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TOPIC: IRS Advice Suggests Caution in Planning with Self-Canceling Installment Notes (SCINs).

MARKET TREND: SCINs can be used in business succession planning as a relatively tax-efficient method for transferring business interests to succeeding generations. With the IRS implicitly ratcheting up its scrutiny of SCINs, however, advisors and clients should proceed with additional caution when considering implementation of these estate planning transactions.

SYNOPSIS: A SCIN is a promissory note that includes a self-cancelation feature relieving the borrower of any future payments if the seller dies during the note term. Arguably, the self-cancelation provision prevents inclusion of the SCIN in the deceased seller's estate for estate tax purposes, and, if the seller dies earlier in the note term, transfers more wealth to the buyer for fewer payments. To avoid making an inadvertent gift, it is critical that the SCIN's value equal the value of the assets sold, which requires the SCIN to factor in a higher principal amount or interest rate as a "risk premium" to account for the seller's potential death during the note term. The recent release of an IRS Chief Counsel Advice (CCA) memorandum on a SCIN transaction after a decade of relative silence on the issue, however, implies an uptick in IRS scrutiny of SCIN transactions, particularly the structure and valuation of the notes, potentially increasing the risk of gift tax exposure for the seller under the SCIN.

TAKE AWAYS: The key to success in a SCIN transaction is to ensure a match between the value of the SCIN and the property sold. Given that the circumstances in which a SCIN would be recommended (e.g., an older or less-than healthy seller) may already trigger additional IRS scrutiny, the renewed interest of the IRS in these transactions means that their implementation requires consultation with experienced professional advisors to ensure proper structuring, documentation and valuation of the SCIN to withstand potential challenges. Insurable sellers may want to consider life insurance as a complement to the transaction, including as a hedge to its risks, and/or to equalize other heirs who may not participate in the sale. Also, life insurance on the buyer (if not a trust) can protect against a potential default in the event of the buyer's early death or offset the buyer's increased estate tax exposure, as the new owner of the assets.

PRIOR REPORTS: 03-22

MAJOR REFERENCES: ***CCA 201330033.***

As with private annuities a few years ago, the IRS has expressed renewed interest in the terms of SCINs, raising the possibility for increased scrutiny of, and challenges to, these transactions. Advisors and individuals must account for this risk and the potential for gift tax exposure when considering the potential benefits of incorporating a SCIN into an individual's wealth transfer plan.

WHAT IS A SCIN?

A SCIN is a promissory note that includes a self-cancelation feature relieving the borrower of any future payment obligations if the seller dies during the note term. Arguably, the self-cancelation provision results in a $0 value for the SCIN in the deceased seller's estate for estate tax purposes. For income tax purposes, if the sale is to someone other than the seller's grantor trust, the IRS position is that the SCIN's cancelation by reason of the seller's death results in the seller's estate recognizing deferred gain from the sale on the estate's first income tax return, which offsets some of the estate tax benefits provided by the SCIN. There should still be a net benefit, however, since the estate tax would apply to the entire amount of remaining payments (which would be significant under an interest-only SCIN) and the income tax would apply to just the taxable income (*i.e.*, the remaining payments less basis attributable to those payments).[1] A sale to the seller's grantor trust may avoid this recognition.[2]

Because a SCIN is an installment note with a term based on the earlier of the seller's life expectancy or a number of years, SCIN valuations often rely on the actuarial tables under IRC §7520 to determine the note's fair market value (**FMV**), using the appropriate table factor based on the seller's life expectancy. To avoid making a gift when selling property in exchange for a SCIN, the FMV of the SCIN must equal or exceed the FMV of the property sold.[3] Unlike standard installment notes, the valuation of a SCIN must account for the risk of early cancelation due to the seller's death. This so-called "risk premium" can be accomplished by increasing the purchase price, using a higher interest rate, or some combination of both.

WHY CONSIDER A SCIN?

SCINs can be attractive vehicles for transferring assets from one generation to the next, particularly where a family business is involved. For example, a parent can structure an installment sale of closely-held company stock to his or her children (or trusts for their benefit) using a SCIN. If the seller dies during the SCIN term, the self-cancelation provision may remove significant value from the seller's estate (including appreciation on the assets sold), while also relieving the buyer from the burden of ongoing payment obligations.

