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AUTHOR'S NOTE

*The **Estate Planning Strategist** is a quarterly publication for attorneys and accountants with some experience in estate planning. It features practical tips, timely commentary, drafting instructions, and tax return preparation examples of sophisticated estate planning techniques. It reviews current developments, new rules, statutes, and caselaw.*

*Each issue is dedicated to one particular technique and includes sample forms with commentary on when and how to use the forms. The **Strategist** can be ordered with a disk that includes sample forms. This fourth issue focuses on the Self-Cancelling Installment Note (SCIN). Subsequent issues will cover topics including Private Annuities and Charitable Remainder Trusts.*

The purpose of this publication is to enhance your professional skills and assist you in advising your clients. Your comments and questions are encouraged.

The author gratefully acknowledges the assistance of his associate, Anthony M. Vizzoni, Esq. with the preparation of this issue.

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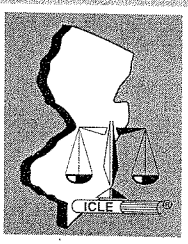

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Self-Cancelling Installment Note (SCIN): The Bet to Die

Introduction – Benefits

The installment sale of assets by a senior family member to a junior family member can result in significant estate tax savings. The proper use of a self-cancelling installment note (SCIN) represents a unique planning opportunity for senior family members who desire to retain the cash flow from those assets they also desire to transfer to junior family members with no gift or estate tax consequence. These goals are similar to those objectives associated with a GRAT, the concept of which was discussed in prior issues. The significant conceptual difference from the GRAT is that the SCIN works best in those cases where the senior family member is not expected to survive the term of the note. In the case of a GRAT, the senior family member must survive the trust term in order to achieve maximum tax benefits. The SCIN can be referred to as the "Bet to Die."

A SCIN is an installment note typically issued by a junior family member in exchange for the purchase of assets from a senior family member. A SCIN calls for a specified number of fixed payments at a specified rate over a set period of time, but also provides that the payments will terminate upon the death of the selling senior family member or members.

Since death terminates the right to receive payments, there is nothing of value to include in the decedent's estate. Accordingly, it is this termination feature that generates the estate tax savings. However, the inclusion of a termination feature in the installment note necessarily means that the inherent value of the note is something less than the value of the underlying property sold, because death during the term of the note extinguishes the right to receive payments.

This can raise potential gift tax concerns which can be eliminated if the termination feature is bargained for as part of the consideration of the sale, and the purchase price reflects this bargain. To avoid this gift tax exposure, the consideration paid for the termination feature should be sufficient to cause the present value of the potential total payments (taking into account an appropriate rate of interest and mortality contingency) to equal or exceed the value of the property purchased. This will be developed more fully in this article.

For income tax purposes, the purchaser is permitted an interest deduction for payments made on the SCIN, subject, however, to the limitations of Section 163 of the Code.[1] The purchaser takes a stepped-up basis in the property purchased, even in the event of the transferor's premature death.[2]

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ABOUT THE AUTHOR

Jerome A. Deener, Esq., the Senior Partner in the law firm of Deener, Feingold & Stern, P.C., is a specialist in individual and corporate taxation and estate planning. Practicing tax law since 1968, Mr. Deener received a Masters Degree in Taxation from New York University School of Law, and was adjunct professor of taxation at Fairleigh Dickinson University's Graduate School of Business. He is a member of the American College of Trust and Estate Counsel, past Chairman of Bergen County Bar Associations Probate and Tax Committees, and a past President of the Estate Planning Council of Bergen County.

Author of numerous articles on estate planning topics, and quoted on the subject in the New York Times, Mr. Deener has lectured extensively on taxation and estate planning for the New Jersey Institute for Continuing Legal Education, the Minnesota State Bar Annual Convention, Bergen and Passaic County chapters of the New Jersey Society of Certified Public Accountants, and various chartered life underwriting groups. He has also served as Chairman of the Fairleigh Dickinson Tax Seminar, presented for the benefit of tax professionals in the Northern New Jersey area.

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A cash basis seller reports interest income in the year of receipt. Gain on the sale of the underlying asset is reported as payments are received based upon the "gross profit ratio" as determined pursuant to the rules of Internal Revenue Code Section 453. Any unrealized gain may be subject to income taxation upon the death of the seller. It is this aspect of the SCIN that has been the recent subject of litigation, and will be further developed below.

