STATE OF ALABAMA,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE
V.	§	ADMINISTRATIVE LAW DIVISION
RONALD O. & JUANITA T. DURHAM 3324 Stoneridge Drive	§	DOCKET NO. INC.85-177
Birmingham, AL 35223,	§	
Taxpayers.	§	

ORDER

This case involves a disputed preliminary assessment of income tax entered by the Revenue Department against Ronald O. and Juanita T. Durham for the calendar year 1984. The Taxpayers were represented in the matter by certified public accountants Michael J. Zarra and Bruce C. Webster and attorney Louis B. Feld. The Revenue Department was represented by assistant counsel Henry A. Leslie, Jr. Based on the evidence submitted in the case, and in consideration of the briefs and reply briefs filed by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

Ronald O. Durham (hereinafter "Taxpayer") and Clyde C. Black were general partners in two limited partnerships, Vestavia Park Apartments, Ltd., which was formed on June 1, 1977 and consisted of Vestavia Park Apartments (170 units), and Park Towne Apartments, Ltd., which was formed on November 30, 1977 and consisted of Park Towne Apartments (50 units). Under both limited partnership agreements, the general partners had broad authority and control over management of the partnership assets, including the right to

dispose of real property and, with the approval of a majority of the limited partners, the right to designate a trustee-in-liquidation for the purpose of disposing of the partnership assets.

With the intention of terminating the limited partnerships, on May 7, 1984 the general partners entered into liquidating trust agreements relative to the two limited partnerships, the Vestavia Park Apartments, Ltd. Liquidation Trust and the Park Towne Apartments, Ltd. Liquidation Trust. The trusts were created for the sole purpose of liquidating the partnership assets. Both trusts had three trustees-in-liquidation, the two general partners and a third party, Mr. John R. Johnston.

Also on May 7, 1984, the general partners transferred the partnership assets of both limited partnerships by warranty deed into the liquidating trusts. On May 8, 1984, the trustees-in-liquidation entered into separate sales agreements to sell the assets of both liquidating trust to United Princeton Corporation, a New Jersey corporation. The sales were completed on June 15, 1984. The Taxpayer asserts that the third trustee-in-liquidation, Mr. Johnston, being knowledgeable in real estate, was responsible for and did in fact negotiate both sales.

Concerning both liquidating trusts, the trustees-in-liquidation were responsible for maintaining and operating the apartments, collecting rent, selling the apartments, and collecting the sales proceeds derived from the sale of the apartments. Upon completion

of the sales, the liquidating trusts were extinguished, and the sales proceeds were distributed to the respective general partners.

Both trusts filed an Alabama trust fiduciary return showing the business transacted by said trust (rents collected, expenses, etc.). No gain was reported from the sale of the apartments. The basis used by the trusts to compute the gain was the fair market value (selling price) of the apartments at the time of their transfer into the liquidating trusts. That is, the Taxpayer took the stepped up basis allowed under §40-18-6(a)(2). The Department disallowed the increase in basis and computed the gain using the original basis in the property, which resulted in the assessment in dispute.

CONCLUSIONS OF LAW

During the period in issue, Code of Alabama 1975, §40-18-6 read in pertinent part as follows:

> (a) Basis (unadjusted) of property - The basis of property shall be the cost of such property with the following exceptions:
>
>> (2) GIFT OR TRANSFER IN TRUST. If the property was acquired by gift or a transfer in trust, the basis shall be the fair and reasonable market value of such property at the time of such acquisition, or if acquired prior to December 31, 1932, the basis shall be the fair and reasonable market value as of that date.

The above statute providing for a step up in basis was first enacted in 1933 and remained unchanged through several recodifications until its repeal by the Corporate Income Tax Reform

Act of 1985. The 1985 amendment provided that the basis of property transferred in trust would be the same as in the hands of the grantor. However, the amendment did specify that for transfers prior to March 31, 1985, the step up in basis would still be allowed.

The Department argues, that the transfer of the apartments into the liquidating trusts was invalid because the grantor (general partners) retained absolute control over the trust corpus. The Department further contends that the transactions lacked any economic substance or business purpose, and therefore were sham and should not be recognized for tax purposes.

Alabama law clearly provides that the reservation by a grantor of the right to revoke, alter or amend the terms of a trust, or retention of control over the trust corpus, will not jeopardize the validity of the trust. Merchant's National Bank v. Cowley , 89 So.2d 616. Further, there was no merger of legal and equitable interest in a single party, which would also have invalidated the trusts. The merger doctrine was enunciated by the Supreme Court in First Alabama Bank of Tuscaloosa v. Webb, 373 So.2d 631, at 634, as follows:

> The doctrine of merger applies when one person becomes the simultaneous owner of identical legal and equitable interests in the same property. The equitable interest merges into the legal interest and absolute ownership ensues, without any division into legal and equitable interests. Bogert, Trust and Trustees, (2nd Ed.) §129. For example, a trustee, who holds fee simple title in trust in certain real estate which makes up the corpus of

> a trust may become the absolute owner of that realty if he becomes the beneficiary of the trust, or in other words, the owner of the equitable interest. The doctrine of merger would merge the legal interest into the equitable interest, since the same person now holds both interests, consequently destroying the trust. The doctrine of merger, however, is an equitable doctrine and would not apply if "serious injustice would result or if the settlor's intent would be frustrated." Bogert, Trust and Trustees, (2nd Ed.) §129.