> ***Example:*** A is 74 years old and wants to transfer $1 million of stock in his company to his grantor trust (Trust), which benefits his son, B, a key employee. A sells the stock to Trust in exchange for an interest-only SCIN with a 9-year term and a principal amount of $1,538,381 (representing a principal risk premium of $538,381), bearing annual interest at 2.0% interest (the 7520 rate then in effect).[4] If A dies just after the second annual interest payment, his death cancels all remaining payments under the SCIN. A has transferred $1 million of stock in exchange for $61,536 (two years of interest payments). If, however, A dies after

the note term, he receives $1,815,290 in total note payments, which will be includible in his estate.

Insurable sellers may want to consider life insurance as a complement to the transaction, including as a hedge to its risks (*e.g.*, IRS adjustments to valuation of the note, resulting in gift tax liability, or survival of the seller). In addition, life insurance (either on the seller or the seller's spouse, if more feasible) can be used to equalize other heirs of the seller who may not participate in the sale. As in the example above, A or A's spouse may create an irrevocable life insurance trust to benefit other children who are not active in the business. Life insurance on a the buyer (if not a trust) can protect against a potential default in the event of the buyer's early death, or offset the buyer's increased estate tax exposure, as the new owner of the assets.

As noted, unless the SCIN transaction involves the seller's grantor trust (which should be income tax neutral), the sale will be a taxable event for the seller, typically reportable under the installment sale method (unless the seller elects otherwise).[5] In addition, the buyer may receive a stepped-up tax basis in the transferred assets and a deduction for the interest payments (subject to typical limitations on interest deductibility under the Internal Revenue Code).

As shown, the SCIN transaction provides more wealth transfer benefits if the seller dies earlier in the SCIN term. Thus, SCIN transactions may work best for individuals aged 60 to 80 for whom death is not imminent[6] but who anticipate shorter than actuarially projected life expectancies due to poor health or family history. Life expectancies, however, are difficult to predict, so when considering the technique, the seller should factor in the impact of his or her survival of the SCIN term.

IRS'S RENEWED INTEREST IN SCINS

Until recently, the IRS has been relatively quiet regarding SCINs, leading many estate planning professionals to see the SCIN arena as somewhat settled. However, the IRS reinvigorated the SCIN debate by releasing CCA 201330033 in July 2013, which called into question the valuation assumptions used in many SCIN transactions to avoid federal gift tax exposure.

In CCA 201330033, the IRS considered to what extent the decedent's sales of stock in a closely-held company to his grantor trusts in exchange for SCINs resulted in gifts subject to federal gift tax, as well as any attendant estate tax consequences arising from cancelation of payments under the SCINs upon the decedent's death. The SCINs were for a set term of years based on the decedent's life expectancy as determined by the § 7520 tables, and required the grantor trust to only make annual interest payments during the note term with the full principal due as a lump-sum on the last day of the term. In one SCIN, the total face value of the note was double the value of the transferred stock, based on the risk premium chosen, while a second SCIN charged a higher interest rate to compensate for the cancelation risk. The decedent passed away less than six months after the sales, so he received no payments from the grantor trusts of either interest or principal under the SCINs.

The IRS determined that a gift resulted from the SCIN transaction because the value of the stock exceeded the value of the consideration provided for in the SCINs. The IRS attacked the SCIN valuations from numerous angles, including the following:

- The IRS disagreed with valuation of the notes by applying the decedent's life expectancy as determined under the §7520 actuarial tables. The IRS stated that those tables apply

"only to value an annuity, any interest for life or term of years, or any remainder," and not for promissory notes.

- The IRS concluded that the "notes should be valued based on a method that takes into account the willing-buyer willing-seller standard" under the federal gift tax regulations, including such factors as the decedent's life expectancy based on his medical history on the gift date.

- The IRS found that the decedent did not rebut the presumption that SCINs between family members are presumed to be gifts and not bona fide transactions unless a taxpayer is able to show that there was a real expectation of repayment and intent to enforce the debt when the transaction was entered into.[7] Here, the IRS noted that the decedent structured the SCINs as interest-only notes with balloon payments of the principal at the end of the term, which, according to the IRS, meant the decedent did not contemplate a steady stream of income from the transactions. Further, the decedent's substantial assets meant he did not need income from the note payments. The IRS believed these circumstances supported its position that the SCINs were merely devices to transfer stock to other family members at below market value, and not bona fide transactions.

