TAX COURT CASE UPDATE

Citation:

William Cavallaro, et al. v. Commissioner, T.C. Memo 2014-189, September 17, 2014.

Overview:

The Tax Court has determined that a merger of two family companies, one owned by the parents and one owned by their sons, resulted in a taxable gift being made from the parents to the sons because the parents' company was undervalued. The dispute largely revolved around whether the ownership of certain valuable technology had been informally transferred to the sons' company when it was initially incorporated or whether it remained with the parents' company at the time of the merger.

The Facts:

In 1979, William and Patricia Cavallaro created a company, Knight Tool Co. ("Knight"), that manufactured tools and machine parts. The parents ran Knight and their three sons worked for the company. Knight manufactured and sold a liquid-dispensing machine. However, problems with the machines caused working capital issues within Knight. One of the sons suggested that he and his brothers take over the production of the machines, and in 1987, the sons incorporated Camelot Systems ("Camelot"), a corporation created to sell machines (although they were still manufactured at Knight). At its incorporation, Camelot issued 150 shares, and each son owned 50 shares. During the meeting that effectuated the incorporation of Camelot, the father handed the Camelot minute book to his son Ken, saying, "Take it; it's yours."

In the general course of its business, Camelot received a purchase order from a customer for a machine and an order was submitted to Knight to request that a machine be made. Knight did not bill Camelot for the machines until they were ready, and Camelot did not pay Knight until Camelot's customer paid Camelot, so Knight bore all of the business risk associated with the sales of the machines. Contracts with outside vendors who provided parts for the machines were made directly with Knight. Camelot had no employees; any person who worked on the machines was on Knight's payroll. Most of Camelot's expenses were paid with Knight funds. Both Knight and Camelot operated out of the same office space.

Based on estate planning advice given to the parents by their accountant, the family contemplated merging Knight and Camelot in 1995. The goal of the merger was to transfer some of the parents' wealth to their sons. However, the parents also met with an attorney who determined that Camelot owned the machines' technology and not Knight, as the accountants believed, because the technology was transferred in 1987

when Camelot was incorporated. There was no paperwork that documented this transfer, but based on the father handing the minute book of Camelot to his son, the attorney thought there was a ceremonial and symbolic transfer of the technology. Initially, the accountants disagreed with the attorney, but they were eventually convinced that the value of the technology, from its creation and including all improvements made to it up until the proposed merger, was in the hands of Camelot (and therefore in the hands of the sons, and not the parents). The parents signed a "Confirmation Bill of Sale" which confirmed the 1987 transfer of the technology from Knight to Camelot, and attempted to document that the value of the technology resided solely in Camelot. The parties decided at that time that a merger of Knight and Camelot was unnecessary because the majority of the value that the parents were concerned about from an estate tax perspective was already in the hands of their sons.

However, for unrelated reasons, the merger of Knight and Camelot did eventually come to pass. On December 31, 1995, the two companies merged in a tax-free merger, with Camelot as the surviving corporation. The stock was distributed 19 percent to the parents and 81 percent to the sons, based on the accountant's valuations of the two companies.

The IRS determined that Knight had been undervalued in the merger, which resulted in the parents making a gift to their sons of the excess value they gave up when they contributed their Knight shares to the merger. The parents were issued notices of deficiency in the total amount of $46.1 million, based on the assumption that Camelot was worth nothing, although the IRS later conceded that the total deficiency was $29.6 million based on the IRS's expert's opinion (which valued Camelot at 35 percent of the merged company's value).

Discussion:

In valuing Knight and Camelot for the merger, the parents' accountant assumed that Camelot owned all of the value of the technology and that Camelot possessed the majority of the value of the merged company, resulting in the agreed upon distribution of stock in the merged company. The parents contended that no gift was made during the merger because the shares they received in the merged company accurately reflected the value of Knight. They contended that Camelot was the manufacturer of the machines, and Knight was the contractor, and their experts argued that Camelot owned the technology because it was transferred to Camelot in 1987.

On the other hand, the IRS contended that because corporate documents showed that Knight was the manufacturer and Camelot was merely the seller (and the parents presented no evidence that showed otherwise), Knight was the owner of the technology, not Camelot, and thus Knight deserved a greater fair market value than Camelot. Using a discounted cash flow method of valuation, the IRS's expert found that Knight accounted for 65 percent of the merged company and Camelot accounted for 35 percent. This calculation resulted in a gift tax liability of $29.6 million for the additional value the parents transferred to their sons.

To determine whether the parents made taxable gifts to their sons through the merger of Knight and Camelot, first the Tax Court had to determine the fair market value of the merged company, and the fair market values of Knight and Camelot on the eve of the merger.

The Tax Court determined that the merger was not at arm's-length and was not made in the ordinary course of business. The court found that any other, unrelated, purchaser of Camelot would have demanded proof of ownership of the technology. Because no proof existed, it is unlikely that an arm's-length purchaser would have paid the amount that the parents exchanged in the merger. The fact that the parents overlooked that Knight really owned the technology, and thus possessed most of the value, coupled with the fact that the parents' estate planning desires consisted of the best way to convey their wealth to their sons, led the Tax Court to determine that the merger and resulting exchange of shares was not an arm's-length transaction.

In valuing the pre-merger companies, the Tax Court disregarded the parents' experts because their valuations were based on Camelot owning the technology. The parents failed to present any evidence that Camelot was the rightful owner of the majority of the merged company. Because Knight had been so undervalued (because its ownership of the technology was mistakenly attributed to Camelot), the parents should have received more shares of the merged company. Therefore, they gave their sons a tax-free gift when they received fewer shares than they were entitled to receive in the merger.

Conclusion:

The Tax Court found that the Camelot shares that the parents received in exchange for their Knight shares were not for full and adequate consideration, and it agreed with the IRS's determination that the parents were liable for $29.6 million in gift tax for gifts made to their sons in the merger.