HEALTHSOUTH CORPORATION,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
SELECT PHYSICAL THERAPY HOLDINGS, INC., (F/K/A HEALTHSOUTH HOLDINGS, INC.),	§	DOCKET NO. BIT. 08-1021
SURGICAL HEALTH, LLC, (F/K/A SURGICAL HEALTH, INC.),	§	
HEALTHSOUTH CORPORATION, D/B/A REBOUND, LLC (F/K/A REBOUND, INC.),	§	
HEALTHSOUTH CORPORATION, D/B/A HEALTHSOUTH PROPERTIES, LLC (F/K/A HEALTHSOUTH PROPERTIES CORPORATION),	§	
And	§	
HEALTHSOUTH CORPORATION, D/B/A HEALTHSOUTH AVIATION, LLC (F/K/A HEALTHSOUTH AVIATION, INC.),	§	
Taxpayers,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department denied corporate income tax refunds requested by HealthSouth Corporation for 1996; Select Physical Therapy Holdings, Inc. (f/k/a HealthSouth Holdings, Inc.) for 1996; Surgical Health, LLC (f/k/a Surgical Health, Inc.) for 1997; HealthSouth Corporation d/b/a Rebound, LLC (f/k/a Rebound, Inc.) for 1997 and 1998; and HealthSouth Corporation, d/b/a HealthSouth Properties, LLC (f/k/a HealthSouth Properties Corporation) for 1996. The above entities (together "Taxpayers") appealed to

the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. A hearing was conducted on April 21, 2009. Bruce Ely and Jimmy Long represented the Taxpayers. Assistant Counsel David Avery represented the Department.

ISSUES

A preliminary issue involves the Administrative Law Division's jurisdiction or scope of review as a result of the Alabama Court of Civil Appeal's recent holding in *Rheem Mfg. Co. v. State, Dept. of Revenue*, ____ So.2d ____ Case 2070792 (Ala. Civ. App. 2/27/2009) cert. pending (Ala. S. Ct. 3/12/2009). As discussed below, the Court held in *Rheem* that if the Department denies a refund petition and the taxpayer appeals to the Administrative Law Division, the Division only has jurisdiction to address the issue or issues raised by the taxpayer when it filed the petition with the Department. The related question in this case is whether the Division has jurisdiction to review or consider an argument raised by the Department for the first time on appeal that the Department failed to state when it initially denied the refunds.

The ultimate issue is whether the Taxpayers are entitled to refunds pursuant to the special IRS audit adjustment refund statute at Code of Ala. 1975, §40-2A-7(b)(2)g.2.; and if so, are the Taxpayers nonetheless equitably barred from getting the refunds pursuant to the Alabama Supreme Court's holding in *Ex parte HealthSouth*, 978 So.2d 745 (Ala. 2007). The Taxpayers also claim that the Department improperly refused to adjust their net operating loss ("NOL") carryover amounts based on the federal audit adjustments. The Department contends that it took no action concerning the NOL carryovers available to the Taxpayers. In any case, if the Taxpayers are entitled to have their Alabama incomes

reduced based on the federal adjustments, the Taxpayers' available NOL carryover amounts should also be adjusted accordingly.

FACTS

The Taxpayers did business in Alabama and were in the HealthSouth group of entities during the years in issue.

Before 2003, certain high-ranking officers at HealthSouth were involved in an illegal scheme to artificially inflate the company's earnings for personal gain. The scheme involved erroneous accounting entries that resulted in the fraudulent overstatement of income on the Taxpayers' federal and Alabama income tax returns for the subject years. The scheme was uncovered in March 2003, and the individual wrongdoers were terminated.

The IRS audited the Taxpayers' federal income tax returns for the years in issue. The extensive audit resulted in numerous adjustments to the returns, including some relating to the fraudulently inflated income amounts reported by the Taxpayers on the returns. The audit ultimately decreased the Taxpayers' federal taxable income by $_____ in 1996, $_____ in 1997, and $_____ in 1998. The IRS adjustments were agreed to and made final in September 2007, and resulted in an aggregate federal refund to the Taxpayers of approximately $_____.[1]

[1]The Taxpayers also petitioned for refunds with 44 other States and the District of Columbia based on the federal audit adjustments. Forty four of those jurisdictions have granted the refunds, and one is challenging the refund on the sole ground that the petition was untimely.

On March 17, 2008, the Taxpayers filed amended Alabama returns for the subject years. The amended returns reflected the applicable IRS audit changes, and requested the refunds in issue pursuant to the special IRS audit adjustment refund statute, §40-2A-7(b)(2)g.2. As discussed below, that statute allows a taxpayer one year to petition for an overpayment of Alabama tax resulting from an IRS audit adjustment.

The Department granted the refunds in full concerning the non-fraud related federal adjustments. It also allowed the fraud-related adjustments, but only to off-set or "zero out" the income reported on the amended returns. It denied all refunds based on the fraud-related adjustments. The Department's November 2008 denial letters to the Taxpayers stated in part as follows – "In accordance with Section 40-10-160 of the Code of Alabama 1975, the Department has determined that the taxpayer is not entitled to a refund of any monies paid as a result of fraud. The provisions of Section 40-10-160 only provides relief if monies are paid in by mistake or as a result of an error in billing."

