STATE OF ALABAMA DEPARTMENT OF REVENUE,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 86-114
WILLIAM H. & RUTH C. MCLEMORE 7100 Atlanta Highway Montgomery, AL 36107,	§ §	
Taxpayers.	§	

ORDER

This case involves a disputed preliminary assessment of income tax entered by the Revenue Department (Department) against William H. and Ruth C. McLemore (hereinafter either "husband", "wife", or "Taxpayers") for the calendar year 1984. A hearing was conducted by the Administrative Law Division on January 7, 1987. The parties were represented by the Hon. Richard Belser and the Hon. Mark Griffin, for the Taxpayers and the Department, respectively. Based on the evidence submitted at said hearing, and in consideration of the arguments and authorities submitted by both parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

This case involves the basis provisions of Code of Ala. 1975, §40-18-6(a)(2), which during the period in question provided that the basis of property acquired by gift shall be the fair market value of such property at the time of the gift.

The pertinent facts are not in dispute: Subsequent to negotiations, on June 28, 1984 the husband entered into an

agreement to sell approximately 8.41 acres of land to the Alabama Christian School of Religion (ACSR). At the time of the agreement, the husband held fee simple title to the property. The wife had no legal interest in he property and was not a party to the preliminary negotiations or sales agreement.

On November 15, 1984, the husband conveyed by gift to his wife approximately 9.81 acres of land, part of which constituted the entire 8.41 acres involved in the June 28, 1984 sales agreement. The sole purpose of the gift, as set out at page two of the Taxpayers' pre-hearing position statement, was to take advantage of the step-up basis provisions found at §40-18-6(a)(2).

On November 21, 1984, the wife sold the subject 8.41 acres to ACSR in accordance with the terms set out in he June 28, 1984 sales agreement between the husband and ACSR. The sales proceeds were deposited by the wife into the Taxpayers' joint bank account.

On their 1984 joint Alabama income tax return, the Taxpayers, per §40-18-6(a)(2), claimed a basis in the property equal to its fair market value at the time of the gift, which, because of the short period between the gift (November 15, 1984) and the sale (November 21, 1984), was determined by the Taxpayers to be equal to the sales price. Consequently, no gain was reported on the sale. The Department rejected the Taxpayers' use of the stepped-up basis and assigned to the property the husband's original basis, which resulted in the preliminary assessment in issue.

CONCLUSIONS OF LAW

Code of Alabama 1975, §40-18-6(a)(2), prior to its amendment in 1985, provided for an increase in the basis of property acquired by gift or transfer in trust 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 of that date.

There is no question that the Taxpayers in the present case complied with the technical requirements necessary for an increase in basis under pre-amendment §40-18-6(a)(2). There was a valid gift from the husband to the wife prior to the sale of the property. However, as state in Basic, Inc. v. U.S., 549 F.2d 740 (1977), the substance of a transaction, and not its form, must govern, and in some instances the technical compliance with a statute must be disregarded for tax purposes.

In Basic, a parent corporation negotiated for the sale of stock, and in a belated attempt to avoid tax of the sale, distributed the stock to a subsidiary corporation prior to consummation of the sale. However, the court held that because the transaction was a foregone conclusion prior to distribution of the stock to the subsidiary, the stock transfer was a sham and should not be recognized for tax purposes. As stated by the court:

> In the 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.

The "substance-over-form" doctrine is commonly attributed to the decision in Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), a case in which the absence of a business purpose made literal compliance with the statutory provisions for a spin-off reorganization insufficient to accomplish what would otherwise have qualified as a tax free transfer.

* * *

Although Gregory was concerned with a corporation reorganization question, the rationale of that case has not been confined in application to such situations alone. Rather, that decision, as Judge Learned Hand explained in Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), has come to stand for the proposition "that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." An even more incisive formulation of the same though was later expressed -- again by Judge Hand -- in Gilbert v. Commissioner, 248 F.2d 399, 411 (2nd Cir. 1957) (dissenting opinion), in these words:

> * * * The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. <u>If however, the taxpayer entered into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it</u>; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose (emphasis as in the original).

