

Arm's Length Merger or Gift?

By Louis Vlahos

Every now and then, a case comes along that is just chock-full of lessons, not only for taxpayers, but for their advisors as well. The Tax Court's decision in *Cavallaro v. Comr.*, T.C. Memo. 2014-189, describes such a case. It involves closely held corporations, related party transactions, a tax-free reorganization and, oh yeah, a huge taxable gift.

Mom and Dad owned a custom tool manufacturing business, Knight Tool, Inc. The corporation employed their sons. In order to diversify their operations and provide another source of revenue, Knight began development of a liquid dispensing machine (the "technology"). The development process proved to be expensive and not very profitable. Mom and Dad decided that Knight should revert to its original line of business. Their sons, however, believed that they could develop a successful liquid-dispensing machine and find a market for it. Mom and Dad assented.

The sons formed a new corporation, Camelot Inc., to which they made a nominal capital contribution in exchange for all of its shares. At no time, however, did Knight grant to Camelot the right to produce or sell Knight's technology.

As the sons continued to develop the machine, Knight continued to compensate them as Knight employees, and Knight personnel (using Knight equipment) assisted them with implementing their development ideas. In time, Knight was manufacturing the machines based on the technology, and Camelot sold and distributed them. The Camelot business became so successful that it eventually represented 90 percent of Knight's business.

Unfortunately, however, Knight and Camelot never took a consis-

tent approach to the overall allocation of income and expenses between them. Instead, it appeared that profits were disproportionately allocated to Camelot, which the court attributed either to the "deliberate benevolence" of Mom and Dad, or else to "a non-arm's length carelessness born of the family relationships."

The lax approach to the relationship between the two corporations was also reflected in the fact that no documentation existed that memorialized any transfer of the technology from Knight to Camelot. Indeed, the documents affirmatively showed that Knight continued to own the technology; when the question of tax credits came up, Knight reported that it owned the technology.

Several years into their "relationship," Knight and Camelot decided that they would need to merge, with Camelot as the surviving entity, if they wanted to expand their European market. They retained an appraisal firm that valued the combined entity at between \$70 and \$75 million. The two corporations merged in an income tax-free merger, with the sons receiving 81 percent of the surviving corporation, based upon the appraisal's incorrect assumption that Camelot owned the technology. Slightly before the merger, the attorney for both corporations prepared a "confirmatory" bill of sale that reflected an earlier purported transfer of the technology from Knight to Camelot despite the lack of any evidence as to Camelot's ownership.

The IRS determined that Mom and Dad made significant gifts to their sons by merging the parent's company (Knight) with and into the sons' company (Camelot) and allowing the sons an 81 percent interest in the merged entity. The court agreed.



Louis Vlahos

The court began by noting that donative intent on the part of the donor is not an essential element for gift tax purposes. The application of the gift tax, it said, is based on the objective facts and circumstances of the transfer rather than

the subjective motives of the donor. The court quoted from IRS regulations: "Where property is transferred for less than an adequate and full consideration ... then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift." Such taxable transfers, the court said, include exchanges between family members. Indeed, when a transaction is made between family members, it is "subject to special scrutiny, and the presumption is that a transfer between family members is a gift."

The taxpayers argued that the transaction should be considered one that was made for "an adequate and full consideration" because it was made in the "ordinary course of business" and was "bona fide, at arm's length, and free from donative intent." Unsurprisingly, the court disagreed with the taxpayers. It pointed out that if an unrelated buyer had approached either Camelot or Knight, it would have demanded to see documentation regarding the ownership of the intangible, and it would have acted accordingly.

The instant case, the court said, did not involve a hypothetical unrelated party; instead, it involved parents "who were benevolent to their sons," and it involved "sons who could ... proceed without the caution that normally attends arm's length commercial dealing between unrelated parties." Throughout the process of developing the intangible, the court found that the parents gave no thought to which corporation would own it, and they gave no

thought to which corporation would pay for its development.

Thus, the court concluded that there was a gift, the amount of which would be based upon a 60 to 40 percent split of values between Knight and Camelot, respectively (as opposed to the 20 to 80 percent split claimed by the taxpayers in the merger)

There are many lessons to be learned here. First and foremost, any related parties, be they family members or commonly controlled business entities, must be especially careful when transacting business with one another. They must recognize that these transactions will be subject to close scrutiny by the IRS, and that they have to "build their case" contemporaneously with the transactions. They must treat each other as unrelated parties as much as possible, by conscientiously documenting all inter-company business dealings, and they must be able to support the reasonableness of any exchanges or transactions between them.