The Taxpayers timely appealed the denied refunds to the Administrative Law Division.

ANALYSIS

(1) Preliminary Issue – The Scope of the Administrative Law Division's Review.

The Department argued in its Answer, at the April 21, 2009 hearing, and in its post-hearing briefs that the Taxpayers are equitably barred from receiving the income tax refunds in issue based on the Alabama Supreme Court's holding in *Ex parte HealthSouth*. As discussed below, the Court held in that case that HealthSouth was not statutorily or

equitably entitled to refunds of personal property tax paid on fictitious items of personal property it had fraudulently reported on its property tax returns. The Department did not specifically cite *Ex parte HealthSouth* when it initially denied the refunds in issue. Rather, as indicated, the Department notified the Taxpayers that they were not entitled to refunds under §40-10-160. That statute relates solely to refunds of personal property tax.

Before the April 21 hearing, the Taxpayers, citing *Rheem*, filed a motion to strike that part of the Department's argument not based on §40-10-160. The Taxpayers' motion reads in part:

> The Alabama Court of Civil Appeals recently held that (the Administrative Law Division) lacked subject matter jurisdiction to grant a taxpayer's requested refund claim based on a ground not initially raised with the Department in the taxpayer's petition for refund. *Rheem Mfg. Co. v. State Dep't of Revenue,* ____ So. 2d ____, Case No. 2070792 (Ala. Civ. App. Feb. 27, 2009), *cert. pet. Pending* (Ala. S. Ct. Mar. 12, 2009); *see also Lee* v. *State Dep't of Revenue,* Admin. Law Div. Dkt. No. INC. 06-835 (March 18, 2009) (noting that the Court of Civil Appeals "held in *Rheem* that [this Court] only has jurisdiction to review an issue or issues *previously addressed by the Department.* That is, [this Court] can only review and decide the legality or propriety of the Department's actions relating to the taxpayer...") (emphasis added). Thus, if *Rheem* is correct, this Court only has jurisdiction to consider arguments raised by *either the Department or taxpayers* that were presented by the respective party before the taxpayer filed its Notice of Appeal regarding the denied refund claim with this Court. *See Rheem, supra* at p. 12-16; Ala. Code § 40-2A-2(2); *see also Title Ins. Co. of Minn. v. State Board of Equalization,* 842 P.2d 121, 130 (Cal. 1992) (citation omitted) ("Men must turn square corners when they deal with the Government; it is hard to see why the [Government] should not be held to a like standard of rectangular rectitude when dealing with its citizens.")

Taxpayers' Motion to Strike at 2 – 3.

In *Rheem*, the taxpayer petitioned the Department for refunds of franchise tax because it claimed that (1) the franchise tax statute was unconstitutional, and (2) it should be allowed to use an alternative apportionment method in computing its capital employed in

Alabama in the subject years. The Department denied the petitions, and the taxpayer appealed to the Administrative Law Division.

While the appeal was pending, the taxpayer raised a third argument concerning push-down accounting. The Administrative Law Division conducted a pre-hearing conference at which both parties agreed that the push-down accounting issue was the overriding issue, and should be decided first. The parties stipulated the facts and briefed the issue. The Administrative Law Division subsequently ruled for the taxpayer on the issue, and the Department appealed to circuit court.

On appeal, the Department argued that the Administrative Law Division did not have jurisdiction to address the push-down accounting issue because the taxpayer had not raised the issue in its petitions for refunds filed with the Department. The circuit court adopted a special master's holding that the Administrative Law Division did not have jurisdiction to hear the issue, and consequently, that the taxpayer was not entitled to refunds. The taxpayer appealed to the Court of Civil Appeals.

The Court of Civil Appeals noted that the Department has a two-tiered refund process. First, a taxpayer is required to petition the Department for a refund. Second, if the Department denies the petition in whole or in part, the taxpayer may appeal to the Administrative Law Division. ". . . it is the Department that first determines the propriety of any such refund, and the Division reviews the Department's decision." *Rheem*, ____ So.2d ____. The Court then affirmed the circuit court's holding that the Administrative Law Division could not address the push down accounting issue because the taxpayer had not

raised the issue when it petitioned the Department for the refunds.[2]

The Taxpayers argue that based on *Rheem*, the Administrative Law Division can only review the Department's stated rationale or reason for denying the refunds in issue. That is, the Division can only review whether the Department correctly denied the refunds based on §40-10-160. If the Taxpayers are correct, their motion to strike should be granted, and the Division could not consider the Supreme Court's holding in *Ex parte HealthSouth*.

After careful review, I now believe that the above interpretation of *Rheem* is too broad. *Rheem* holds that in appeals involving refunds, the Administrative Law Division cannot address an issue unless it was previously raised before the Department as a basis for the refund. The Taxpayers filed amended returns and claimed the refunds in issue based on the IRS audit adjustment refund statute, §40-2A-7(b)(2)g.2. The Administrative Law Division is thus authorized to review whether the refunds are due under that statute. And while *Rheem* bars the Division from addressing additional issues, it does not bar the Department from raising an argument as to why the refunds should be denied, including whether the refunds are equitably barred based on the Supreme Court's holding in *Ex parte HealthSouth*.