The Basic case was decided for the government on the

interrelated grounds that there was no valid business purpose for the subject transaction, as illustrated by the above excerpts, and also because the whole transaction had been conceived and substantially concluded prior to the stock distribution. The latter point, that a transaction must be looked at as a whole and a sale made in substance by one party cannot be changed for tax purposes into a sale by another through a sham transfer of the asset prior to the sale, was first established in the landmark case, Commissioner v. Court Holding Co., 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, upon discovering that the transaction as contemplated would lead to a tax on both the corporation and the corporate shareholders, the corporation attempted to avoid the corporate tax by distributing the property to the shareholders prior to the sale. The court found that while the sale had been completed by the shareholders, in actuality the corporation had agreed to make the sale and therefore the transaction should be treated for tax purposes as a sale by the corporation. As stated by Justice Black:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, 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 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. (emphasis added)

For additional cases in support of the Court Holding principle, see Magneson v. C.I.R., 753 F.2d 1490 (1985) (concerning the "step transaction doctrine"); Wichita Terminal Elevator Co., et al. v. Comm. of Internal Revenue, 162 F.2d 513 (1947); General Guaranty Mort. Co. v. Tomlinson, 335 F.2d 518 (1964); Blueberry Land Co. v. Comm., 361 F.2d 93 (1966); Bush Bros. and Co. v. C.I.R., 668 F.2d 252 (1982); also generally Hines v. U.S., 477 F.2d 1063 (1973), cases at footnote 8.

In 1950, the Supreme Court, in United States v. Cumberland Public Service Commission, 338 U.S. 451, 70 S.Ct. 280, again addressed the issue presented in Court Holding, and on slightly different facts decided that the gain on the transferred assets should not be imputed to the original owner.

The conflicting results reached in the Court Holding and Cumberland Public Service Commission decisions raised many questions as to how to treat the numerous factual variations that invariable arise. In an attempt to clarify the matter, and as a direct result of the Court Holding and Cumberland Public Service Commission conflict, Congress enacted §337 of the Revenue Code of 1954, which set definite guidelines for corporate taxpayers in determining whether for tax purposes a sale is by a liquidating

corporation or by the shareholders who are to receive the proceeds. For a history of the Court Holding/Cumberland Public Service Comm. conflict, and the resulting enactment of §337, see Central Tablet Manufacturing Co. v. U.S., 94 S.Ct. 2516 (1974) and Benedict Oil Company v. U.S., 582 F.2d 544 (1978).

However, for most situations there can be no certain rule for application of the principle. As stated in Baumer v. U.S., 580 F.2d 863 (1978):

> The 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 its objective 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, to determine the factual category in which a particular transaction belongs . . . "

Nonetheless, although each case must be decided on its own peculiar facts, a reasonable guideline for application of the rule in most instances was set out in Hines v. U.S., supra:

> 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 not involvement or control. (Emphasis as in original).

In the present case, the husband negotiated for the sale of the property. The property was then transferred by gift to the wife, after which the wife sold the property in accordance with the terms of the sales agreement between the husband and the purchaser. The single and admitted purpose for the gift from the husband to the wife was to obtain an increased basis in the property and thereby avoid income tax on the gain realized from subsequent sale of the property. Clearly, there could be no better example of a circumstance that would fit more exactly within the parameters of the above principle that a transaction must be taken as a whole, and that a transaction entered into without a business motive and for the primary purpose of tax avoidance should not be recognized for tax purposes. Accordingly, in spite of a technical compliance with the statute, because the sale was negotiated and in effect completed prior to the gift and because there was admittedly no business purpose for the gift, the transfer of the property must be ignored for tax purposes and the sale must be treated as having been made by the husband.

