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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 consistent 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."

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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.

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 intercompany 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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