In any case, the Department's denial letters stated that "the taxpayer is not entitled

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[2] Interestingly, the Court did not remand the case for further proceedings, even though Rheem had properly raised as an issue before the Department its use of an alternative apportionment method. The Department had agreed that the alternative apportionment method issue should be addressed later, if necessary. "The parties also agreed (at the pre-hearing conference before the Division) that the other non-constitutional issue concerning Rheem's use of an alternative apportionment method would be decided later, if necessary." *Rheem Mfg. Co. v State of Alabama*, F. 00-132A, et seq. (Admin. Law

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to a refund of any monies paid in as a result of fraud." That statement is clearly based on the Supreme Court's holding in *Ex parte HealthSouth*. Consequently, the Department did in substance rely on the holding in *Ex parte HealthSouth* as a basis for denying the refunds. The Taxpayers' motion to strike is denied.[3]

Div. F.O. 4/21/06) at 2. That issue has never been decided.

[3]The scope and practical effect of the *Rheem* decision is still unclear. Most refunds are "petitioned for" via a return or amended return. Taxpayers usually do not state or specify an issue or reason for the refund when they request a refund on a return or amended return. Consequently, if the refund claimed on a return or amended return is denied or deemed denied, and the taxpayer appeals to the Administrative Law Division, what issue or issues would the Division have jurisdiction to decide, i.e., what issues were "raised" by the taxpayer when the return or amended return was filed?

There is also the question of whether the *Rheem* rationale applies to final assessments appealed to the Administrative Law Division. What if the Department audited a taxpayer's income tax return, disallowed a $10,000 charitable contribution, and assessed the taxpayer for the additional tax due. On appeal, can the Administrative Law Division only review the charitable contribution issue? Code of Ala. 1975, §40-2A-7(b)(5)d.1. provides that on appeal, the Administrative Law Division can increase or decrease the final assessment to reflect the correct amount due. But does *Rheem* hold that the Division can increase or decrease the assessment only relating to the item or issue, i.e., the charitable deduction in the above example, that was the basis for the final assessment? Other such questions are yet to be decided.

And while I do not believe it was the intent of the Court of Civil Appeals, the *Rheem* decision will also hamper the efficient and fair administration of justice by the Department. Since the Uniform Revenue Procedures Act, Code of Ala. 1975, §40-2A-7 et seq., was enacted in 1992, and indeed since the Administrative Law Division was created and began hearing appeals in 1983, the Division has always taken the position that when a taxpayer appealed to the Division, the Division's duty was to determine the taxpayer's correct liability for the tax and period in issue. Consequently, once a taxpayer appealed a final assessment or denied refund to the Division, all issues that were relevant to the taxpayer's correct liability for the period would be reviewed. For example, assume that a taxpayer filed an amended income tax return and claimed a refund based on an additional $10,000 charitable deduction. The Department denied the refund, and the taxpayer appealed. On appeal, the Division had always, before *Rheem*, considered all issues relevant to the taxpayer's correct liability for the year in deciding the amount of refund due, if any. Consequently, if on appeal it was discovered that the taxpayer was entitled to another previously unclaimed deduction, or that another claimed deduction should be disallowed, or

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that the taxpayer had failed to report some income on the return, those issues, whether detrimental or beneficial to the taxpayer, would also be addressed, again with the end goal of determining the taxpayer's correct liability for the period.

With the *Rheem* decision, however, the Division's ability to determine a taxpayer's correct liability is hindered. Again using the $10,000 disallowed charitable deduction example, what if on appeal the Department discovered that the taxpayer had underreported income by $10,000. Such "additional issues" have been raised by both taxpayers and the Department in hundreds of appeals before the Division since 1983, and before *Rheem*, the Division had in all cases considered the additional issue or issues in arriving at the correct tax due. In the above example, if the Division determined that the disputed $10,000 deduction claimed by the taxpayer should be allowed, it would have been offset by the $10,000 in unreported income. No refund would be due, and the taxpayer would have paid the correct tax due, no more, no less.

But post-*Rheem*, the Division only has the jurisdiction to hear the issue or issues raised by the taxpayer in the refund petition, i.e., the disallowed $10,000 charitable deduction in the above example. Consequently, even if the $10,000 in unreported income was discovered while the appeal was pending, the Administrative Law Division could not consider that issue in deciding the case. Rather, the taxpayer would be allowed the deduction and the resulting refund. The Department could, of course, assess the taxpayer for additional tax based on the unreported income, but in many instances the statute of limitations for doing so will have expired (just as the statute for petitioning for a refund based on the push-down accounting issue had expired for the taxpayer in *Rheem*).

Importantly, before *Rheem*, the Department had never objected to the Division addressing all issues on appeal that were relevant to a taxpayer's liability for the period in issue. Indeed, the Department itself has in hundreds of cases on appeal raised an issue that was not raised or addressed by either party before the appeal. Before *Rheem*, the Division had always considered those issues, again with the end goal of determining the taxpayer's correct liability. Post-*Rheem*, those issues cannot be addressed. Even in *Rheem*, the Department initially agreed that the push-down accounting issue was the over-riding issue and should be decided first by the Administrative Law Division.

