

Hedging Death and Taxes

Self-canceling installment note transactions can minimize the short-term economic risk of mortality, and spare heirs the expense of estate taxes

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The repeal of the estate tax in 2010, with the concomitant phase-out over the intervening years, poses a paradox for planners:¹ The tax will strike unevenly depending upon the year of death. A person dying in 2004 will have a significantly larger estate tax liability than someone who dies during 2009. For example, a \$5 million estate will owe about \$1 million more in estate tax if the individual dies five years sooner. (See “Hang in There,” page 59.)

On the surface, it might appear that the simplest way to hedge this risk is with life insurance. But the real answer is more complicated.

Underwriting plays a factor, but some individuals are just too expensive to be insured. Better: A self-canceling installment note (SCIN) transaction is a similar hedge that could be implemented for a fraction of what the insurance premiums would cost.² While some uncertainty still clouds

the use of a SCIN—and the strategy is subject to potential attack by the Internal Revenue Service—such aggressive planning can result in substantial transfer-tax savings, and so should be given serious consideration.

A SCIN can transfer assets to a younger generation at lower transfer-tax costs.

UNDER THE SCIN

A sophisticated version of the relatively common installment-sale technique, a SCIN is a promissory note in which the payor and payee agree that payments need be made only while the payee, or a third party, is living. If desired, the note can be structured so that payments during the term of the note consist solely of interest. A single principal payment is made at the end of the note's term—and then only if the payee is alive. Should the payee fail to survive to the maturity date, the estate may argue that the entire

principal balance is excluded from the payee's taxable estate.

Savvy application of a SCIN can significantly reduce the transfer-tax costs of passing on assets to younger-generation family members. It also can even out the discrepancies of the estate tax system that arise from early mortality. Thus, a family could save a significant portion—or all—of the estate tax that otherwise would be paid to the IRS.

COURT APPROVAL

A recent court decision has given renewed vigor to the SCIN as a powerful estate-tax-planning strategy. In *Costanza v. Commissioner*,³ the U.S. Court of Appeals for the Sixth Circuit blessed a SCIN sale. Moreover, the court reaffirmed the beneficial estate tax implications: The unpaid note balance in a SCIN transaction was not included in the seller's estate.

The appellate court in *Costanza* found that the lower court had erred in concluding that the SCIN was not a bona fide transaction. The alteration of checks paid on the note, back-dating of documents and failure to make timely payments were not significant enough to invalidate the transaction. Interestingly, the Service did not seriously press a potential vulnerability—the inadequacy of the risk premium and the failure of the parties to properly compute, negotiate or document that element of the sale.

The bottom line is that even with egregious facts—the proverbial “i”s not dotted and “t”s not crossed—the appellate court was willing to approve the SCIN sale.

RISK PREMIUM

A SCIN requires a premium—in the form of an increase in either the interest rate on the unpaid balance or the principal amount of the note—to compensate the payee for the risk that not all payments will be received over the maximum term. If the payee is not alive at the end of the note term, however, no part of the principal will be received in a balloon note sale. In this type of transaction, the purchaser

pays only interest until the end of the term, paying the principal in a lump sum, or “balloon,” at the end of the note term. A balloon note sale often will be desirable to achieve the maximum estate tax savings if the seller dies during the term of the note. The increased risk that the seller will receive no principal payments under the balloon note generally requires a higher risk premium. If the risk premium would be too high, or if the seller needs to receive principal as well as interest payments during the term of the note, a better alternative might be a traditional note in which each payment includes both interest and principal.

There is no legal guidance on how to calculate the risk premium in a SCIN. Although in *Estate of Moss v. Commissioner*,⁴ the U.S. Tax Court viewed the risk premium as a necessary element,⁵ it provided no direction as to the calculation. The basic rule was approved by Congress⁶ under Internal Revenue Code Section 2512: The value of the property transferred must equal the consideration, and any excess value will be deemed a gift. Similarly, the IRS general counsel opined (in the last general counsel memorandum on the subject, issued in 1986) that, in a SCIN, the value of the property sold and the obligation must be “substantially equal.”⁷

The predicate issue then is whether to use “projected” life expectancy (such as under IRC Section 7520) or actual life expectancy. The 1986 general counsel memo advanced the theory that the seller's actual, rather than his actuarial, health may be considered. Some practitioners have adopted this view.⁸

