

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

§

v.

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DOCKET NO. INC. 86-101

ROBERT E. & MARY C. TATE
Crown Regency Unit 609
1220 Beacon Parkway East
Birmingham, AL 35209,

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Taxpayers.

ORDER

This case involves two disputed preliminary assessments of income tax entered against Robert E. and Mary C. Tate (hereinafter "Taxpayers") for the years 1982 and 1983, as well as the disallowance by the Department of a refund claimed by the Taxpayers for 1983. A hearing was conducted in the matter by the Administrative Law Division on September 10, 1986. The Taxpayers were represented by the Hon. C. Fred Daniels. Assistant counsel Mark Griffin appeared on behalf of the Department. Based on the evidence taken at the hearing, in addition to an exhibit (redemption-option agreement) submitted subsequent to the hearing by agreement of the parties, and in consideration of post-hearing briefs filed by both parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

At the beginning of 1982, Mr. Tate, a long time employee of Poole Truck Lines, Inc. (hereinafter "Poole") owned one hundred fifty shares of Poole stock. Mr. Tate's cost basis in the entire one hundred fifty shares was negligible. During 1982, a conflict

arose between Mr. Tate and the principal owner of Poole, and negotiations began for the sale of Mr. Tate's stock to Poole. At approximately the same time, the Taxpayers decided that Mrs. Tate should become an equal shareholder of the Poole stock with Mr. Tate. Consequently, as will be discussed, Mrs. Tate was given seventy-five shares of the Poole stock by Mr. Tate on various occasions in 1982 and 1983.

Although the evidence as submitted by the parties at the hearing was incomplete and on occasion speculative, as close as can be determined, the following transactions occurred relative to the Poole stock during 1982 and 1983: On August 8, 1982, Mr. Tate sold fifty shares to Poole for \$500,000.00. Prior to September 14, 1982, Mrs. Tate was given either twenty-five or fifty shares by Mr. Tate. Based on evidence to be discussed later, it would appear that only twenty-five shares were transferred to Mrs. Tate at that time. On September 14, 1982, Mrs. Tate sold twenty-five shares to Poole for \$250,000.00.

Mrs. Tate sold another twenty-five shares to Poole sometime between January 1, 1983 and April 4, 1983. The check from Poole to Mrs. Tate for the twenty-five shares, totaling \$250,000.00, was dated January 1, 1983, but wasn't deposited by Mrs. Tate until April 4, 1983. It is unclear exactly when Mrs. Tate acquired the twenty-five shares sold by her between January 1, 1983 and April 4, 1983. However, on February 1, 1983, a redemption/option agreement

was entered into between both Taxpayers and Poole providing that twenty-five of the remaining seventy-five shares of Poole stock were to be sold to Poole for \$250,000.00 in 1983, and that Poole would have an option to purchase the last fifty shares for \$500,000.00 in 1984. The agreement specified that Mr. Tate owned the seventy-five remaining shares, thus indicating that Mrs. Tate was not given the twenty-five shares that she sold in early 1983, and consequently could not have sold those shares, until after the redemption/option agreement of February 1, 1983. The remaining fifty shares were sold, twenty-five shares each by Mr. and Mrs. Tate, in September 1983. The total purchase price for the last fifty shares was \$475,000.00.

Concerning the redemption/option agreement, Mr. Tate, as owner of the stock, was the "Seller/Optionor", Poole was designated as "Purchaser/Optionee", and Mrs. Tate was "Assignee". As stated, the agreement provided that Poole would buy twenty-five shares immediately (before April 4, 1983), with an option to purchase the remaining fifty shares in 1984. The purchase price for each twenty-five share lot was \$250,000.00. It was agreed that Mrs. Tate, as a party to the agreement, could received some or all of the shares, and that she would be bound by the terms of the agreement. As stated, it appears that fifty of the seventy-five shares involved with the redemption/option agreement were given to and subsequently sold by Mrs. Tate. As with the initial 1982

negotiations between Poole and the Taxpayers, there is no evidence indicating to what extent, if any, Mrs. Tate participated in negotiating the agreement.

The stock sold by Mrs. Tate was paid for by Poole checks made payable to Mary C. Tate. The sales to Mr. Tate were paid by Poole checks made payable to Mr. Tate. However, in all cases the money received was deposited in various joint accounts to which both Mr. and Mrs. Tate had equal access, and was subsequently used to make joint gifts and payments of joint liabilities.

For 1982, the taxpayers filed a joint Alabama return and reported thereon a gain on Mr. Tate's stock sales. No gain was reported on the sales by Mrs. Tate. On their 1983 joint return, the Taxpayers initially reported a gain from the sales made by both Mr. and Mrs. Tate. However, an amended 1983 return was subsequently filed indicating no gain from the sales by Mrs. Tate.

A refund petition for 1983 was also filed as a result of the amended return.

