to assess tax within one year from when it learns that the IRS audit Achange has become final . . .@ It also provides that the Alabama adjustments must be limited to only those items changed in the federal return. The final IRS audit included only 65 percent of the $1.75 million as income.

Consequently, any tax assessed by the Department pursuant to the special one-year statute would be limited to the 65 percent taxed by the IRS.

But while the Department was limited under the special one-year statute, the Department was also authorized to assess the Taxpayer under any other applicable statute of limitations in '40-2A-7(b)(2). Section 40-2A-7(b)(2)g.1. specifies that the Department Ashall be allowed to assess the tax within the time period otherwise allowed by this section.@

Section '40-2A-7(b)(2) allows the Department to assess additional tax within three years from when a return is filed. The Taxpayers filed an amended 1993 return in September 1997. The Department clearly assessed the Taxpayers within three years from that date. Any tax assessed pursuant to the general three year statute is not limited to any final IRS audit changes. The Department thus was authorized to assess the entire $1.75 million as income.

The Department is directed to remove from income the attorney fees paid by the Taxpayers. A Final Order will then be entered for the adjusted amount due. 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 March 17, 2000.

BILL THOMPSON
Chief Administrative Law Judge

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