While an interesting theoretical point—and possibly a worthy academic exercise—the practical dilemma imposed on taxpayers who might be required to determine their actual rather than actuarial life expectancy suggests it's best to use published tables. Asking a taxpayer to compute his own life expectancy (based on the peculiarities of individual risk factors) requires knowledge and judgment that would likely be, in many cases, beyond the taxpayer's (and his coun-

If the seller does not survive the note term, the family gains a transfer-tax windfall.

sel's) ken. Even a physician cannot—at least not without a proper scientific analysis—determine a patient's life expectancy.⁹ Doctors are notoriously overly optimistic about their patients.¹⁰

Rather than rely on a doctor's forecast, life insurance companies supply an individual's medical data to an actuary who assesses survival prospects.¹¹ While viatical settlements are routinely made—and there seems to be a cottage industry catering to the elderly population's need for life-expectancy computation¹²—end-of-life forecasting may be much more difficult than this subspecialty might indicate.¹³ Requiring an analysis of the facts and circumstances in each case could increase the potential for abuse and put a terrible strain on the IRS and taxpayers—not to mention the courts.

The valuation approach mandated in many other areas of tax law shows that certainty of result and uniformity of application outweigh individual accuracy. In almost every case in which life expectancy plays a role in determining the value of an interest in property, the IRC and regulations have mandated the use of uniform tables to avoid embroiling taxpayers and the government in endless disputes over the many factors that must be considered in estimating the life expectancy of any individual.¹⁴

Most taxpayers should be able to rely on published mortality tables. But regulations promulgated under Section 7520 limit use of the standard mortality tables to individuals who are not “terminally ill.”¹⁵ An individual is considered terminally ill if he is suffering from a deteriorating physical condition with greater than a 50 percent probability of dying within one year.¹⁶ Despite noise to the contrary from certain commentators and practitioners, it seems consistent with congressional policy and Section 7520 that the regulations and tables under Section 7520 be used to pro-

ject life expectancy in non-terminally ill cases, including for SCINs.

To construct a model to compute a principal risk premium, one must discount each payment the seller is to receive by two elements: the likelihood of receipt and the time value of money. The “likelihood of receipt” discount must be applied so that the seller is compensated for the risk that he may die before a given payment is received.¹⁷

Although in theory various mortality tables could be selected,¹⁸ the

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so-called 90CM table used under Section 7520¹⁹ may be most appropriate in the SCIN context. While Section 7520, by its terms, applies only to the value of an annuity, term interest, remainder or reversion, there seems little reason (beyond semantics) not to apply its rationale and consistency to the SCIN.

TYPICAL TRANSACTION

In a common scenario, a surviving spouse (who otherwise would be subject to the estate tax) would sell an asset to her children. Rather than paying cash, the children could issue an interest-only promissory note with a self-cancellation feature. The note would provide that if the seller (the surviving spouse) is not alive when the note terminates, then the principal balance is forgiven. The children would be obligated to make interest payments during the term of the note. But these interest payments can be made from the transferred asset itself—so the children would not need any cash initially or during the term of the note.²⁰

If the surviving spouse is not living at the end of the note term, the children will own the asset without owing further payments. Neither the asset nor the note balance is included in the seller's estate for estate tax purposes. If the spouse is still alive, the children must pay back the principal balance on the note, which will require a premium. In that event, the children could be forced to provide some of their own assets to their parent to cover the amount due. But it is this even-handedness (the children win financially if mom dies early, and possibly lose if she does not) that makes the transaction reasonable from a tax policy perspective. Further, the children can take steps to reduce their risk of losing money at the end of the term (such as aggressive investing or, even easier, using an aggressively discounted asset for the sale).

GRANTOR TRUST

The previous hypothetical scenario is straightforward but ignores the income tax issues. Unless additional steps are taken, the interest or dividends paid on the transferred asset will generate taxable income for the children. And the sale itself would generate a capital gain if the property sold consists of low-basis assets. More importantly, the interest paid on the note signed by the children generates taxable income for the surviving spouse.

As in the basic installment-sale technique, the seller can establish a grantor trust for the children and use it as the purchaser to solve the income tax issues. There is no gain or loss recognition on the sale, the income of the transferred asset is taxed to the seller (the surviving spouse/grantor), as it would have been without the sale, and the interest paid on the note is not taxable to anyone.

Importantly, no gain is recognized on the sale to the trust. Transactions between a grantor and a grantor trust are not recognized for income tax purposes.²¹ Accordingly, the grantor trust initially would have a carryover basis in the assets purchased.

