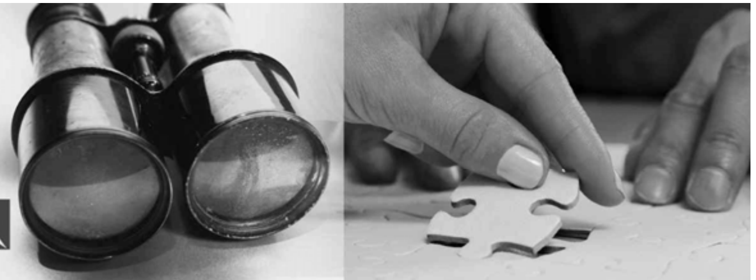
INSIGHTS & STRATEGIES



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VALUATION PLANNING

Built-In Gains Tax Discount Following Conversion From a "C" to an "S" Corporation

In a recent case, the Tax Court approved a method for determining the discount for the built-in gains tax for a regular C corporation that converts, prior to the valuation date, to a subchapter S corporation. *Estate of Litchfield v. C.I.R.,* T.C. Memo 2009-21.

Built-In-Gains Tax

For the 10-year recognition period following the election by a regular C corporation to convert to subchapter S status, the corporation is subject to a corporate-level tax (built-in gains tax) on assets owned before the election period. The tax is at the highest corporate rate, and applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for federal income tax purposes. Code Sec. 1374; Reg. Sec. 1.1374-4.

Example: *On December 31, 2006, Able Corp elected to convert to S status, effective January 1, 2007. On that date its manufacturing facility (real estate and improvements) has a fair market value of $1 million and an adjusted basis of $500,000. Able's built-in gain is $500,000. On January 1, 2008, Able sells the facility for $2 million. Able pays a corporate rate tax on the $500,000 built-in gain; the balance of the gain is passed through to shareholders in the same manner as any other sub S gain.*

The Litchfield Built-In Gain

When Marjorie Litchfield died on April 17, 2001, she was the beneficiary of a QTIP marital deduction trust created under her husband's will. The assets of the QTIP trust are included in Marjorie's gross estate for estate tax purposes. Code Sec. 2044. The QTIP trust owns interests in two family C corporations, a 43.1 percent interest in LRC and a 22.9 percent interest in LSC. Both corporations were formed in the 1920s, and converted to subchapter S status, effective January 1, 2000, almost 16 months before Marjorie's death. Therefore, more than eight years remained in the recognition period.

LRC's assets include Iowa farmland and marketable securities valued at $33.2 million of which $14.3 million is attributable to the estate's 43.1 percent interest. LSC's assets consist primarily of marketable securities valued at $52.8 million of which $12.1 million is attributable to the estate's 22.9 percent interest. No shares of either company have ever been sold on the open market. The policies of the two companies generally discourage sales to outsiders.

As of the alternate valuation date, LRC's $33.2 million net asset value included $28.8 million in built-in capital gains (divided approximately $20.8 million to farmland and real property and $9 million to marketable securities). At the alternate valuation date, LSC's $52.8 million net asset value included $39 million in built-in capital gains.

The Built-In Capital Gains Discounts

The issues involved the appropriate discounts for the built-in gains, minority interest, and lack of marketability. Before any

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ASSET PROTECTION PLANNING

Experts' Article: Recent Developments In Contempt Law Involving Offshore Trusts

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Introduction

Three high profile contempt of court cases have been the subject of much discussion among asset protection professionals lately. This article summarizes the factual backgrounds of the cases, the final results thereunder, and applies their results toward the notion that asset protection planning through offshore trusts remains a highly effective integrated estate planning tool. Some of the facts described below are rather egregious, including transfers of assets made at (or after) the last minute an direct disobedience of court orders and directives. The authors of this summary would like to point out that if favorable results have been reached under cases this extreme, then the reader can certainly appreciate how favorable results can be achieved when planning is done under circumstances of proper timing and motive, and as part of an overall integrated estate plan.

1. *Morris v. Morris, Case No. 502005CA006191XXXMB (Circuit Court, 15th Judicial Circuit, Palm Beach County, Florida, 2006).*

In July 2001, Leland and Merry Morris entered into a post-nuptial agreement outlining their respective child support obligations. One provision of the agreement stated that if Merry challenged any provision of the agreement after the parties' divorce, Leland could seek the return of $1 million in cash, the marital home and all previous alimony payments. Leland and Merry divorced in August 2001. Merry thereafter sought enforcement of the existing visitation rights and to modify the visitation schedule. Leland counter-claimed against Merry and won a judgment against her for the assets just described. After the judgment was entered, Merry settled and transferred assets to a Cook Islands trust.

Over the course of the next few years, Merry was held in contempt of court numerous times as she repeatedly failed to appear at hearings and otherwise disobey court orders. In fact, Merry disappeared from December 2005 through January 2008, at which time she surrendered to authorities.