The Department's long-standing interpretation of a statute should be given great weight. *Patterson v. Emerald Mt. Expressway Bridge, LLC,* 856 So.2d 826, 833 (Ala. Civ. App. 2002), citing *Yelverton's, Inc. v. Jefferson County*, 742 So.2d 1216 (Ala. Civ. App. 1997). The Court of Civil Appeals apparently was unaware of the Administrative Law Division's long-standing practice (and the Department's acceptance of that practice) of addressing all issues in an appeal. It is, of course, not known what effect, if any, knowledge of that long-standing interpretation of the Uniform Revenue Procedures Act, §40-2A-7 et seq., would have had on the Court. The Court was also apparently unaware of, or in any case did not address, the fact that an appeal of a final assessment or denied refund by a taxpayer directly to circuit court is de novo, whereas post-*Rheem*, an appeal to

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Issue (2). Are the Taxpayers statutorily entitled to refunds, and if so, are they nonetheless equitably barred from receiving the refunds?

The Department argues that the Taxpayers are not entitled to refunds because (1) they do not qualify for refunds under the applicable refund statutes, Code of Ala. 1975, §§40-2A-7(c)(1) and 40-2A-7(b)(2)g.2.; and (2) they are in any case equitably barred from getting the refunds. The Department cites the Alabama Supreme Court's holding in *Ex parte HealthSouth* in support of its position. I disagree because this case can be distinguished from *Ex parte HealthSouth*.

The issue in *Ex parte HealthSouth* was whether HealthSouth was entitled to refunds of personal property tax pursuant to §40-10-160. Pursuant to its fraudulent accounting scheme, HealthSouth had intentionally reported fictitious items of personal property on its 2001, 2002, and 2003 Jefferson County personal property tax returns. The County tax assessor assessed HealthSouth for the tax due on those fraudulent returns, which HealthSouth paid.

HealthSouth subsequently filed amended property tax returns for the subject years and requested refunds after the fraud was uncovered. The tax collector allowed the amended 2003 return as an adjustment in that year because HealthSouth had not yet paid the 2003 tax due. The tax collector, and later the Jefferson County probate court, denied the refunds for 2001 and 2002. HealthSouth appealed to the Court of Civil Appeals.

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the Administrative Law Division is limited to a review of the proceedings below. Again, it is not known what effect, if any, that discrepancy may have had on the Court.

The Court of Civil Appeals addressed three issues: (1) was HealthSouth entitled to refunds pursuant to the personal property tax refund statute, §40-10-160; (2) was the County's assessment of property tax based on the fraudulent returns an illegal assessment; and (3) was HealthSouth entitled to refunds for 2001 and 2002 because the tax assessor had allowed an adjustment for 2003?

The Court first addressed §40-10-160, which allows for a refund of personal property tax paid by "mistake" or "error." The Court found that HealthSouth was not entitled to a refund under the statute because "mistake" or "error" does not include an intentional misrepresentation. "We cannot conclude that the legislature intended §40-10-160, Ala. Code 1975, to allow a refund of taxes paid on fictitious items intentionally listed on a tax return in furtherance of a fraudulent scheme to inflate earnings." *HealthSouth*, 978 So.2d at 742.

The Court next found that the County's assessment was not invalid or illegal. That issue is not relevant in this case because the Department has not assessed the Taxpayers for additional tax due.

Finally, the Court addressed HealthSouth's claim that because the tax assessor had adjusted HealthSouth's 2003 liability based on its amended return for that year, the assessor should also be required to accept the amended returns for 2001 and 2002. The Court found that HealthSouth's claim was equitable in nature, and that "[a] party seeking equitable relief, however, must have acted with equity and must come into court with clean hands." *HealthSouth*, 978 So.2d at 745. The Court thus concluded that HealthSouth could not obtain a refund on equitable grounds due to its own inequitable conduct. HealthSouth

appealed to the Alabama Supreme Court.

The Supreme Court affirmed. It first concluded that the Court of Civil Appeals had correctly held that a refund was not due under §40-10-160 because "neither 'error' nor 'mistake' (as used in §40-10-160) contemplates dishonest activity." *Ex parte HealthSouth*, 978 So.2d at 748. It next affirmed the Court of Civil Appeals' holding that because the company did not have clean hands, it was also not entitled to equitable relief.

This case can first be distinguished from *Ex parte HealthSouth* because while HealthSouth was not entitled to refunds under the applicable personal property tax refund statute, §40-10-160, the Taxpayers in this case are entitled to refunds under the applicable income tax refund statutes, §§40-2A-7(c)(1) and 40-2A-7(b)(2)g.2.

Alabama's general refund statute, §40-2A-7(c)(1), allows taxpayers to petition for a refund of "any overpayment of tax or other amount erroneously paid to the department or concerning any refund which the department is required to administer." The phrase "any overpayment of tax" encompasses all taxes overpaid to the Department. The second phrase "or other amount erroneously paid" refers to any other non-tax money or amount, the $75 motor vehicle inspection fee required by Code of Ala. 1975, §32-8-87(l), for example, that may be erroneously paid to the Department. The latter phrase does not include any tax paid to the Department, or the Legislature would have stated "or other tax erroneously paid."[4] It must be presumed that the Legislature used a particular word, i.e.,

[4] "Tax" is defined at Code of Ala. 1975, §40-2A-3(22) as '[a]ny amount, . . ., levied or assessed against a taxpayer. . . ." Income tax, sales and use tax, license tax, etc., are levied by statute and assessed against taxpayers by the Department, and thus each is a "tax" as defined by §40-2A-3(22). But the motor vehicle inspection fee and similar fees are never levied or assessed by the Department. If a person does not pay the inspection fee (continued)

"amount" versus "tax" for a reason. *State v. Amerada Hess Corp.*, 788 So.2d 179 (Ala. Civ. App. 2000).