Estate Tax Benefit

The significant feature of the self-cancelling installment note is the removal of the property sold from the decedent's estate. The Tax Court has held, in two cases, that since the note is cancelled at death, the value of the note is not includable in the decedent's gross estate.[3] IRS has acquiesced to the result in the Tax Court decision.[4]

Accordingly, the deceased noteholder's Federal estate tax return, Form 706, will not include any reference to the promissory note which, by its terms, is required to be cancelled upon death. This can result in substantial estate tax savings, particularly where the remaining principal balance at the moment immediately prior to death is large.

To achieve this estate tax benefit, the SCIN transaction must be properly structured. Consideration should be given to the Internal Revenue Code Section 2036, which could cause the property to be included in the decedent's gross estate.[5] The seller should therefore not retain the gratuitous use of the property, limit the buyer's right to dispose of the property, or otherwise reserve control over it. However, the sold property may be collateral for the note.[6] Additionally, the seller might wish to limit the right to dispose for two years to avoid the application of the related party resale rules of Internal Revenue Code Section 453(e).[7]

The cancellation feature should be bargained for, and the buyer should pay a premium for this feature. The bargained for element is critical for gift tax purposes, but is also important for estate tax purposes. The failure to pay a premium for the cancellation feature suggests that the transaction is, at least in part, a gift with a retained life estate and includable in the decedent's gross estate.[8]

A sample form document is attached as Exhibit "A." This form contains the "garden variety" cancellation feature, similar to the cancellation feature in the *Moss* case cited in endnote 3 above.

Income Tax Consequence to Seller in Year of Death

While the Tax Court has ruled that a SCIN is not taxable for estate tax purposes, the same does not hold true for income tax purposes. The unrealized or unreported installment sale gain, if any, must be reported in the year of death. If no gain exists, as in the case of high basis property, there will be no adverse income tax consequence in the year of death.

Assuming zero basis property, and capital gains rates, the maximum income tax cost of 28% compares favorably to an estate tax inclusion rate of 50 - 55%. For example, assume an installment obligation with a face amount of $500,000 is cancelled on the death of the senior family member and that the decedent's basis in the note is zero. Assume further that the estate is in a 50% bracket. The potential federal income tax cost is $140,000 (28%

of $500,000). This cost is offset by the estate tax savings of $250,000 (50% x $500,000). Therefore, the net tax benefit to the family is $110,000. If the decedent's basis in the note was $500,000 (i.e., he sold property with a basis of $500,000), there would be no income tax consequence, and the benefit to the family is the entire estate tax savings of $250,000.

The issue which is the subject of most recent litigation is whether the unrealized gain should be reported on the decedent's final income tax return, or on the fiduciary income tax return of the estate.

Section 453B(f) requires income recognition by the decedent in the year of death on his final Form 1040 under the theory that the cancellation of the note constitutes a disposition of the obligation and not a transmission thereof.

On the other hand, Section 691(a)(5)(iii) and 691 (a)(2) provide that a cancellation is treated as a transfer by the estate, with income taxable to the estate, and not to the decedent, which income is reportable on the fiduciary income tax return.

Reporting the gain on decedent's final Form 1040 under the theory of 453B(f) is advantageous to the estate, since the income tax liability attributable to the cancelled SCIN is fully deductible on the Federal estate tax return, Form 706 as a claim against the estate.[9] If the income tax payable in the year of the decedent's death is deductible as a claim against the estate, the overall tax cost will be reduced. If in the above example, the income tax cost of $140,000 was deductible as a claim against the estate, the net tax cost will be reduced to 14%, or $70,000.[10]

On the other hand, reporting the unrealized gain on the estate income tax return, Form 1041 on the theory that it constitutes income in respect of a decedent under 691 principles, is a disadvantage to the estate. Although, the taxpayer required to realize income in respect of a decedent is entitled to an offsetting deduction for the estate tax attributable to the value of the underlying asset,[11] there is no offsetting deduction available in the case of a SCIN. This occurs since the value of the SCIN is not taxable for estate tax purposes.