In July 2008, Merry was released after serving about five months after she agreed to a settlement under which she would pay $1,000,000 of the $2,500,000 owed to Leland into a trust fund for their children. The Cook Islands trustee agreed to release the funds because Merry's children were beneficiaries of the trust. Merry's attorney stated that had the children not been beneficiaries, no deal would have been reached. The settlement agreement provided that if Merry violates the agreement, then Leland can demand Merry pay the remaining $1,500,000.00.

From an asset protection perspective, Merry was successful by being able to negotiate a result for 40 percent of the judgment and by being able to pay this amount into a trust for her children rather than to her former spouse.

2. *United States of America v. Raymond and Arline Grant,* Case No. 00-08986-Civ-Jordan (S.D. FL 2005).

The underlying issue in *Grant* was whether Raymond and Arline Grant had the power to repatriate assets based upon the provisions of their Bermuda and Jersey, Channel Islands trusts. After years of litigation with the IRS, the Court held that based upon the trusts' provisions, Raymond and Arline had the power to repatriate the trusts' assets. A judgment was entered against Raymond and Arline for more than $36 million in unpaid taxes. The U.S. government unsuccessfully attempted to repatriate the assets held by the trusts. In 2005, the Court affirmatively answered the issue of whether Arline (as Raymond had by this time passed away) had the power to repatriate the trusts' assets. The Court held that the Grants' Bermuda trust conferred upon Arline the power to change the trustee at any time; therefore, she should either be able to instruct the trustees to repatriate assets or she could remove the foreign trustee and appoint a domestic trustee that could then comply with the Court's order and repatriate the assets.

In May 2008, Arline was ordered to show cause why she should not be held in contempt for failing to abide by the repatriation order. The Court concluded that Arline sufficiently established that she was unable to comply with the order by acknowledging that she made significant efforts to repatriate the funds to the United States, either directly to her or to a U.S. trustee. For example, she sent a letter to the Jersey trustee enclosing the repatriation order and seeking information about the procedure to repatriate funds. In response to Arline's letter, the Jersey trustee's lawyers responded that any attempted exercise of her right to remove the trustee and to appoint a U.S. resident trustee would not be a valid exercise of Arline's power as trust beneficiary.

The Court further acknowledged that Arline contacted the trustee for the Bermuda trust, which refused to assist her. Arline also sent letters to financial institutions asking them to serve as transferee trustees. These requests were rejected in part because of the possibility that the offshore trustees would fight any attempt to repatriate.

The Court acknowledged that while more than two years had elapsed since the repatriation order's issuance, the failure to repatriate the funds was not for a lack of effort. The Court stated that it was reluctant to blame Arline for the trustees' denial of her requests to repatriate the funds. As a result, the Court ruled that Arline sufficiently established that she was unable to repatriate the assets and the order to show cause was denied.

3. *In re Stephan Jay Lawrence, 238 B.R. 498 (Bankr. S.D. FL 1999).*

Stephan Lawrence experienced a securities account margin deficit after the 1987 stock market crash, leading to an arbitration award against him of more than $20 million. Within weeks after the arbitration award, Lawrence created and funded an offshore asset protection trust. The court found Lawrence to be an extremely unreliable witness who lacked any semblance of credibility. Without credible countervailing evidence, the bankruptcy court held that Lawrence retained control over the trust and that he had the power to repatriate the trust's assets. Lawrence was subsequently held in contempt of court and incarcerated for failure to comply with the Court's repatriation order.

A hearing was held on December 8, 2006, by which time, Lawrence had been incarcerated for about six years. The Court ruled that there was no realistic possibility that Lawrence would comply with the court order to repatriate trust assets. As a result, the Court released Lawrence from incarceration because the punishment no longer served the civil purpose of coercing Mr. Lawrence to act as the court had directed him to act. The Court further stated that although Lawrence had the ability to comply with the contempt order, his incarceration could not last indefinitely. Thus, Lawrence was released and the funds stayed protected even where impossibility of performance was not a defense.

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discounts, the estate's minority interests of 43.1 percent in LRC and 22.96 percent in LSC were valued at $14.3 million and $12.1 million, respectively.

Estate's Expert's Methodology – Built-In Gains Discounts

Although the court stated that both experts were qualified, it accepted the estate's expert's calculation of the appropriate built-in gains discounts. The estate's expert, among other things, reviewed corporate minutes and talked with the officers and directors about plans for asset sales. The expert projected sales dates for appreciated assets and estimated appreciation for the assets during the holding periods until the projected sales date, calculated the capital gains taxes to be paid, discounted those taxes to current value, and subtracted the present value of the capital gains taxes from the net asset values of LRC and LSC, respectively.

For LRC, the expert calculated a projected average asset holding period of five years. Using a capital gains tax rate of 38.8 percent, the expert estimated that the present (as of the valuation date) value of