The third phrase in §40-2A-7(c)(1) – "or concerning any refund which the department is required to administer" – relates to those motor fuel-related taxes that are initially correctly paid, but for which the taxpayer is later entitled to a refund based on how the product is ultimately used. For example, if a farmer purchases taxed gasoline and uses it for both taxable on-road and nontaxable agricultural purposes, Code of Ala. 1975, §40-17-102 specifies that a refund is due on that portion used for agricultural purposes. "If gasoline is used on the farm for agricultural purposes,. . . the ultimate purchaser of such gasoline shall be entitled to receive a refund" of the state tax paid on the gasoline. See also, Code of Ala. 1975, §40-17-142, which allows for a refund of motor fuel tax paid by motor carriers subject to the motor carrier fuel tax. The Department is required to administer those refunds, which is why the third phrase was included in §40-2A-7(c)(1).

The above confirms that each of the three phrases in §40-2A-7(c)(1) has a distinct and different field of operation. The first phrase "any overpayment of tax" applies to any tax paid to the Department over the correct tax due; the second phrase "other amount erroneously paid" relates to any inspection fee or other non-tax amount that is erroneously paid; and the third phrase, as discussed, relates to tax that is not initially overpaid, but concerning which the taxpayer is later entitled to a refund.

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up front, the Department simply does not inspect the vehicle. That fee, and others, are thus not a "tax," which is why §40-2A-7(c)(1) also makes reference to "other amount (other than a tax) erroneously paid. . . ."

In short, the general refund statute allows for a refund of any overpayment of tax, and is not limited to only tax erroneously paid, as argued by the Department. The general refund provision at §40-2A-7(c)(1) is much broader than and thus can be distinguished from the personal property tax refund statute at issue in *Ex parte HealthSouth*.

More to the point, the IRS audit adjustment refund statute in issue, §40-2A-7(b)(2)g.2., clearly allows for a refund of any "overpayment" of tax resulting from an IRS audit adjustment. The word "erroneous" or the phrase "erroneously paid" are not in that statute. Consequently, just as under the general refund statute, §40-2A-7(c)(1), an income tax refund is due under the IRS audit adjustment statute for any income tax overpaid. The issue then is whether the income tax in issue was overpaid by the Taxpayers.

The federal income tax refund statute, 26 U.S.C.A. §6402, provides that "[i]n the case of any overpayment," the Secretary shall, subject to certain set-off and credit provisions, refund the net overpayment to the taxpayer. Alabama's general refund statute, §40-2A-7(c)(1), is modeled after the federal refund provision in that it allows a taxpayer to petition for a refund of "any overpayment of tax. . . ." As discussed, the IRS audit adjustment refund statute, §40-2A-7(b)(2)g.2., also uses the word "overpayment." The use of "overpayment" in both §§40-2A-7(c)(1) and 40-2A-7(b)(2)g.2. is clearly modeled after the federal refund statute, and is not a coincidence. The federal statute of limitations for filing refund petitions at 26 U.S.C.A. §6511(a), and the Alabama statute of limitations at Code of Ala. 1975, §40-2A-7(c)(2)a. are also identical in substance, which further establishes that

the Alabama refund statute was modeled after its federal counterpart.[5]

Because the Alabama refund statute is modeled after its federal counterpart, federal case law interpreting the federal statute should be applied and followed in interpreting the Alabama statute. *State, Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala. Civ. App. 1994); *Ex parte Jones Mfg. Co., Inc.*, 589 So.2d 208 (Ala. 1991).

The United States Supreme Court has plainly stated that an overpayment of income tax includes any tax paid over the correct amount due, regardless of why the overpaid tax

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[5] Before 1992, Alabama's Revenue Code, Title 40, Code 1975, contained a hodgepodge of refund provisions relating to the various taxes administered by the Department. Code of Ala. 1975, §40-18-43 allowed for refunds of income tax paid "through mistake or error"; Code of Ala. 1975, §40-23-32 provided that if the Department determined that sales tax had been overpaid, the amount should be refunded to the taxpayer; Code of Ala. 1975, §40-1-34 provided generally that a taxpayer could petition for a refund of any tax paid to the Department "by a mistake of fact or law. . ."; and so forth, to cite only a few.

All refund provisions in Title 40 relating to refunds administered by the Department were repealed in 1992 by Acts 1992, No. 92-186, and were replaced by the current uniform refund provision at §40-2A-7(c)(1). The Department argues that the language in §40-2A-7(c)(1) was modeled after prior §§40-1-34 and 40-18-43. It thus contends that because the language used in those prior statutes was similar to the language used in the property tax refund statute in issue in *Ex parte HealthSouth*, §40-10-160, the holding in *Ex parte HealthSouth* controls, and the Taxpayers are thus also not entitled to income tax refunds under §40-2A-7(c)(1). Department's Third Brief at 4. I disagree.