SAMPLE SALE

Even for elderly sellers, a relatively short-term SCIN does not add a significant risk premium to the principal balance on the note. For example, a 77-year-old selling an asset for a five-year (interest-only) SCIN would need a 31 percent increase in the note balance (as the risk premium) to compensate for the risk of mortality in that period. Accordingly, an asset valued at \$2 million for sale purposes would require interest payments of about \$110,000 a year for five years—that is, the \$2 million plus the risk premium of \$622,311, multiplied by the interest rate.²² A combination of dividends, interest and sales of grantor trust property could provide the cash for such payments. If a discounted asset (such as a partnership interest) is used in the transaction, an assumed growth rate of only 5 percent would provide a transfer tax benefit even after the principal was repaid. Thus, assuming a 33 percent discount on the asset sold, an asset worth \$3 million would be valued at \$2 million for purposes of the sale. At the end of the term, even after the payment of the note principal, about \$600,000 transfer-tax-free remains for the children. If the seller is deceased, over \$3 million is transferred. (See “SCIN at Work,” this page.)

The upshot is that for no transfer tax cost, a family can effectively hedge the short-term economic risk of mortality. If the seller outlives the note term, he receives his property back at the end of the term plus perhaps a minimal amount. If he does not survive the note term, the family gains a transfer tax windfall. All the while, the taxpayer eliminates the

HANG IN THERE

Due to quirks in the phase-out of the estate tax, dying in 2009 is a lot less costly to beneficiaries than dying in 2004

TAXABLE ESTATE	2004 TAX	2009 TAX	DIFFERENCE
\$4 million	\$1.185 million	\$225,000	\$960,000
5 million	1.665 million	675,000	990,000
7.5 million	2.865 million	1.8 million	1.065 million
10 million	4.065 million	2.925 million	1.14 million

*Note: These calculations incorporate the assumption that taxpayers have not previously used any of their applicable credit amount or marital or charitable deductions.

SCIN AT WORK

A self-canceling installment note can provide a transfer tax benefit even if the principal must be repaid. For example:

ASSUMPTIONS:

SCIN asset pro rata value	\$.3 million
Sale price of interest (at 33 percent discount)	\$2 million
Seller's age at time of sale	.77
Seller's actuarial life expectancy	.9.9 years
Interest rate for note payment	.4.2%
Calculated principal risk premium	\$.622,311
Assumed growth rate of transferred asset	.5%

YEAR	INTEREST PAYMENT	PRINCIPAL PAYMENT	GROWTH OF ASSET LESS PAYMENT
2005	\$110,137	\$0	\$3,039,863
2006	110,137	0	3,081,719
2007	110,137	0	3,125,668
2008	110,137	0	3,171,814
2009	110,137	2,622,311	597,957

short-term risk of mortality in light of an ever-increasing amount of applicable credit.

The benefits of SCINs may outweigh the risks of future scrutiny by the IRS. Particularly now, with increasing budget deficits and the corresponding uncertainty over efforts to eliminate the estate tax, planners may want to have the SCIN sale at the ready for use in appropriate family settings.

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Endnotes

1. The phase-out of the estate and generation-skipping transfer taxes was part of the Bush tax-cut package (H.R. 1836; Public Law 107-16) signed into law on June 7, 2001. In order to comply with reconciliation procedures, the tax-cut bill included a “sunset” provision, under which the law, the Economic Growth and Tax Relief Reconciliation Act of 2001, expires at the end of 2010.
2. A \$1 million term policy for an average 77-year-old male, for example, could cost about \$30,000-\$40,000 per year, or up to \$200,000 total over five years.
3. 320 F.3d 595 (6th Cir. 2003), rev'g *Costanza v. Commissioner*, T.C. Memo 2001-128 (upholding the SCIN