As further stated in the above case, the key factor in determining the applicability of merger is that the same person must hold both full equitable and full legal interest in the property. The doctrine does not apply where there is diversity of interest between more than one trustee or more than one beneficiary. Thus, there was no merger of legal and equitable interest in the present case because both trusts had three separate trustees-in-liquidation. See also, Sisson v. Swift, 9 So.2d 891, and Black v. Black, 238 So.2d 861.

The Department also argues that the transfer of the apartments into the liquidating trusts was done for tax avoidance only, and therefore should not be recognized for tax purposes, citing Frank Lyon Co. v. U.S., 435 U.S. 561, and Rice's Toyota World, Inc. v. Commissioner of Internal Revenue, 752 F.2d 89.

In Edwards v. U.S., 572 F.Supp. 22, the U.S. District Court, citing Markosian v. Commissioner, 73 T.C. 1235, discussed the rule of substance over form (sham transactions) in tax matters as follows:

> Technical considerations and legal niceties of the law of trusts which petitioner seeks to hide behind will not obstruct our view when the sole purpose of this subterfuge is the avoidance of Federal income tax. To be sure, a taxpayer has the legal right to minimize his taxes or avoid them totally by any means which the law permits. [Cites omitted]. However, this right does not bestow upon the taxpayer the right to structure a paper entity to avoid tax when that entity does not stand on a solid foundation of economic reality. When the form of the transaction has not, in fact altered any cognizable economic relationships, we will look through that form and apply the tax law accordingly to the substance of the transaction.

In Rice's Toyota, the court, citing Frank Lyon Co., adopted a two pronged approach in determining if a transaction is, for tax purposes, a sham. There must be no business purpose for the venture, and there must be no reasonable possibility of making a profit.

The Taxpayer asserts that the purpose behind the creation of the liquidating trusts and the transfer of the apartments into the trusts was to better facilitate the sale of the apartments, with the goal of terminating the partnerships. Liquidating trusts have been previously recognized as valid instruments, see Paine v. U.S., 32 F.Supp. 672; Helvering v. Washburn, 99 F.2d 478; and Commissioner v. Atherton, 50 F.2d 740, and are generally formed for the purpose of consolidating management of an asset so that it can be more readily sold. A liquidating trust may be especially useful if a large number of varied parties have an interest in the

property.[1]

By the addition of a third trustee-in-liquidation, who had the authority to negotiate and sell the trust assets, the general partners no longer had absolute control over the assets. If a transaction alters any economic relationships and rights concerning the parties and property involved, the transaction is not a pure sham and should not be voided. Edwards v. U.S., supra. As stated in Rice's Toyota supra, at page 92, "a transaction cannot be

---

[1]In Helvering v. Washburn, supra, a group of individuals separately owned several large tracts of land. The tracts were consolidated to better enhance their sale potential, and were placed in trust for the purpose of getting title in better condition for sale, which was necessary because of the large number of persons with an interest in the property. The court citing Commissioner v. Atherton, supra, stated, "[I]n the instant case, the trustees are holding parcels of land for an opportunity to sell, collecting rents and paying taxes and distributing available funds, and it is a strict trust".

treated as a sham unless the transaction is shaped solely by tax avoidance considerations".

Concerning the second prong of the Rice's Toyota test, the creation of a trust and the transfer of property into the trust is not a transaction that is normally entered into to realize a profit. Rather, as discussed above, a trust is created for other business considerations, such as to enhance management of the property, or, as in the present case, to facilitate the sale of the property. Certainly a gain is not expected from the transfer itself of property into a trust. Consequently, the transfer in issue could not be categorized as a sham merely because it did not directly result in a profit.

The statute providing for an increase in basis was first enacted in 1933 and was reenacted on several occasions without change. Only with the 1985 Corporate Income Tax Reform Act was the artificial increase repealed, effective March 31, 1985. There is evidence indicating that the Department had long recognized and allowed the step up in basis provided by §40-18-6(a)(2), and further, that the Department had actively sought and achieved the closing of the loophole through passage of the Corporate Income Tax Reform Act of 1985.

The reenactment of a statute without change signifies legislative approval of the language of the statute and the manner in which it has been administered. Hamm v. Proctor, 198 So.2d 782;

Jones v. Phillips,185 So.2d 378. Further, the manner in which a statute has been construed by a State agency over a number of years must be given favorable consideration where such agency action has for years controlled the conduct of public business. Glencoe Paving Co. v. Graves, 94 So.2d 872, citing Ex parte Darnell, 76 So.2d 770.

Prior to 1985, §40-18-6(a)(2) plainly and unambiguously provided that all property transferred in trust shall be given a step up in basis. it is well-settled that the plain language of a statute cannot be ignored, Morgan County Commissioners v. Powell, 293 So.2d 830, Ott v. Moody, 216 So.2d 177, and should be taken to mean exactly what it says, Alabama Industrial Bank v. State ex rel. Avinger, 237 So.2d 108, Jefferson County Board of Education v. Alabama Board of Cosmetology, 380 So.2d 913.

Based on the above, the basis of the partnership assets transferred into the valid liquidating trusts should be the fair market value of the assets when transferred, as allowed under §40-18-6(a)(2), as it read during the period in question. Accordingly, the assessment in issue should be reduced and made final in the amount of zero.

Done this 3rd day of October, 1986.

BILL THOMPSON
Chief Administrative Law Judge