STATE OF ALABAMA DEPARTMENT OF REVENUE,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 86-113
ALFRED J. GAMBLE P. O. Box 2286 Montgomery, AL 36103,	§ §	
Taxpayer.	§	

ORDER

This case involves three disputed preliminary assessments of income tax entered by the Department against Alfred J. Gamble (hereinafter "Taxpayer") for the years 1982, 1983 and 1984. A hearing was conducted on June 25, 1986 at which the parties were represented by Alan E. Rothfeder and Jo Karen Parr, for the Taxpayer, and Adolph Dean, for the Department. Based on the undisputed facts of the case, and in consideration of the arguments and authorities presented by both parties at the hearing and through post-hearing briefs, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

On June 25, 1982, the Taxpayer, as grantor, created the Alfred J. Gamble Lifetime Trust (hereinafter "Trust"). The Trust named the Taxpayer as sole trustee, with provisions for successor trustees in the event of the death, resignation, unwillingness or inability of the Taxpayer to serve as trustee. The Taxpayer acted as trustee at all times during the years in dispute. Under the terms of the Trust, the trustee had sole discretion to apply all or part of the income or principal for the benefit of the grantor and his children and other lineal descendants. The grantor also reserved the right to alter, amend or revoke the Trust at any time after the first fifteen months of its existence. Upon the death of the grantor, certain Trust property was to be distributed to various specific beneficiaries, with the remainder going in equal shares to the Taxpayer's two sons.

On July 26, 1982, the Taxpayer transferred an apartment complex known as Village Green East Apartments to the Trust by warranty deed. The apartments had been purchased by the Taxpayer in 1976. The transfer of additional property to the Trust was specifically authorized under the terms of the Trust.

On November 30, 1982, the Village Green East Apartments were sold by the Trust to Eastwick, Ltd., a California partnership. The sale was executed on behalf of the Trust by the Taxpayer, in his capacity as trustee. In connection with the sale, the purchaser executed a promissory note in favor of the Taxpayer, as trustee, under which payments of principal and interest were made in the amounts of $43,136.64 on December 1, 1982, $406,876.45 on March 31, 1983, and $448,182.07 on March 30,1984. The above payments were deposited in the Trust bank account.

The parties stipulated that all transactions relating to the Trust should have been reported on Form 41, State of Alabama Fiduciary Income Tax Return, but that no such return was file for any of the three years in issue.

The Department audited the Taxpayer and determined that the gain realized from the sale of the Village Green East Apartments was attributable to the Taxpayer, and should be computed using the Taxpayer's original basis in the property. The Taxpayer argues that the gain is taxable to the Trust, and that under Code of Alabama 1975, §40-18-6(a)(2), the basis of the subject property should be the fair market value of the property at the time it was transferred to the Trust. The Department counters that the transfer of the property does not qualify for the stepped up basis under §40-18-6(a)(2) "because said transfer was not a true arm's-length transaction and thus a merger of interest occurred">

CONCLUSIONS OF LAW

During the years 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:
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> > (2) GIFT OR TRANSFER IN TRUST. If the property was acquired by gift or transfer in trust, the basis shall be the fair 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 primary issue is whether the transfer of the apartments to the Trust in 1982 was a valid transfer in trust so as to qualify the property for the increase in basis provided by §40-18-6(a)(2).

The Department's principal argument is that the trust is invalid due to the doctrine of merger.

The merger doctrine was discussed by the Alabama Supreme Court in First Alabama Bank of Tuscaloosa v. Webb, 373 So.2d 631, at 634 (1979), 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 interest. Bogert, Trust and Trustees, (2nd Edit.) §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 Edit.) §129.

As further stated by Justice Embry in the above case, the key ingredient in determining the applicability of merger is that the same person must hold both full equitable and full legal interest in the trust property. The doctrine does not apply where there is a diversity of interest, with either more than one trustee or more than one beneficiary. Sisson v. Swift, 9 So.2d 891 (1942); Black v. Black, 238 So.2d 861 (1970). In Black, the Court made the following comment:

> The fact that the persons named as executor (trustees) are also beneficiaries does not affect the validity of

> the trust. It is true that the same person cannot be at the same time sole trustee and sole beneficiary of the same identical interest, but a cestui que trust, a beneficiary, is not prohibited from occupying the position of trustee for his own benefit where he is a trustee for others as well.

