STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 87-111
FRED AND SYLVIA BERMAN P.O. Box 10145 Birmingham, AL 35202,	§	
Taxpayers.	§	

ORDER

The Revenue Department assessed income against Fred and Sylvia Berman ("Taxpayers") for the years 1983 and 1984. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on November 4, 1988. The Taxpayers were represented by Jo Karen Parr, Esq. Assistant counsel Mark Griffin appeared on behalf of the Department. Based on the evidence presented in the case, the following findings of fact and conclusions of law are hereby entered.

FINDINGS OF FACT

The relevant facts are undisputed.

Fred Berman was during the subject years a limited partner in two Alabama limited partnerships, Scheuer-Baro, Ltd. ("Scheuer-Baro") and Scheuer-Baro II, Ltd. ("Scheuer-Baro II"). The assessments in issue are based on income received by Mr. Berman from three transactions involving the above-named limited partnerships.

(1) The transfer by Scheuer-Baro of certain Louisiana property ("Baro property") into the Baro Land Trust, the subsequent sale of said property by the Trust in 1981, and the

disbursal of the sales proceeds by the Trust in 1983.

(2) The sale by Scheuer-Baro of an apartment, complex, Fairway View I Apartments, to National Property Investors 6 on May 31, 1984.

(3) The sale by Scheuer-Baro II of an apartment complex, Place Du Plantier Apartments, to National Property Investors 6 on May 31, 1984.

(1) THE BARO PROPERTY

Scheuer-Baro created the Baro Land Exchange Trust on September 22, 1981. The designated trustee was an employee of one of the general partners, but otherwise had no interest in the partnership. The Trust named Scheuer-Baro as its sole beneficiary and was formed for the stated purpose of effectuating a non-simultaneous like-kind exchange under §1031 of the Internal Revenue Code.

Scheuer-Baro transferred to the trustee the Baro property, all contracts, leases and rights associated therewith, and all rights under a Real Estate Sales Agreement and Real Estate Exchange Agreement with T. D. Bickham, Jr. The transfer of the property was made simultaneous with creation of the Trust and was for a nominal consideration.

The trustee subsequently sold the Baro property to Bickham pursuant to the above sales and exchange agreements. The trustee was unable to effectuate a non-simultaneous like-kind exchange and subsequently distributed the proceeds of the sale in March, 1983.

The Taxpayers computed their proportionate gain on the proceeds received from the sale of the Baro property by using the

partnership's original cost basis in the property. That is, the Trust claimed a stepped-up basis in the property equal to the property's fair market value at the time of transfer of the property to the Trust, citing Code of Ala. 1975, §40-18-6(a)(2), prior to its amendment in 1985.

(2) SALE OF FAIRWAY VIEW I APARTMENTS

Scheuer-Baro sold the Fairway view I Apartments to National Property Investor 6 on May 31, 1984. National Property took the property subject to a first mortgage, paid cash in the amount of $1,892,000.00, and gave a promissory note for $1,500,000.00. The promissory note is secured by a second mortgage on the property. Under its terms, no principal payments are due for ten years and interest accrues at 9 percent annually but is actually paid on an accelerated scale computed from 7 1/4 percent in year 1 to 10 1/2 percent in year 10. The purchaser has made all required interest payments to date.

The Taxpayers reported their proportionate gain from the sale of Fairway View I Apartments on the installment method. The Taxpayers now concede that the installment method was not applicable. However, the Taxpayers do argue that the $1,500,000.00 promissory note received as part of the sale should be given a reduced or no value in computing their gain on the transaction.

Mr. Herbert Scheuer, Jr., a general partner in the partnership, testified that the actual fair market value of the Fairway View I Apartments was approximately equal to the cash

received by the partnership, and that the $1,500,000.00 promissory note is worth less than its face value and was tacked onto the deal to artificially inflate the sales price for the benefit of the purchaser.

(3) SALE OF PLACE DU PLANTIER APARTMENTS

Scheuer-Baro II sold Place Du Plantier Apartments to National Property Investors 6 on May 31, 1984. National Property took the property subject to a first mortgage, paid cash of $2,143,000.00 at closing, and gave a promissory note for $1,800,000.00. The promissory note is secured by a second mortgage on the property. The terms of the promissory note are the same as for the note concerning the Fairway View I Apartments.