In *Estate of Frane v. Commissioner*, the Tax Court held that the unrealized gain is reported on the decedent's final Form 1040 on the theory that the installment obligation is cancelled within the meaning of Sections 453B(a) and (f) of the Internal Revenue Code.[12]

However, the United States Court of Appeals for the Eighth Circuit reversed the Tax Court holding on this issue and held that the gain is reported on the fiduciary income tax return on the theory that Sections 691(a)(2) and 691(a)(5) are the controlling provisions. The court reasoned that the deferred gain is income in respect of a decedent that was "transferred" by the decedent's estate and therefore taxable to the estate on its fiduciary income tax return.[13] This position was also advanced in an earlier Revenue Ruling.[14]

To attain the advantageous income tax consequences of the Tax Court holding, taxpayers outside the Eighth Circuit should nonetheless consider using the Tax Court approach under 453B, and report the deferred gain on Form 1040. The Tax Court is a court with national jurisdiction and has the obligation to apply its interpretation of the law on a uniform basis. Therefore, the Tax Court is generally not bound by the decisions of the Court of Appeals except in the circuit to which an appeal would lie.[15] Thus, taxpayers who are within the jurisdiction of the Third Circuit, where the issue has not yet been decided, may continue to report the gain on the decedent's final income tax return, Form 1040, although clients should be advised of the contrary position espoused by the Eighth Circuit.

A second and more aggressive alternative is to entirely avoid the income tax consequences relating to the cancellation of indebtedness. This can arguably be accomplished by structuring the note in a manner consistent with Judge Halpern's dissenting view in the *Frane* decision.

In *Frane*, the Tax Court majority held that the decedent's death was not a "contingency" affecting the total purchase price, since the language of the note in question contained a stated price and provided that death of the noteholder caused the remaining principal to be cancelled and extinguished as though paid in full. The majority therefore reasoned that by treating the unpaid balance as fully paid, a cancellation occurred which triggered a disposition under Section 453B.

Under the dissent's view, had the note been structured whereby the selling price or obligation was totally contingent (somewhere between zero and the stated purchase price), and, as a condition precedent to each payment, the Seller must be alive, the gain could have been avoided. In other words, if the Seller died before a scheduled potential payment, the obligation to make such payment did not come into existence. Consequently, there

would be no obligation to cancel within the meaning of Section 453B and presumably 691(a)(5).

In the dissent's view, therefore, a note containing such contingency language would avoid the income tax consequence, since there would be no obligation to cancel.

The language consistent with the dissent is set forth in the sample form document attached as Exhibit "B."

In either event, the cancellation does cause the purchaser to incur discharge of indebtedness income. We are not dealing with the cancellation of indebtedness, but rather with the cancellation of a contingent obligation which does not generate income to the obligor.[16]

Avoiding the Gift Tax Consequences

Section 2501 imposes a tax on the transfer of property by gift. The gift tax applies to all transactions whereby property is gratuitously passed or conferred upon another, regardless of the needs or device employed.[17] When property is transferred for less than adequate consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift taxable in the year the gift is made.[18]

In the case of a SCIN, there is a potential gift tax exposure resulting from the cancellation feature. As previously indicated, the cancellation feature causes the note to have a value that would be less than the value of the property purchased, since there is an actuarial probability that the seller may not survive the term of the note.

Currently, there is no regulatory or judicial guidance regarding acceptable methods for computing the present value of the anticipated payments. The IRS position is that no gift tax will be imposed if the sales price and length of payment are reasonable in light of the facts and circumstances of the case. The value of the installment obligation and the property sold must be equal.[19] IRS does not provide guidance as to the method of determining the value of the installment note.

It has been suggested that this gift tax exposure can be reduced or eliminated if the buyer pays a premium for the cancellation feature, and such premium is large enough to cause the present value of the anticipated payments (taking into account an appropriate interest rate and mortality contingency of the seller) to equal the value of the underlying property. The premium can be either in the form of an increased interest rate or in the form of an increased purchase price. Either increase indicates that the cancellation feature was bargained for.

Computing such a payment stream may be accomplished by using an annuity factor that takes into account the value of an annuity for the shorter of the note term or the life of the seller. This factor should be based upon the Applicable Federal Rate under Section 7520 and the age of the seller in the month that the transaction closes and can be found in the actuarial tables published by IRS.[20] These tables must be used even in the case of a seller whose medical condition suggests a true life expectancy less than that in the IRS tables, provided there is at least a 50% probability that the seller will survive for more than one year.[21]

Once the factor is determined, it should be divided by the value of the property purchased to determine the anticipated payments needed to cause the present value of such payments to equal the value of the property purchased. The appropriate interest rate that will generate these payments is then computed, and it is this rate that is charged under the note. The interest rate charged should be in excess of the Applicable Federal Rate as determined under Internal Revenue Code Section 1274 and which is in effect at the date of the transfer. This approach is developed more fully in the Example below.