If the Legislature had intended to model §40-2A-7(c)(1) after §§40-1-34 and 40-18-43, it would have used the same language used in those statutes, i.e., tax paid "by a mistake of fact or law" (§40-1-34), or tax paid "through mistake or error" (§40-18-43). The Legislature did not, however, use those words or phrases, but rather used the word "overpayment" as found in the federal refund statute. The clear intent of the Legislature when it enacted §40-2A-7(c)(1) in 1992 was to enact a uniform refund statute modeled after its federal counterpart so that settled federal case law and guidelines could be used as precedent in interpreting the Alabama statute. See also, Code of Ala. 1975, §40-18-1.1 (Various federal income tax provisions adopted by Alabama so as to "aid the interpretation of the state tax laws through increased use of federal judicial and administrative determinations and precedents.")

was remitted. "Section 6511(a) applies to claims for refund of a tax 'overpayment.' The common sense interpretation is that a tax is overpaid when a taxpayer pays more than is owed, for whatever reasons or no reason at all. Even in *Bull*, the case upon which the dissent relies to assert that retention of the gift tax is unjust or fraudulent, we described the inconsistent tax as being an 'overpayment.' (cite omitted) The word encompasses 'erroneously,' 'illegally,' or 'wrongfully' collected taxes. . . ." *United States v. Dalm*, 110 S. Ct. 1361, 1369 (1990).

Following the federal precedent, §§40-2A-7(c)(1) and 40-2A-7(b)(2)g.2. must be construed as allowing a refund of tax overpaid for any reason, including the fraudulent reporting of fictitious income by the Taxpayers. This conclusion is supported by the fact that the IRS, 44 States, and the District of Columbia have granted the Taxpayers refunds of the income tax overpaid as a result of the fraudulently reported fictitious income. See also, *Harlan v. United States*, 312 F.2d 402 (Ct. Cl. 1963) (Refund granted for overpayment of income tax that resulted from taxpayer's prior fraudulent behavior.).[6]

The above conclusion is also supported by the law review article cited by the Alabama Supreme Court in *Ex parte HealthSouth*, Boise, *Playing with 'Monopoly Money': Phony Profits, Fraud Penalties and Equity*, 90 Minn. L. Rev. 144, 147-48 (2005). *Ex parte HealthSouth*, 978 So.2d at 753. The author vigorously argues in the article that taxpayers that report fictitious income on fraudulent returns <u>should</u> be denied income tax refunds on equitable grounds. The author readily concedes, however, that under the current system,

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[6] In HealthSouth's property tax case, the Court of Civil Appeals acknowledged the holding in *Harlan*, but distinguished the case because it "did not concern a refund of ad valorem property taxes based on mistake or error of law. . . ." *HealthSouth*, 978 So.2d at

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refunds are allowed in such cases.

> In such circumstances, the Secretary of the Treasury is authorized to make a refund only if it is determined that there was an "overpayment." Although the term is not explicitly defined in the Internal Revenue Code, the Supreme Court has held that an overpayment arises from "the payment of more than is rightfully due." (quoting *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947)) Thus, a company that has paid federal income tax on earnings that were fraudulently inflated *quite clearly has made an overpayment for those purposes and may seek a refund of the excess tax paid.* (emphasis added)

Boise, 90 Minn. L. Rev at 147.

The author also cites several public policy reasons why a taxpayer that fraudulently overstates income on a return should not get a refund. He then states that "[g]iven these policy considerations, it is unconscionable that a taxpayer should not only avoid significant penalties, but also readily receive a refund of taxes in excess of what was really owed along with interest on the overpayment. *Unfortunately, that is exactly the way the current system works.*" (emphasis added) Boise, 90 Minn. L. Rev. at 212.

Regardless of whether one agrees or disagrees with the law review article as to what the law should be, it is clear that under current law, if a taxpayer is entitled to an income tax refund under the applicable statute, the courts must apply that law and the refund must be granted, regardless of public policy concerns. "[I]t is (a court's) job to say what the law is, not to say what it should be." *Alabama Department of Revenue v. Jim Beam Brands Co, Inc.*, ____ So.2d ____, ____ (Ala. Civ. App. 2008), quoting *DeKalb County LP Gas Co. v. Suburban Gas, Inc.*, 729 So.2d 270, 276 (Ala. 1998).

In summary, Alabama's general refund statute is modeled after its federal counterpart, and allows for a refund of any overpayment of tax, which, under federal and

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742 n.3. *Harlan* is, however, directly on point with this income tax refund case.

corresponding Alabama law, is any tax paid over the correct amount due. The IRS audit adjustment provision, §40-2A-7(b)(2)g.2., is also modeled after the federal statute in that it also allows for a refund of any "overpayment" of Alabama income tax based on federal audit changes. The Taxpayers clearly otherwise satisfied the requirements of the IRS adjustment refund provision, and are thus entitled to refunds under that statute.[7]

The Taxpayers also are not equitably barred from receiving the refunds based on the holding in *Ex parte HealthSouth*. As discussed, Alabama's appellate courts rejected HealthSouth's claim that it was statutorily entitled to property tax refunds under §40-10-160. HealthSouth also asserted as an independent basis for the refunds that it was, in substance, equitably entitled to the refunds. That is, it claimed that it was entitled to affirmative equitable relief, i.e., refunds, to which it was not otherwise statutorily entitled. The appellate courts also rejected that claim.