- Based on the SCINs' automatic cancelation provision, the balloon payment of principal that pushed the majority of repayment to the end of the term, and the decedent's poor health, the IRS found that it was unlikely the full amount of the SCINs would be repaid, making them worth far less than their stated amounts.

The IRS did note, however, that the SCIN transactions took place with grantor trusts that the seller had previously funded with transfers of stock, which could allow the decedent's estate to argue that the SCINs were genuine debt because the trusts had sufficient assets to repay the loan.

WHY THE CCA MATTERS

The position taken by the IRS in this CCA indicates that SCIN transactions likely will come under greater scrutiny by the IRS, including in the following areas:

- In looking at whether the SCINs were bona fide notes, the IRS highlighted the interest-only structure of the SCINs combined with the principal risk premium that deferred most of the payments under the notes until the end of the term. Going forward, clients should review the benefits and risk associated with a similar structure as compared to SCINs providing for an interest risk premium with interest-only notes or amortization of the interest and principal over the note term.

- The IRS believes that the seller's need for income from the note demonstrates a real expectation that the note would be repaid and the debt enforced. But if a clients structures a SCIN transaction, particularly with his or her grantor trust, to show a demonstrable need for income from the note, does that make his or her estate vulnerable to an argument under IRC §2036 that the decedent retained a right to income from the property, pulling its value back into the estate?

- If the seller does not need the income from the SCIN, what other evidence of a bona fide transaction will suffice, if, as in this case, there was inadequate time to prove there was regular administration and payments under the note, or efforts to enforce the note if there

were missed payments? In such cases, proper documentation of the SCINs and evidence that the purchaser has the ability to repay the notes will be critical to in facing potential challenges.

One way to minimize the burden of unexpected gift or estate tax liability may be to incorporate life insurance products into the estate plan. Making provision for an additional revenue source upon a decedent's death can ease liquidity concerns if federal tax payments arise.

TAKE-AWAYS

- For the right client, SCINs can serve as a transfer tax-efficient tool to pass appreciated assets to future generations. A critical component of the technique's success is to ensure that the FMV of the SCIN matches the FMV of the assets sold.

- The recently-issued CCA, however, indicates that the IRS will increase its scrutiny of intra-family SCIN transactions, particularly those where the vast majority of payments under the note are deferred until the end of the term.

- The renewed interest of the IRS in SCINs means that their implementation requires consultation with experienced professional advisors to ensure proper structuring, documentation, and valuation of the SCIN to withstand potential challenges.

- Insurable sellers may want to consider life insurance as a complement to the transaction, including as a hedge to its risks, and/or to equalize other heirs who may not participate in the sale. Also, life insurance on the buyer (if not a trust) can protect against a potential default in the event of the buyer's early death or offset the buyer's increased estate tax exposure, as the new owner of the assets.

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[1] See the discussion of SCINs in Steven R. Akers and Philip J. Hayes, "Estate Planning Issues with Intra-Family Loans and Notes," *Texas Tax Lawyer*, Winter 2013.

[2] Although the position is not completely free from doubt. *Id.*

[3] See IRC § 2512(b); Reg. § 25.2512-8.

[4] For SCINs, some practitioners use the applicable federal rate (**AFR**) specified for the note term, while others suggest using a slightly higher rate (such as the 7520 rate for a mid-term note, which is 120% of the AFR set for an annually compounding mid-term note). The interest rate will be higher than the "base" rate if an interest risk premium is used.

[5] *See* generally Reg. §15A.453-1. Note that special rules apply to installment sale transactions between related persons if the related purchaser sells the property within two years of acquisition. As the installment sale rules are detailed and complex, a full discussion of them is beyond the scope of this *Washington Report.*

[6] The actuarial tables under IRC§7520 will not apply to value a SCIN if there is at least a 50% probability that the individual will not survive for more than 1 year from the valuation date. There is a presumption that an individual who survives for at least 18 months was not terminally ill "unless the contrary is established by clear and convincing evidence." *See* Regs. §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

[7] See *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), rev'g T.C. Memo 2001-128. In *Costanza*, the taxpayer sold property to his son in exchange for a SCIN that provided for monthly payments of principal and interest at a premium rate.