The non-recognition of gain on Mrs. Tate's stock sales is based on the Taxpayers' claim that Mrs. Tate should be allowed the step up in basis provided by Code of Ala. 1975, §40-18-6(a)(2), as that section read prior to 1985. That section provided in relevant part that the basis of property acquired through gift should be the fair market value of the property at the time of the gift. The Taxpayers contend that the fair market value of the Poole stock

when given to Mrs. Tate was equal to the sales price by Poole, thereby resulting in no gain.

The Department concedes that the stock gifts to Mrs. Tate were valid and properly executed, and that the stock was sold by Mrs. Tate to Poole after the gifts occurred. However, the Department argues that the gifts of the stock were invalid attempts by Mr. Tate to assign income from the subsequent stock sales, done for the sole purpose of avoiding income tax, and accordingly, should not be recognized for tax purposes. Based thereon, in addition to several minor adjustments which are not in dispute, the Department recomputed the Taxpayer's liability for 1982 and 1983 using Mr. Tate's lower basis in the stock, and entered the preliminary assessments in issue.

CONCLUSIONS OF LAW

Code of Alabama 1975, §40-18-6(a)(2), as it read during the years in dispute, provided for a step up in basis as follows:

(2) GIFT OR TRANSFER IN TRUST. - If the property was acquired by gift or 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.

In the case at hand, there is no question that the gifts of the Poole stock from Mr. Tate to Mrs. Tate were valid, or that Mrs. Tate subsequently sold the stock to Poole. Given those facts alone, it would appear that the transactions should be allowed a step up basis under the above section. However, in some instances,

the technical compliance with a statute must be disregarded for tax purposes. The substance of a transaction, not its form, must govern. Wichita Terminal Elevator Co., et al. v. Commissioner of Internal Revenue, 162 F.2d 513 (1947); Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935); Knetsch v. United States, 364 U.S. 361, 81 S.Ct. 132 (1960). As stated in Basic, Inc. v. U.S., 549 F.2d 740 (1977):

In matters of taxation, the point is often made that it is the substance of a transaction that determines its tax consequences rather than the form or timing with which it has been carried out. This doctrine or rule is a corollary of the fundamental principle of statutory construction that a transaction or event, even though falling within the literal terms of a statute, may yet be outside its spirit or purpose and thus be outside its intended scope.

In Basic, a parent corporation received from one subsidiary corporation the stock of another second-tier subsidiary. The distribution resulted in a tax reduction to the parent on the subsequent sale of the stock. The Court, after discussing the substance-over-form doctrine, ruled for the government, holding that the whole transaction was full blown conclusion prior to the stock distribution, and accordingly, that the stock transfer was a sham and should be ignored for tax purposes, citing Commissioner v. Court Holding Company, 324 U.S. 331; 65 S.Ct. 707 (1945).

In Court Holding, a corporation negotiated and orally agreed to sell certain assets to a third-party purchaser. However, after discovering that the transaction as contemplated would lead to a

tax on both the corporation and the corporate shareholders to whom the sales proceeds would later be distributed, the corporation attempted to avoid the corporate tax by distributing the property to the shareholders, who in turn consummated the sale. The Tax Court found that while the sale had been completed by the shareholders, in actuality the corporation had in substance agreed to make the sale and therefore the transaction should be treated for tax purposes as a sale by the corporation. As stated by the Court:

[T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

The Taxpayers recognize that the principles enunciated in Court Holding relate to the present case (Taxpayers' brief at page 10), but counter that the Court Holding decision, as limited and explained in later cases, especially United States v. Cumberland Public Service Co., 338 U.S. 451, 70 S.Ct. 280 (1950), would mandate a holding for the Taxpayer.

The Cumberland Public Service case in substance involved almost the same factual situation as Court Holding. Cumberland contemplated the sale of various assets, and after several rejected offers, the Cumberland shareholders, in order to avoid tax, caused

a partial liquidation of Cumberland's assets followed by Cumberland's dissolution. The shareholders then sold the assets.

The Supreme Court upheld the Tax Court's finding that the sale had been by the shareholders and not the corporation, and thus that the gain should not be imputed to the corporation.

The seemingly conflicting results of the Court Holding and Cumberland Public Service cases have caused much confusion in subsequent cases.¹ The courts have recognized that no rule can fit every case, and that each case must turn on its own particular facts. As stated in Baumer v. U.S., 580 F.2d 863 (1978):

[T]he courts have recognized that there are a potentially unlimited number of variations and permutations of transfers raising the Court Holding issue. The characterization of a particular transaction as "real or a sham", Cumberland, supra, 70 S.Ct. at 282, depends in large measure on a subjective judgment based on the special facts of each case. No appellate court, no matter how ingenious, can devise a simple, mechanical formula which will reveal the "correct" characterization of the transaction at issue in every instance. As the Court held in Cumberland, "[i]t is for the trial court, upon consideration of the entire transaction, to determine the factual category in which a particular transaction belongs . . ."