This case can be distinguished because the Taxpayers in this case are not seeking equitable relief, but rather are statutorily entitled to refunds pursuant to §40-2A-7(b)(2)g.2. The Supreme Court's holding in *Ex parte HealthSouth* thus does not apply in this case. Unclean hands prevented HealthSouth from obtaining affirmative equitable relief to which it was not otherwise entitled, but equity does not prevent the Taxpayers from obtaining income tax refunds to which they are statutorily entitled.

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[7] As discussed, the Department granted the Taxpayers refunds based on the non-fraud IRS adjustments. The Department thus does not dispute that the Taxpayers have technically complied with the requirements of §40-2A-7(b)(2)g.2. because but for that provision, the refunds would otherwise have been out-of-statute.

The Department argues that refunds are equitable actions, and that "equitable considerations such as the 'clean hands doctrine' must be met before the words of the statute become relevant." Department's Third Brief at 1, n.1. I disagree.

Refunds are creatures of statute that are allowed by legislative grace. "Taxation is a matter of statutes, and equitable considerations cannot override the provisions of the statute. . . ." *Alamo Nat. Bank of San Antonio v. Comm. of Int. Revenue*, 95 F.2d 622, 623 (5th Cir. 1938). As stated by the Alabama Supreme Court in *Patterson v. Gladwin Corp., et al*, 835 So.2d 137, 145 – "'It is well settled that the right to reclaim money voluntarily paid to the state or the counties thereof, as taxes, is a creature of legislative grace. . . .' *Board of Revenue & Road Comm'rs of Mobile County v. Jones*, 236 Ala. 244, 245, 181 So. 908, 909 (1938) (quoting *Lee v. Cunningham*, 234 Ala. 639, 642, 176 So. 477, 480 (1937)). 'In the absence of statute a refund of monies paid into the state treasury under color of the revenue laws of the state were not subject to refund.' *Curry v. Johnston*, 242 Ala. 319, 320, 6 So. 2d 397, 397 (1942)."

If refunds were purely equitable actions, Alabama's appellate courts could have denied the HealthSouth property tax refunds on purely equitable grounds, in which case they would not have first considered the applicability of §40-10-160. The courts did, however, first consider if refunds were due under §40-10-160, which indicates that if refunds had been due under that statute, they would have been granted.

Equitable principles do, under the appropriate circumstances, have a place in tax matters, as the court so stated in *Alamo Nat. Bank*, 95 F.2d at 623. The Court of Civil Appeals also cited three cases in *HealthSouth* for the proposition that "Alabama courts

have also indicated that equitable principles have a place in tax matters." *HealthSouth*, 978 So.2d at 744. But *Alamo Nat. Bank* and the three cited Alabama cases, *Sims v. White*, 522 So.2d 239, 240 (Ala. 1988), *Grant v. State*, 667 So.2d 1369, 1372 (Ala. Civ. App. 1994), and *Town of Camp Hill v. James*, 686 So.2d 1208, 1211 (Ala. Civ. App. 1996), can all be distinguished from this case, and, importantly, none hold or suggest that a taxpayer entitled to a refund under the applicable refund statute should be denied the refund on equitable grounds.

In *Alamo Nat. Bank*, the taxpayers reported as income in 1921 a liquidating dividend of $17,035. They took over the assets of the liquidated business and continued operating it until they sold the business in 1931. They reported a cost basis of $216,560 on their 1931 return, not the $17,035 amount reported on their 1921 return. The Fifth Circuit held that because the taxpayers had reported the lower basis in 1921 (and consequently paid less tax than was actually due in that year), they were bound in equity by that decision and were required to use the lower basis in computing their gain in 1931. The Court thus in substance invoked equity to ensure that the taxpayers paid the correct tax due on the transactions.

This case can be easily distinguished because there was no tax actually owed by the Taxpayers on the fraudulently reported income. Thus, unlike the taxpayers in *Alamo Nat. Bank*, who were ultimately required to pay the government the correct tax due, the Taxpayers in this case have paid the Department more tax than was actually owed.

In *Sims v. White*, the Alabama Supreme Court merely held that "[e]quity and fairness would dictate that if a taxpayer is entitled to interest on ad valorem taxes paid as a result of

an excessive assessment, then a taxpayer who paid ad valorem taxes on an illegal and void assessment should be entitled to interest as well." *Sims*, 522 So.2d at 241. That holding is clearly inapplicable in this case.

In *Grant v. State*, the taxpayer argued, among other things, that he was entitled to a refund of excessive interest paid on various sales tax final assessments. The Court of Civil Appeals affirmed the circuit court's holding that the taxpayer should have raised the claim in a prior proceeding, and that "collateral estoppel prohibits a taxpayer from relitigating in this action a claim that he should have asserted in the prior case." *Grant*, 667 So.2d at 1372.

Collateral estoppel does not apply in this case because except for HealthSouth, the Taxpayers in this case were not involved in HealthSouth's property tax case. Also, the issue of whether HealthSouth and the other Taxpayers in this case are entitled to income tax refunds under §40-2A-7(c)(1) and §40-2A-7(b)(2)g.2. clearly was not and could not have been raised as an issue in the HealthSouth property tax refund case. Collateral estoppel thus does not apply.

