

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

§

v.

§

DOCKET NO. INC. 86-107

JOHN L. DIJT
1621 Trinity Blvd.
Montgomery, AL 36106,

§

§

Taxpayer.

§

ORDER

This case involves a disputed preliminary assessment of income tax entered by the Revenue Department ("Department") against John L. Dijt ("Taxpayer") for the year 1984. A hearing was conducted in the matter by the Administrative Law Division on June 11, 1987. The parties were represented at said hearing by the Hon. James M. Scott, for the Taxpayer, and assistant counsel Mark Griffin, for the Department. Based on the evidence submitted by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

Prior to its amendment in 1985, Code of Ala. 1975, §40-18-6(a)(2) provided in part that the basis of property acquired by a transfer in trust should be the fair market value of such property at the time of transfer, i.e. a step-up in basis. The issue in this case is whether certain stock transferred by the Taxpayer into a trust should be allowed a stepped-up basis under the above section.

The pertinent facts, as stipulated by the parties, are not in

dispute:

Thermal Components, Inc. ("Thermal") was organized by John C. Dijt in 1971. Dijt disappeared in 1976 and is presumed dead. At the time of his death, Dijt owned 252,000 shares of Thermal stock, 55,000 of which were subsequently distributed to the Taxpayer.

Subsequent to Dijt's death, several other companies approached Thermal with an interest in purchasing the company. All such offers were considered by rejected because not enough Thermal shareholders and directors were interested in selling.

In 1983, Insilco, Inc. ("Insilco") initiated an attempt to purchase Thermal. Again there was disagreement as to whether the company should be sold.

On December 5, 1983, a number of pro-sale stockholders, including the Taxpayer, formed the Thermal Trust ("Trust") for the purpose of consolidating ownership and control over a large block of Thermal stock so as to facilitate the possible sale of the company. The facts relating to the Trust, as stipulated by the parties, are set out below:

23. The Trust was irrevocable. The Trust could not be terminated by Taxpayer acting alone, or in concert with all the remaining grantors.

24. The trustee was the First Alabama Bank of Montgomery, N.A., (the "Trustee") , a professional corporate fiduciary.

25. The Taxpayer is not a director, employee or shareholder of the Trustee.

26. The Taxpayer gave up all voting rights on his

Thermal stock for six months, including all right to vote on whatever offer Insilco or any subsequent offeror might make.

27. Once contributed to the Trust, Taxpayer could not sell, or refuse to sell, his stock to Insilco or any other buyer, or participate in any bidding contract or takeover struggle.

28. The Trust had full, absolute, legal ownership to all of the shares contributed to it.

29. Taxpayer was not an officer or director of Thermal.

30. Taxpayer did not negotiate with Insilco and, in fact, never met with any Insilco representative prior to transferring his stock to the Thermal Trust.

31. The Grantor's stock certificates were delivered to the Trustee and were thereafter transferred on the books of Thermal to the ownership of the Trustee. All voting rights for all the shares in the trust were thereby vested in the Trustee.

On December 7, 1983, Insilco and Thermal entered into a conditional merger agreement, subject to, among other things, approval by a majority of the Thermal shareholders.

On January 4, 1984, a shareholders' meeting was conducted for the purpose of voting on the Insilco proposal. The Trustee voted by proxy on behalf of the shares held by the Trust. The sale was approved and on January 6, 1984, the Trust surrendered its shares in return for \$6,425,510.00, of which the Taxpayer received \$1,968,477.01.

The Trust filed an Alabama income tax return, and by taking a step-up in basis showed no gain of the sale of stock. Upon investigation, the Department rejected the claimed step-up in basis

and entered the preliminary assessment in issue.

CONCLUSIONS OF LAW

The pre-amendment version of §40-18-6(a)(2), which allowed for a step-up in basis, 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 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 such date.

On its face, the transfer and subsequent sale of the Thermal stock by the Trust would appear to qualify for a step-up basis as allowed by the above section. However, the Department argues that substance over form must govern, and consequently, that the transfer must be ignored for tax purposes because the sale of the stock had already been negotiated by the Taxpayer prior to its transfer, and further, that the Taxpayer did not relinquish control and authority over the stock upon its transfer into the Trust.

It is well-settled that substance over form must govern in tax matters, Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266; Knetsch v. U.S., 364 U.S. 361, 81 S. Ct. 132; Edwards v. U.S., 572 F.Supp. 22, and that a transaction which complies with the technical requirements of a statute may yet be outside of its intended scope. Basic, Inc. v. U.S., 549 F.2d 740.

The courts have recognized that a transaction is, for tax purposes, a sham if there is no business purpose other than the avoidance of taxes. Rice's Toyota World, Inc. v. C.I.R., 752 F.2d 98; Frank Lyon Co. v. U.S., 435 U.S. 561, 98 S.Ct. 1291. However, in the present case the Trust was created for the valid purpose of enhancing the possibility of selling the company.¹ By transferring the stock to the Trust, the Taxpayer relinquished control over the stock, including the right to negotiate a sale of the stock for a period of six months, see stipulation, at paragraphs 26, 27 and 28.

If a transaction alters any economic relationships and rights concerning the parties and property involved, the transaction is not a pure sham. Thus, because the transfer of the stock to the Trust had a valid purpose other than the avoidance of taxes, and because the transfer clearly reduced the Taxpayer's control and authority over the stock, the transaction was not a pure sham of the type that must be disregarded for tax purposes. Edwards v. U.S., supra; Rice's Toyota World, Inc. v. C.I.R., supra.

The courts have further recognized that a transfer of property immediately prior to its sale cannot serve to shift the tax

¹For cases involving "liquidating trusts", formed for the purpose of facilitating the sale of property with multiple owners, see Helvering v. Washburn, 99 F.2d 478, and Commissioner v. Atherton, 50 F.2d 740.

liability from the transferor to the transferee if the transferor had negotiated for and in effect completed the sale prior to the transfer, Commissioner v. Court Holding Co., 324 U.S. 331, 55 S.Ct. 707.

In Court Holding, the U.S. Supreme Court held that the sale of assets by a corporation's shareholders should be treated as a sale by the corporation for tax purposes because the corporation had negotiated and substantively completed the sale prior to the transfer of the assets. The gain was thus taxed to the corporation. As summarized by the Court:

The 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 later 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 Department cites Court Holding in support of its argument that the sale of stock was a foregone conclusion prior to creation of the Trust. However, the evidence is clear that the Taxpayer had not negotiated with Insilco or otherwise agreed to sell his stock prior to formation of the Trust, see stipulation, at paragraph 30. Thus, the Court Holding rationale is not applicable.

A taxpayer may arrange his business so as to pay as little tax as possible, Gregory v. Helvering, supra. The only requirement is that the transaction must have a legitimate business purpose. As

stated in Basic, Inc. v. U.S., supra:

The touchstone, therefore, that distinguishes a transaction worthy of being recognized as it appears from one deserving to be disregarded is the presence of a "good business purpose" rather than the absence of any desire on the taxpayer's part to pay taxes. The taxpayer's purpose to escape taxes is legally neutral. Chisholm v. Commissioner, 79 F.2d 14.

Pre-amendment §40-18-6(a)(2) clearly allowed for a step-up in basis for property transferred into trust. Thus, only if the transfer of stock was motivated for no business purpose other than the avoidance of taxes should it be set aside. That not being the case, the Taxpayer (Trust) should be allowed a step-up in basis on the stock in issue.

The above considered, the Department is hereby directed to reduce and make final the assessment in issue showing no tax due.

Done this 2nd day of July, 1987.

BILL THOMPSON
Chief Administrative Law Judge