Thus, the determinative question is whether the Taxpayer, while being the sole trustee, was also the sole beneficiary of the Trust. Under the Trust, the Taxpayer retained the right to revoke (after 15 months) or alter the Trust instrument, and also kept control of the beneficial use and enjoyment of the Trust assets during his lifetime. Various remainder beneficiaries were designated that would receive the assets upon the Taxpayer's death.

Numerous authorities, examples of which are set out below, hold that a remainder interest in property held in trust becomes a vested right of the remainder beneficiary upon creation of the trust, notwithstanding that the property is subject to a prior interest and may be completely consumed or diverted by the prior interest holder.

> It seems to be a reasonable well-established general rule that the fact that property in which a remainder interest is created is also subjected to a power in the holder of a prior interest under which the property may be wholly or partially consumed or diverted so as to prevent the remainderman's enjoyment thereof does not render the remainder contingent, and the courts, in view of the well-established preference for early vesting, regard the possibility that the remainder may never vest in enjoyment as involving only a condition subsequent, so that the remainder is vested subject to defeasance rather than contingent. 61 A.L.R.2d, at page 477.

> The reservation of a power of revocation and modification does not prevent the creation of a trust in the lifetime

> of the settlor, and the beneficiary at once acquires a future interest, although it is an interest subject to be divested by the exercise of the power. The death of the settlor is not a condition precedent to the vesting of the interest in the beneficiary. Scott on Trusts, (3rd Edit.) §57.1, at page 478.
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> Suppose, however, that the settlor reserves not only a beneficial life interest but also a power of revocation. Such a trust is not necessarily testamentary. The declaration of trust immediately creates an equitable interest in the beneficiaries, although the enjoyment of the interest is postponed until the death of the settlor, and although the interest may be divested by the exercise of the power of revocation. The disposition is not essentially different from that which is made where the settlor transfers the property to another person as trustee. Scott on Trusts, (3rd Edit) §57.6, at page 517. On the other hand, if the beneficial interest is limited to the settlor for life and on his death the property is to be conveyed to his children, or issue, or descendants, he is not the sole beneficiary of the trust, but an interest in remainder is created in his children, issue or descendants. Restatement of Trusts, (2nd Edit.) §127, at page 273.

For specific cases on point, see Gray v. Union Trust Company of San Francisco, 154 P. 305; Randall v. Bank of America, N.T. & S.A., 119 P.2d 754; and First National Bank of Cincinnati v. Tenney, 138 N.E.2d 15.

Based on the above authority, it is clear that the remainder beneficiaries named in the Trust instrument were vested with an equitable interest in the Trust property upon creation of the Trust, and that their vested interest also attached to the property in issue, and the sales proceeds derived therefrom, that has subsequently made a part of the Trust corpus. Thus, there being more than one beneficiary with a vested interest in the Trust property, the doctrine of merger is inapplicable.

The Department argues that where an Alabama statue has been modeled after a federal statute, federal authority should be controlling. Best v. State, Department of Revenue, 417 So.2d 187. Consequently, the Department contends that 26 U.S.C. §§644 and 674 should control in the present case. Section 644 imputes to the grantor any gain realized on the sale of trust assets made within two years of the transfer into trust. Section 674 provides in effect that the grantor shall be considered the owner of any portion of the trust corpus or income over which he retains unfettered control. For other sections attributing trust assets and income to the grantor, see 26 U.S.C. §§671, 672, 673, 675, 676 and 677.

The Taxpayer agrees that federal authority should control when it relates to a similar Alabama statute. However, the Taxpayer correctly points out that §§644 and 674 are not applicable because Alabama has no similar statutes.

On the other hand, the Taxpayer cites persuasive federal authority in support of its position in Sarah A. W. Coursey v, Commissioner of Internal Revenue Service, 33 BTA 1068. That case was decided under the old federal law (§113(a)(4) of the Revenue Act of 1928) from which §40-18-6(a)(2) was modeled, and held, in substance, that property transferred in trust should be allowed a step up in basis. Thus, under the federal progenitor to §40-18-

6(a)(2), an increase in basis would be allowed.