- transaction but with no ruling on the calculation of the risk premium).
4. *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), acq. 1981-2 C.B. 1, 1981 WL 383629 (IRS ACQ Dec. 31, 1981).
 5. "The parties have stipulated that decedent's sale of stock for which the notes were issued was a bona fide sale for adequate and full consideration. The cancellation provision was part of the bargained for consideration provided by decedent for the purchase price of the stock." *Moss* at 1246.
 6. "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year." 26 USC Section 2512.
 7. GCM 39503, 1986 WL 373070 (IRS GCM May 7, 1986).
 8. See, for example, Jerome M. Hesch and Elliott Manning, "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 805-Second Tax Management Portfolio (Bureau of National Affairs) Estates, Gifts and Trusts Series, Private Annuities and Self-Canceling Installment Notes (adopting the position in GCM 39503, 1986 WL 373070 (IRS GCM May 7, 1986)); and Sheldon I. Banoff, Michael O. Hartz and Valentina Famparska, "Appellate Court Upholds SCIN as Bona fide Sale: Planning Opportunities Enhanced," *Journal of Tax* (May 2003), page 292.
 9. But see the life expectancy calculator at www.LifeExpectancy.com, created by Strauss & Shavelle, Inc.
 10. Nicholas A. Christakis, *Death Foretold: Prophecy and Prognosis in Medical Care* (University of Chicago Press, 1999).
 11. David Strauss and Robert M. Shavelle, "Doctors are Not Experts on Life Expectancy," *Economica LTD*, Summer 1998, Vol 3, No. 2.
 12. For example: 21st Services, Minneapolis, Minn.; Fasano Associates, Washington, D.C.; and, AMScot Laboratories, Cincinnati, Ohio as described at usilatinamerica.com/Firmas%20independientes.htm.
 13. William L. Meadow and Cass R. Sunstein, (2001), "Statistics, Not Experts," *Duke Law Journal*, 51:629-646.
 14. For a brief review of the history of using standard mortality tables for federal tax purposes, stretching back to the Civil War-era inheritance tax, see *Gelb v. Commissioner*, 298 F.2d 544 (2d Cir. 1962) (footnote 7); and John Bogdanski, Federal Tax Valuation Section 5.05, Sec. 5.06 (2003). But see *Estate of Gribauskas v. Commissioner*, 342 F.3d 85 (2nd Cir. 2003), and the cases cited therein (which found that standard valuation tables produced an unrealistic and unreasonable result in cases where lottery winnings were subject to substantial restrictions on transferability).
 15. See 26 Code of Federal Regulations Section 25.7520-3(b)(3). "The mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this paragraph (b)(3), an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year. However, if the individual survives for eighteen months or longer after the date the gift is completed, that individual shall be presumed to have not been terminally ill at the date the gift was completed unless the contrary is established by clear and convincing evidence."
 16. Many commercial software programs capable of calculating a SCIN risk premium default to or suggest the mortality table under IRC Section 7520. See, for example, zcalc.com; brentmark.com; tigertables.com; bnasoftware.com and numbercruncher.com.
 17. Original principal plus risk premium = \$2 million ÷ $\sum i (lx + n \div lx) * (1 \div (1 + i)^n) + [(lx + 5 \div lx) * (1 \div (1 + i)^5)]$; $n=1$
 $lx = \text{lives remaining under IRC Section 7520's 90CM table and } i = \text{Section 7520 interest rate.}$
 18. For example: Table 1983 Basic—formerly used to calculate required minimum distributions under 26 USC Section 401(a)(9); Table Annuity 2000—used to calculate required minimum distributions after the 2002 Final Regulations under Section 401(a)(9); Table 1983 GAM (50 percent male, 50 percent female)—used in some cases to determine life expectancies (formerly defined as the "applicable mortality table" under Section 417(e); Table UP-1984—used to determine pre-59-distributions from qualified retirement plans; and Table 90CM—the mortality table currently used to value annuity, income, remainder and reversionary interests for estate and gift tax purposes.
 19. IRC Section 7520: "(a) General rule.— For purposes of this title, the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined—(1) under tables prescribed by the Secretary, and (2) by using an interest rate (rounded to the nearest 2/10 this of 1 percent) equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls."
 20. However, careful consideration must be given to 26 USC Section 2036 in order to preclude an argument by the Service that the seller retained the right to income from the property. The regulations provide that, "A decedent's gross estate includes...the value of any interest in property transferred...except to the extent that the transfer was for an adequate and full consideration...if the decedent retained...(i) The use, possession, right to the income, or other enjoyment of the transferred property...." Treas. Reg. 20.2036-1(a)21.
 21. Rev. Rul. 85-13, 1985-1 CB 184; TAM 200341005, 2003 WL 22321616, IRS TAM (Oct. 10, 2003). In the case of a SCIN sale to a non-grantor trust, gain would be recognized. But if the installment sale method applies, the gain would be reported ratably as the payments are received. A loss on a SCIN sale may not be recognized if the related taxpayer rule under IRC Section 267 applies. Importantly, at the death of the seller, with a non-grantor trust purchaser, gain would be recognized by the estate. *Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993).
 22. See endnote 17 for the formula to calculate the risk premium in an interest-only SCIN.