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In this article, Ryan discusses *Cavallaro v. Commissioner*, in which the Tax Court held that a merger of two family-owned businesses resulted in a substantial taxable gift. The taxpayers avoided penalties by demonstrating that they relied in good faith on the mistaken advice of competent tax advisers.

The Tax Court recently held that shares conveyed in the merger of two family-owned businesses constituted a taxable deemed gift.[1] However, the taxpayers fended off penalties by establishing that they relied in good faith on the advice of their tax advisers.

The taxpayers, William and Patricia Cavallaro, formed Knight Tool Co. in 1976, with the husband owning 49 percent and the wife 51 percent of the company's stock. Mrs. Cavallaro ran the front of the shop (office) and Mr. Cavallaro the back (production). At the time of incorporation, the Cavallaros had three teenage sons: Ken, Paul, and James. The boys worked part time in the family business during school and eventually full time.

Knight was a contract manufacturer that produced custom tools and parts for other companies. Five years into operation, Knight sought to expand by creating, producing, and selling its own product. Mr. Cavallaro and Ken decided to produce an automated liquid adhesive dispensing machine for use in producing computer circuit boards. Knight created a prototype that it began selling under the name CAM/ALOT (''computer-assisted machine to be sold and used a lot''). Knight invested considerable time and expense in developing CAM/ALOT. Despite this, early versions of the machine were subpar and failed to generate significant sales. Mr. and Mrs. Cavallaro finally gave up on CAM/ALOT and reverted to their original tool-making business.

Ken and his brothers, however, believed that they could successfully develop and market CAM/ALOT. To pursue this, the three sons formed a new company called Camelot Systems Inc., with each owning a one-third share.[2] At the meeting in 1987 incorporating Camelot, the lawyer handed the corporate minute book to Mr. Cavallaro, who was in attendance but was neither an incorporator nor shareholder of the new entity. To make it clear that Camelot was not his company, Mr. Cavallaro immediately gave the book to Ken, saying, ''Take it; it's yours.''

Ken then began working on improving CAM/ALOT. He visited customers and trade shows to get feedback on early versions of the computerized dispensing machine. Ken relayed this information to Knight engineers and worked with them to develop a better product. According to the court, ''his efforts were timely, as they coincided with a relative boom in the liquid-dispensing industry.'' Eventually, CAM/ALOT represented 90 percent of Knight's business.

Cavallaros' Estate Planning

In the early 1990s, Mr. and Mrs. Cavallaro engaged Ernst & Young to review their estate plan. The significant value of Knight, owned entirely by the senior Cavallaro generation, posed the most challenging estate tax issue. In the accountants' opinion, Knight and Camelot should be merged, and the combined entity transferred to the sons in a transfer-tax-advantaged manner and then eventually sold to a third party.[3]

The Cavallaros also engaged an attorney from a prominent Boston law firm to assist in estate planning.[4] He also identified the potential transfer tax liability flowing from a transfer of Knight to the Cavallaro children as problematic. In contrast to the

[1] *Cavallaro v. Commissioner*, T.C. Memo. 2014-189.

[2] Each brother contributed an equal share for a total initial capital contribution of $1,000.

[3] After the 1995 merger, Camelot was sold to a third party for $57 million in cash plus up to $43 million in deferred payments based on future profits.

[4] The lawyer was a longtime acquaintance of Mrs. Cavallaro.

accountants, the lawyer viewed the two-company structure as advantageous. He took the position that CAM/ALOT (and its associated value) was owned by Camelot because Knight symbolically transferred the CAM/ALOT technology to Camelot in 1987 when Mr. Cavallaro handed over the Camelot minute book to Ken.[5] To belatedly document this transaction, the attorney suggested that Mr. Cavallaro and Ken sign affidavits and a confirmatory bill of sale attesting to the 1987 transfer.

The accountants initially resisted the estate planner's view that Camelot owned the technology, citing the lack of alignment of that position with the existing documentation in the public domain (financial statements, tax returns, etc.). The Cavallaros were unaware of the disagreement among their advisers regarding ownership of CAM/ALOT. Eventually, the lawyer prevailed, and in 1995 the Cavallaros signed the documents memorializing the symbolic 1987 transfer of CAM/ALOT to Camelot.

Merger

In 1995, for reasons unrelated to estate planning, Knight and Camelot began formulating a plan for merging the two companies.[6] An E&Y accountant assessed the proposed combined entity at $70 million to $75 million, with Knight accounting for only $13 million to $15 million (or about 19 percent) of that figure.[7] In completing his report, the appraiser assumed that Camelot owned the CAM/ALOT technology. On December 31, 1995, the two companies merged with Camelot as the surviving corporation.[8] Based on the appraisal of the relative values of each company to the merger, Mr. and Mrs. Cavallaro (as former Knight shareholders) received 19 percent of the stock of the combined entity, and the Cavallaros' sons received the remaining 81 percent (divided equally among them).

