

ROSA P. DAVIS
P.O. Box 553
Hayneville, AL 36040,
DIVISION

§ STATE OF ALABAMA
DEPARTMENT OF REVENUE
§ ADMINISTRATIVE LAW

Taxpayer,

§ DOCKET NO. INC. 00-493

v.

§

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

FINAL ORDER

The Revenue Department assessed Rosa P. Davis (“Taxpayer”) for 1995 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 January 10, 2001. Ramona Blankenship represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

ISSUE

The Taxpayer received \$7.5M when she settled a lawsuit in 1995. The issue in this case is whether all or a portion of the net amount received by the Taxpayer should 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 “damages received . . . on account of personal injuries or sickness.” That section further provided, however, that the exclusion “shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness.”

FACTS

The Taxpayer sued Associates Financial Services Company of Alabama, Inc. and related companies in 1993. Her complaint and amended complaints alleged that the defendants had defrauded her concerning a mortgage on her

residence. The complaint and amended complaints demanded unspecified compensatory and punitive damages.

The parties settled the lawsuit in 1995 for \$7.5M. The settlement agreement did not allocate the proceeds between compensatory and punitive damages. The Taxpayer's attorneys received \$3,773,000 in attorney fees. She received the balance.

The Taxpayer failed to report the settlement proceeds on her 1995 federal and Alabama income tax returns. The IRS audited the Taxpayer and included the entire amount as income. The Taxpayer and the IRS later agreed that 35 percent of the net amount received by the Taxpayer should be excluded pursuant to §104(a)(3), and that 65 percent of the legal fees should be allowed as an itemized deduction, subject to the 2 percent floor.

The Department received the IRS information, and also excluded from income 35 percent of the net amount received by the Taxpayer. The Department excluded all of the attorney fees paid by the Taxpayer pursuant to the Administrative Law Division's decision in *Gladie Kitchens v. State of Alabama, Inc.* 97-320 (Admin. Law Div. Opinion and Preliminary Order 11/22/99).¹ The Taxpayer appealed.

ANALYSIS

This issue was previously addressed in *Kitchens*, supra. The Opinion and Preliminary Order in that case stated in part as follows:

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.

¹The Administrative Law Division excluded the attorney fees from the taxpayer's income in *Kitchens* based on *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1955), and *Davis v. C.I.R.* 76 T.C. Memo 1998-248.

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, O’Gilvie 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.

Kitchens, Inc. 00-493 at 2-3.

As in *Kitchens*, the best evidence in this case concerning the proper allocation between punitive and compensatory damages is the Taxpayer’s complaint and amended complaints. Neither those documents nor the settlement agreement allocate the amount received between punitive and compensatory damages. Consequently, again as in *Kitchens*, the split applied by the IRS, 65/35 in this case, is also appropriate for Alabama purposes. See generally, Code of Ala. 1975, §40-18-1.1.

The Department also properly excluded the attorney fees from the Taxpayer's gross income.

The 1995 final assessment is affirmed. Judgment is entered against the Taxpayer for tax and interest of \$170,195.28. Additional interest is also due from the date of entry of the final assessment, July 21, 2000. The Taxpayer should contact the Department's Collection Services Division concerning payment.

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

Entered January 12, 2001.