A simple and reasonable yardstick for application of the rule was set out in Hines v. U.S., 477 F.2d 1063 (1973):

¹As a direct result of the questions raised by the Court Holding and Cumberland Public Service decisions, Congress saw fit to enact §337 of the Revenue Code of 1954 so as to set a definite guideline for tax practitioners in determining whether for tax purposes a sale is made by the liquidating corporation or the shareholders who are to receive the assets. See Central Tablet Manufacturing Co. v. U.S., 94 S.Ct. 2519 (1974) and Benedict Oil Company v. U.S., 582 F.2d 544 (1978).

We hold that the sine qua non of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation in fact participated in the sale transaction, by negotiation, prior agreement, post distribution activities, or participated in any other significant manner, could the corporation be charged with earning the income sought to be taxed.

Any other result would unfairly charge the corporation with tax liability for a transaction in which it had no involvement or control. (emphasis as in original)

In the present case, the evidence is unclear as to exactly when the negotiations began between the Taxpayers and Poole for the sale of the Poole stock. It has been established, however, that in early 1982, Mr. Tate and the principal owner of Poole developed a conflict and that negotiations began shortly thereafter, presumably while Mr. Tate still owned all of the shares.

It is further established that fifty of the seventy-five shares sold by Mrs. Tate were sold in 1983, after the February 1, 1983 redemption/option agreement was completed. Obviously, Mr. Tate, as owner of all of the remaining shares at the time of the agreement, must have actively participated in negotiating the agreement. Thus, because Mr. Tate was actively involved in negotiating the sale of all of the Poole stock, even that portion that was eventually sold by Mrs. Tate, in accordance with the Court Holding and Hines cases, among others, for tax purposes the sales by Mrs. Tate must be treated as if they had been made by Mr. Tate.

Accordingly, the Taxpayers should not be allowed an increase in

basis under §40-18-6(a)(2).

The Taxpayers argue that the twenty-five shares sold by Mrs. Tate in September, 1983 were negotiated separately by Mrs. Tate and were not controlled by the redemption/option agreement. It is true that the sale occurred in 1983 as opposed to 1984, as contemplated in the agreement, and also that the sale amount was slightly less than negotiated (\$237,500.00 versus \$250,000.00). But nonetheless, although the terms and timing of the sale may have been altered slightly, it is clear that the sale had been previously negotiated and arranged as set out in the redemption/option agreement, which was negotiated by Mr. Tate prior to the gift of the shares to Mrs. Tate.

The Taxpayers argue that the ultimate issue is whether Mr. Tate entered into a written agreement which required Mrs. Tate to sell (Taxpayers' brief at pages 15 and 17), and the fact of Mr. Tate's participation in negotiations for the sale of the stock was of no consequence (Taxpayers' brief at page 18). However, clearly a written agreement to sell is not necessary for the Court Holding doctrine to apply. As set out in Hines, if a party participates in any significant manner, the imputed income rule should apply. Wichita Terminal Elevator Co., et al. v. Commissioner of Internal Revenue, supra; General Guaranty Mortgage Co. v. Tomlinson, 361 F.2d 93; Bush Bros. and Co. v. C.I.R., 668 F.2d 255; see generally Hines v. U.S., supra, at footnote 8.

In summary, the stock transactions began with Mr. Tate, as sole owner of the entire one hundred fifty shares, negotiating for the sale of the stock to Poole. If and to what extent Mrs. Tate participated in the initial or subsequent negotiations is not relevant. The important fact is that Mr. Tate clearly was involved. In August, 1982, Mr. Tate began selling the stock. At about the same time, the Taxpayers decided that Mrs. Tate should be given one-half of Mr. Tate's shares. The reason given was that the Taxpayers owned all of their other assets jointly and that they wanted the Poole stock to also be jointly owned. However, at that time negotiations had already begun for the sale of the shares to Poole. Thus, it is clear that the gifts to Mrs. Tate were done for tax purposes only.

The fact that a taxpayer may arrange a transaction taxable.² However, if the facts indicate that the transaction was negotiated prior to the asset transfer, as in Court Holding, then it must fail for tax purposes. If the facts indicate a sale after transfer of the assets, with no prior negotiations, as in Cumberland Public Service, then the transaction will stand. In the present case, the facts indicated that Mr. Tate was actively involved in negotiating

²In Basic, Inc. v. U.S., supra, the dissenting judge, citing Chisholm v. Commissioner, 79 F.2d 14 (1935) and Commissioner v. Newman, 159 F.2d 848 (1947) (dissenting opinion), argued that the desire to avoid taxes will not in itself defeat the transaction. Rather, the determining element is whether the transaction had a "good business purpose". No such motive existed in the present case, other than the desire to save taxes.

the sales to Poole prior to transfer of the seventy-five shares to his wife. Thus, the gifts must be ignored for tax purposes.

The above considered, the Department is hereby directed to make final the preliminary assessments in issue, and also deny the 1983 refund petition filed by the Taxpayers. Applicable interest should be added as required by statute.

Done this 21st day of November, 1986.

BILL THOMPSON
Chief Administrative Law Judge