Another way to avoid the gift tax exposure is to simply make the installment obligation payable on demand. This method has been judicially approved in the *Wilson* case.[22] However, it has been suggested that the demand feature in the note may cause the transaction to be classified as a revocable transfer within the scope of Internal Revenue Code Section 2038 because as of the decedent's death the enjoyment of the transferred interest is subject to change through the exercise of the decedent's power to demand payment or to revoke the transfer if payment is not made.[23] Thus, although the demand feature would eliminate gift tax concerns, this same feature can cause the note to be included in the decedent's estate.

Leveraging the Benefits of a SCIN

The tax benefits of a SCIN can be leveraged in the case of a sale of Limited Partnership interests or closely held S Corporation stock, since such interests can be sold at their discounted values.

In the case of a closely held S corporation, a senior family member contemplating the sale of stock may first consider recapitalizing the Corporation into voting and non-voting shares. The senior family member

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can retain the voting stock, thereby retaining sole control, and thereafter sell the non-voting shares at its discounted value.

Example

Assume the outstanding stock of S Corp. is owned by F, a widower and resident of the State of New Jersey. Assume further that the Corporation is worth $1,000,000 and F has a zero basis in the stock. The net income of S Corporation, which also equals its cash distributions, is $100,000, and it is anticipated that this level of income and cash flow will continue into the foreseeable future.

S is currently employed in the business and is the likely heir. F is 65 years old and his health is deteriorating; however, his physician has indicated that there is at least a 50% probability that F can survive for more than one year.

If F's estate remains unplanned, the estate tax consequence attributable to his interest in the Corporation is $500,000, assuming a 50% estate tax rate.

To minimize the estate tax exposure, F can consider recapitalizing the Corporation into voting shares having a "real" value of $100,000 and non-voting shares having a "real" value of $900,000. Assuming a business appraiser opined that the non-voting stock should be discounted in value by 33-1/3% due to lack of control and lack of marketability, F can sell the non-voting stock to S for $600,000 in exchange for a self-cancelling installment note with payments amortized over a 16-year term. Assuming the current Applicable Federal Rate is 9% and a sales price of $600,000, the interest rate charged under the note should be approximately 12% in order to avoid gift tax consequences. This would translate to payments of $86,034. The present value of these payments, based upon the Applicable Federal Rate of 9% and appropriate mortality contingency, equals or exceeds the value of the property sold. Therefore, no gift tax exposure should exist.

The computations are as follows:

1. The actual life expectancy of F, as determined pursuant to Treas. Reg. Sections 20.7520-1 and 20.2031-7(d)(6), is 16.5 years; therefore, the term of the SCIN is 16 years.[24]
2. The annuity factor for the shorter of one life or a stated term of years for a person aged 65, using 9% as the Applicable Federal Rate is 6.9753. (*See* IRS Publication 1457, Actuarial Values, Alpha Volume, at page 5.)
3. The annual payments required to cause the present value of total payments to equal the value of the property sold is $86,017.80 ($600,000 divided by 6.9753).
4. Annual payments of $86,017.80 over a 16-year amortization period (i.e., the term of the SCIN) yield an interest rate of 11.9966%, compounded annually. Therefore, the SCIN will bear an interest rate of approximately 12%, to avoid the gift.

Since S now owns 90% of S Corp., S is entitled to $90,000 of the $100,000 earnings. This provides the cash flow required to make the SCIN payments. F will continue to receive approximately $96,034 per year ($10,000 from his share of the S Corporation stock and $86,034 from the sale of the S Corporation stock).

Upon F's demise, the maximum estate tax savings will be $450,000. The income tax costs will be anywhere between zero and $210,000 (assuming federal capital gains rate of 28% and state income tax rate of 7%), depending upon (i) F's basis in the stock, (ii) whether gain, if any, is reported in the year of death, or (iii) in the case of unrealized gain, whether the income tax liability is taken as a deduction against the estate tax.[25]

Conclusion

The SCIN offers a unique planning opportunity which may result in substantial estate tax savings. The SCIN is particularly attractive in the case of a taxpayer who is not expected to survive his or her life expectancy, but who has at least a 50% probability of surviving for more than one year from the date of sale.