As with the Fairway View I Apartments, the Taxpayers reported their proportionate gain from the sale of the Place Du Plantier Apartments on the installment basis, but now concede that the installment method was inappropriate. However, the Taxpayers further contend that the promissory note for $1,800,000.00 is in effect worthless for the same reasons as the note concerning the Fairway View I sale, and thus should not be included in the computation of gain.

CONCLUSIONS OF LAW

(1) Baro Property

The issue is whether the transfer of the subject Baro property by Scheuer-Baro to the Trust should be allowed a step-up in basis pursuant to Code of Ala. 1985, §40-18-6(a)(2), as that section read

during the subject year and before its amendment in 1985.

The Department argues that the subject transfer in trust was a subterfuge to avoid tax, that substance over form must control, and consequently, that the transfer of the property from the partnership to the trust should be ignored for tax purposes, citing Basic, Inc. v. U.S., 549 F.2d 748; Commissioner v. Court Holding Company, 324 U.S. 331, 65 S.Ct. 707, and other federal case authorities.

However, the Alabama Court of Civil Appeals has made clear that pre-1985 §40-18-6(a)(2) must be literally construed and that any property transferee in trust or by gift must be allowed a stepped-up basis, regardless of the purpose for the transfer, see State, Department of Revenue v. McLemore, Civ. 6544, decided November 30, 1988. Accordingly a step-up in basis must be allowed in the present case.

THE FAIRWAY VIEW I AND PLACE DU PLANTIER APARTMENTS

The issue concerning the apartment sales is whether the promissory notes received by the partnerships from National Properties should be given full value in computing the gain from the sales.

Code of Ala. 1975, §40-18-7 governs the computation of gain or loss from the sale of property and reads as follows:

> (a) Computation of gain or loss. Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in subsection (b) of §40-18-6, and the loss shall be the excess of such basis

over the amount realized.

> (b) Amount realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair and reasonable market value of the property, other than money, received.

The Taxpayers contend that the promissory notes were in effect worthless when received and thus should not be included as part of the amount realized under the above sections. That is, the fair market value of the notes was zero, or at least less than their face value.

However, an accrual basis taxpayer must report income when the right to receive the income is fixed and the amount to be received is reasonably certain. Lomas and Nettlecon Fin. Corp. v. U.S., 486 F. Supp. 652, see also Trea. Reg. 1.446-1(c)(i).

In Lomas and Nettlecon, the taxpayer sold an apartment complex in return for a promissory note. The taxpayer valued the note at 90% of face value and reported income accordingly. The taxpayer presented expert testimony to the effect that the note was speculative and that its fair market value was no more than 50% of its face value. The court rejected the taxpayer's position and taxed the note at full value:

> Plaintiff's contention essentially is that it received other property that should be valued at its fair market value. If it were a cash basis taxpayer, that argument might hold water. But it is an accrual method taxpayer and the argument does not hold water.
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> An accrual method taxpayer must report income, as we have seen above, when the right to receive it is

> fixed and the amount to be received is reasonably certain.
>
> When the developers made the note, the obligation became fixed and the terms of the note fixed the amount to be received. This is not the case where events subsequent have called into question the viability of a note as in the situation of the 12,000 acres of Louisiana bayou land. This is the pure and simple situation in which a seller sold a piece of property for a promise to pay money in the future. The major attribute of the accrual method of accounting is that a future right to receive money is treated as if the money were received today. That there is a possibility of default some time in the future is of no moment. In almost any conceivable situation, there exists some chance that future payments will not be received. Until events arise as those discussed in section II of this opinion, an accrual method taxpayer must report a promise to pay expressed in monetary terms as money received as of the date of accrual.

In the present case, the amount of the notes and the issuer's obligation to pay were fixed when the notes were issued. As stated above, "[T]hat there is a possibility of default some time in the future is of no moment". Accordingly, the notes must be included as income at face value.

The Department is hereby directed to recompute and make final the assessments in issue as set out above, with applicable interest.

Entered this 22nd day of February, 1989.

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BILL THOMPSON
Chief Administrative Law Judge