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SQUEEZING A FEW EMBARRASSING FACTS INTO A SUITCASE

By Stephen J. Roberts

WILLIAM CAVALLARO, DONOR, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PATRICIA CAVALLARO, DONOR, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

T. C. Memo 2014-189, Docket Nos. 3300-11, 3354-11

On September 17, 2014, Judge Gustafson filed an interesting decision in a case whose facts will sound familiar to those who work with, or in, multi-generation family businesses. The crux of the case was the ownership of technology used to produce a new product which was much more profitable than the original family business. On the face of it, the estate planning strategy of pushing growth to the next generation seemed sound. But as always, the devil is in the detail. Here is a summary of the Court's decision:

In 1976, the Cavallaros started Knight Tool Company, a machine shop in Haverhill, Massachusetts. The three sons of the Cavallaros all eventually joined their parents in the business. In 1982, Knight Tool employees created a liquid-dispensing machine prototype for use in assembling computer circuit boards. The prototype was named "CAM/ALOT," for "computer assisted machine," and the hope that they could sell "A LOT" of machines. Knight Tool spent a significant amount of money over the next 5 years developing the CAM/ALOT machine.

In 1987, the CAM/ALOT machine was diverting capital and management attention from Knight Tool's primary machine tool business. The Cavallaros' three sons believed they could find commercial applications for the CAM/ALOT machine and incorporated Camelot Systems, Inc. with $1,000 start-up capital. Mr. Cavallaro handed the Camelot Systems minute book to his eldest son and said, "Take it, it's yours."

The sons continued on the Knight Tool payroll and worked with Knight Tool engineers on refinements to the CAM/ALOT machine. Improvements to the machine, and aggressive marketing, led to increased and very profitable CAM/ALOT sales. The machines were manufactured by Knight Tool while Camelot Systems served as the sales agent. Camelot Systems had no employees or separate bank accounts from 1987 to 1995.

In 1994, the senior Cavallaros retained an attorney at a prominent Boston law firm to develop an estate plan. The attorney believed that the value of the CAM/ALOT technology belonged to Camelot Systems despite the lack of any documentation. He apparently based his belief on the symbolic transfer of the Camelot minute book to the eldest son in 1987.

The law firm prepared affidavits and a "confirmatory" bill of sale attesting to a 1987 transfer of the CAM/ALOT technology to Camelot Systems. When questioned by Knight Tool's accountant about some discrepancies in the affidavits, the attorney wrote, "…the historian has to give it form without being discouraged by having to squeeze a few embarrassing facts into the suitcase by force."

By 1995, the CAM/ALOT product was being sold in Europe. The European Union required manufacturing product certification, and it was determined that merging Knight Tool and Camelot Systems would expedite the certification. The Cavallaros retained Ernst & Young to value the two companies. E&Y assumed that Camelot Systems owned the CAM/ALOT technology.

E&Y determined a value for the merged companies of $70 to $75 million, of which Knight Tool's portion of that amount was between $13 and $15 million. The companies effected a tax-free merger on December 31, 1995, with Camelot the surviving corporation. Using the E&Y values, the senior Cavallaros received 19% of the shares of the new company, and their sons received 81%.

In 1996, Camelot was sold to a third party for $57 million in cash plus future considerations. In 1998, the IRS opened an examination of the income tax returns of Knight Tool and Camelot Systems. During the examination, the IRS learned that there might be gift tax issues in connection with the 1995 merger and opened a gift tax examination in early 1998. The IRS issued summonses for documents held by E&Y. The petitioners challenged these summonses, but the Federal Court of Appeals denied their motion. In 2005, the senior Cavallaros each filed Gift Tax returns for the 1995 tax year, reporting no taxable gifts and no gift tax liability. The IRS issued notices of deficiency in late 2010 determining that pre-merger Camelot Systems had zero value, and therefore any shares of the combined entity held by the sons were subject to gift tax.

At trial, the Petitioners offered two experts who assumed that Camelot Systems held the CAM/ALOT technology. Both experts for the taxpayers determined values for the companies in the range of $70 to $75 million. The IRS expert assumed that the technology was owned by Knight Tool and determined a value for the combined companies of $64.5 million.

Judge Gustafson decided that the technology was not transferred to Camelot Systems prior to the merger. While the Court ruled strongly in favor of the IRS, the Judge did not base his decision on the testimony of the Service's expert, citing a number of flaws in his testimony. As both of the taxpayers' experts assumed incorrectly that Camelot owned the technology, their testimony was disregarded entirely. Left with no other expert but the Service's, the Court accepted his flawed finding that the senior Cavallaros had made gifts to their sons in 1995 of $29.6 million.

The IRS also argued for 6662 and 6663 accuracy and fraud penalties. The Court found no reasonable cause for these penalties as the taxpayers had placed,"… good faith reliance on a mistaken legal opinion of a competent tax advisor…" The Judge laid responsibility for the errors by the taxpayers on the attorney as,"…author of this fiction of a 1987 transfer, which he concocted from facts recounted to him by the Cavallaros about the 1987 meeting."

None of the parties in this matter seemed well-served by their experts. The accountant for the taxpayers admitted lying in his testimony and altering documents he had prepared years earlier. The Service's expert introduced flawed analysis. At the end of the day, the taxpayers are left with a substantial gift tax obligation.

ABOUT THE AUTHOR

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