Indirect Gift

In January 1998 the IRS audited Knight's and Camelot's 1994 and 1995 income tax returns. In the course of that examination, the IRS recognized that the 1995 merger may have involved an indirect gift. It thus opened a gift tax examination. In 2005 the Cavallaros filed a gift tax return for 1995 reporting no taxable gifts and no gift tax liability as a result of the merger. In 2010 the IRS issued a notice of deficiency for 1995 determining that the Knight-Camelot combination resulted in a $46 million taxable gift from the Cavallaros to their sons.

Whether a gift occurred as a result of the merger depended on whether each party to the transaction received an ownership interest in the combined entity commensurate with the consideration that they provided.[9] That issue in turn depended on the relative values of Knight and Camelot on the eve of the merger. At trial, the Cavallaros offered two valuation reports: one prepared contemporaneously with the merger and another prepared by a different expert in preparation for trial. Both of those appraisals assumed that Camelot owned the CAM/ALOT technology and, as a result, allocated only about 19 percent of the value of the combined entity to Knight. The IRS's expert, however, assumed that Knight owned CAM/ALOT and he thus attributed 65 percent of the value of the merged entity to Knight.

The crucial question for valuation purposes was which company owned CAM/ALOT before the merger. The Cavallaros argued that Camelot owned the technology as of the 1987 symbolic transfer from Knight. Judge David Gustafson sided with the IRS and held that Knight originally owned CAM/ALOT and never transferred it to Camelot. The court viewed the relationship between the two companies as follows: Knight, as owner of the technology, manufactured the CAM/ALOT machines, and Camelot, as a mere sales agent, distributed them to customers. The companies' financial statements and tax returns reflected this relationship.[10] Also, the CAM/ALOT trademark was registered in Knight's name until the merger of the two companies in 1995. The court gave no weight to the documents prepared by the estate planning attorney in 1995 to memorialize the purported 1987 transfer.

Gustafson also found that the companies' course of conduct reflected Knight's ownership of the technology. Knight entered into key contracts for

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[5]The lawyer testified that this reminded him of "the ancient way of transferring land." Presumably, CAM/ALOT had negligible value in 1987.

[6]For CAM/ALOT to be distributed in Europe, both Camelot and Knight needed to be certified under European Union law. To avoid having both companies separately undergo this long and expensive certification, they decided to merge.

[7]The accountant used a market-based approach, identifying comparables for Knight and the combined entity. He did not separately value Camelot, because he could not find suitable comparables for the pre-merger company.

[8]This was a tax-free merger for income tax purposes.

[9]Reg. section 25.2512-8 (taxable transfers include "sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor").

[10]On amended tax returns for 1990 to 1993, Knight claimed research credits under section 41 for investments in the CAM/ALOT technology. After adopting the attorney's view that Camelot owned the technology, the accountants filed another set of amended returns for both companies that disclaimed the research credits for Knight and claimed them for Camelot.

CAM/ALOT and remained financially at risk for order nonpayment. Further, the economic burden of additional financing fell on Knight and/or Mr. and Mrs. Cavallaro individually. Although Knight bore the bulk of the economic risk associated with CAM/ALOT, a disproportionate share of the economic rewards from the venture was allocated to Camelot.[11] According to the court, this allocation of profits resulted ''not [from] the objective values of the companies but either to the deliberate benevolence of Mr. and Mrs. Cavallaro toward their sons or else to a non-arm's length carelessness born of the family relationships of the parties.''

Given the court's holding that the CAM/ALOT technology resided in Knight, it disregarded both of the Cavallaros experts' valuations, which presumed ownership in Camelot. According to the court, this left ''petitioners with no evidence on this critical issue as to which they have the burden of proof.'' As a result, the court accepted the IRS expert's valuation of $64.5 million for the merged entity, with 65 percent of this value attributable to Knight and 35 percent assigned to Camelot. Accordingly, the value of the indirect gift from the Cavallaros to their sons was $29.6 million (the difference between the 81 percent of the merged entity that the sons actually received and the 35 percent that they should have received given the value of Camelot before the merger).[12]

Bad Bargain or Gift?

The Cavallaros tried to characterize the result of the merger as an improvident bargain made in the ordinary course of business. Reg. section 25.2512-8 provides that ''a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth,'' and thus not a gift. The court held that the 1995 merger was not at arm's length. An unrelated hypothetical buyer would demand contemporaneous documentation of transfer of ownership of CAM/ALOT technology and would not be satisfied with mere self-serving, after-the-fact assertions of ownership. Instead, the court viewed this as a related-party transaction, deserving of and unable to withstand heightened scrutiny.

