

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

§

v.

§

DOCKET NO. INC. 87-220

EDWARD L. WARRINGTON  
1200 Beacon Parkway East, #700  
Birmingham, AL 35203,

§

§

Taxpayer.

§

ORDER

The Revenue Department assessed income tax against Edward L. Warrington ("Taxpayer") for the calendar year 1985. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on May 4, 1989. James N. Brown, III, Esq. and Jack B. McNamee, Esq. appeared for the Taxpayer. Assistant counsel Mark Griffin represented the Department. Based on the evidence presented by the parties, the following findings of fact and conclusions of law are hereby entered.

FINDINGS OF FACT

The issue to be decided is whether the Taxpayer should be allowed an increase or step-up in the basis of stock transferred into trust prior to March 15, 1985. The statute in question is Code of Ala. 1975, §40-18-6(a)(2).

The Taxpayer founded Warrington Associates, Inc. ("W.A.") in 1968. The Taxpayer owned a majority and controlling amount of the stock of W.A. until 1983. In 1983, the Taxpayer transferred all of his W.A. shares into a revocable trust (Trust No. 1). Trust No. 1 provided for a management committee to operate W.A. in the event of

the Taxpayer's death or incapacity.

The Taxpayer negotiated for the sale of the W.A. stock, and on December 13, 1984 entered into a non-binding agreement with the intent of selling all of the stock to Systems Designers International ("S.D.I.").

The Taxpayer subsequently created a second revocable trust (Trust No. 2) on January 29, 1985. All of the shares of W.A. stock that had been previously assigned to Trust No. 1 were reassigned to Trust No. 2 concurrent with the creation of Trust No. 2. Trust No. 2 granted the Taxpayer broad powers and control over the corpus of the trust, and also included numerous non-tax related Provisions concerning the Taxpayer's estate and the distribution of trust assets to the Taxpayer's children.

On January 31, 1985, the trustee of Trust No. 2 executed a sales agreement selling the subject stock to S.D.I.

The sales proceeds were paid over to Trust No. 2 and deposited in the W.A. account. The Taxpayer then authorized the trustee of Trust No. 2 to make specific disbursements, including payment of some of the Taxpayer's personal liabilities and liabilities and a one million dollar payment directly to persons other than the Taxpayer. The balance of the proceeds were transferred into the Trust No. 2 bank account.

The Taxpayer filed a 1985 Alabama income tax return and claimed a cost basis in the stock equal to the fair market value of the

stock at the time of the transfer to Trust No. 2 in January, 1985.

The fair market value was estimated to be the subsequent sales price of the stock. Consequently, no gain was reported by the Taxpayer.

The Department disallowed the step-up in basis and recomputed the Taxpayer's gain from the sale by subtracting the Taxpayer's original cost basis in the stock from the sales price of the stock.

The resulting gain is the basis for the preliminary assessment in question.

The Department's position is that the transfer of the stock into Trust No. 2 was a sham in that its only function or purpose was to avoid tax by taking advantage of the step-up provision in §40-18-6(a)(2). However, the Department conceded at the administrative hearing that the transfer of the stock into Trust No. 1 in 1983 was not primarily motivated to avoid tax, and consequently that the basis of the stock should be stepped up to the stock's fair market value at the time of the transfer in 1983.

#### CONCLUSIONS OF LAW

Code of Ala. 1975, §40-18-6(a)(2) provided prior to its amendment in 1985 that the basis of property transferred in trust or by gift should be stepped up to the fair market value of the property at the time of transfer. The step-up provision was repealed effective March 15, 1985.

The Administrative Law Division has decided at least two cases

relating to a transfer in trust and the step-up provisions of pre-amendment §40-18-6(a)(2). Docket Nos. Inc. 85-177 and Inc. 86-113.

The Department argued in those cases that a step-up in basis should be disallowed because the subject property was transferred into trust for tax avoidance motives only. The taxpayer prevailed in both cases because the trusts were created for valid business reasons other than the avoidance of tax.

In the present case, Trust No. 2 was certainly created to take advantage in the step-up provisions of §40-18-6(a)(2), but case, Trust No. 2 was certainly created to also served various other valid business purposes other than tax avoidance. However, the motives for creating the trust are not controlling or relevant in that the Court of Civil Appeals has ruled that the step-up provisions of pre-amendment §40-18-6(a)(2) must be followed if the technical terms of the statute are satisfied. That is, any property transferred in trust or by gift prior to March 15, 1985 must be allowed a step-up in basis. State,, Department of Revenue v. McLemore, Civ. 6544, decided November 30, 1989, cert. denied March 24, 1989.

McLemore involved a gift of property, but the reasoning of the court would be equally applicable to transfers in trust. Thus, the gain from the sale of the W.A. stock should be computed giving the stock a basis equal to the fair market value of the stock at the time of the transfer into Trust No. 2 in January, 1985. The fair

market value was properly estimated to be equal to the subsequent sales price of the stock in February, 1985. Consequently, the sale resulted in no gain.

The above considered, the assessment is reduced and made final showing no tax due.

Entered this the 1st day of June, 1989.

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BILL THOMPSON  
Chief Administrative Law Judge