The SCIN may be particularly useful when selling minority or non-voting interests in an S corporation or family limited partnership, where the underlying assets are likely to appreciate. The applicable discounts in valuing the interest sold can mitigate the bargained for price or interest rate increase.

The potential detriment to using the SCIN is the possibility that the senior family member survives the full term, since the payments received are includable in his or her estate to the extent such payments have not otherwise been exhausted. Furthermore, in the case of low basis assets, the income tax consequences in year of death are in some doubt. However, where the underlying asset sold is a high-basis asset, income taxes will be minimal. ■

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1. *See generally* I.R.C. Sec. 163. As a general proposition, a non-corporate taxpayer may deduct "investment interest" only to the extent of "net investment income" for the taxable year. The same rule applies to a non-corporate taxpayer who purchases an interest in a C Corporation. Debt incurred to purchase an interest in a pass-through entity, such as stock in an S Corporation or a partnership interest, is allocated to the underlying assets of the entity. To the extent such debt and interest is allocated to assets used in a trade or business in which the purchasing shareholder materially participates, the deduction limitation rules of Section 163 do not apply. Complete application of Section 163 is beyond the scope of this article.
2. G.C.M. 39503 (June 28, 1985).
3. Cain v. Commissioner, 37 T.C. 185 (1961); Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2.
4. *See* endnote 3, *supra*.
5. I.R.C. 2036(a) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration), by trust or otherwise, under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
6. *See* Estate of Moss v. Commissioner, cited in endnote 3, *supra*.
7. In the case of an installment sale to related persons, special rules apply with respect to the later sale or disposition of the property by the related person. If a person sells property to a related person and the related person thereafter resells the property within two years of the initial transaction, the amount realized by the related person on the second disposition is treated as a payment received at that time by the original seller. The resale, therefore, accelerates gain recognition to the original seller.
8. *See* endnote 5, *supra*.
9. I.R.C. Sec. 2053; Reg. 20.2053-6.
10. If decedent is survived by his spouse and the full marital deduction is claimed, no additional estate tax benefit will result.
11. I.R.C. Sec. 691(c).
12. Estate of Frane v. Commissioner, 98 T.C. 341 (1992).
13. Estate of Frane v. Commissioner, C.A.-8, 93-2 U.S.T.C. Para. 50,386; 998 F.2d 567 (1993).
14. Rev. Rul. 86-72, 1986-1 C.B. 253.
15. Lawrence v. Commissioner, 27 T.C. 717 (1957); Golson v. Commissioner, 54 T.C. 742 (1970).
16. Corporation de Ventas de Salitre y Yoda v. Commissioner, 130 F.d 141 (C.A. 2).
17. Treas. Reg. 25.2511-1(c).
18. I.R.C. Sec. 2512.
19. *See* endnote 2, *supra*.
20. Treas. Reg. 20.7520-1 and 20.2031-7 (d)(6). The computation of this factor appears in the IRS tables found in IRS Publication 1457, Actuarial Values, Alpha Volume, at page 5.
21. Proposed Reg. 1.7520-3(b) & 20-7250-3(b); see also Rev. Rul. 80-80, 1980-1 C.B. 194.
22. Catherine L. Wilson v. Commissioner, 64 T.C. Memo. 1994-480 (1992).
23. Richard B. Covey, Esq., *Practical Drafting* (Jan. 1993).
24. G.C.M. 39503 cited in endnote 2 above provides that if the term of a SCIN exceeds the actuarial life expectancy of the Seller, the SCIN will be re-characterized as a private annuity. This can result in loss of the interest deduction by the purchaser, and may also result in basis adjustments to the purchaser in the year of the Seller's death. However, no taxable gain will be triggered in the year of the Seller's death, as in the case of a SCIN.
25. If F's basis in the stock is $600,000, no income tax results. Therefore, the tax benefit is equal to the estate tax savings of $450,000.

    Under the dissent in *Frane*, if the note is properly drafted, there may be no income tax consequence. Therefore, the tax benefit would be the estate tax savings of $450,000.

    If the unrealized gain is reported on Form 1040, the estate tax savings are increased by an additional $120,000 (50% x $210,000), since the $210,000 income tax liability is deductible on the estate tax return. Thus, the net tax benefit is $360,000 ($450,000 plus $120,000 less $210,000). If the unrealized gain is reported on Form 1041, there is no off-setting deduction available. Therefore, the net tax benefit is $240,000 ($450,000 less $210,000). ■

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