A final argument forwarded by the Department is that the transfer in trust was a sham, done for tax avoidance only, and therefore should not be recognized, citing Edwards v. U.S., 572 F.Supp. 22. The court held in Edwards, citing Markosian v. Commissioner, 73 T.C. 1235, stated as follows:

> Technical considerations and legal niceties of the 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 the 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 both Edwards and Markosian, the taxpayers attempted to avoid tax by transferring their business and personal assets and their lifetime services to a family trust. Both trusts were voided mainly because the taxpayers had retained significant control over the use and enjoyment of the trust assets. Income from the assets was thus attributed to the taxpayers under 26 U.S.C. §§674 and 677. See Edwards, at page 25.

The Taxpayer argues that the family trust attempted in Edwards was an obvious sham and has not relationship to the trust in issue. It is correct that the facts in the two cases are discernable different. Further, as stated previously, there are no Alabama statutes similar to the federal statutes relied on in Edwards, 26 U.S.C. §§674 and 677. However, the rule of law concerning sham transactions enunciated in Edwards may still be applicable.

In determining whether the transfer of the property to the Trust was a sham, the pertinent questions are whether the Trust was valid, which has been established, and then whether the transfer of the subject property had any economic substance or was motivated by any purpose aside from the step up in basis allowed under §40-18-6(a)(2).[1]

[1]In Rice's Toyota World, Inc. v. C.I.R., 752 F.2d 89, at page 91, citing Frank Lyon v. U.S., 435 U.S. 561, 98 S.Ct. 1291, the court adopted a two-pronged approach in

determining if a transaction is, for tax purposes, a sham. There must be no business purpose, and there must be no reasonable possibility of making a profit. However, the business purpose and profit motive tests should not be strictly applied in the present case because the transfer of property into trust is not a transaction which is normally motivated by business or profit considerations. Certainly no profit or gain is expected from the transfer of property from an individual to a trust. The purpose may be to obtain better management of the trust assets, or, as perhaps in the present case, to insure an orderly disposition of the assets at some future date.

The Department's argument is that the transfer was a sham because the Taxpayer, as trustee, retained absolute control and full beneficial enjoyment over the Trust assets during his life. However, as previously discussed, the remainder beneficiaries were immediately vested with an interest in the corpus upon creation of the Trust, notwithstanding that such interest was subject to alteration, revocation or extinguishment by the Taxpayer. If a transaction alters any economic relationships or rights concerning the property and parties involved, as in the present case, then the transaction is not a pure sham and should not be voided. Edwards v. U.S., supra. As stated in Rice's Toyota, at page 92, "a transaction cannot be treated as a sham unless the transaction is shaped solely by tax avoidance considerations."

The statute allowing a step up in basis for property transferred in trust was first enacted in 1933 and was re-enacted on several occasions without change. Only with the passage of the Corporate Income Tax Reform Act of 1985 was the artificial increase in basis repealed. There is no evidence that, prior to 1985, the Revenue Department ever challenged or disputed a step up in basis under §40-18-6(a)(2). Department Regulation 810-3-6-.02(1)(b) merely tracks the language of the statute, without further comment. The reenactment or recodification of a statute without change signifies legislative approval 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; Glencoe Paving Co. v. Graves, 94 So.2d 872, citing Ex parte Darnell, 76 So.2d 770.

Section 40-18-6(a)(2), prior to 1985, plainly allowed for a step up in basis. The Taxpayer is correct in arguing that "when the language as used by the lawmakers is plain, it is the duty of the courts to obey; no discretion is left; and courts should not stray into bypaths or search for reasons outside the plain letter of the law upon which to rely for the purpose of giving a different meaning or interpretation, for 'when language is plain it should be considered to mean exactly what it says.' State ex rel. Little v. Foster, 130 Ala. [154] 163 (30 So. 477)." Ex parte Bozeman, 63 So. 201; Dixie Coaches, Inc. v. Ramsden, 190 So. 92; State v. Robinson Land & Lumber Co. of Alabama, 77 So.2d 641.

The above considered, the basis for computing the gain from the sale of the subject property should be the higher basis allowed by §40-18-6(a)(2). Accordingly, the Revenue Department is hereby directed to reduce and make final the preliminary assessments in issue showing no tax due.

Done this the 26th day of September, 1986.

BILL THOMPSON
Chief Administrative Law Judge