It is unclear what equitable principle the Court of Civil Appeals was referring to when it cited *Town of Camp Hill v. James*. There is no discussion or mention of equity in the majority opinion. The dissent does briefly mention the "theory of unjust enrichment," in discussing whether one of the parties had standing, *Town of Camp Hill*, 686 So.2d at 1213, but clearly that equitable theory does not apply in this case.

Finally, the Alabama Supreme Court cited with approval in *Ex parte HealthSouth* the U.S. Supreme Court's holding in *Stone v. White*, 57 S. Ct. 851 (1937). *Ex parte HealthSouth*, 978 So.2d at 754. The Supreme Court applied equitable principles to deny a

refund in that case, but again this case can be distinguished.

In *Stone v. White*, a trust incorrectly paid income tax on trust income that should have been paid by the trust's sole beneficiary. The trust sued for a refund. The Supreme Court noted that the government's claim against the beneficiary was time-barred, and that if the trust's refund was granted, the beneficiary, as the income recipient, would ultimately benefit. The Court concluded that the trust and the beneficiary represented the same interest, and that in equity the tax paid by the trust should be applied to offset the tax owed by the beneficiary. "[A]ny recovery in this action (by the trust) will be income to the beneficiary, and will deprive the government of a tax to which it is justly entitled and enable the beneficiary to escape a tax which she should have paid." *Stone v. White*, 57 S. Ct. at 853.

This case can be distinguished because the State is not "justly entitled" to the tax in issue that was overpaid on the fictitious income. The Taxpayers also will not "escape" tax which they should have paid because the tax in issue was not owed to begin with. The Court applied the doctrine of equitable recoupment in *Stone v. White* to ensure that the taxpayer, the beneficiary, paid the correct tax due.[8] That equitable result can be reached in this case only if the Taxpayers are allowed the refunds in issue.

To summarize, the Taxpayers satisfied the requirements for obtaining refunds under the IRS audit adjustment statute, §40-2A-7(c)(2)g.2. The income tax paid on the fictitious income during the subject years was clearly an overpayment of tax under the federal

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[8] As discussed in the Taxpayers' Reply Brief at 7, n. 3, as a result of *White v. Stone* and similar cases, Congress codified the doctrine of equitable recoupment and similar doctrines in what is now 26 U.S.C. §§1311 – 1314.

income tax refund provision, 26 U.S.C. §6402, and correspondingly also a refundable overpayment under the applicable Alabama income tax refund statutes, §§40-2A-7(c)(1) and 40-2A-7(b)(2)g.2.

The refunds also are not equitably barred based on the Alabama Supreme Court's holding in *Ex parte HealthSouth* because, unlike HealthSouth in the property tax case, the Taxpayers in this case are not seeking affirmative equitable relief to which they are not otherwise entitled. Equitable principles can apply in tax cases to ensure that a taxpayer pays the correct tax due, see *Alamo Nat. Bank* and *Stone v. White*, but the Taxpayers in this case have paid more income tax than they actually owed in the subject years, and equity does not prevent them from obtaining refunds of the overpaid tax to which they are statutorily entitled.

Finally, I disagree with the Department that the Taxpayers are attempting to benefit from the fraudulent accounting scheme. The guilty officers may have temporarily benefited when they received inflated salaries and/or bonuses based on the fictitious profits, but that did not benefit the Taxpayers, who, as described by the Department, were still "teetering on the edge of financial ruin." Department's Second Brief at 6. On the contrary, the Taxpayers were harmed by the scheme because they were required to pay the inflated salaries and bonuses, and also hundreds of millions of dollars in taxes on the fictitious income, which further deteriorated their financial status. The guilty officers, as agents of the Taxpayers, were authorized and obligated to act for the benefit of the Taxpayers, see *Systrends, Inc. v. Group 8760*, 959 So.2d 1052 (Ala. 2006). Their unauthorized actions pursuant to the fraudulent accounting scheme greatly harmed the Taxpayers and were thus

outside of their scope of authority. The Taxpayers should not be punished, i.e., denied refunds to which they are statutorily entitled, because of those unauthorized actions.

The refunds are granted. The Department is directed to issue the Taxpayers refunds as follows: HealthSouth Corporation, 1996 refund of $_____; Select Physical Therapy Holdings, Inc. (f/k/a HealthSouth Holdings, Inc.), 1996 refund of $_____; Surgical Health, LLC (f/k/a Surgical Health, Inc.), 1997 refund of $_____; HealthSouth Corporation d/b/a Rebound, LLC (f/k/a Rebound, Inc.), 1997 and 1998 refunds of $_____; and HealthSouth Corporation, d/b/a HealthSouth Properties, LLC (f/k/a HealthSouth Properties Corporation), 1996 refund of $_____. Additional interest is also due as required by Code of Ala. 1975, §40-1-44(b)(1). The Taxpayers' available NOL carryover amounts should also be adjusted to reflect the IRS audit changes. Judgment is entered accordingly.

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

Entered July 16, 2009.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: David E. Avery, III, Esq.
Bruce P. Ely, Esq.
James E. Long, Jr., Esq.
Melody Moncrief