STATE OF ALABAMA DEPARTMENT OF REVENUE,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 86-269
THOMAS C. & ELSIE A. CREWS Route 2 Box 112 Prattville, AL 36067,	§ §	
Taxpayer.	§	

ORDER

The Department entered a preliminary assessment of income tax against Thomas C. and Elsie A. Crews ("Taxpayers") for the calendar year 1984. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on November 11, 1987. The Taxpayers were represented by J. Theodore Jackson, Jr. and Lloyd V. Crawford. Assistant counsel Mark Griffin appeared on behalf of the Department. Based on the undisputed evidence presented in the case, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

Mr. Crews purchased a parcel of realty on the Eastern Bypass in Montgomery, Alabama in 1977. The land was leased by Mr. Crews to an automobile dealership in the early 1980's.

In October, 1984, Mr. Crews and the owner of the automobile dealership discussed the possible sale of the land to the dealership. The initial sales price mentioned was the land's appraised value of $1,425,000.00. Negotiations continued between attorneys for the two parties.

On December 19, 1984, Mr. Crews transferred the subject property by gift to his wife. Mr. Crews, under questioning by the Department's attorney, testified as to the purpose for the transfer as follows:

> A. Well, if the proceeds were not such -- if the tax burden, if -- what I was, in essence, trying to do was to protect my wife from something that might happen, such as my death, with her involvement in the business. She has thirty-seven and a half percent of ownership of a company that is family owned. Hers is equal to my ownership. And the though was to transfer to her at the same time to protect her from something that mights incur upon my death.
>
> Q. You mean by giving her the property you felt you were protecting her?
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> A. Well, that is correct. In other words, if she had the assets, and so forth, should something happen to me, to continue to run the company because she would end up with my stock in the company through the will and, therefore, she would be responsible for all of the company's debts and everything involved with it.

Mr. Crews further testified, in response to his own attorney as follows:

> Q. You mentioned that you wanted Mrs. Crews to have this property in her own name. At the time you transferred this property to her, you did not know whether the sale would go through or not?
>
> A. That is correct.
>
> Q. It was a possibility that would happen?
>
> A. That is correct.
>
> Q. But were you willing if the sale did not go through for her to end up owning the property in just her name?

A. Yes, sir.

Q. And that was because you wanted to give her some independent net worth?

A. That is correct.

Q. And you mentioned that she owned as much in your family corporation as you do. Has she signed guaranties of notes for several million dollars --

A. That is correct.

Q. And your concern was that if something happened to you she would have ready assets that could be converted to cash if she had to pay a notice?

A. That is correct.

Sale negotiations continued after the property transfer, and the sale was consummated on December 28, 1984. Various details of the sale were not agreed upon at the time that the property was transferred to Mrs. Crews. Of primary concern was proper title insurance and the method by which the sale proceeds would be paid. All decisions after the December 19, 1984 property transfer were made jointly by both Taxpayers.

The total purchase price of $1,425,000.00 was paid in installments on December 28, 1984 and January 7, 1985. The proceeds were temporarily deposited in a joint bank account. After several months, $1,000,000.00 was used to buy four single premium life insurance policies, two on the life of Mr. Crews and two on the life of Mrs. Crews. The balance of the sale proceeds was used to pay joint debts.

The Taxpayers claimed a cost basis in the property equal to the fair market value of the property at the time of the December 19, 1984 gift. Because of the proximity of the gift date and the subsequent sale date, the fair market value at the time of the gift was determined to be the sales price of $1,425,000.00. Consequently, no gain was reported by the Taxpayers on their 1984 joint Alabama income tax return.

The "step-up" in basis was claimed by the Taxpayers under Code of Ala. 1975, §40-18-6(a)(2). The Department disallowed the increase in basis and computed a gain using Mr. Crews' original cost basis in the property.

CONCLUSIONS OF LAW

The issue is whether the Taxpayers should be allowed a stepped-up basis in the subject property under the provisions of Code of Ala. 1975, §40-18-6(a)(2), as that section read prior to its amendment in 1985. The 1985 amendment effectively eliminated the step-up provisions for gifts and transfers in trust.

Pre-amendment §40-18-6(a)(2) 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 as of that date.

There is no question that the Taxpayers in the present case complied with the technical requirements necessary for a step-up 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, the substance of a transaction must govern in tax matters, and in some instances the technical or formal compliance with a statute must be disregarded for tax purposes. Basic, Inc. v. U.S., 549 F.2d 740 (1977).

In Basic, a parent corporation negotiated for the sale of stock. In a belated attempt to avoid tax of the sale, the parent distributed the stock to a subsidiary corporation prior to consummation of the sale. The court ruled that the stock transfer was a sham and should not be recognized for tax purposes because the sale had been negotiated and was a foregone conclusion prior to the distribution, and also that the distribution had served no valid business purpose. As stated by the court:

> 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.
>
> 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 statuary provisions for a spin-off reorganization insufficient to accomplish what would otherwise have qualified as a tax free transfer.

* * *

> *** 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. 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; 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 original).

Further, 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. 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, the corporation discovered that the transaction as contemplated would lead to a tax on both the corporation and the corporate shareholder, and thus attempted to avoid the corporation tax by distributing the property to the shareholders prior to the sale. The court determined that the transaction should be treated for tax purposes as a sale by the corporation because the corporation had negotiated and in effect completed the transaction. As state 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 again addressed the issue presented in Court Holding, and on slightly different facts decided that the gain on the sale of the transferred assets should not be imputed to the original owner. United States v. Cumberland Public Service Commission, 338 U.S. 451, 70 S.Ct. 280.

The opposite results in Court Holding and Cumberland illustrate that each case must be decided on its own facts. However, a reasonable guideline for application of the rule in most instances was set out in Hines v. U.S., 477 F.2d 1063, at 1069-70:

> We hold 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, Mr. Crews initiated negotiations with the dealership and through counsel continued negotiations prior to the gift to his wife. Mr. Crews assisted in negotiations after the gift and until the day of the sale. The final sale price was the same as the price first considered by Mr. Crews and the dealership in October, 1984. Mr. Crews participated in the sale negotiations in such a clear and dominant manner that the sale was in effect made by him, and not his wife. Although the final details had not been agreed upon at the time of the gift, clearly the decision to sell and the sales price had been determined.

In addition, there was clearly no substantive business purpose for the gift. The sale proceeds were held and used jointly by the Taxpayers. If Mr. Crews was concerned with the economic well-being of his wife, as he clearly was, he could have simply made the sale and then given the net proceeds to his wife. Giving the property to his wife immediately before the sale was unnecessary. A primary reason for the sale of the property may have been to simplify Mr. Crews' estate or to give the Taxpayers more liquidity. However, the only logical purpose in giving Mr. Crews title to the property immediately prior to the sale was to avoid taxes.

This is the third case heard by the Administrative Law Division involving the basis of gift property under pre-amendment §40-18-6(a)(2). The first two cases were also decided for the

Department, and both Taxpayers appealed to Montgomery County Circuit Court. One of the cases has been decided in favor of the Department, CV-87-363-K. The other is still under submission, CV-87-539-G.

The above considered, the Department is hereby directed to make the assessment final as entered, with applicable interest as required by statute.

Done this 14th day of March, 1988.

BILL THOMPSON
Chief Administrative Law Judge