Taxpayers also must recognize that taxable gifts can occur in a business setting. Mom & Dad had the right idea when they sought to shift the appreciation in the Camelot business to their sons. They were right to retain the services of an appraiser to determine the relative values of the two corporations at the time of the merger. However, their failure to properly and formally transfer the technology at a time when its value was low and its future was unknown—to act at arm's length—and their failure to treat with Camelot as they would have with any unrelated person, ultimately made their gift more costly.

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This is part five of a five part series.

“Call it what you want, incentives are what get people to work harder.”

-Nikita Khrushchev

Most of our clients are closely held, often family-owned businesses. The current owners may be the founders of the business, or they may be a generation or two removed. Sometimes, the owners have children who are active in the business and who may have manifested an ability to take over the business. In those cases, our goal is to provide for the smooth transition and succession of management and ownership of the business to those children.

No heir? Or not sure yet?

Quite often, however, the children may have no interest in the business, may not be capable of operating it effectively, or they have not yet exemplified the ability or inclination to do so.

This could put the owners in a quandary, with the only feasible option being a sale of the business at some point down the road. Of course, the owners' first priority in this instance will be to maximize the return on their investment, both for themselves and for their family. Depending upon the business, this may require the retention and cooperation of some key executive employees.

The question then, is how to incentivize and reward these key employees; how to align their interests with those of the owners;

how to entice them to stay with the business, to keep growing the business, to help prepare the business for a likely sale?

There are several options to consider.

Incentive compensation choice 1: equity (or something like it)

On the one hand is “equity-based” compensation, which may take two forms.

A. Employee becomes an owner.

Under the first form, the employee may become an owner through grants of stock in the employer, bargain sales of employer stock, and non-qualified options to acquire such stock. In any of these scenarios, the stock may be voting or non-voting, it may be vested immediately or it may vest over time, and the right to exercise the option may or may not be immediately vested.

B: Employee feels like an owner

The second form does not involve the actual issuance of employer stock but, rather, seeks to mimic, to some extent, the “economics” of stock ownership. This includes phantom stock plans (on which there are many variations) and stock appreciation rights. Each of these is basically just a form of non-qualified deferred compensation, the amount of which is tied either to the value of the “shares” credited to the employee's account or to the appreciation in the value of such shares. (Where the employer is a partnership or LLC, a so-called

“profits interest” may be issued, which entitles the employee to a share of future profits and future appreciation.)

The ultimate decision as to which equity-based plan is best suited for a particular business depends upon a number of factors, including the existing owner's tolerance for minority-interest shareholders, as well as the relative bargaining/negotiating positions of the employer and the key employee.

In my experience, the preference of most business owners is to avoid the actual issuance of equity (even as to family members, at least not until they have proven themselves in the business). Even with a tightly-drafted shareholders agreement, the rights afforded to a minority shareholder under state common law, and the potential for litigation – especially with an employee with whom there is no familial relationship – can make issuing equity a risky choice. Additionally, employees often do not want the obligations that often come along with ownership, e.g., personal guarantees of business loans and leases, restrictions on transfer, etc. (We will cover the issuance of stock options in a future post.

Incentive compensation choice 2: non-equity compensation

Alternatively, the incentive may take the form of a deferred compensation arrangement where the amount of the compensation is not tied by some formula to the value of the equity or to the ultimate sale price for the business. It should be noted, however, that the actual payment of the deferred compensation

might be contingent upon the sale of the business. Indeed, many employers are naturally inclined to defer, and even condition, the payment of the compensation until the occurrence of a major liquidity event. Of course, because the timing of a sale cannot be predicted, such a contingent arrangement may have to account for many factors:

- Should the executive be immediately vested?
- Should he or she vest over a number of years, or only upon a sale of the business?
- Should payments be allowed upon certain events prior to a sale, including at the death or disability of the employee, or for some hardship?
- Should the deferred compensation be “secured” in some fashion?

Regardless of how these questions are answered, it is important to note that the many ways of structuring a deferred compensation agreement for the key employee of a business all share two critical elements: (a) in order to successfully defer the employee's tax liability, the arrangement must comply with certain tax principles that have been developed by the IRS and the courts over several decades, and that were modified by § 409A of the Code in 2004; and (b) this compliance must be ensured at the inception of the deferred compensation arrangement – otherwise, the tax and economic results that the parties envisioned will not be attained and someone will be very unhappy.