The Taxpayers' representatives, in an excellent brief, cite numerous cases which hold in part that a tax benefit should not be denied simply because the form of a transaction chosen by a taxpayer resulted in less tax than another form that was available. That proposition is correct as far as it goes. It is axiomatic that a taxpayer may arrange his affairs in such a way as to pay as

little tax as possible. Gregory v. Helvering, supra; Superior Oil Company v. Mississippi, 280 U.S. 390, 50 S.Ct. 169 (1930); Atlantic Cost Line R. Co. v. Phillips, 332 U.S. 168, 67 S.Ct. 1584 (1947). However, while the motive to pay as little tax as possible is neutral and should not in itself defeat the legitimacy of a transaction for tax purposes, to stand the transaction must also have served a legitimate business purpose. As pointed out by the dissenting judge in Basic v. United States, supra:

> The touchstone, therefore, that distinguishes a transaction worth 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.

A review of several of the cases cited by the Taxpayers in brief further illustrates the necessity for business purpose in determining the validity of a transaction. In Maysteel Products, Inc. v. C.I.R., 287 F.2d 429 (1961), the taxpayer prevailed because the subject transaction did in fact have economic substance. As stated by the court:

> The Government relies on cases such as Knetsch v. United States, 364 U.S. 361, 81 S.Ct. 132, 5 L.Ed.2d 128; Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596; and Gilbert v. Commissioner of Internal Revenue, 2 Cir., 248 F.2d 399, affirmed after remand, 2 Cir., 262 F.2d 512. But those cases involved instances where the transaction relied upon was a mere sham or lacked economic reality. In such situations the courts properly disregard form for substance.

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> The transaction here had economic substance, was not a sham nor rigged device without real substance or risk, and inducement or motive is without significance. Taxpayer incurred the risk of loss in event of decline in the market; was entitled to benefit from any advance; it was not bound to make the gift it ultimately did but could have retained the benefits of the transaction. Substantive and economic reality were present.
>
> The motive involved does not destroy the commercial reality and genuineness of the transaction . . .

In Lewis & Taylor, Inc., v. C.I.R., 447 F.2d 1074 (1971), the taxpayer again prevailed, again on the basis that the transaction in questions was economically viable:

> The December 4, 1961 agreement conformed to the economic reality of the transaction. In Peter Pan Seafoods, Inc. v. United States, (9th Cir. 1969, 417 F.2d 670, we held that where a transaction has economic substance an d is economically realistic, it should be recognized for tax purposes, and the fact that a transaction is so arranged that the tax consequences are highly favorable to one of the parties affords the Commissioner no license to recast it into one of less advantage. Gyro Engineering Corporation v. United States (9th Cir. 1969), 417 F.2d 437.
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> We agree, <u>and we reassert that if there was a good business reason</u> to amend the initial agreement, it is not for the Commissioner to insist that the abandoned agreement be adhered to merely because it allows a larger tax return to the United States. (emphasis added)

The Taxpayers' case is boosted by the holdings in Sun Properties v. United States, 220 F.2d 171 (1955), and Woolley Equipment Co. v. United States, 268 F.Supp 358 (1966). In the Sun Properties case, the court found that the sale of property for the sole purpose of realizing a gain was in itself a valid business transaction. In Woolley, the court stated that "tax considerations

have become so important today that tax avoidance alone may well constitute a legitimate business purpose for transacting business in a particular manner."

However, the Sun Properties and Woolley decisions represent the minority view. The majority opinion, as illustrated by the numerous authorities cited herein, is that a transaction entered into for purely tax purposes, and with no redeeming business motives, must be ignored for tax purposes, even if the technicalities of the transaction fit squarely within the requirements of the statute. Thus, while the present situation involved a valid gift, which under most circumstances would be allowed an increase in basis under §40-18-6(a)(2), if the Court Holding, Gregory and the numerous other related cases cited herein have any meaning, the gift to the wife, for the reasons cited herein, must be ignored.

The above considered, it is hereby determined that the preliminary assessment in issue is correct and should be made final as entered, with appropriate interest as required by statute.

Done this 23rd day of March, 1987.

BILL THOMPSON
Chief Administrative Law Judge