Penalties

At trial, the IRS asserted an addition to tax for failure to file a timely gift tax return, and alternative accuracy-related penalties.[13] Although these penalties applied,[14] the court held that the Cavallaros successfully established a reasonable cause defense to avoid liability.[15] Mr. and Mrs. Cavallaro provided accurate and necessary information to their advisers. It was the lawyer, said Gustafson, who was the author of the ''fiction of a 1987 transfer,'' whereas Mr. Cavallaro never gave the issue of assignment of CAM/ALOT technology any thought.[16] Given that the Cavallaros lacked any advanced formal education[17] or familiarity with sophisticated tax planning, the court found that they were justified in relying on the advice of experts from well-known law and accounting firms.

Failure of Team Advising

Although the Cavallaros won on the penalty issue, they lost on the underlying gift tax liability.[18] Gustafson seemed to place the blame for this result squarely on the group of professionals servicing the Cavallaros.[19] Generally, an advisory team approach to estate planning can yield many benefits to the client and to the professionals involved.[20] However, these gains can be realized only if the professionals work together collaboratively to develop and implement an effective plan. The Cavallaros' team failed as a result of an overzealous lawyer pushing an unrealistic plan on a group of accountants whose sins ranged from unjustified deference to willful misconduct.

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[11]The two companies shared accounting, payroll, and banking systems.

[12]The gift amount of $29.6 million is equal to the difference between $52.2 million (or 81 percent of $64.5 million) and $22.6 million (or 35 percent of $64.5 million).

[13]Sections 6651(a)(1) and 6662.

[14]Because the Cavallaros did not file Form 709 until nine years after the 1995 gifts, the section 6651(a)(1) penalty applied. Because the Cavallaros reported zero gifts for 1995 on their gift tax returns but the court determined that they made gifts totaling $29.6 million in that year, the gross valuation misstatement penalty applied. *See* section 6662(h).

[15]*See* section 6651(a)(1) (avoidance of penalty if taxpayer can show that failure to file was ''due to reasonable cause and not due to willful neglect'') and section 6664(c)(1) (avoidance of penalty if taxpayer can show ''that there was reasonable cause'' for the underpayment and he ''acted in good faith'').

[16]This position was reiterated by Mrs. Cavallaro at trial.

[17]Mr. Cavallaro left high school to attend trade school, and Mrs. Cavallaro graduated high school but left secretarial school after one year.

[18]A liability that will include accrued interest from 1995. *See* section 6601.

[19]After placing blame on the Cavallaros' advisers for concocting the fictitious 1987 transfer, Gustafson said, ''Since those professionals are not parties here and have not had a full opportunity explain or defend themselves, we refrain from further comment on them.''

[20]*See* Daniel G. Worthington, ''TEAM SPORT: A Multidisciplinary Approach to Advanced Estate Planning,'' WealthManagement (July 30, 2001).

The estate planning attorney took an overly aggressive position on the crucial issue of ownership of CAM/ALOT that did not reflect reality. A good plan applied to bad facts is unlikely to succeed. In both the public and private spheres, the Cavallaros consistently ignored the separate legal existence of Knight and Camelot. Given this, the lawyer failed in his attempt to repackage the disregarded two-company structure into an advantageous tax strategy. However, the same strategy used at an earlier stage with contemporaneous documentation and buy-in from the clients may have generated enough good facts to support the narrative.

The accountants recognized that the lawyer's interpretation of the import of the 1987 meeting was "at odds with all the evidence." In defending his construction, the attorney replied: "History does not formulate itself, the historian has to give it form without being discouraged by having to squeeze a few embarrassing facts into the suitcase by force." Unfortunately, ignoring unhelpful facts will not make them go away. After a "correspondence campaign," the lawyer prevailed, and the accountants acquiesced.[21]

Knight's outside accountant engaged in willful misrepresentation. In response to a request from the IRS for the companies' 1991 combined financial statements, the Knight accountant altered the documents to reflect the Cavallaros' litigating position that Camelot owned the technology, while Knight was a mere contractor.[22] When questioned on the issue, he lied to the court, disclaiming knowledge of or responsibility for the after-the-fact modifications. Given this, Gustafson properly discredited his testimony.

Conclusion

This case serves as a reminder that a shift in value resulting from related-party corporate restructuring may generate a gift. By adopting an unrealistic position, the Cavallaros and their professional team failed to appreciate that heightened scrutiny is applied to non-arm's-length transactions. Although improper advising allowed the taxpayers to avoid penalties, they remain liable for a substantial gift tax liability.

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[21]All this correspondence became available after the IRS issued third-party summonses to E&Y seeking documents generated during communications with the attorney concerning the Cavallaros' estate planning. The Cavallaros filed petitions in district court to quash these summonses. The district court denied the petitions, and the First Circuit affirmed that decision. *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002).

[22]The unaltered narrative in the financial statements provided that Knight was "the sole provider of machines sold by Camelot" and that Camelot's principal business activity was "the selling of computerized liquid dispensing machines."